Harvard Roundtable on Corporate Governance

March 15–16, 2016

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Tab 1: The Preceding Proxy Season

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Corporate Governance Survey—2015 Proxy Season

Posted by David A. Bell, Fenwick & West LLP, on Tuesday, February 2, 2016

Editor's note: David A. Bell is partner in the corporate and securities group at Fenwick & West LLP. This post is based on portions of a Fenwick publication titled *Corporate Governance Practices and Trends: A Comparison of Large Public Companies and Silicon Valley Companies (2015 Proxy Season)*; the complete survey is available here.

Since 2003, Fenwick has collected a unique body of information on the corporate governance practices of publicly traded companies that is useful for Silicon Valley companies and publicly-traded technology and life science companies across the U.S. as well as public companies and their advisors generally. Fenwick's annual survey covers a variety of corporate governance practices and data for the companies included in the Standard & Poor's 100 Index (S&P 100) and the high technology and life science companies included in the Silicon Valley 150 Index (SV 150).[1]

Significant Findings

Governance practices and trends (or perceived trends) among the largest companies are generally presented as normative for all public companies. However, it is also somewhat axiomatic that corporate governance practices should be tailored to suit the circumstances of the individual company involved. Among the significant differences between the corporate governance practices of the SV 150 high technology and life science companies and the uniformly large public companies of the S&P 100 are:

[1] The S&P 100 is a cross-section of companies across industries, but is not a cross-section of companies across all size ranges (it represents the largest companies in the United States). While the SV 150 is made up of the largest public companies in Silicon Valley by one measure—revenue, it is actually a fairly broad cross-section of companies by size, but is limited to the technology and life science companies based in Silicon Valley. Compared to the S&P 100, SV 150 companies are generally much smaller and younger, have lower revenue. The 2015 constituent companies of the SV 150 range from Apple and Hewlett-Packard (HP) with revenue of approximately $200B and $110B, respectively, Ultratech and Marketo with revenue of approximately $151M and $150M, respectively, in each case for the four quarters ended on or about December 31, 2013. HP went public in 1957, Apple in 1980, Ultratech in 1993 and Marketo in 2013. Apple and HP's peers clearly include companies in the S&P 100, of which they are also constituent members (nine companies were constituents of both indices for the survey in the 2015 proxy season). Ultratech and Marketo's peers are smaller technology companies that have market capitalizations well under $5B, many of which went public relatively recently. In terms of number of employees, the SV 150 averages 9,115 employees, ranging from HP with 302,000 employees spread around the world in dozens of countries to companies such as Aemetis with 131 employees in two countries, as of the end of their respective fiscal years 2014. The S&P 100 averages 133,000 employees and includes Wal-Mart with 2.2 million employees in more than two dozen countries at its most recent fiscal year end.

- **Dual-class Stock**. There is a clear multi-year trend of increasing use of dual-class stock structures among SV 150 companies, which allow founders or other major long-term holders to retain control of a company through special shares with outsized voting rights. Their use has tripled since 2011 to 9.4%, up from 2.9%.
- **Classified Boards**. Companies in the S&P 100 have inherent protection from hostile takeovers in part due to their much larger size, so we've seen them declassify in recent years from ~47% a little more than a decade ago down to only 10% in the 2015 proxy season (though that is unchanged from 2014). During that same 10 year period the number of SV 150 companies with classified boards has held firm at ~45%, though with the top 15 companies in Silicon Valley (measured by revenue) now having rates lower than their S&P 100 peers.
- **Insiders.** While there has been a longer term downward trend in insiders in both groups, the percentage of insider directors has held essentially steady over the past five years in the SV 150 but has declined slightly in the S&P 100 over the same period.
- **Board Leadership.** Silicon Valley companies are also substantially less likely to have a combined chair/CEO (35% compared to 76% in the S&P 100). Where there is a board chair separate from the CEO, the S&P 100 are about as likely as SV 150 companies to have a non-insider chair (in the 2015 proxy season, 58% compared to 60%, respectively).
- **Gender Diversity.** Overall, 2015 continued the long term trend in the SV 150 of gradually increasing numbers of women directors (both in absolute numbers and as a percentage of board members), as well as the trend of declining numbers of boards without women members. The rate of increase for the SV 150 continues to be higher than among S&P 100 companies. Women directors make up an average of 19.1% of board members among the top 15 companies of the SV 150, compared to 21.6% among their peers in the S&P 100. The number of SV 150 companies without women directors fell to 48 (compared to 57 in the 2014 proxy season and 72 companies as recently as the 2012 proxy season).
- **Majority Voting.** While there is a clear trend toward adoption of some form of majority voting in both groups, the rate of adoption remains substantially higher among S&P 100 companies (92% compared to 47% of SV 150 companies in the 2015 proxy season, in each case unchanged from the 2014 proxy season), although in the S&P 100 majority voting declined 5% from the 2011 proxy season (compared to an 11% increase for the SV 150).
- **Stock Ownership Guidelines.** Stock ownership guidelines for executive officers remain substantially more common among S&P 100 companies (in the 2015 proxy season, 96% compared to 61% in the SV 150), though there was a marked increase among the SV 150 in the 2015 proxy season. There has been a substantial increase for both groups over the course of the survey (from 58% for the S&P 100 and 8% for the SV 150 in 2004), including a 9% increase in the SV 150 over the last year. Similar trends hold for stock ownership guidelines covering board members (although the S&P 100 percentage is about 10% lower for directors compared to officers over the period of the survey, while the SV 150 has been slightly higher for directors compared to officers in recent years).
- **Executive Officers.** In both groups there has been a long-term, slow but steady decline in the average number of executive officers per company, as well as a narrowing in the range of the number of executive officers in each group, which continued in the 2015 proxy season. The SV 150 moved from an average of 8.8, maximum of 18 and minimum of 4 in the 1996 proxy season to an average of 6.2, maximum of 14 and minimum of 2 in the 2012 proxy season. The S&P 100 companies moved from an average of 13.2,

maximum of 41 and minimum of 5 in 1996 proxy season to an average of 10.7, maximum of 21 and minimum of 3 in the 2014 proxy season.

Complete Coverage

In complete publication, available here, we present statistical information for a subset of the data we have collected over eleven years. These include:

- makeup of board leadership
- number of insider directors
- gender diversity on boards of directors
- size and number of meetings for boards and their primary committees
- frequency and number of other standing committees
- majority voting
- board classification
- use of a dual-class voting structure
- frequency and coverage of executive officer and director stock ownership guidelines
- frequency and number of shareholder proposals
- number of executive officers

In each case, comparative data is presented for the S&P 100 companies and for the high technology and life science companies included in the SV 150, as well as trend information over the history of the survey. In a number of instances we also present data showing comparison of the top 15, top 50, middle 50 and bottom 50 companies of the SV 150 (in terms of revenue),[2] illustrating the impact of company size or scale on the relevant governance practices.

The complete publication is available here.

[2] The top 15, top 50, middle 50 and bottom 50 companies of the SV 150, include companies with revenue in the following respective ranges: $6.2B or more, $1.4B or more, $315M but less than $1.3B, and $126M but less than $314M. The respective average market capitalizations of these groups are $118B, $44B, $3.1B and $1.6B.

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2015 Annual Corporate Governance Review

Posted by Rajeev Kumar, Georgeson Inc., on Friday, February 12, 2016

Editor's note: Rajeev Kumar is a senior managing director of research at Georgeson Inc. This post is based on the executive summary of a Georgeson report; the full report is available here.

The stage for the 2015 proxy season was set early by the actions of the New York City Comptroller's Office in sponsoring 75 shareholder proposals, with proxy access playing out as the dominant governance issue. The total number of shareholder proposals, as a result, reversed its decline and registered its highest total in the past five years. Support for say-on-pay proposals remained high, support for director elections continued to increase and the issues of board composition and succession planning remained in the spotlight. There were continued calls for engagement between issuers and shareholders, emphasizing increased participation by directors and a focus on long-term value creation and related issues. Proxy fight activism continued to raise interesting issues and discussions about how best to deal with activists.

Shareholder Proposals by Number: Significant Increase in 2015

Reversing a three-year decline, the number of shareholder proposals increased during the 2015 proxy season, hitting its highest level in five years. A total of 462 corporate governance shareholder proposals were submitted in 2015, an increase of 5.5 percent from 2014. The increase is significantly more pronounced when looking at the number of proposals in 2015 that were voted on by shareholders: 333 of the 462 submitted shareholder proposals (with the rest withdrawn or omitted), representing an increase of almost 34 percent over the 249 proposals that went to a vote in 2014. The percentage of submitted proposals that made it to a vote jumped from 57 percent in 2014 to 72 percent in 2015, another five-year high. Board-related proposals—more specifically, proxy access proposals—were the primary reason behind this increase. The S&P 1500 had 72 proxy access proposals come to a vote in the first half of 2015, compared with 13 in 2014.

Individual shareholders again accounted for a large portion of 2015's shareholder proposals and submitted nearly half of the proposals that went to a vote. However, as a percentage their share declined from 2014. This was attributable to public pension funds nearly doubling the number of proposals they submitted in 2015, as New York City pension funds took the lead in sponsoring the proxy access proposals.

Governance-Related Shareholder Proposals: The Year of Proxy Access

We noted in last year's report that a consensus opinion has clearly started to form in favor of the Securities and Exchange Commission's 2010 rule version of proxy access (that was later vacated), which called for holders to own three percent of the shares for three years, allowing nominations for up to 25 percent of the board. We suggested that the strong levels of support might result in more shareholder resolutions being submitted going forward. However, little did we expect the proxy access proposal to take center stage in 2015 the way that it did. Following the 2014 proxy season, the New York City Comptroller's Office launched the "Boardroom Accountability Project," submitting the three-percent/three-year version of the proxy access proposal to 75 companies and bringing the proxy access issue to the forefront. The 75 companies were targeted based on three priority issues of climate change (33), board diversity (24) and excessive CEO pay (25), with some companies appearing in more than one category. The next big turn of events occurred when the SEC unexpectedly reversed its earlier ruling that had provided "no-action" relief to Whole Foods to exclude the proxy access shareholder proposal based on the "conflicting proposal" rule. Not only did the SEC withdraw the no-action relief to Whole Foods, but it decided to review the whole issue of conflicting proposals, suspending its practice of providing such no-action relief to exclude shareholder proposals on the basis that they directly conflict with a management proposal involving the same subject matter. The SEC's decision left many companies that were considering using such relief in a quandary as to how to proceed. As things played out, most of the companies ended up including the shareholder proposal expressing the board's opposition but without including the company's own counterproposal on proxy access. Some companies proactively adopted, proposed to adopt or proposed for shareholder vote a three-percent/three-year proxy access provision. As a result, they entered into a settlement with the proponent for the withdrawal of the shareholder proposal. Six companies adopted proxy access with the higher five-percent ownership threshold while six companies (Expeditors International of Washington's counter-proposal was at three percent threshold) included such a counter-proposal on the ballot looking to defeat the shareholder proposal that advocated a lower three-percent ownership threshold.

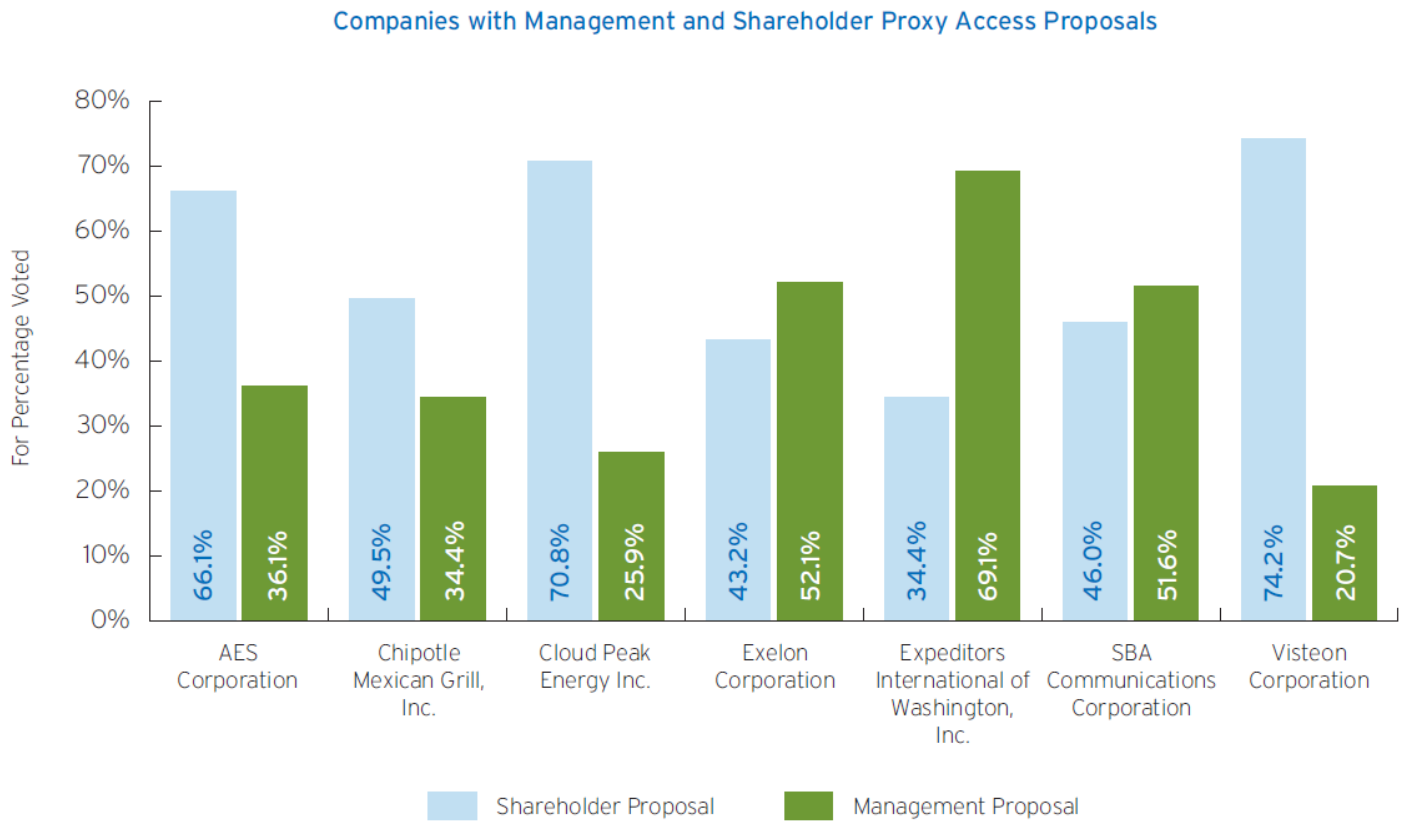
To date, a total of 110 proxy access shareholder proposals were filed in 2015. Proposals at 88 companies went to a vote, with 18 omitted, withdrawn or merged-out (four are still pending). The average support level has been close to 54 percent of votes cast in favor, with 52 of the 88 proposals (59 percent) receiving majority support.

Shareholder Proposal

Company Name	For Percentage Voted	Years Requested	Percent Requested	Nominations Up To
AES Corporation	66.1%	3 Years	3.0%	25.0%
Chipotle Mexican Grill Inc.	49.5%	3 Years	3.0%	25.0%
Cloud Peak Energy Inc.	70.8%	3 Years	3.0%	25.0%
Exelon Corporation	43.2%	3 Years	3.0%	25.0%
Expeditors International of Washington Inc.	34.4%	3 Years	3.0%	25.0%
SBA Communications Corporation	46.1%	3 Years	3.0%	25.0%
Visteon Corporation	74.2%	3 Years	3.0%	25.0%

Management Proposal

Company Name	For Percentage Voted	Years Requested	Percent Requested	Nominations Up To
AES Corporation	36.1%	3 Years	5.0%	20.0%
Chipotle Mexican Grill Inc.	34.5%	3 Years	5.0%	20.0%
Cloud Peak Energy Inc.	25.9%	3 Years	5.0%	10.0%
Exelon Corporation	52.1%	3 Years	5.0%	20.0%
Expeditors International of Washington Inc.	69.1%	3 Years	3.0%	20.0%
SBA Communications Corporation	51.6%	3 Years	5.0%	20.0%
Visteon Corporation	20.8%	3 Years	5.0%	25.0%



The vote results at the seven companies that included a competing proposal have been mixed. In three instances the shareholder proposal received majority support while the management proposal did not, and in three other instances the results were flipped—the management proposal received majority support while the shareholder proposal did not. In one final instance neither proposal garnered majority support.

Many of the shareholder-sponsored proposals in 2014 were not modelled after the SEC's version and therefore did not receive Institutional Shareholder Services' (ISS's) support. Of the 17 proposals that went to a vote in 2014, nine proposals were of the three-percent/three-year variety that were opposed by the board but received ISS support. The average support was approximately 52 percent, with five of the nine proposals (55.5 percent) receiving a majority of votes cast in favor. It is interesting to note that when comparing the voting results of such proposals from 2015 with those of 2014, the outcome is not that different. In 2015, there were 84 such cases, and the average support level was 52.7 percent with over 58 percent receiving majority support. The likely reason that the expected higher level of support did not materialize is that there is still no consensus among institutional investors to support the three-percent/three-year proxy access proposal. Among the largest shareholders, a few favor an ownership threshold higher than the three percent, while a few others do not generally support proxy access.

For the 2016 proxy season, it will be interesting to see how companies that received shareholder proposals in 2015 respond to shareholder mandates, especially in cases where the proposal

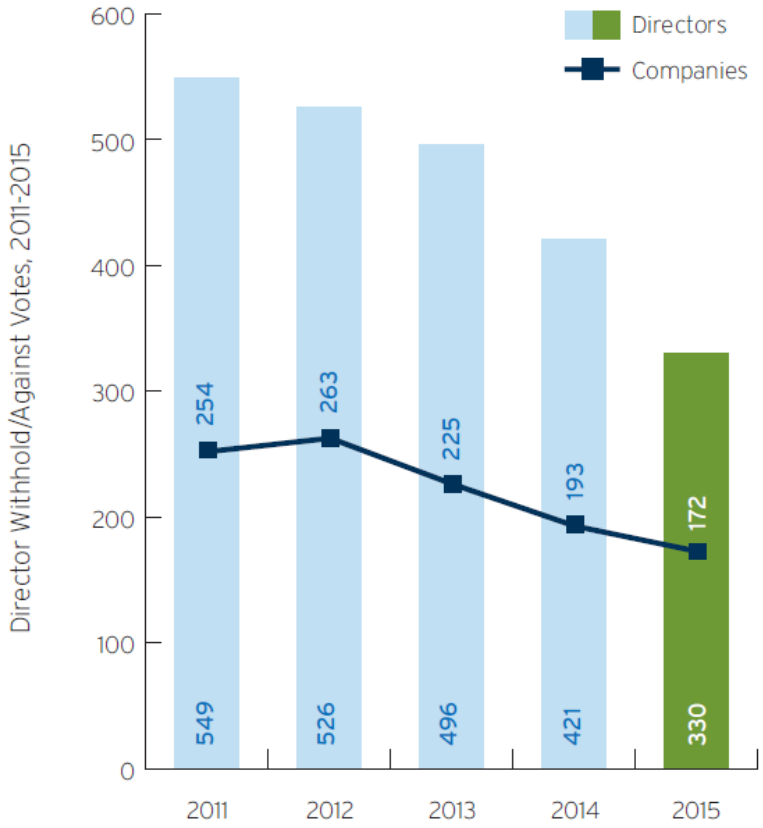
received meaningful but less than majority support. One thing is certain—we can expect to see another wave of shareholder proposals next year, and there will be continued focus and momentum on this issue. And the SEC will again be in the spotlight, as its guidance following its staff review of conflicting proposal Rule 14a-8(i)(9) will affect companies' responses to the 2016 proposals.

While proxy access dominated the governance-related proposals, the two other top proposals related to independent board chairs and shareholders' right to act by written consent. The independent chair proposal largely mirrored the results of 2014 in terms of both volume and average shareholder support. In 2015, 58 proposals were voted on, and the average level of support was nearly 30 percent. The volume of proposals regarding shareholders' right to act by written consent increased by 30 percent from last year, and the 39 percent average shareholder support for the 35 proposals in 2015 was roughly in line with last year's average.

Director Election: Increasing Focus on Board Composition and Succession Planning

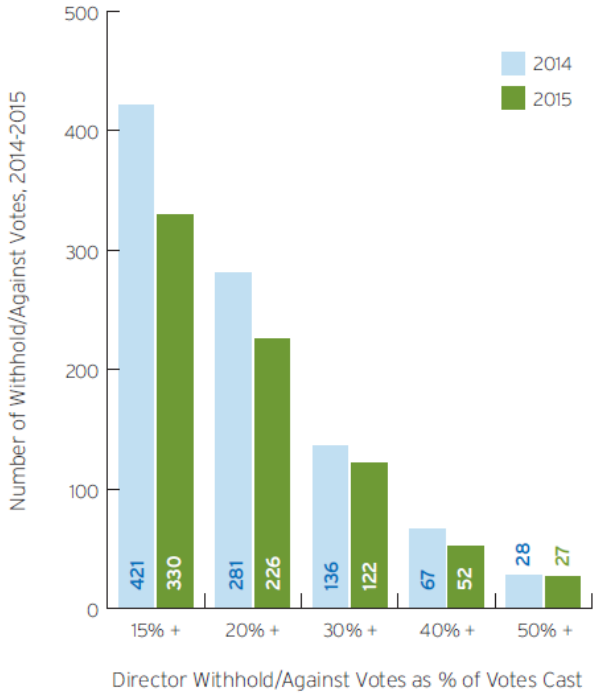
The trend of increased support for director elections that started in the 2011 proxy season, corresponding with the introduction of mandatory say on pay, continued in 2015. Among the S&P 1500 companies, the number of directors receiving 15 percent or greater opposition fell from 421 in 2014 to 330 in 2015. Indicative of the impressive showing, the number of directors receiving 15 percent or greater opposition has now fallen by more than 50 percent since 2010, according to Georgeson data.

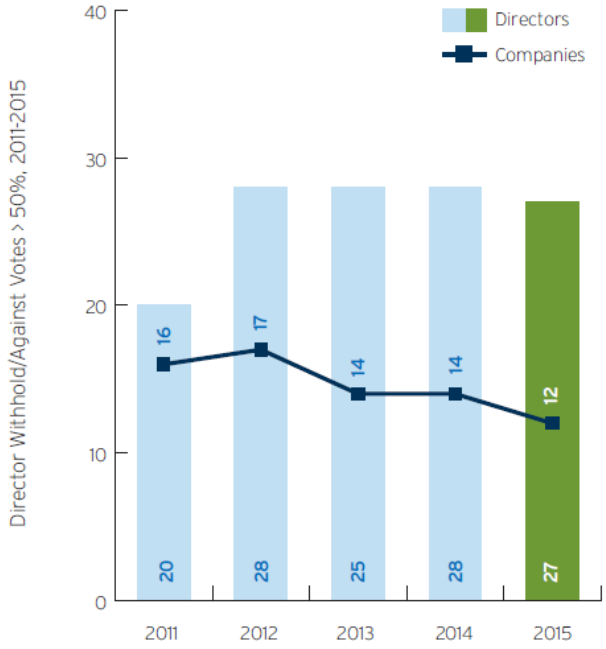
The number of directors who faced majority opposition to their election was consistent with last year: 27 directors failed to get majority support in 2015 compared with 28 directors in 2014. The 27 directors were nominees to 12 companies, with 16 of them (over 59 percent) representing just three companies. In a repeat from last year, nine directors at Healthcare Services Group Inc. received majority withhold votes for reasons of a) non-responsiveness to 2014 majority-supported shareholder proposals, and b) failure to address the issues underlying the majority opposition to its 2014 director nominees. CtW Investment Group was conspicuously absent this year after having led the charge of "vote no" campaigns against the reelection of directors in all but one case in 2014. No such campaign surfaced during the 2015 proxy season.



S&P 1500 Withhold/Against Votes – 15% or Greater

2015: 330 directors at 172 companies
2014: 421 directors at 193 companies
2013: 496 directors at 225 companies
2012: 526 directors at 263 companies
2011: 549 directors at 254 companies





S&P 1500 Director Withhold/Against Votes

330 directors had withhold/against votes of 15% or greater
226 directors had withhold/against votes of 20% or greater
122 directors had withhold/against votes of 30% or greater
52 directors had withhold/against votes of 40% or greater
27 directors had withhold/against votes of 50% or greater

S&P 1500 Withhold/Against Votes – 50% or Greater

2015: 27 directors at 12 companies
2014: 28 directors at 14 companies
2013: 25 directors at 14 companies
2012: 28 directors at 17 companies
2011: 20 directors at 16 companies

There were 15 shareholder proposals relating to board composition on the ballot in 2015 compared with nine in 2014. Four of these proposals were on the topic of board diversity and received 11.1 percent average shareholder support, down substantially from the average of 29.1 percent in 2014. The remaining proposals similarly had a low average level of voter support.

Board composition and succession planning continued to be in the spotlight in 2015. The issues about a board's skill set and qualifications increasingly became targets of activism. The boards were faced with growing demands and challenges, with (among other issues) proxy fight activists frequently targeting long-tenured directors, the Thirty Percent Coalition and other groups continuing to push for greater board diversity, and cybersecurity and other IT risks affecting an increasing number of companies.

Shareholders, who now have increased expectations of boards, looked for greater direct engagement to understand how the directors think and interact as well as the skills they bring to the table. To help ensure the board has the necessary skills and expertise, a board succession plan and a regular process of board refreshment are viewed as increasingly necessary.

Shareholder Engagement: Calls for Increased Participation of Directors

In their effort to improve corporate governance, institutional investors continued to push for greater engagement with companies—especially for direct engagement with directors. Several major institutional investors wrote letters to companies (generally representing their largest holdings) supporting good corporate governance and highlighting the importance of shareholder engagement.

Instead of leaving the task of engagement to the chairman or a senior independent director, Vanguard's letter proposed the creation of "shareholder liaison committees" to give shareholders greater access to board members. F. William McNabb III, Vanguard's chief executive, indicated that meetings with directors would allow investors to express their opinions and allow discussion about important long-term issues.[1]

To date, we are aware of only one company, Tempur Sealy, that has agreed to create a shareholder liaison committee, following its proxy situation with H Partners. Many other companies have made directors available to speak with shareholders without such a committee.

BlackRock, Inc. CEO Larry Fink, in a letter to his firm's largest portfolio companies, encouraged them to take a long-term approach to creating value. BlackRock views the use of its voice through engagement with the companies as an effective mechanism to help promote such focus.[2]

Roger W. Ferguson Jr., CEO of TIAA-CREF, similarly urged investors and companies to collaborate cooperatively, as this helps achieve outcomes that further the long-term interests of all shareholders. TIAA-CREF was also active in pushing for proxy access reform and wrote a letter to its top 100 portfolio companies asking them to voluntarily adopt proxy access by October, using the three-percent/three-year/25-percent model.[3]

SEC Chair Mary Jo White, in her remarks at the national conference of the Society of Corporate Secretaries and Governance Professionals, asked companies to be proactive in building meaningful communication and engagement with their shareholders. She urged more companies to embrace engagement so that more shareholders will be incentivized to choose direct engagement as their preferred first approach over the shareholder proposal process.[4]

The case for engagement between companies and their shareholders clearly gained further ground during the 2015 proxy season. There is an increasing realization of the mutual benefits of engagement, as it allows insight into both parties' perspectives and promotes greater alignment.

Say on Pay: Shareholder Support Remains High

In its fifth year of mandatory votes, say on pay (SOP) proposals continued to receive high levels of shareholder support. Based on 2015 vote results for Russell 3000 companies with meetings through June 30, the average support level increased marginally from last year, and at nearly 92 percent, represents the best results for the proposal thus far. The results likely reflect the impact

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[1] Vanguard CEO Shareholder Relations Letter
[2] http://www.blackrock.com/corporate/en-at/literature/publication/long-term-value-letter-041415.pdf
[3] http://www.thecorporatecounsel.net/member/FAQ/ShareholderAccess/03_15_TIAA-CREF.pdf
[4] Building Meaningful Communication and Engagement with Shareholders.

of ISS's recommendations, since the percentage of ISS's negative recommendations for SOP proposals declined to its lowest level this year: approximately 11 percent. The average vote in favor at companies that received ISS's favorable recommendation remained at the 95 percent level—the same level as in 2014. In 2015, however, the level of support at companies that received ISS's negative recommendation declined to a little less than 65 percent.

The main reason for low levels of support on SOP proposals continues to be a pay-for-performance disconnect, where the CEO's pay level is misaligned with the company's stock price performance. Special one-time grants made to CEOs (and other named executive officers) without adequate justification and/or lacking performance conditions were also one of the main pay concerns for shareholders.

Executive compensation became an issue of increasing focus in proxy fights in 2015. Dissidents at Qualcomm Inc., DuPont Co. and Perry Ellis criticized those companies on the use of performance metrics that inappropriately rewarded executives for lack of "true performance." At Shutterfly Inc., where the company's SOP proposal has received low shareholder support in the past two years, the CEO's pay became the dissident shareholder's main complaint. In addition to supporting two of the dissident's three nominees, shareholders rejected the company's SOP proposal with more than 78 percent opposition.

While average support levels for SOP proposals remain high, it is important for companies to pay attention to their specific situations. Companies should address any shareholder concerns from the previous year(s) or any misalignment that may have resulted from changes in compensation programs or as a result of poor performance.

Compensation-Related Shareholder Proposals: Focus on Change-in-Control, Clawback, and Equity Retention

There were a greater number of compensation-related shareholder proposals in the 2015 proxy season—an increase of 16 percent from last year—with voter support averaging 28 percent. Almost three-fourths of the 71 proposals related to one of the following three issues:

1. Prohibiting acceleration of vesting of equity awards in the event of a change-in-control situation
2. Recouping compensation of senior executives
3. Requiring senior executives to retain a significant portion of their equity awards

After a breakout year in 2014, change-in-control proposals saw an uptick in volume with 26 proposals appearing in 2015 compared with 20 such proposals last year. Average support declined slightly from 35 percent in 2014 to 33 percent in 2015, with only one of the proposals receiving majority shareholder support this year (FirstMerit Corporation) versus four in 2014. While the recoupment policy proposals jumped in number, from three in 2014 to 14 in 2015, the equity retention proposals more than halved, from 26 in 2014 to 12 in 2015. The best-performing proposal was on the issue of shareholder ratification of future severance arrangements, with an average of 42 percent of votes cast in its favor and three of the seven proposals (Hologic, Staples and TCF Financial Corporation) receiving majority shareholder support.

Environmental and Social (E&S) Proposals: Fewer Political Activity Proposals See Increased Support

In 2015, shareholder proposals relating to political activity fell from their perch as the leading topic for shareholder proposals, replaced by proxy access. However, when considered by category, environmental and social topics continued to represent the largest proposal type. In 2015, there were 63 political activity proposals, a 25 percent reduction in volume from 84 in 2014. All the other prominent subcategories of E&S proposals saw an increase: climate change and greenhouse gas emissions (34 proposals in 2015 versus 28 proposals in 2014), labor and human rights (10 in 2015 versus eight in 2014), and sustainability reporting (19 in 2015 versus 13 in 2014).

As in prior years, political activity proposals generally requested more robust disclosure of company political spending, lobbying activities and board oversight policies. Political spending proposals averaged shareholder support of 24 percent compared with an average of 20 percent in 2014, while the support level for lobbying activity proposals remained unchanged at 22 percent. None of the political activity proposals this year managed to receive majority support, although four such proposals did in 2014.

The CPA-Zicklin Index, which ranks companies based on their political transparency and oversight practices, expanded its benchmarking from the top 300 to all of the S&P 500 companies (using the same 24 indicators as in 2013 and 2014). The Center for Political Accountability (www.politicalaccountability.net) again partnered with the Sustainable Investments Institute, a nonprofit that conducts impartial research on companies' ESG practices, to collect the data and to score companies based on their political disclosure practices. The CPA's index findings were

released in early October and in the past companies with low scores have found themselves the targets of shareholder resolutions.

Contested Solicitations: To Capitulate or to Fight? That Is the Question

With activism continuing to perform better than other hedge fund strategies, activist investors hit another record for their assets under management, with more than $140 billion as money continued to pour in to activism in 2015. As activist investors put their increasing war chest to work, 2015 brought another year of a high volume of proxy fights involving more companies with larger market caps being targeted.

Of the 36 proxy fights Georgeson tracked where dissidents filed proxy materials, eight were settled or withdrawn. Of the 28 situations that went the distance and came to a vote, the contest results were even: management won in 12 cases, and the dissident gained representation in 12 cases (four situations are still pending as of the writing of this report). The company win rate of 50 percent represents an improvement over the 40 percent success rate we noted in last year's report. However, the results of the proxy fights that went to a vote don't tell the full story. In many situations, the activist campaigns settled before the dissidents filed proxy materials. According to FactSet data, 2015 saw a record number of settlements when all activist campaigns were included.

While activist hedge funds generated superior returns for their investors, the debate continued as to whether activists who agitate for change actually improve company performance. While activism may be successful as an investment strategy, are the activists focused on short-term gains that may lead to negative consequences for the company and the broader economy in the long term? Larry Fink, chief executive of BlackRock Inc., the largest asset manager in the world, questioned the merits of such maneuvers as paying dividends and buying back stock, which are often carried out under pressure from activist investors. In his letter to the CEOs of S&P 500 companies, he indicated that the effects of the short-term phenomenon were troubling and that investors instead need to focus on long-term strategies and long-term outcomes. Fink's letter likely surprised CEOs, as investors are generally seen to favor high dividends and bigger buybacks.

The issue of investing for the long term was also crucial to 2015's highest-profile proxy fight that went to a vote, which also was the largest in U.S. history. Prominent activist investor Nelson Peltz, Chief Executive Officer and founding partner of the hedge fund Trian Partners, narrowly lost a bruising proxy battle against the $67 billion conglomerate E.I. du Pont de Nemours and Company (DuPont). In defeating Peltz, DuPont defended its investment in scientific research and raised the concern that Trian would slash research and development expenditures, an argument that resonated with some investors. DuPont's victory has been viewed as significant because there is a concern that many companies capitulate to activists' demands too readily. Even Marty Lipton, the most famous corporate defense attorney and one of the most outspoken critics of activism, suggested during the DuPont fight that in order to avoid the risks and potential harm from a public proxy contest, more companies should think about settling early rather than taking up a fight with activists.[5] The support that DuPont received from many of its significant

[5] Some Lessons from *DuPont-Trian*.

shareholders indicates it is possible to win their endorsement if the company is pursuing a viable long-term strategy.

In addition to the DuPont proxy fight, there were a few other notable contested situations and developments. In a first, Third Point was successful in getting shareholder support for a special pay arrangement for its two activist directors on Dow Chemical Company's board. The directors will be paid by Third Point for their service based on how Dow's stock performs in the coming years. A dissident director pay arrangement that did not come to fruition occurred at General Motors Company. A group of investment funds represented by Harry Wilson, a former Obama administration Task Force on the Auto Industry member, pushed the company to buy back stock and give Wilson a seat on the board. Wilson had contractual agreements with the investment funds that provided him a percentage of any gain in the value of their GM holdings resulting from his efforts. General Motors eventually settled with Wilson and agreed to buy back stock without giving him a seat on the board. In another unusual occurrence, the hedge fund H Partners launched a vote-no campaign employing a dissident proxy card against three incumbent directors, including the CEO at Tempur Sealy International Inc. Typically, vote-no campaigns are waged using an "exempt solicitation" approach that does not employ a separate dissident card. Furthermore, in a rare vote-no outcome, Tempur Sealy entered into a settlement with H Partners whereby the three directors stepped down following significant opposition, ranging from nearly 80 percent to roughly 90 percent, to their election. In its continuing efforts to improve shareholder rights at lodging and hospitality REITs, labor union UNITE HERE targeted 15 companies in 2015 with proposals such as declassifying the board, giving shareholders a say in the use of antitakeover statutes and establishing the rights of shareholders to initiate bylaw amendments. While five of the targets agreed to implement the requested reforms, about half a dozen others agreed to include the proposals in their proxy materials. At the remaining four companies, UNITE HERE filed a separate proxy card under Rule 14a-4 with no dissident candidates but seeking shareholder support for its proposals. The dissident proposals fared extremely well, with most receiving majority voter support.

The complete publication is available here.

Harvard Law School Forum on
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Four Takeaways from Proxy Season 2015

Posted by Ann Yerger, EY Center for Board Matters, Ernst & Young LLP, on Tuesday, July 14, 2015

Editor's Note: Ann Yerger is an executive director at the EY Center for Board Matters at Ernst & Young LLP. The following post is based on a report from the EY Center for Board Matters.

As the 2015 proxy season concludes, some key developments stand out. Most significantly, a widespread investor campaign for proxy access ignited the season, making proxy access the defining governance topic of 2015.

The campaign for proxy access is closely tied to the increasing investor scrutiny of board composition and accountability, and yet—at the same time—the number of votes opposing director nominees is the lowest in recent years.

Also, the number of shareholder proposal submissions remains high, despite the fact that ongoing dialogue between large companies and their shareholders on governance topics is now mainstream. These developments are occurring against a backdrop of increased hedge fund activism, which continues to keep boards on alert.

This post is based on EY Center for Board Matters' proprietary corporate governance database, ongoing conversations with investors, and insights from EY's Corporate Governance Dialogue Dinner series, which convenes institutional investors, directors, corporate secretaries, academics and corporate governance advisors to discuss key developments impacting the governance landscape.

Proxy access gains momentum amid increased scrutiny of boards—but opposition to director nominees remains low

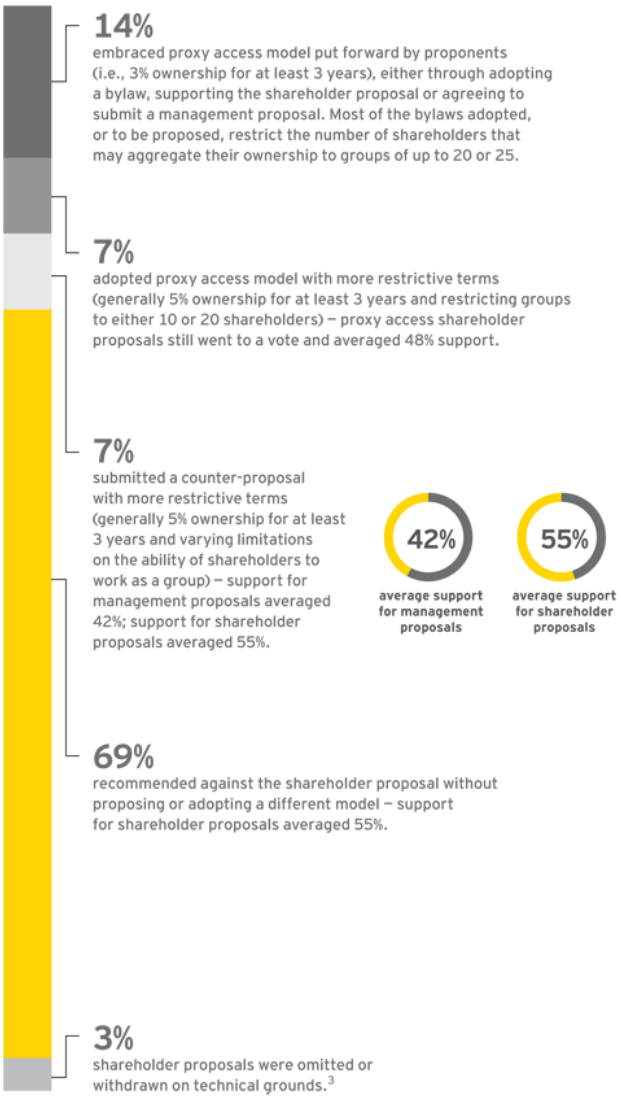
Around 100 high-profile companies faced proxy access shareholder proposals this year—more than four times the total submitted for 2014. Even more companies are discussing the topic internally and with key shareholders, in part due to a letter-writing campaign in support of proxy access launched by one of the largest US asset managers prior to the 2015 proxy season.

The proxy access shareholder proposals have been highly successful: around 60% of the proposals that have gone to a vote so far secured majority support, and those that did not secure majority support averaged 42% support. The proposals generally suggest a proxy access model with the same key ownership terms (i.e., 3% ownership for at least three years) set forth in the SEC's now-vacated proxy access rule.

At least 22 companies have adopted proxy access bylaws in recent years, and 15 of these (nearly 70%) have applied these terms. This year's proxy access campaign reveals strong support for this model even when alternative terms are proposed by management.

Based on what the EY Center for Board Matters is hearing, some directors believe that widespread adoption of proxy access across the US market is now a matter of time. These directors say proxy access is likely to follow in the path of de-staggered boards and majority voting for director elections, which have become standard practice among large companies as a result of investors pushing for these changes company-by-company through shareholder proposals, letter-writing campaigns and dialogue.

Notwithstanding, most companies continue to take a wait-and-see approach as this year's proxy access developments play out. Long-term institutional investors who support proxy access maintain that the right should be in place at all companies—regardless of corporate performance or record on governance—so that it is there if needed, but anticipate that proxy access will be used in rare cases as a last resort.



In many ways, this year's proxy access campaign seems like a culmination of investors' growing focus on board composition and accountability. In recent years, investors have increasingly sought confirmation that boards have the skill sets and expertise needed to provide strategic counsel and oversee key risks facing the company, including environmental and social risks.

Many investors have also raised concerns regarding the lack of turnover on boards, pushed for increased gender and racial diversity on boards, sought greater disclosure around director qualifications and continued long-standing campaigns to make annual director elections under a majority vote standard common practice among S&P 1500 companies.

And yet, just as board composition is under increasing scrutiny, opposition to director nominees continues to decline—in 2015 reaching its lowest level in seven years.

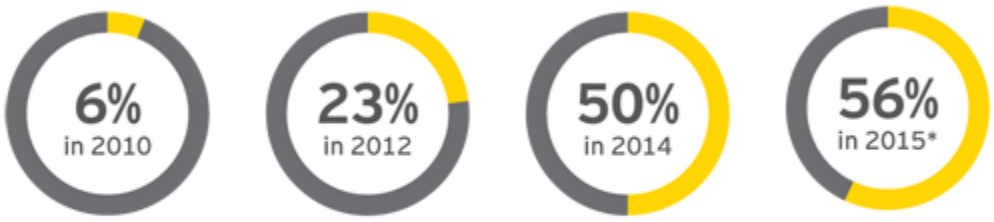
For now, it appears that long-term institutional investors' concerns around board composition and accountability are playing out primarily through the support of structural governance changes (e.g., majority voting and proxy access) and behind the scenes through engagement discussions—and not through voting against director nominees.

This approach is in direct contrast to activist hedge fund investors, who may push for changes in the board slate as part of efforts to seek greater control.

Company-investor engagement is now mainstream and continuing to evolve

Company-investor engagement on governance topics—and disclosure of these efforts in the proxy statement—continues to grow, jumping from just 6% of S&P 500 companies five years ago to more than half of those companies in 2015.

S&P 500 companies disclosing engaging with investors



** Percentages for 2015 based on 444 proxy statements for S&P 500 companies available as of 17 June 2015.*

While executive compensation remains a primary engagement driver, a variety of other governance topics—board and executive leadership, board composition and diversity, sustainability practices, audit committee reporting and other proxy disclosures, to name a few—are a growing part of those conversations.

In addition, this year's proxy access shareholder campaign and the persistent challenge of activist hedge funds are also driving increased company-shareholder engagement as companies seek to understand key shareholders' views on proxy access and other governance interests.

Based on what the Center for Board Matters is hearing from institutional investors, many investors remain wary of engagement-for-engagement's sake. They generally prefer to direct time and resources toward companies where engagement may be necessary for the investor to reach a fully informed voting decision or where they have governance concerns—and prefer discussions outside of proxy season.

Companies initiating engagement efforts should do so with a clear agenda and purpose. Most investors are fine with engaging with management but may request to speak to a director if the subject under discussion is a board matter (e.g., executive compensation) or if they feel the need to escalate the dialogue.

In those cases, the director's ability to speak to the substance of the issue at hand, demonstrate expertise, and listen to the investors' point of view is critical.

The challenge from activist hedge funds persists

Activist hedge funds may offer fresh perspectives on how a company may enhance its operations or market valuation—and some campaigns have helped to improve shareholder value. But activists are also often seen by management and boards as a disruptive influence—and their influence is rising.

As of the end of the first quarter of 2015, there were already 71 shareholder activist hedge fund campaigns underway, compared to about 250 for all of last year, suggesting that 2015 will be another big year for hedge fund activism. Some companies are taking proactive measures to prepare for—and potentially offset the influence of—activist investors.

These include:

- Building early warning triggers (e.g., tracking unusual stock trading patterns and monitoring participation in earnings calls)
- Preparing a team of internal executives and external advisors
- Assessing vulnerabilities around capital structure, business portfolio, operational improvements, a potential sale of the company, and governance practices
- Actively engaging with institutional shareholders to build relationships and understand their governance interests and views of the company

As recent high-profile proxy contests have demonstrated, institutional investors can be a vocal and prominent ally for the company—or for the activist—in an activist campaign. When companies engage with long-term institutional investors and demonstrate responsiveness to their concerns, those same investors are better positioned to support the company in an activist situation.

Some observers believe that activism plays a positive disciplinary role in the market and cite the benefits of activism on shareholder value. For example, the Florida State Board of Administration (SBA) recently released a report which found that SBA votes supporting dissident nominees where the dissident won were associated with economic portfolio gains.

On the other hand, concerns have been raised by others that certain changes often advocated by activists (e.g., spin-offs, cost-cutting measures that impact research and development) may create short-term benefits at the expense of long-term value and the broader health of the market and the economy.

Companies making changes to reach a settlement with activists—or that could be perceived as pre-empting an activist campaign—may consider communications that explain why the board determined such changes are in the best long-term interest of the company.

Shareholder proposal submissions remain high, driven largely by environmental and social topics

Following a peak in 2013, shareholder proposal submissions remain high this year despite the sustained increase in company-shareholder engagement. This is because institutional shareholders that submit proposals view them as an invitation to a discussion and a practical way to trigger substantive engagement.

The EY Center for Board Matters is tracking more than 900 shareholder proposals submitted for meetings through June 30, 2015, which is around 50 more shareholder proposals than we tracked over the same period last year.

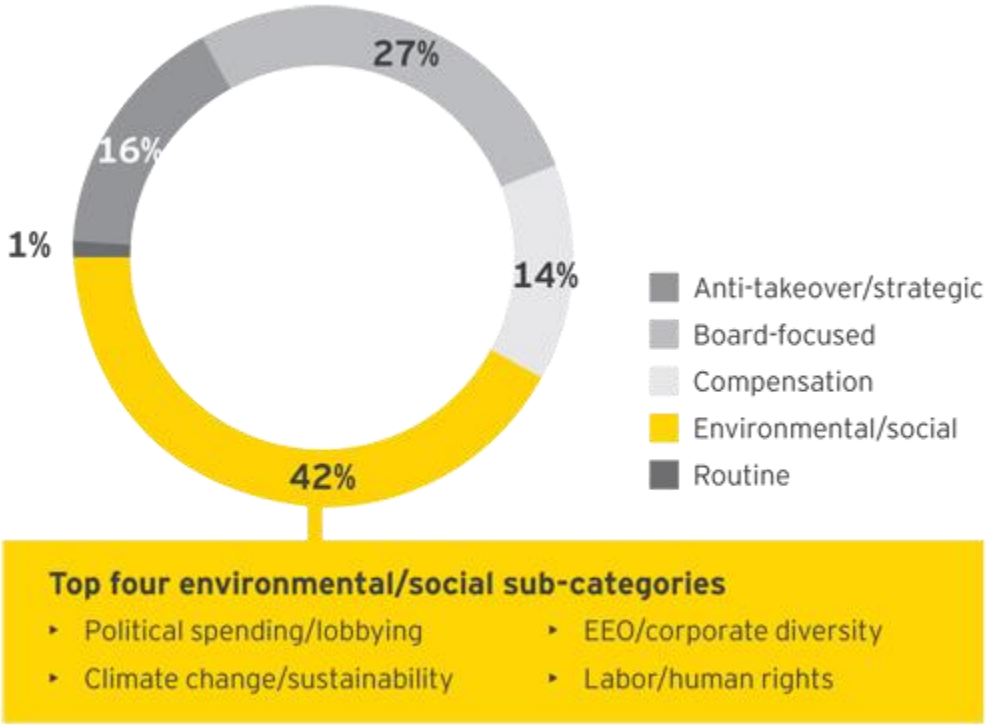
- Proxy access (a board-focus topic) may be the most commonly submitted shareholder proposal this year; however, when considered by category, environmental and social topics continue to dominate the shareholder proposal landscape in terms of overall number of proposals submitted. Shareholder proposals on environmental and social topics represent 42% of all shareholder proposals submissions in 2015, compared to 46% in 2014 and 39% in 2013.
- In recent years, the shareholder proposal withdrawal rate has hovered at around 30%, but that has dipped to 26% so far this year. This decrease is due, in part, to the fact that proxy access shareholder proposals, which have a low withdrawal rate, top the list of most commonly submitted shareholder proposals this year. Also, 2015 has seen a major decrease in the submission of proposals seeking the elimination of classified boards (down from 100 submissions in 2013 to only 20 this year), which typically have a high withdrawal rate.
- Similar to 2014, around half of shareholder proposals voted on were supported by 30% or more of votes cast (the level at which most boards take notice), and around 15% of the proposals received majority support. Failure to implement a majority-supported shareholder proposal can lead to votes against incumbent nominees in the following year.

Large investors paying closer attention to environmental- and social-related value and risk drivers

How companies are managing risks and opportunities related to the environmental and social impacts of their operations is increasingly part of the factors assessed by mainstream investors. For example:

- Nearly 200 US asset owners and investment managers are signatories to the United Nations-supported Principles for Responsible Investment (PRI) Initiative. Through PRI, investors are working to incorporate sustainability considerations into their investment decision making and ownership practices.
- While BlackRock prefers not to publicly disclose details of engagement with specific companies, this institutional investor recently teamed with Ceres, a nonprofit sustainability advocacy group, to create guidance for US institutional investors on engaging with companies and policymakers on sustainability issues. The guide includes tools and case studies geared toward broadening and deepening company-investor dialogue on environmental, social and governance factors impacting value creation.
- State Street's 2015 Stewardship Report discloses its voting and engagement priorities on key governance topics, including environmental and social matters (e.g., climate change and conflict minerals), and includes voting and engagement results from the past year.

Shareholder proposal submissions by proposal category, 2015



Most common shareholder proposals submitted in 2015

	Average support	Proposals submitted	Proposals withdrawn
Adopt proxy access	55%	106	12%
Appoint independent board chair	29%	77	6%
Disclosure and oversight of lobbying spending	25%	61	46%
Disclosure and oversight of political spending	30%	49	33%
Report on sustainability	28%	47	45%
Allow shareholders to act by written consent	39%	43	0%
Set and report on GHG emissions reduction targets	23%	37	38%
Limit accelerated vesting of equity awards	33%	35	17%

Shareholder proposals receiving highest average vote support in 2015

	2010 average support	2015 average support
Eliminate classified board	62%	73%
Adopt majority vote to elect directors	56%	68%
Adopt proxy access	n/a	55%
Eliminate supermajority vote	74%	55%
Allow shareholders to call special meeting	43%	44%

Support for say-on-pay proposals holds strong

In the fourth year of mandatory say-on-pay (SOP) proposals, support for corporate executive compensation policies and practices remains high, averaging around 92%. The number of SOP proposals with less than 50% of votes cast continues to be low, consistent with earlier years. So far, only 2% of all SOP proposals voted this year (30 SOP proposals) have received less than 50% support. In all of 2014, 59 proposals failed. Most companies respond quickly to low SOP

votes. For meetings in 2011 through May 2015, only 29 companies failed to secure majority support for their SOP votes two or more times. Only five companies saw their proposals fail three or more times.

Opposition to compensation committee members in conjunction with some negative SOP votes is evident

At the start of mandatory SOP, many investors appeared to express pay-related concerns primarily through negative SOP votes (versus directly opposing the re-election of compensation committee members). But 2015 vote results at companies with less than 70% SOP support show that compensation committee members averaged two to three times greater opposition votes than fellow board members—and four times greater opposition than compensation committees at companies with greater SOP support.

Conclusion

Communicating and building relationships with key investors is increasingly important, both for gaining valuable investor insights that may inform company decision-making and for helping to secure support for the board. As company engagement programs become more sophisticated, and as proxy statements continue to evolve, the bar for effective communication continues to be raised.

From what we're hearing from investors, the key to effective engagement is quality—not quantity. There is increasing pressure on companies to make engagement meaningful and purpose driven. Timing can also be key: given the extensive holdings of many institutional investors, often the best time to lay the groundwork for engagement is outside of proxy season.

Tab 2: Director Election Arrangements

New York City Comptroller
Scott M. Stringer

NEWS
PRESS RELEASE

FOR IMMEDIATE RELEASE PR16-01-005
January 11, 2016
Contact: Eric Sumberg, (212) 669-3535, esumberg@comptroller.nyc.gov

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COMPTROLLER STRINGER, NEW YORK CITY FUNDS, ANNOUNCE EXPANSION OF BOARDROOM ACCOUNTABILITY PROJECT

Push for greater accountability in corporate boardrooms has increased the number of companies with viable proxy access bylaws from 6 in 2014 to 115 today

NYC Funds release 2015 Post-Season Report on Shareowner Initiatives

(New York, NY) – Building on the market-changing rollout of the Boardroom Accountability Project in 2015, New York City Comptroller Scott M. Stringer announced today that the New York City Pension Funds have filed 72 new shareowner resolutions calling on companies to adopt meaningful proxy access bylaws. Since November 2014, the number of companies with these bylaws has

increased from 6 to 115, an unprecedented rate of adoption for shareowner-driven initiatives.

"In 2015, investors finally broke through corporate America's decade-long opposition to proxy access," Comptroller Stringer said. "The message they delivered to corporate boards is this: shareowners want a meaningful voice in the boardroom and they are prepared to voice their support for that right. Today, companies are responding by adopting proxy access at an astounding rate and momentum is growing for this movement toward greater accountability."

In November 2014, Comptroller Stringer and the NYC Pension Funds launched the Boardroom Accountability Project by filing 75 non-binding shareowner resolutions requesting that companies adopt a bylaw to give investors owning 3 percent of a company for 3 or more years the right to list their director candidates on a company's ballot. Joined by a coalition of investors with more than $1 trillion of assets under management, the campaign has been enormously successful: two-thirds of the proposals that went to a vote received majority support and 37 of the companies have agreed to enact viable bylaws to date.

In total, 109 companies have enacted viable proxy access bylaws since the launch of the project, either in response to a shareowner proposal or proactively, including 78 companies between October and December 2015.

In 2016, the City funds' 72 company focus list includes:

- 36 companies from its 2015 focus list which have not yet enacted, or agreed to enact, a 3% bylaw with viable terms; this includes companies that enacted unworkable bylaws requiring 5% ownership, some of which received binding proposals to amend their bylaw.
    - Six of the 36 have subsequently been withdrawn after the companies enacted, or agreed to enact, a 3% bylaw.
- 36 new companies, with a focus on the funds' largest portfolio companies as well as coal-intensive utilities, board diversity laggards and companies with excessive CEO pay.
    - Nine of the 36 have subsequently been withdrawn after the companies enacted, or agreed to enact, a 3% bylaw.

To view a full list of the 2016 focus list, please click here.

To view a full list of the 2015 focus list and voting and enactment results, please click here.

“The City Pension Funds invest in nearly 3,500 U.S. companies. We depend on boards to make the right decisions that create long-term value. The best way to ensure that we have the right people on those boards, those who are independent, diverse and accountable, is through proxy access. This reform gives investors a seat at the table and ensures that boards are responsive to the concerns of its shareowners,” Stringer said.

Recent studies have shown the link between proxy access and shareowner value. A 2014 analysis of studies by the CFA Institute found that proxy access could improve the responsiveness of boards, which could raise the value of all companies by nearly 1 percent or $140 billion across the U.S. market. A 2015 study by staff economists at the Securities and Exchange Commission found a 0.5 percent increase in shareowner value at the 75 companies the Boardroom Accountability Project targeted.

On Monday, Comptroller Stringer also released the 2015 Post-Season Shareowner Report, a summary of the City funds' over the past year, including a complete breakdown of voting results and agreements stemming from the push for proxy access.

Comptroller Stringer serves as the investment advisor to, and custodian and a trustee of, the New York City Pension Funds. The New York City Pension Funds are comprised of the New York City Employees’ Retirement System, Teachers’ Retirement System, New York City Police Pension Fund, New York City Fire Department Pension Fund and the Board of Education Retirement System.

In addition to Comptroller Stringer, the New York City Pension Funds’ trustees are:

New York City Employees’ Retirement System: Mayor Bill de Blasio’s Representative, John Adler (Chair); New York City Public Advocate Letitia James; Borough Presidents: Gale Brewer (Manhattan), Melinda Katz (Queens), Eric Adams (Brooklyn), James Oddo (Staten Island), and Ruben Diaz, Jr. (Bronx); Henry Garrido , Executive Director, District Council 37, AFSCME; John Samuelsen, President Transport Workers Union Local 100; Gregory Floyd, President, International Brotherhood of Teamsters, Local 237.

Teachers’ Retirement System: Mayor Bill de Blasio’s Appointee, John Adler; Chancellor’s Representative, Raymond Orlando, New York City Department of Education; and Sandra March, Thomas Brown and David Kazansky, all of the United Federation of Teachers.

New York City Police Pension Fund: Mayor Bill de Blasio’s Representative, John Adler; New York City Finance Commissioner Jacques Jiha; New York City Police

Commissioner William Bratton (Chair); Patrick Lynch, Patrolmen's Benevolent Association; Michael Palladino, Detectives Endowment Association; Edward D. Mullins, Sergeants Benevolent Association; Louis Turco, Lieutenants Benevolent Association; and, Roy T. Richter, Captains Endowment Association.

New York City Fire Department Pension Fund: Mayor Bill de Blasio's Representative, John Adler; New York City Fire Commissioner Daniel A. Nigro (Chair); New York City Finance Commissioner Jacques Jiha; Stephen Cassidy, President, James Slevin, Vice President, Edward Brown, Treasurer, and John Kelly, Brooklyn Representative and Chair, Uniformed Firefighters Association of Greater New York; John Farina, Captains' Rep.; Paul Ferro, Chiefs' Rep., and James J. McGowan, Lieutenants' Rep., Uniformed Fire Officers Association; and, Thomas Phelan, Marine Engineers Association.

Board of Education Retirement System: Schools Chancellor Carmen Fariña; Mayoral: Issac Carmignami, Elzora T. Cleveland, Norm Fruchter, Vanessa Leung, Lori Podvesker, Stephanie Soto, Miguelina Zorilla-Aristy; Benjamin Shuldiner, Laura Zingmond (Manhattan BP), Fred Baptiste (Brooklyn BP), Debra Dillingham (Queens BP), Robert Powell (Bronx BP) and Kamillah Payne-Hanks (Staten Island BP); and employee members Joseph D'Amico of the IUOE Local 891 and Milagros Rodriguez of District Council 37, Local 372.

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Proxy Access Bylaw Developments and Trends

Posted by Janet T. Geldzahler, Sullivan & Cromwell LLP, on Friday, September 4, 2015

Editor's note: Janet T. Geldzahler is of counsel at Sullivan & Cromwell LLP. This post is based on a Sullivan & Cromwell publication by Ms. Geldzahler, H. Rodgin Cohen, Robert W. Reeder III, and Marc Trevino. The complete publication, including Annexes, is available here. Related research from the Program on Corporate Governance includes Lucian Bebchuk's The Case for Shareholder Access to the Ballot and The Myth of the Shareholder Franchise (discussed on the Forum here), and Private Ordering and the Proxy Access Debate by Lucian Bebchuk and Scott Hirst (discussed on the Forum here).

The significant success of shareholder proxy access proposals this year is likely to result in even more shareholder proposals for proxy access in the 2016 proxy season. As of August 13, 2015, 82 shareholder proxy access proposals have come to a vote in 2015, and 48 have passed. In many cases, shareholder proposals were approved despite a pre-existing bylaw (most often adopted after the receipt of the shareholder proposal) or a conflicting proposal by the company with modestly more restrictive terms. The average vote in favor of all proposals was 54.4%, and ISS recommended for all shareholder proxy access proposals.

This post summarizes developments in the area of proxy access, including an analysis of the record of company responses to shareholder proxy access proposals received during 2015 (with further detail set forth in Annex A of the complete publication). Those companies that receive a proxy access shareholder proposal or that are evaluating preemptive adoption of a proxy access provision will want to consider the appropriate terms and requirements. In all cases, as a matter of preparedness, companies should be aware of options to respond to potential shareholder proxy access proposals. For more information regarding shareholder proposals generally, our 2015 Proxy Season Review (discussed on the Forum here), which we distributed on July 20, details the results of these proposals during the 2015 proxy seasons.

As a threshold matter, we emphasize that the practical consequences of adopting proxy access remain unclear. Although a small number of proxy access bylaws have been in existence for a couple of years (four provisions predated 2011), we are not aware of any proxy access nominees to date. More importantly, in the area of activist campaigns for board seats, we do not believe proxy access is likely to play a significant role. Activist investors are unlikely to use proxy access for several reasons. First, like now-vacated Rule 14a-11, proxy access bylaws require that the nominating shareholders be passive investors without the intent to influence the control of the company. Many activist investors will not meet this passivity requirement. Second, proxy access bylaws require the nominating shareholders to meet a three-year holding period. Such a holding period is inconsistent with some activist investors' historical investment periods. Proxy access bylaws restrict the number of nominations generally to 20-25% of the board, and activist proxy contests are often for more seats. Finally, activists who threaten or wage proxy contests are

unlikely to use proxy access (even if they could meet the passivity requirement) because the solicitation efforts that can be undertaken as part of a traditional proxy contest provide substantially greater flexibility and a greater likelihood of success and the cost is generally not substantial compared to the investment made in the issuer.[1] Other potential nominating shareholders may be deterred as well.

Depending on the market value of the issuer and the concentration of holdings, it may be difficult to accumulate sufficient shares in a "group" to nominate an individual without requiring compliance with the proxy rules—Rule 14a-2(b)(7), which exempts solicitations to form a nominating group, only applies to Rule 14a-11 nominations.[2] Potential nominating shareholders also may be concerned about the possible loss of 13G eligibility, or the potential formation of a 13D group.[3] Individuals may be reluctant to serve as proxy access nominees—in the typical activist situation, the nominated individual can rely on the activist undertaking substantial effort and expense to win the proxy contest, whereas efforts for a proxy access nominee would by their very nature likely be more limited. In addition, activist nominees generally receive indemnification agreements from the activist, which may or may not be provided to proxy access nominees in the future. We do expect, over time, that shareholders will make some use of proxy access, but we see no evidence that its use will become routine or widespread. It is also possible that the SEC may revise some of the ancillary rules adopted together with Rule 14a-11, to provide comparable exemptions for nominations and solicitation activities pursuant to proxy access bylaws, or consider no-action relief, eliminating some impediments to proxy access utilization.

Key Proxy Access Terms and the Emergence of Market Trends

The appropriate terms of a proxy access bylaw will differ from company to company and proxy access bylaws as a whole are still relatively new. However, trends are beginning to develop for certain key terms. To assist companies in the process of considering their own proxy access provisions, we analyze below a summary of key terms that have been adopted by public

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[1] Most proxy access bylaws do not prohibit additional solicitation efforts for that nominee, other than requiring the use of the issuer's proxy card and in some cases the filing of all soliciting material with the SEC, whether or not required by the proxy rules. However, there are a number of restrictions that limit shareholder solicitation efforts in connection with using proxy access. First, virtually all proxy access bylaws have a 500-word limitation on proponent statements to be included in the proxy statement, as did Rule 14a-11 (which provided for 500 words for each nominee). Second, the exemption for solicitation efforts by a nominating stockholder or group for its nominee contained in Rule 14a-2(b)(8) is limited to nominations under now-vacated Rule 14a-11 (and in response to comments the SEC declined to expand it to nominations pursuant to a corporation's governing documents). Third, many proxy access bylaws prohibit proceeding under both proxy access and the advance notice provisions in the bylaws. Finally, the exemption under Rule 14a-2(b)(1) (where no authorization or revocation is furnished or requested) is unavailable unless the nominating stockholder takes the improbable position that it is not acting on behalf of its nominee.

[2] The SEC rejected comments that the exemption under Rule 14a-2(b)(7) also cover formation of a group under a company's governing documents, because "[g]iven the range of possible criteria companies and/or shareholders could establish for nominations, we continue to believe it would not be appropriate to extend the exemption to those circumstances." The adopting release noted that in forming a nominating group, shareholders would also have the option to structure their solicitations under the exemptions for solicitations of no more than 10 shareholders (Rule 14a-2(b)(2)) and for certain communications that take place in an electronic shareholder forum (Rule 14a-2(b)(6)).

[3] The exception for director nominations to the passive investor requirements of Rule 13d-1(b)(1)(i) applies only to nominations under Rule 14a-11. Here again the SEC declined to extend the exception to nominations under a company's governing documents because of the differing criteria that could be adopted, noting instead that Schedule 13G eligibility would be a fact-specific inquiry. In the adopting release, the SEC noted "nominating shareholders will need to consider whether they have formed a group under Exchange Act Section 13(d)(3) and Rule 13d-5(b)(1)…."

companies thus far. Attached to the complete publication as Annex B is a sample form of proxy access bylaw that companies can use as a starting point in crafting their own bylaw, whether to be adopted proactively, as a competing or substantially implementing proposal, in negotiations with a proponent, or following a successful shareholder proposal.

1. **Ownership threshold and holding period for making a nomination.** All shareholder proposals in 2015 have proposed a 3% ownership threshold, which was the threshold in Rule 14a-11. [4] Of the 35 proxy access bylaws adopted after 2010, 25 have had a 3% ownership threshold, and ten have had a 5% ownership threshold. Of the 15 most recent adoptions (only one of which was in response to a successful shareholder proposal), 14 have been at the 3% threshold. The only exception is SBA Communications Corporation, which adopted a 5% bylaw after its non-binding management proposal at that level defeated a 3% shareholder proposal. All proxy access proposals and almost all bylaws have a continuous three-year holding period requirement, which was also the holding requirement in Rule 14a-11 (a limited number of earlier bylaws contain a shorter period).
2. **Formation of shareholder groups.** Only four bylaws (three of which were adopted before 2014) do not address the use of shareholder groups to reach the ownership threshold. Of the remaining 35, 21 permit a group of 20 holders, one permits a group of 15, seven permit a group of 10, one permits a group of five and five have no limit on the number of group participants. Of the 15 most recent adoptions, eleven were at 20, one each at 15 and 10, one did not permit groups, and one had no limit. A subset of bylaws provides that funds or companies under common management constitute one person. In its policy survey disseminated August 4, 2015, ISS asked whether a group limit of less than 20 adopted after a successful shareholder proposal should be considered non-responsive and potentially warrant withheld or against votes for directors.[5] In its Proxy Access: Best Practices publication (discussed on the Forum here), the Council of Institutional Investors ("CII") noted it does not endorse a limit on the number of shareholders in the nominating group. Generally, proxy access bylaws provide that shareholders cannot be in more than one nominating group.
3. **Maximum number of nominees.** Companies should consider the maximum number of access nominees eligible for nomination to the board. Ignoring pre-2011 bylaws, 25 issuers have a 20% maximum, nine have a 25% maximum, and one bylaw provides for only one proxy access director. Of the most recent 15 adoptions, eleven were at 20% and four at 25%. CII opposes a limitation that would prevent shareholders from nominating at least two candidates. Most shareholder proposals provide for a 25% maximum.
4. **Definition of owners.** All post-2010 bylaws require that the ownership position has full economic and voting rights, as did Rule 14a-11, and excludes borrowed shares and shares subject to options, derivative or similar agreements. Although the instructions to Rule 14a-11 specifically provided that loaned stock would be considered continuously owned if the nominating stockholder had the right to recall the loaned stock and did so upon notification that its nominees would be included in the proxy statement, most bylaws do not address loaned stock. Ten issuers, including GE, Microsoft, Prudential, Bank of America, Broadridge and Merck, however, do provide that loaned stock is considered

[4] Data throughout this post is based on information from ISS and FactSet Shark Repellent, as well as our own selective review of public filings.

[5] The 2016 ISS policy survey can be accessed at: http://www.issgovernance.com/iss-releases-annual-policy-survey.

owned as long as it is recallable, and, in some cases, recalled. If stock loans are not addressed, the lending of stock may cause a break in "ownership" because in a typical stock loan both voting and dispositive rights pass to the borrower. CII has publicly stated that loaned securities should be counted towards the ownership threshold if the participant has the right to recall those securities for voting purposes and will vote the securities at the meeting, as well as representing it will hold those securities through the date of the annual meeting.

5. **Deadline for notice.** Proxy access bylaws vary widely on this point. Most advance notice (as opposed to proxy access) bylaws require notice to be delivered 90-120 days prior to the anniversary of the prior year's annual meeting date. The deadline for shareholder proposals under Rule 14a-8 is 120 days prior to the anniversary of the date of the issuer's proxy statement for the prior year, and the window provided in vacated Rule 14a-11 was 120-150 days prior to the anniversary of the date the registrant mailed its proxy statement in the prior year. Rule 14a-18 provides that a shareholder nominating a proxy access nominee under the issuer's governing documents must provide notice on a Schedule 14N by the date specified in the registrant's advance notice provision, or if no such date is in place, no later than 120 days before the anniversary of the mailing of the issuer's proxy materials in the prior year.
    - Of the 35 bylaws adopted after 2010, 17 have the same window provided by Rule 14a-11—120-150 days prior to the anniversary of the mailing of the prior year's proxy statement. Five issuers have the 14a-8 deadline, which is effectively the same deadline as the prior 17, but with no window. Another seven issuers have a window of 120-150 days prior to the anniversary of the prior year's annual meeting. Only ten issuers have the same deadline for proxy access as they do for nominations under their advance notice bylaw.
    - In considering a required notice period, there are at least four issues that should be considered. First, issuers typically need more time than the advance notice deadline of 90-120 days prior to mailing because of the time required for reviewing and confirming the information provided (because material inaccuracies are generally a ground for exclusion in proxy access bylaws) and potentially engaging in discussions with the nominating stockholder or nominee. Second, a window ensures that the issuer is not receiving proposals throughout the year. Third, extending the general advance notice deadline to the proxy access deadline or window could result in a determination by ISS that this is a unilateral bylaw amendment resulting in a negative board recommendation—ISS specifically referred to increasing advance notice requirements in its 2016 policy survey. Fourth, if the general advance notice deadline is different from the proxy access deadline, it may be desirable to avoid any ambiguity of what constitutes an "advance notice provision" under Rule 14a-18 and to amend the advance notice bylaw to reflect the separate deadline (or window) applicable to proxy access nominations.[6]
6. **Treatment of incumbent access directors.** Companies should consider whether incumbent directors who were access nominees should count against the maximum number of nominees for a number of years after their election, to prevent the board from

[6] Because Rule 14a-18 provides that Schedule 14N is to be provided to the registrant by the date specified in the registrant's advance notice provision, absent including a proxy access deadline in the advance notice provision, there could be an ambiguity as to which deadline prevails for purposes of filing Schedule 14N. Existing advance notice provisions should generally be carefully reviewed to ensure there are not inconsistencies with proxy access bylaws.

having an incentive not to renominate them. This type of provision has been adopted by about slightly more than one-third of public companies who provide for proxy access. Similarly, five companies have restricted shareholders from nominating further nominees for a period of two years if that shareholder has a prior successful access nominee currently serving on the board

7. **Nominee eligibility.** Proxy access bylaws include a number of eligibility standards for access nominees, including independence under relevant stock exchange standards, lack of affiliation with competitors, no criminal convictions, no violation of law or stock exchange requirements caused by the nomination and not providing materially inaccurate information. Fourteen companies permit the exclusion of nominees who have compensation arrangements with third parties for serving as a director of the issuer—although ISS has specifically questioned in its 2016 policy survey whether this provision should be considered nonresponsive. CII believes "limiting the pool of eligible board candidates by excluding those who receive candidacy fees would be an unduly onerous requirement"—it is unclear whether a "candidacy fee" would include all forms of third party director compensation.
8. **Required information with respect to nominating shareholders and nominee.** A company's bylaws may require submission of reasonable information about the candidate and the nominating party, similar to what is called for by typical advance notice provisions. In this regard, it should be noted that the SEC's Schedule 14N, which was adopted in conjunction with Rule 14a-11, remains in effect and would apply in the case of a nomination under a company proxy access bylaw. The company bylaw should be drafted to work in conjunction with Schedule 14N. Careful attention should be given to what information, in addition to existing advance notice provisions and Schedule 14N is really necessary, given ISS's question in its current policy survey as to whether such additional disclosure requirements may be "nonresponsive."
9. **Repeat nominee eligibility restrictions.** Although the exclusion of candidates who received below a specified threshold of support (usually 25%) of votes cast in a previous annual meeting appears to be a universal provision, ISS has queried in its policy survey if this should be considered "nonresponsive" and CII opposes restrictions on renominations as a result of receiving a prior low vote.
10. **Other limitations.** A company may determine to place reasonable limitations on the use of proxy access, including making it unavailable where a shareholder has provided a notice of a nomination under the advance notice bylaw—28 bylaws have such a provision (although in six instances proxy access is disallowed only if the number of non-proxy access candidates exceeds a certain number). Most companies have explicitly prevented a nominating shareholder from distributing a separate proxy card or from participating in solicitations for other candidates.

These and other considerations are addressed in the form of proxy access bylaw attached as Annex B to the complete publication.

Company Responses To Proxy Access Proposals

During the 2015 proxy season, companies employed a variety of strategies in response to shareholder proxy access proposals. To assist companies in evaluating the appropriate strategy, we have outlined below the most frequent forms of response and included as Annex A

to the complete publication a more detailed summary of the results for companies which have adopted each respective response.

- **No Company Action.** For companies that allowed the shareholder proposal to come to a vote, but simply suggested shareholders vote against it, the shareholder proposal passed (> 50% support) 57% of the time.

- **Company Offered Competing Proposal.** Some companies have allowed the shareholder proposal (typically a 3% ownership threshold) to come to a vote while also offering their own company proposal (typically a 5% ownership threshold). These proposals often varied in other key terms as well. This response had mixed results and the company proposals passed approximately half of the time (in one instance, both the company and the shareholder proposal failed). In most instances, these company proposals were non-binding and covered the same provisions as the competing shareholder proposal did. This appears to be a superior approach to putting the full bylaw up for a vote. Presenting a detailed bylaw could engender a negative reaction from some shareholders in contrast to the simpler shareholder proposal and, should the company proposal lose, it would be very difficult for the company to determine exactly which provisions shareholders were voting against.

- **Preemptive Adoption.** Nine companies chose to adopt their own proxy access bylaw prior to the annual meeting and saw mixed results. At these companies, four shareholder proposals were passed and five failed.

- **Intent Announcement.** Four companies announced an intent to adopt their own proxy access proposal. In three of these cases, the shareholder proposal passed despite the intent announcement from the company, and in the fourth case the vote in favor was 49.4%.

- **Management Supported Shareholder Proposal.** At two companies, the company supported the shareholder proposal and in a third instance, the board took no position (although it detailed a number of governance factors for shareholders to consider), and in those three cases, the shareholder proposal passed with overwhelming support.

- **No Action Sought for Substantial Implementation.** General Electric was able to exclude a proxy access proposal on the basis of substantial implementation.[7]

Next Steps

The advisability of proactively adopting a proxy access provision will vary from company to company. Relatively few companies have done so to date, and trends are still evolving. In addition, as of today, most of the issuers who saw successful shareholder proposals have not yet implemented a proxy access bylaw. Accordingly, as of today there seems to be no compelling reason to adopt a proxy access bylaw proactively, although that could change, depending on a number of factors, including market practice, the development of more detailed, and restrictive,

[7] The General Electric no-action letter and related correspondence is available at:http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2015/kevinmaharrecon030315-14a8.pdf.

shareholder proposals, or the adoption of a particularly narrow view by ISS of which provisions would be considered "responsive." There are, however, a number of concrete steps that are advisable to take now.

- **Review Shareholder Profile.** Issuers should review their shareholder profile with their proxy solicitor to determine the likelihood of success if a shareholder proxy access proposal is made. It should be assumed, however, consistent with most governance trends, that the support of institutional shareholders for proxy access will grow over time.
- **Consideration of Potential Terms.** Consideration of what terms would be appropriate, and preparing potential bylaws, is advisable at this stage. Proxy access bylaws are complicated and should be tailored to fit with existing bylaw provisions as well as a company's particular situation. Becoming familiar with the mechanics and evaluating terms will allow companies to respond quickly as trends become clearer or if a proposal is received. Although shareholder proposals were not excluded on the basis of conflicting with management proposals this year,[8] GE was able to exclude a proposal on the basis of substantial implementation. Depending, in particular, on what limitations ISS determines to impose on "responsiveness" following its policy survey, which should be announced in November, it may be preferable to adopt a proxy access provision and seek to exclude the shareholder proposal as substantially implemented, or to structure a competing non-binding proposal, in order to have greater flexibility in crafting the other provisions in the proxy access bylaw. Depending on who proposes proxy access provisions next year, it may also be possible to successfully negotiate an acceptable outcome as well. All these actions are more easily undertaken with a bylaw considered in advance.
- **Board Preparation.** As a part of an issuer's general review with its Board of proxy season developments, the Board should be informed about developing proxy access trends, and the potential advantages and disadvantages of the various strategies relating to proxy access. Again, a prepared Board will allow companies to respond quickly.

The complete publication, including Annexes, is available here.

[8] For a discussion of the SEC staff's decision, and the announcement by SEC Chair White that spurred it, see our publication, dated January 16, 2015, entitled "SEC Staff Suspends No-Action Relief on Conflicting Shareholder Proposals." Chair White has indicated that the goal with respect to this issue "is to provid[e] clarity for next year's proxy season." *See* SEC Chair White Speech, available at:http://www.sec.gov/news/speech/building-meaningful-communication-and-engagement-with-shareholde.html (and discussed on the Forum here).

Is Proxy Access Inevitable?

Sidley Austin LLP, [excerpt, pp.1-21]

November 2015

SIDLEY AUSTIN LLP
SIDLEY

November 4, 2015

SIDLEY UPDATE

Is Proxy Access Inevitable?

Review of 2015 Proxy Access Results and Provisions – Related Considerations for Boards and Counsel

This article revises our Sidley Updates issued July 24, 2015 and September 29, 2015 to reflect the most recent developments relating to proxy access, including new SEC guidance and draft proxy voting policy updates issued by Institutional Shareholder Services (ISS). Among other things, we have updated the chart of proxy access provisions in Appendix A (which are presented on a company-by-company basis as of November 3, 2015) to add the terms adopted by 25 companies since our last update.

Efforts by shareholders to directly influence corporate decision-making are intensifying, as demonstrated by the significant increase over the past three years in financially focused shareholder activism and the more recent efforts by large institutional investors to encourage directors to "engage" with shareholders more directly.

Through the collective efforts of large institutional investors, including public and private pension funds, shareholders at a significant number of companies are likely, within the next several years, to gain the power to nominate a portion of the board without undertaking the expense of a proxy solicitation. By obtaining proxy access (the ability to include shareholder nominees in the company's own proxy materials), shareholders will have an additional lever to pull to influence board decisions.

Snapshot of Proxy Access Provisions Adopted in 2015 (as of November 3, 2015)

Provision	Prevalence of Selected Alternatives	Shareholder Viewpoints*	Proxy Advisory Firm Policies and CII Position
Ownership threshold and duration	• 3% / 3 years – 55/62 (89%); included in SEC vacated rule • 5% / 3 years – 7/62 (11%)	• Most favor 3% • Vanguard favors 5% • Shareholder proposals more likely if adopt 5%	• ISS and GL support 3% • CII supports 3% and views 5% as "troublesome"
Nominee limit (Max. % of board)	• 20% cap – 32/62 (52%) • Greater of 2 or 20% – 20/62 (32%) • 25% cap – 10/62 (16%); included in SEC vacated rule	• Most favor 20-25%	• ISS and GL support 25% • Less than 20% identified as "problematic" in ISS policy survey • CII favors ability to nominate at least two candidates
Nominating group size limit	• 20 – 51/62 (82%) • 15 – 3/62 (5%) • 10 – 4/62 (6%) • 5 – 1/62 (2%) • 1 – 1/62 (2%) • No limit – 2/62 (3%); included in SEC vacated rule	• General consensus that limit of 20 is reasonable • Possibility of shareholder proposals seeking removal of limits	• ISS favors minimal or no limits; less than 20 identified as "problematic" in ISS policy survey • CII views *any* limit as "troublesome"

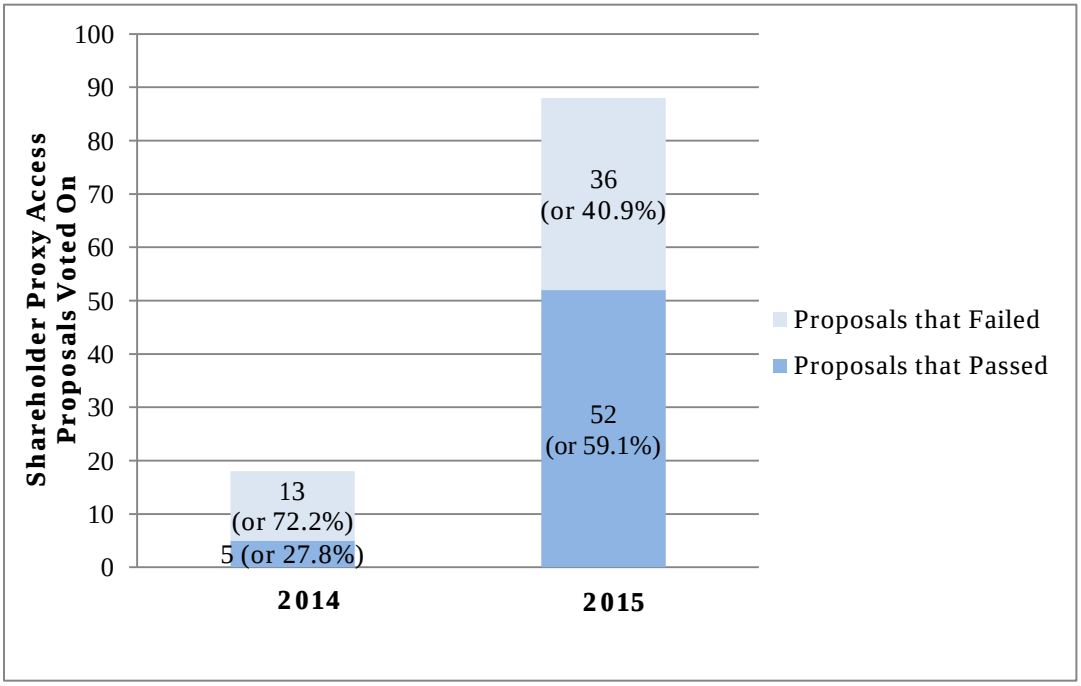
* Derived from publicly available voting policies as well as preferences expressed through engagement and voting results.

While proxy access has been the subject of shareholder proposals for several years, 2015 is a tipping point. This year's proxy season saw a significant increase in the number of shareholder proxy access proposals and shareholder support for such proposals (see highlights box below), as well as an increased frequency of negotiation and adoption of proxy access via board action – including an accelerating trend towards board adoption without having received a shareholder proposal – or, to a lesser extent so far, submission of a management proposal to a shareholder vote.

Key Highlights of Shareholder Proxy Access Proposals Voted on in 2015*

- 88 proposals were voted on, up from 18 in 2014
- 52 passed (59.1% of the total), up from 5 (27.8%) in 2014
- 36 did not pass (40.9% of the total), compared to 13 (72.2%) in 2014
- Average percentage of votes cast in favor was 54.3%, up from 34.0% in 2014

* Data points in this update are derived from SharkRepellent.net, last accessed on November 3, 2015. All voting results in this update are calculated on the basis of votes cast "for" the proposal divided by the sum of votes cast "for" and "against" that proposal (not taking into account abstentions).



Proxy access initiatives had limited levels of success in years prior to 2015. However, shareholder support started to increase in 2014 as proponents began to focus on the 3% for three years ownership requirement adopted by the Securities and Exchange Commission (SEC) in its 2010 rulemaking efforts (as described below).

This year, with a major initiative from public pension funds led by New York City Comptroller Scott M. Stringer and with encouragement from major investors, such as TIAA-CREF, and the large institutional investor industry group, the Council of Institutional Investors (CII), proxy access is taking hold. Adding to the momentum is the SEC's removal for the 2015 proxy season of a key defense in the form of no-action relief in situations in which a company intends to put forward its own competing proposal. Proxy advisory firm policies that support proxy access and discourage efforts to defend against proxy access proposals add to the momentum. Moreover, in

August 2014, the CFA Institute published a report discussing the potential economic benefits of proxy access; this report has been cited by Comptroller Stringer and several other proponents in their proposals.[1]

The broad-based shareholder campaign for proxy access on a company-by-company basis, and the apparent momentum developing among targeted companies and other leading companies to respond by taking action to adopt proxy access (with or without a shareholder proposal), is reminiscent of the campaign several years ago for companies to replace plurality voting with majority voting in the uncontested election of directors. Both issues relate to the ability of shareholders to influence the composition of the board, and both campaigns show the power of concerted efforts at private ordering.

Overview

- The SEC's 2010 Proxy Access Rule
- Uptick in Shareholder Proxy Access Proposals in 2015
- Institutional Investor Support for Proxy Access
- Proxy Advisory Firm Policies on Proxy Access
  - ISS Proxy Access Responsiveness Policy
- Grounds for Exclusion of Shareholder Proxy Access Proposals
  - New SEC Guidance on Excludability of Directly Conflicting Shareholder Proposals
- Voting Results on Proxy Access Proposals
- Adoption of Proxy Access Provisions During 2015 and Typical Parameters
  - Spotlight: Limitations on the Size of the Nominating Group
- Potential Impact of Proxy Access on Corporate Governance
  - International Perspectives on Proxy Access
- Practical Considerations

The SEC's 2010 Proxy Access Rule

The SEC has unsuccessfully sought to adopt a market-wide proxy access rule for decades. Most recently, in 2010, the SEC adopted a proxy access rule (Exchange Act Rule 14a-11) that would have given shareholders the ability to nominate candidates through the company's proxy materials if a shareholder (or a group of shareholders without any limit on the size of the nominating group) held 3% of the company's shares for at least three years. Under the rule, a nominating shareholder (or group of shareholders, with no limit on the size of the group) could nominate one proxy access director, or 25% of the board, whichever is greater. Rule 14a-11 was adopted shortly after Section 971 of the Dodd-Frank Act confirmed the SEC's authority to promulgate a proxy access rule. The SEC issued final rules mandating proxy access in August 2010, which were scheduled to become effective in November 2010. In addition, the SEC also amended Exchange Act Rule 14a-8(i)(8) to allow shareholder proposals relating to proxy access and certain other director election mechanisms.[2]

In September 2010, Business Roundtable and the U.S. Chamber of Commerce challenged Rule 14a-11. In 2011, the U.S. Court of Appeals for the District of Columbia Circuit vacated Rule 14a-11 on the grounds that the SEC had acted "arbitrarily and capriciously" in promulgating the rule and failing to adequately assess its economic impact.[3] The SEC did not appeal the court's decision and has not re-proposed any proxy access rule since that

decision; however, the amendment to Rule 14a-8 described above became effective in September 2011, thereby opening the door to shareholder proposals seeking proxy access.[4]

Uptick in Shareholder Proxy Access Proposals in 2015

In public comments on the SEC's proposed Rule 14a-11, several commenters expressed the view that the matter should be left to shareholders and companies to decide on a company-by-company basis through private ordering.[5] Private ordering may take place, for example, pursuant to Section 112 of the Delaware General Corporation Law.[6]

Approximately 15 companies adopted proxy access prior to 2015, including a few large companies, such as Hewlett-Packard Company (now known as HP Inc.), The Western Union Company and Verizon Communications Inc., which each adopted proxy access after receiving a shareholder proposal on the topic, as well as some companies that have since gone private. In addition, proxy access with a 5% for two years ownership threshold has been mandatory for companies incorporated in North Dakota since 2008; and we are aware of one public company that reincorporated to North Dakota with the stated purpose of taking advantage of this and other "shareholder-friendly" provisions.[7] To date, no shareholder has included a director nominee in the proxy materials of a United States company pursuant to a proxy access right.[8]

The private ordering effort is now in full swing. Shareholder proposals seeking proxy access were the defining feature of the 2015 proxy season, with more than 115 companies receiving proposals requesting that the board amend the bylaws to allow large, long-standing shareholders (or groups of shareholders) to nominate directors and include those nominees in the company's own proxy statement and related materials. The number of shareholder proxy access proposals submitted for the 2015 proxy season is more than four times the number submitted for the 2014 proxy season.

The New York City Pension Funds, with approximately $160 billion under management, accounted for the majority of the proxy access proposals submitted for the 2015 proxy season. In November 2014, Comptroller Stringer announced the "Boardroom Accountability Project," targeting 75 companies with non-binding shareholder proxy access proposals.[9] The proposals request that the board adopt a bylaw to give shareholders who meet a threshold of owning 3% of the company's stock for three or more years the right to include their director candidates, representing up to 25% of the board, in the company's proxy materials, with no limit on the number of shareholders that could comprise a nominating group. According to Comptroller Stringer, the targeted companies were selected due to concerns about the following three priority issues:

- Climate change (i.e., carbon-intensive coal, oil and gas and utility companies).
- Board diversity (i.e., companies with little or no gender, racial or ethnic diversity on the board).
- Excessive executive compensation (i.e., companies that received significant opposition to their 2014 say-on-pay votes).

Although members of Comptroller Stringer's office have publicly stated that they intend to continue their efforts in this area, they have not yet disclosed the priority issues they intend to target in 2016.

Institutional Investor Support for Proxy Access

Proxy access is supported by many institutional investors, including the following:

- *BlackRock* – will review proxy access proposals on a case-by-case basis and generally support them provided that their parameters are not "overly restrictive or onerous" and "provide assurances that the mechanism will not be subject to abuse by short-term investors, investors without a substantial investment in the company, or investors seeking to take control of the board."[10] In early October 2015, BlackRock announced that it will put a management proxy access proposal on the ballot for its annual meeting in May 2016 with the following terms: 3% for three years for up to 25% of the board with a group size limit of 20.
- *California Public Employees' Retirement System (CalPERS)* – has indicated that proxy access is one of its strategic priorities for the 2015 proxy season and its support of proxy access proposals at 100 companies this year.[11]
- *California State Teachers' Retirement System (CalSTRS)* – supports proxy access at the 3% for three years threshold, capped at a minority of board seats.[12]
- *TIAA-CREF* – wrote to the 100 largest companies in which it invests in February 2015, encouraging them to adopt proxy access at the 3% for three years threshold.[13]
- *T. Rowe Price* – supports proxy access for owners of 3% or more of the company's outstanding shares, with a holding period requirement of no less than two years and no more than three years.[14]
- *Vanguard* – generally supports proxy access at the 5% for three years threshold, capped at 20% of board seats.[15]

Fidelity generally votes against management and shareholder proposals to adopt proxy access.[16]

CII has long supported proxy access, favoring a broad-based SEC rule imposing proxy access. Absent such a rule, Section 3.2 of CII's *Corporate Governance Policies* states that a company should provide access to management proxy materials for an investor or a group of investors that have held in the aggregate at least 3% of the company's voting stock for at least two years, to nominate less than a majority of the directors.[17]

On August 5, 2015, CII issued guidelines setting forth what it considers best practices for companies adopting proxy access provisions. The guidelines highlight seven provisions that CII finds "troublesome" in that they could "significantly impair shareowners' ability to use proxy access, or even render access unworkable."[18] The provisions that are of most concern to CII are:

- An ownership threshold of 5%.
- The percent or number of board members that may be elected could result in fewer than two proxy access nominees.
- Aggregation of shareholders to form a nominating group is limited to a specified number.
- Not counting loaned shares (that meet certain conditions with respect to recall and voting) toward the ownership threshold during the holding period.
- A requirement for a nominating shareholder to continue to hold the requisite percentage of shares after the annual meeting.

- Re-nomination restrictions in the event a proxy access nominee fails to receive a specified minimum percentage of votes.
- Prohibitions on third-party compensation arrangements with proxy access nominees (although CII supports disclosure of such arrangements).

When the guidelines were issued, the interim executive director of CII stated that every proxy access provision in effect at the time included at least one of these "troublesome" provisions.[19]

In mid-October 2015, CII reported that the United Brotherhood of Carpenters recently sent letters to 50 companies seeking a proxy access right in the event that the board refuses to accept the resignation of an incumbent director who fails to receive majority support.[20] The letters were sent to companies with a majority voting standard and a director resignation policy and that had shareholder proxy access proposals on the ballots for their 2015 annual meetings, whether or not those proposals received majority support.

Some institutional investors that favor proxy access coordinated their efforts during the 2015 proxy season in an attempt to increase investor support for the proxy access proposals they sponsored. Specifically, the New York City Pension Funds, CalPERS and other large labor-affiliated pension funds each filed Form PX14A6Gs with the SEC enabling them to communicate in support of their proxy access proposals (but not collect actual proxies) without such communications being subject to the proxy solicitation rules.

According to a recent report by Broadridge and PricewaterhouseCoopers, institutional investors are four times more likely to support proxy access than are individual investors: 61% of votes cast by institutional investors were in favor of proxy access in 2015, compared with only 15% of those cast by individual retail investors.[21] The report also indicated that retail investors voted only 28% of the shares they own. These findings suggest that companies facing a proxy access vote should consider ways of engaging with retail investors and encouraging them to vote.

Proxy Advisory Firm Policies on Proxy Access

Both Institutional Shareholder Services (ISS) and Glass, Lewis & Co. generally favor proxy access for significant, long-term shareholders.

ISS

In prior years, ISS analyzed proxy access proposals on a case-by-case basis. Beginning with the 2015 proxy season, ISS will generally recommend in favor of shareholder and management proxy access proposals with all of the following features:

- An ownership threshold of not more than 3% of the voting power.
- A holding period of no longer than three years of continuous ownership for each member of the nominating group.
- Minimal or no limits on the number of shareholders that may form a nominating group.
- A cap on the number of available proxy access seats of generally 25% of the board.

ISS will review any additional restrictions for reasonableness. Where a company includes both a management proposal along with a shareholder proposal, ISS will compare them in relation to the guidance above. ISS will generally recommend a vote against proposals that are more restrictive than the ISS guidelines.

ISS will also generally recommend a vote against one or more directors if a company omits from its ballot a properly submitted shareholder proxy access proposal, if the company has not obtained any of the following:

- The proponent's voluntary withdrawal of the proposal.
- A grant of SEC no-action relief.
- A U.S. district court ruling that exclusion is appropriate.[22]

On November 2, 2015, ISS announced that, beginning on November 23, 2015, its QuickScore governance ratings product will track, on a "zero-weight" basis, whether a company has adopted proxy access. In particular, ISS will track the minimum ownership threshold and holding period, the maximum number of shareholders that can comprise a nominating group and the maximum percentage or number of board seats open to proxy access nominees.[23]

Glass Lewis

Glass Lewis' proxy voting policies for 2015 provide that it will review on a case-by-case basis shareholder proxy access proposals and the company's response, including whether the company offers its own proposal in place of, or in addition to, the shareholder proposal. Glass Lewis will consider:

- Company size.
- Board independence and diversity of skills, experience, background and tenure.
- The shareholder proponent and the rationale for the proposal.
- The percentage of ownership requested and the holding period requirement; although note that Glass Lewis policy does not specify a preferred percentage.
- The shareholder base in both percentage of ownership and type of shareholder (such as a hedge fund, activist investor, mutual fund or pension fund).
- Board and management responsiveness to shareholders, as evidenced by progressive shareholder rights policies (such as majority voting or board declassification) and reaction to shareholder proposals.
- Company performance and steps taken to improve poor performance (such as appointing new executives or directors or engaging in a spin-off).
- Existence of anti-takeover protections or other entrenchment devices.
- Opportunities for shareholder action (such as the ability to act by written consent or the right to call a special meeting).[24]

Glass Lewis does not solicit feedback on its policy updates, which are typically released in November.

ISS Proxy Access Responsiveness Policy

ISS launched its annual policy survey[25] in August 2015, thereby signaling that ISS may refine its position on proxy access.[26] Specifically, the survey asks: if a board adopts proxy access with material restrictions not contained in a majority-supported shareholder proposal, which types of restrictions should be viewed as problematic enough to call into question the board's responsiveness and potentially warrant "withhold" or "against" votes against directors? ISS provided the following examples of potentially problematic restrictions:

- Ownership thresholds in excess of 3% or 5%.
- Ownership duration greater than three years.
- Aggregation limit of less than 20 shareholders.
- Cap on proxy access nominees set at less than 20% of the existing board (rounded down).
- More restrictive advance notice requirements.
- Information disclosures that are more extensive than those required of the company's nominees, by the company, the SEC or relevant exchanges.
- Re-nomination restrictions in the event a proxy access nominee fails to receive a stipulated level of support or withdraws his or her nomination.
- Restrictions on compensation of proxy access nominees by nominating shareholders.

The inclusion of this question in the survey suggests that ISS may issue negative vote recommendations against directors of companies that do not implement a majority-supported shareholder proxy access proposal substantially in accordance with its terms.

On September 28, 2015, ISS published the results of its annual policy survey.[27] A majority of investor respondents were of the view that ISS should issue negative vote recommendations against directors if the ownership threshold exceeds 3% (72% of investor respondents) or 5% (90%), if the holding period exceeds 3 years, if the size of the nominating group is fewer than 20 and/or if the cap on the number of proxy access nominees is less than 20% of the current board size. Company respondents generally did not agree that directors should be penalized for imposing restrictions on proxy access after shareholders had approved a shareholder proxy access proposal, although a slight majority agreed that votes against directors could be warranted if the company established an ownership threshold greater than 5%.

The policy survey did not seek feedback on ISS proxy voting policy with respect to proxy access proposals (e.g., to include consideration of the provisions listed above that are not currently addressed in the policy); however, ISS could nevertheless change its policy to incorporate such considerations or any other matter.

On October 26, 2015, ISS issued its key proposed draft policy changes applicable to the 2016 proxy season for public comment, none of which relate to proxy access. Although ISS has in the past announced policy changes that were not submitted for public review, it has indicated in preliminary discussions that it does not expect to make any major changes to its policy relating to proxy access. ISS expects to release its final policy updates applicable to the 2016 proxy season on November 18, 2015.

Grounds for Exclusion of Shareholder Proxy Access Proposals

Under the SEC's proxy rules, a company may exclude a shareholder proxy access proposal from its proxy materials if the proposal fails to meet any of the procedural and substantive requirements of Exchange Act Rule 14a-8. A company may seek no-action relief from the SEC Staff, pursuant to which the company can exclude the proposal from its proxy materials. Two substantive grounds that have been relied on by companies seeking to exclude a shareholder proxy access proposal are that the proposal directly conflicts with a management proposal (Rule 14a-8(i)(9)) or has already been substantially implemented by the company (Rule 14a-8(i)(10)). However, as discussed below, the SEC Staff recently issued guidance that will make it more difficult for a company to obtain no-action relief under Rule 14a-8(i)(9) on the grounds that a shareholder proxy access proposal directly conflicts with a management proxy access proposal.

Directly Conflicting Proposals

In early December 2014, the SEC's Division of Corporation Finance granted no-action relief to Whole Foods Market, Inc. on the basis that a 3% for three years shareholder proxy access proposal directly conflicted with a 9% for five years management proposal.[28] When Whole Foods filed its preliminary proxy statement with the SEC after this relief was granted, the ownership threshold in the management proposal was reduced from 9% to 5%.

In the wake of the no-action relief granted to Whole Foods, it was broadly expected that companies would counter shareholder proxy access proposals by putting forward management proxy access proposals with higher minimum ownership thresholds, and obtain no-action relief on the basis that the proposals were conflicting and therefore excludable. However, following the grant of no-action relief to Whole Foods, James McRitchie, the proponent of the Whole Foods proposal, appealed the grant to the full SEC and a letter-writing campaign by incensed institutional shareholders followed.

In January 2015, SEC Chair Mary Jo White reversed course. In an unusual development, Chair White directed the SEC Staff to review Rule 14a-8(i)(9) as a basis for exclusion. As discussed in a previous Sidley Update,[29] following Chair White's direction, the Division of Corporation Finance announced that it would express no view on the application of Rule 14a-8(i)(9) for the remainder of the 2015 proxy season in connection with all shareholder proposals—not just those seeking proxy access—and withdrew the no-action relief previously granted to Whole Foods.[30]

Business Roundtable and other commentators expressed concern that the SEC's approach forced companies faced with a shareholder proxy access proposal that are considering a management proposal to either include the shareholder proposal in the proxy materials, even though it will compete with the similar management proposal and possibly lead to confusion, or omit the shareholder proposal, creating a heightened risk of litigation and negative targeting by certain pension funds and proxy advisory firms. As described below, seven companies have included competing shareholder and management proxy access proposals on the ballot. We are not aware of any company omitting a shareholder proxy access proposal without first obtaining no-action relief or withdrawal. In a speech in late June 2015, SEC Chair White noted that, notwithstanding concerns that shareholders would be confused by two competing proposals, "shareholders were able to sort it all out and express their views."[31]

New SEC Guidance on Excludability of Directly Conflicting Shareholder Proposals

On October 22, 2015, the Staff of the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14H (CF) ("SLB No. 14H")[32] which provides new guidance on the excludability of shareholder proposals that "directly conflict" with management proposals under Rule 14a-8(i)(9). As discussed in a previous Sidley Update,[33] after reviewing the history and intended purpose of Rule 14a-8(i)(9) per SEC Chair White's request, the SEC Staff announced in SLB No. 14H that it will interpret the rule more narrowly than it has in the past. Going forward, the SEC Staff will permit a company to exclude a shareholder proposal as directly conflicting with a management proposal only "if a reasonable shareholder could not logically vote in favor of both proposals, *i.e.*, a vote for one proposal is tantamount to a vote against the other proposal."

A non-binding shareholder proposal seeking proxy access on terms different from management's proxy access proposal will generally not be excludable under Rule 14a-8(i)(9). Proposals seeking a similar objective (*e.g.*, proxy access) but on different terms (*i.e.*, a different means of accomplishing the same objective) would not "directly conflict," as a reasonable shareholder could logically vote in favor of both proposals. The SEC Staff provided the following example of proposals that will not be deemed to directly conflict: (i) a management proposal that seeks to allow shareholders holding at least 5% of the company's stock for at least five years to nominate up to 10% of the directors and include nominees in the company's proxy materials and (ii) a shareholder proposal that seeks to allow shareholders holding at least 3% of the company's stock for at least three years to nominate up to 20% of the directors and include nominees in the company's proxy materials.

The SEC Staff does not believe that a reasonable shareholder would logically vote for two binding shareholder and management proposals that contain two mutually exclusive mandates. In the case of such a "direct conflict," the SEC Staff could, in its no-action response, allow a shareholder proponent to revise its proposal to make it non-binding rather than binding, and therefore potentially not excludable under Rule 14a-8(i)(9).

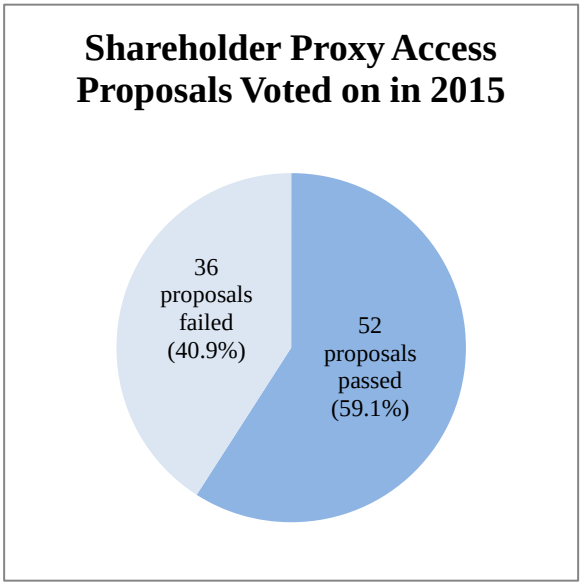
In light of the new guidance, we expect to continue to see competing proxy access proposals on ballots during the 2016 proxy season. In a situation where both the management and shareholder proposals are approved by shareholders, the board may have to consider the effects of both proposals; the SEC Staff does not consider such a decision to represent the kind of "direct conflict" the rule was designed to address. In SLB No. 14H, the SEC Staff noted that, to minimize concerns about shareholder confusion, any company that includes shareholder and management proposals on the same topic on its ballot can include proxy statement disclosure explaining the differences between the two proposals and how the company would expect to consider the voting results.

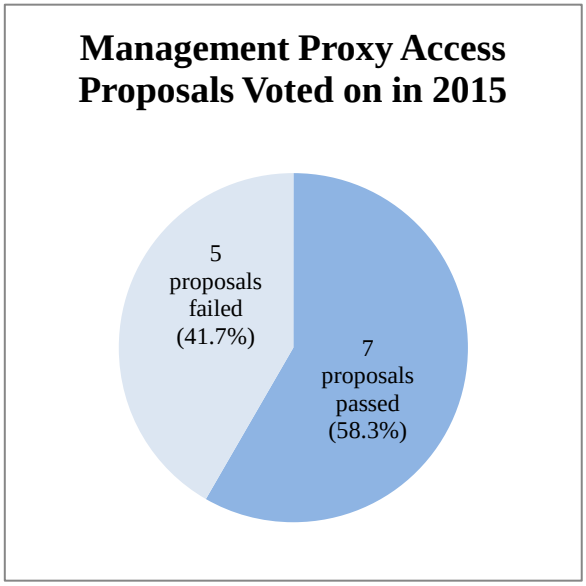
Substantially Implemented Proposals

Companies that adopt proxy access can seek to omit a shareholder proxy access proposal on the grounds that it has been "substantially implemented" by the company.

In March 2015, the SEC granted General Electric Company no-action relief allowing it to exclude a shareholder proxy access proposal on these grounds. The shareholder proposal had sought an ownership threshold of 3% for three years, for up to 20% of the board's seats but was silent on the number of shareholders that could comprise a nominating group. General Electric adopted a proposal with the same 3% for three years threshold for up to 20% of board seats, but limited to 20 the number of shareholders that could compromise a nominating group.[34]

Voting Results on Proxy Access Proposals





Proxy access proposals with a 3% for three years ownership threshold have a fair likelihood of receiving majority shareholder support.

Shareholder Proposals

Eighty-eight shareholder proxy access proposals have been voted on in 2015, averaging support of approximately 54% of votes cast; 52 proposals (59.1%) have received majority support while 36 (40.9%) did not pass. Management opposed all but three of the proposals; it supported two of the proposals and provided no recommendation with respect to one proposal. ISS supported all shareholder proposals, most of which included a 3% for three years ownership threshold (such as Comptroller Stringer's proposals).

Voting results on shareholder proxy access proposals in 2015 appear to be influenced by the following factors:

Factors Increasing Shareholder Support	Factors Decreasing Shareholder Support
• No competing management proxy access proposal on the ballot	• Competing management proxy access proposal on the ballot
• Company has not adopted proxy access prior to the meeting	• Company has adopted proxy access prior to the meeting; significantly lower support if previously adopted at 3% ownership threshold
• Less insider ownership	• Greater degree of insider ownership
• Less voting retail shareholders	• More voting retail shareholders
• Combative tone of corporate disclosure around proxy access concept	• More conciliatory/open tone of corporate disclosure around proxy access concept
• Concerns relating to corporate performance, shareholder rights and/or compensation	• Lack of concern relating to corporate performance, shareholder rights and/or compensation
• Shareholder proposal voted on later in the proxy season, as momentum towards proxy access has accelerated	• Shareholder proposal voted on earlier in the proxy season

In 2014, 18 shareholder proxy access proposals were voted on and averaged support of approximately 34% of votes cast. Five proposals passed, each of which included a 3% for three years ownership requirement. The eight proposals that deviated from that formulation received average support of only 9% of votes cast. Thirteen proposals did not pass.

Management Proposals

Twelve management proxy access proposals have been voted on in 2015, averaging support of 61.5% of votes cast; seven proposals (58.3%) passed while five (41.7%) did not pass (including one that received majority support but fell short of the company's supermajority vote requirement). ISS recommended votes in favor of five of these proposals (which followed the 3% for three years formulation) and against seven of these proposals (six of which included a 5% for three years ownership threshold; one included a 3% for three years threshold (as discussed below)).

Competing Shareholder and Management Proposals

At seven companies shareholders voted on two proxy access proposals at the 2015 annual meeting—a shareholder proposal at a 3% ownership threshold and a management proposal at a 5% ownership threshold (other than one management proposal at a 3% threshold). ISS recommended for all seven shareholder proposals. ISS recommended against all seven management proposals, including at the one company which proposed a 3% for three years threshold but imposed more restrictive terms than the shareholder proposal. Specifically, the management proposal at that company included a cap of 20% of board seats (compared with a 25% cap in the shareholder proposal) and a limit of 20 shareholders in the nominating group (compared with no limit in the shareholder proposal).

As shown in the table below, the management proposal passed at three companies, the shareholder proposal passed at three companies, neither proposal passed at one company and there were no instances where both proposals passed. As noted above, SEC Chair White recently stated that, despite the concerns of some commentators, there did not appear to be shareholder confusion with respect to competing proposals. We expect to continue to see competing proxy access proposals on ballots in the 2016 proxy season in light of the new SEC guidance on Rule 14a-8(i)(9) discussed above.

	Shareholder Proposals			Management Proposals		
Company	**Parameters**	**ISS Rec.**	**% Support***	**Parameters**	**ISS Rec.**	**% Support***
The AES Corporation	3% 3 years 25% cap No limit on size of nominating group	For All	66.4	5% • 3 years • 20% cap • monitoring peer company practices and soliciting shareholder input when fixing limit (Advisory)	Against All	36.2
Chipotle Mexican Grill, Inc.			49.9	5% • 3 years • 20% cap • limit of 20 (Binding)		34.7
Cloud Peak Energy Inc.			71.1	5% • 3 years • 10% cap • limit of 1 (Binding)		25.9
Exelon Corporation			43.6	5% • 3 years • 20% cap • limit of 20 (Advisory)		52.6
Expeditors International of Washington, Inc.			35.0	3% • 3 years • 20% cap • limit of 20 (Advisory)		70.3
SBA Communications Corporation			46.3	5% • 3 years • 20% cap • limit of 10 (Advisory)		51.7
Visteon Corporation			75.7	5% • 3 years • 20% cap • monitoring peer company practices and soliciting shareholder input when fixing limit (Advisory)		21.2
Average % Support of Votes Cast			**55.4**			**41.8**

Adoption of Proxy Access Provisions During 2015 and Typical Parameters

Sixty-two companies have adopted proxy access during 2015, and they have done so in a range of circumstances as described in the chart included in Appendix A. All companies adopted proxy access in their bylaws except for one company, which incorporated it into the certificate of incorporation. Thirteen companies adopted proxy access without having received a shareholder proxy access proposal – this trend is accelerating.

That chart included in Appendix A highlights the key parameters of the proxy access provisions adopted so far this year, including the minimum ownership threshold, the maximum percentage of board seats open to proxy access nominees and the maximum number of shareholders that can comprise a nominating group. The chart also highlights additional selected provisions relating to the treatment of loaned shares, share ownership post-annual meeting, third-party compensation arrangements, the nomination deadline and exclusion of proxy access nominees if a director nomination has been made under the company's advance notice provision.

Based on data derived from SharkRepellent.net, last accessed on November 3, 2015, more than 10% of companies in the S&P 500 have now adopted proxy access. Several additional companies have publicly committed to adopt proxy access in 2015 or 2016, including companies which made such commitments in exchange for the withdrawal of a shareholder proxy access proposal, and companies where non-binding management proxy access proposals received majority support in 2015. At three companies that adopted a proxy access bylaw prior to the 2015 annual meeting, their respective boards subsequently amended the bylaws after shareholder proxy access proposals with less restrictive terms passed at the annual meetings. Specifically, CF Industries Holdings, Inc., Marathon Oil Corporation and The Priceline Group Inc. amended their proxy access bylaws to (i) decrease the required ownership percentage from 5% to 3% and (ii) change the maximum percentage of board seats available to proxy access nominees from 20% to 25%. The amendment to The Priceline Group Inc.'s bylaw also eliminated the 20 shareholder limit on forming a group for purposes of meeting the required ownership percentage.

While market practice continues to develop, the proxy access provisions adopted by companies during 2015 include several elements that are beginning to emerge as typical, although there are some variations. In addition to the key parameters and selected provisions described in the chart included in Appendix A, proxy access provisions delineate various procedural and informational requirements, proxy access nominee eligibility conditions and circumstances in which a company will not be required to include a proxy access nominee in its proxy materials.

Typical Provisions

Nomination Deadline; Limited to Annual Meetings

Requests to include proxy access nominees in the company's proxy materials typically must be received within a window of 120 to 150 days before the anniversary of (1) the date on which the company released its proxy statement for the previous year's annual meeting (40 out of 62 companies (65%)) or (2) the previous year's annual meeting (7 out of 62 companies (11%)). Less commonly, the deadline is a window of 90 to 120 days before the anniversary of the previous year's mailing date (2 out of 62 companies (3%)) or annual meeting date (5 out of 62 companies (8%)). Seven out of 62 companies (11%) require that requests be received prior to the date that is 120 days before the date the company released its proxy statement to shareholders in connection with the previous year's annual meeting (i.e., the same as the deadline for shareholder proposals under Exchange Act Rule 14a-8, which does not incorporate a window). Proxy access provisions typically specify that

proxy access may only be used with respect to director elections at annual meetings (but not special meetings) of shareholders.

Net Long Beneficial Ownership of 3% or 5%

Three percent for three years is emerging as the most common ownership threshold (55 out of 62 companies (89%)), although some companies have adopted a 5% for three years threshold (7 out of 62 companies (11%)). As discussed above, three companies that initially adopted proxy access at a 5% ownership threshold subsequently amended their bylaws to decrease the required ownership percentage to 3%.

A nominating shareholder is typically deemed to own only those outstanding common shares of the company as to which the shareholder possesses both the full voting and investment rights pertaining to the shares, and the full economic interest in such shares. For example, shares subject to any derivative arrangement entered into by the shareholder or any of its affiliates would not qualify as eligible ownership for proxy access purposes. Loaned shares count as "owned" for purposes of meeting the ownership threshold in most of the proxy access provisions adopted to date (45 out of 62 companies (73%)), subject to certain conditions. Where loaned shares count toward ownership, most provisions require that the nominating shareholder has the power to recall the loaned shares within a specified time frame (most commonly, on three or five business days' notice), or may terminate the share lending within a specified time frame. A few provisions require that the nominating shareholder has actually recalled the loaned shares prior to the end of the relevant period.

Holding Period

All of the proxy access provisions adopted so far in 2015 provide that the nominating shareholder must own the requisite amount of shares for at least three years. A nominating shareholder is typically required to continue to own the requisite amount of shares until the nomination date, the record date and annual meeting date and, at 27 out of 62 companies (44%), is required to represent that it will, or intends to, continue to own the requisite shares for at least one year after the annual meeting.

Nominee Limit and Procedure for Selecting Candidates if Nominee Limit is Exceeded

Most companies have limited the number of board seats available to proxy access nominees to 20% of the board (32 out of 62 companies (52%)), eight of which provide for a minimum of one proxy access nominee. Companies are increasingly limiting the number of board seats available to proxy access nominees to the greater of two or 20% of the board (20 out of 62 companies (32%)). Several companies have adopted a 25% cap (10 out of 62 companies (16%)). In most cases, if the calculation of the maximum number of proxy access nominees does not result in a whole number, the maximum number of proxy access nominees that the company would be required to include in its proxy materials would be the closest whole number below the applicable percentage (e.g., 20% or 25%).

Most proxy access provisions provide that, if a vacancy occurs on the board after the nomination deadline but before the date of the annual meeting, and the board decides to reduce the size of the board in connection with the vacancy, the nominee limit would be calculated based on the reduced number of directors. Any proxy access nominee who is either subsequently withdrawn or included by the board in the proxy materials as a board-nominated candidate typically would count against the nominee limit (including in a specified number of future years). Many proxy access provisions provide that the maximum number of proxy access nominees that the company would be required to include in its proxy materials will be reduced by the number of director

candidates nominated by any shareholder pursuant to the company's advance notice provisions (21 out of 62 companies (34%)).

Any nominating shareholder that submits more than one nominee would be required to provide a ranking of its proposed nominees. If the number of proxy access nominees from all nominating shareholders exceeds the nominee limit, the highest ranking qualified person from the list proposed by each nominating shareholder, beginning with the nominating shareholder with the largest qualifying ownership and proceeding through the list of nominating shareholders in descending order of qualifying ownership, would be selected for inclusion in the proxy materials, with the process repeating until the nominee limit is reached.

Limitation on the Size of the Nominating Group

All but two companies that have adopted proxy access during 2015 have limited the number of shareholders that are permitted to comprise a nominating group. A nominating group size limit of 20 is the most common (51 out of 62 companies (82%)); however, a small number of companies have set a lower limit (e.g., 1, 5, 10 or 15; see Appendix A). Proxy access provisions often also provide that a shareholder cannot be a member of more than one nominating group. Many companies require that one group member be designated as authorized to act on behalf of all other group members.

Information Required of All Nominating Shareholders

Each nominating shareholder is typically required to provide certain information to the company, including:

- Verification of, and information regarding, the stock ownership of the shareholder as of the date of the submission and the record date for the annual meeting (including in relation to derivative positions).
- The Schedule 14N filed by the shareholder with the SEC.
- Information regarding each proxy access nominee, including biographical and stock ownership information.
- The written consent of each proxy access nominee to (1) be named in the proxy statement, (2) serve as a director if elected and (3) the public disclosure of the information provided by the shareholder regarding the proxy access nominee.
- A description of any arrangement with respect to the nomination between the shareholder and any other person.
- Any other information relating to the shareholder that is required to be disclosed pursuant to Section 14 of the Exchange Act, and the rules and regulations promulgated thereunder.
- The written consent of the shareholder to the public disclosure of the information provided to the company.

Nominating shareholders are generally permitted to include in the proxy statement a 500-word statement in support of their nominees. The company may omit any information or statement that it, in good faith, believes would violate any applicable law or regulation.

Nominating shareholders are also typically required to make certain written representations to and agreements with the company, including in relation to:

- Lack of intent to change or influence control of the company.

- Intent to maintain qualifying ownership through the annual meeting date and, at 27 out of 62 companies (44%), for one year beyond the meeting date.
- Refraining from nominating any person for election to the board other than its proxy access nominees.
- Intent to be present in person or by proxy to present its nominees at the meeting.
- Not participating in any solicitation other than that relating to its nominees or board nominees.
- Not distributing any form of proxy for the annual meeting other than the form distributed by the company.
- Complying with solicitation rules and assuming liability and providing indemnification relating to the nomination, if required.
- The accuracy and completeness of all information provided to the company.

Information Required of All Proxy Access Nominees

Each proxy access nominee is typically required to make certain written representations to and agreements with the company, including in relation to:

- Acting in accordance with his or her duties as a director under applicable law.
- Not being party to any voting agreements or commitments as a director that have not been disclosed to the company.
- Not being party to any compensatory arrangements with a person or entity other than the company in connection with such proxy access nominee's candidacy or service as a director that have not been disclosed to the company.
- Complying with applicable laws and stock exchange requirements and the company's policies and guidelines applicable to directors.
- The accuracy and completeness of all information provided to the company.

Proxy access nominees are also typically required to submit completed and signed D&O questionnaires.

Several companies have adopted a provision requiring each proxy access nominee to submit an irrevocable resignation to the company in connection with his or her nomination, which would become effective upon the board determining that certain information provided by the proxy access nominee in connection with the nomination is untrue or misleading or that the nominee or the nominating shareholder breached any obligations to the company.

Exclusion or Disqualification of Proxy Access Nominees

It is typical for proxy access provisions to permit exclusion of proxy access nominees from the company's proxy statement if the nominating shareholder (or at some companies, any shareholder) has nominated any person (or at some companies, one or more of the proxy access nominees) to the board pursuant to the company's advance notice provisions (52 out of 62 companies (84%)).

In addition, the company is typically not required to include a proxy access nominee in the company's proxy materials if any of the following apply:

- The nominee withdraws, becomes ineligible or does not receive at least 25% of the votes cast at his or her election. Such person is typically ineligible to be a proxy access nominee for the two annual meetings following such vote.
- The nominating shareholder participates in the solicitation of any nominee other than its nominees or board nominees.
- The nominee is or becomes a party to a compensatory arrangement with a person or entity other than the company in connection with such nominee's candidacy or service as a director that has not been disclosed to the company or, at 20 out of 62 companies (32%), under any circumstances, whether or not disclosed.
- The nominee is not independent under any applicable independence standards. Some companies require nominees to meet heightened standards of independence applicable to audit committee and/or compensation committee members under SEC, stock exchange and/or IRS rules.
- The election of the nominee would cause the company to violate its charter or bylaws, any stock exchange requirements or any laws, rules or regulations.
- The nominee has been an officer or director of a competitor (often as defined in Section 8 of the Clayton Antitrust Act of 1914) within the past three years.
- The nominee is the subject of a pending criminal proceeding or has been convicted in a criminal proceeding within the past 10 years.
- The nominee is subject to any order of the type specified in Rule 506(d) of Regulation D promulgated under the Securities Act.
- The nominee or the nominating shareholder has provided false or misleading information to the company or breached any obligations under the proxy access provision.

Several proxy access provisions include "creeping control" limitations which take various forms. A proxy access nominee elected by shareholders will typically count towards the proxy access nominee limit in future years (often two or three years after election). At some companies, if a nominating shareholder's nominee is elected to the board, then such nominating shareholder may not utilize proxy access for the following two annual meetings (other than with respect to the nomination of the previously elected proxy access nominee).

The board or the chairman of the annual meeting may declare a director nomination by a shareholder to be invalid, and such nomination may be disregarded, if the proxy access nominee or the nominating shareholder breaches any obligations under the proxy access provision or the nominating shareholder does not appear at the annual meeting in person or by proxy to present the nomination.

Spotlight: Limitations on the Size of the Nominating Group

Companies that have already adopted proxy access should bear in mind that shareholders may seek to modify the terms of such provisions in the future. For example, Mr. McRitchie, the proponent at Whole Foods and several other companies that have since adopted proxy access, has criticized many proxy access bylaws as embodying "proxy access lite" and has indicated that he may in the future propose "precatory or binding bylaw resolutions to try to eliminate the limitation on group participants and to address other possible issues to be discovered upon closer examination of adopted bylaws."[35] More recently, in the face of increasing adoptions of "proxy access lite" provisions, Mr. McRitchie announced that he "will be circling back to these companies to get more favorable terms."[36] Mr. McRitchie also announced that he has tightened the language in his template proxy access proposal with the goal of "avoiding proxy access lite from the start," and has begun submitting the revised template to companies that have not yet adopted proxy access provisions.[37] The template provides for at least two proxy access nominees, no limitation on the size of the nominating group and that loaned shares should count toward the ownership threshold.

The public pension funds led by New York City Comptroller Stringer have also expressed concerns about certain "unworkable" proxy access provisions adopted to date, including provisions which limit the number of shareholders who can aggregate to form a nominating group.[38]

Although untested, in light of recent comments by the Director of the SEC's Division of Corporation Finance, it seems likely that no-action relief would not be available on the "substantially implemented" basis unless the company can show that it substantially implemented the *removal of the limit* sought by the proponent.[39]

Potential Impact of Proxy Access on Corporate Governance

It remains to be seen what impact proxy access will have on corporate governance. At companies where proxy access has been adopted, boards and management may become more focused on the quality of shareholder relations, communications and engagement, in an effort to avoid a contested election against one or more proxy access nominees.

One of the benefits of the board self-determination that occurs absent a proxy contest or proxy access situation is the ability of the board to ensure that its composition is aligned with its view of what the company needs for effective oversight. This is not a simple matter given the mosaic of skill sets, experience and diversity that is needed on a board.

An elected proxy access director will owe the same fiduciary duties as the other directors, though some may view proxy access directors as potentially having an allegiance to the nominating shareholder's interests. Depending on the circumstances, however, there may be a greater risk that the proxy access director is viewed by the rest of the board as an outsider or even an adversary.

Concerns about how proxy access may impact board dynamics include:

- **Board fragmentation**. The board may become dominated by factions that are aligned with particular segments of the shareholding body rather than the shareholding body as a whole.
- **Board dysfunction**. Distrust among directors may develop and lead to board dysfunction with an associated negative impact on the quality of board oversight.

Concerns about how proxy access may impact a company in general include:

- **A higher risk of legal challenges**. Disagreement among directors may lead to a greater risk of legal challenges, including challenges in contexts that lack business judgment rule protection, subjecting transactions to heightened standards of review.

- **Joint shareholder action**. Special interest shareholders could coordinate to increase their representation on the board without the shareholding body at large understanding the potential for joint action.
- **Increased costs and distractions**. Proxy access can lead to increased costs and distractions without delivering improvements in company or board performance.
- **Potential withdrawal of existing directors**. Incumbent directors may choose to resign rather than serve alongside a particular proxy access director.

International Perspectives on Proxy Access

In considering how proxy access may impact corporate governance in the United States, it may be helpful to consider international experiences. The CFA Institute Report on Proxy Access indicates that proxy access has historically been used sparingly to elect directors in countries that have adopted proxy access, including Canada, the UK, Australia, France, Germany, the Netherlands, Norway, Switzerland and Brazil. For example, the report cites to a 2009 finding that proxy access nominations at Canadian companies are often withdrawn prior to a vote because companies are "more willing and more likely to reach agreements with investors to avoid a vote."[40]

The CFA Institute Report on Proxy Access also evaluates the relationship between company returns and proxy access elections in Canada, the UK and Australia, and states that "[t]o the extent that proxy access provides governance benefits from a policy perspective, a preliminary analysis suggests that adverse financial impacts are negligible."[41]

Practical Considerations

Notwithstanding the concerns outlined above, it appears inevitable that proxy access will soon play a larger role in corporate governance as a result of private ordering.

Proxy access will likely follow the pattern of majority voting in uncontested director elections and become common among S&P 500 companies in the next several years, assuming that institutional investors continue to campaign through shareholder proposals and the threat of shareholder proposals.

Companies have several alternatives when considering whether and when to adopt proxy access. Companies where a proxy access proposal received majority support in 2015 should consider proxy advisor policies when implementing proxy access—specifically, the likelihood of negative vote recommendations on director elections if the board has "failed to act" on a majority-supported shareholder proposal.

We expect that many companies will follow a "wait and see" approach, particularly if they have not previously received a shareholder proxy access proposal; however, the trend towards adopting proxy access without having received a shareholder proposal is accelerating. If faced with a proxy access proposal, counsel should be prepared to help the board and management consider the full range of options available given the company's circumstances.

Some companies may choose to proactively adopt a proxy access bylaw by board action or by requesting shareholder approval of a bylaw (or charter) amendment at the next annual meeting, in either case with or without a prior public commitment to adopt proxy access. This may help position the company as a governance leader—particularly if no shareholder proposal has been received—and, depending on the specific provisions, may minimize the likelihood of receiving a future shareholder proxy access proposal. A company taking this approach should ensure that it can justify any proxy access provision with thresholds that are more onerous than

3% for three years (e.g., by disclosing preferences of its shareholders as communicated to the company through engagement).

As companies are considering these alternatives, they should:

- Follow developments in this area and keep the nominating and corporate governance committee and the full board generally apprised.
- Know the preferences of their shareholder base (as evidenced in proxy voting policies and other public statements, and voting history on proxy access proposals) and engage with shareholders with respect to proxy access.
- Keep abreast of proxy advisory firm policies and guidance relating to proxy access.
- Stay apprised of the terms upon which companies are adopting proxy access.
- Review the advance notice and director qualification provisions in the bylaws and consider whether and, if so, how such provisions may be aligned with a proxy access provision if implemented. In addition, companies that have cumulative voting in place may wish to consider eliminating cumulative voting or requiring cumulative voting to be suspended if a proxy access nominee is included in the company's proxy materials.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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Building Meaningful Communication and Engagement with Shareholders

Mary Jo White, [excerpt, from remarks at the Society of Corporate Secretaries and Governance Professionals]

June, 2015

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Building Meaningful Communication and Engagement with Shareholders

Posted by Mary Jo White, U.S. Securities and Exchange Commission, on Thursday, June 25, 2015

Editor's note: Mary Jo White is Chair of the U.S. Securities and Exchange Commission. The following post is based on Chair White's remarks at the national conference of the Society of Corporate Secretaries and Governance Professionals, available here. The views expressed in this post are those of Chair White and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

Universal Proxy Ballots

Universal proxy ballots: there has been renewed discussion about whether the proxy rules currently provide shareholders with a sufficient range of choice in exercising voting decisions in election contests if they are voting by proxy rather than in person at the company's annual meeting. There are calls, as there were a number of years ago, for the Commission to consider requiring universal proxy ballots.

As you know, in a contested director election, it is not generally possible for shareholders to pick freely from nominees on each side's proxy cards unless they attend and vote in person at the meeting. By operation of state law requirements, the proxy rules, and practical considerations, shareholders executing a proxy face an either/or proposition: they can vote for either the entire slate of candidates put forward by management or by a proponent—they cannot pick and choose the individuals that they believe are the best candidates from the two slates.

While a proponent putting forth a minority slate of candidates under our "short slate" rule may "round out" its slate with some company nominees, it is the proponent who chooses which company nominees shareholders using the proponent's proxy card must support. State law generally provides that a later-dated proxy revokes an earlier-dated one, which can make it impossible or at least impractical to vote for some nominees on each side's card. And while under current proxy rules, both sides' nominees can consent to appear on each other's proxy cards, that consent is given very rarely, if ever.

Given these obstacles, some have requested that the Commission revise the proxy rules to facilitate the use of a "universal proxy ballot," a single proxy card that would list both management's and a proponent's nominees in contested director elections, allowing shareholders to vote for a mix of nominees of their own choosing.

As you know, we held a roundtable in February on ways to improve the proxy voting process. One panel focused on the state of contested director elections and whether changes should be

made to the federal proxy rules to facilitate the use of universal proxy ballots. It was, as always, a lively discussion.

Some strongly believed that it was past time to consider adopting the universal ballot. Others questioned whether effecting only this change to the current proxy voting system was appropriate when so many other issues have also been raised, and expressed concern about possible unintended consequences. Panelists thus differed on whether the adoption of a universal proxy ballot would increase or decrease shareholder activism or otherwise impact the outcome of election contests. Some believed that it would embolden activists to run more contests. Others posited that it could stimulate increased cooperation and settlements between issuers and activists, thereby decreasing contests. No one specifically called into question the fundamental concept that our proxy system should allow shareholders to do through the use of a proxy ballot what they can do in person at a shareholders' meeting. Given the diverse set of views represented at our roundtable, I took this as at least a bit of a breakthrough.

All of the participants agreed that if the Commission were to revise the proxy rules to implement a universal proxy ballot, the "devil would be in the details." Questions include when a universal ballot could be used, whether it would be optional or mandatory and under what circumstances, whether any eligibility requirements should be imposed on shareholders to use universal ballots, what the ballot would look like, and whether both sides must use identical universal ballots. While I agree that the "devil will be in the details," I have asked the staff to bring appropriate rulemaking recommendations before the Commission on universal proxy ballots.

But, like so many issues that seem to unnecessarily have shareholders and companies at odds, this is one where you do not have to wait for the Commission to act. Give meaningful consideration to using some form of a universal proxy ballot even though the proxy rules currently do not require it. If a company's or proponent's nominees gave their consent to appear on the other side's proxy card, then all shareholders would have the full range of voting options available to them. I realize that putting this into practice may have its challenges and that companies could choose different ways of making it work. But it could be beneficial for your shareholders. And we would welcome hearing about your experiences as we consider rulemaking in this area. Providing shareholders with the same voting rights that they would have if they were present at the meeting and eliminating procedural obstacles should be a shared goal of both companies and shareholders.

2016 Proxy Season:
Engagement, Transparency, Proxy Access

Weil, Gotshal & Manges LLP, [excerpt, p. 7]

February 2016

On the Horizon: Universal Proxy Ballots

The Staff of the SEC's Division of Corporation Finance is currently working on rulemaking recommendations for the implementation of universal proxy ballots in contested elections. Existing federal proxy rules, state law requirements and practical considerations make it virtually impossible for shareholders in a contested election to choose freely among management and proponent nominees on each side's proxy cards, unless they attend and vote in person at the shareholders' meeting. As a result, shareholders executing a proxy card currently must choose between voting for the entire slate of candidates put forward by management or voting for the slate put forth by the proponent.[25] The adoption of a universal proxy ballot system would mean that a single proxy card would list both management and proponent nominees and allow shareholders to vote for a mix of nominees in a contested election. Some have argued that the existing system favors management's nominees and that a universal ballot would serve to bolster activist campaigns, particularly when seeking minority board representation. On the other hand, a universal ballot could help management limit the impact of an activist's campaign by recommending that shareholders vote for only certain nominees on the dissident's slate.

Recent events have signaled that rulemaking could be imminent. In 2014, the Council of Institutional Investors (CII) reignited interest in universal ballots with a petition to the SEC requesting an amendment to the proxy rules to facilitate their use.[26] In February 2015, the SEC hosted a Proxy Voting Roundtable that included a panel discussion on this topic.[27] In April 2015, The California Public Employees' Retirement System (CalPERS) submitted a supplement to the Proxy Voting Roundtable in which it provided its written endorsement for the use of universal ballots.[28] SEC Chair Mary Jo White championed a universal ballot rulemaking initiative in a June 2015 speech,[29] urging companies not to wait for the SEC to act and to "[g]ive meaningful consideration to using some form of a universal proxy ballot even though the proxy rules currently do not require it."[30]

Specific issues the Staff is grappling with in connection with this rulemaking initiative include: (1) whether universal ballots should be optional or mandatory for all parties in an election contest; (2) how the ballots should look and whether both sides should be required to use identical universal ballots; (3) whether universal proxies should be available in all contests or just in "short slate" elections; (4) whether any eligibility requirements to use universal ballots should be imposed on shareholders; and (5) what timing, filing and dissemination requirements should be imposed on shareholders seeking to use universal ballots.

3. Keeping Up With Fast-Moving Proxy Access Developments

"Proxy access" represents another turning point in the corporate governance of public companies. Designed to enable shareholders to use a company's proxy statement and proxy card to nominate one or more director candidates of their own, it is increasingly gaining acceptance as corporate behemoths such as Apple, General Electric, Microsoft, IBM, Chevron, Coca-Cola, Merck, Staples, McDonald's, Goldman Sachs, JPMorgan Chase and others adopt proxy access bylaws.

Proxy access came to the forefront during the 2015 proxy season through Rule 14a-8 proposals submitted by certain pension funds and other governance-oriented activists, including 75 proposals submitted by the Boardroom Accountability Project launched by the New York City Comptroller and the New York City Pension Funds. In 2015, over 91 proxy access proposals were submitted to a shareholder vote, with 55 receiving majority support.[31] Since January 1, 2015, 124 companies have adopted proxy access bylaws, whether voluntarily or in response to a shareholder proposal, and a recent uptick in companies implementing proxy access indicates that many boards have been addressing the topic in anticipation of their 2016 annual meetings.[32] It remains to be seen whether, this season, any of the companies that have adopted proxy access will face the first round of proxy access nominees. In *Appendix I*, we provide the list of companies that have adopted proxy access bylaws since January 1, 2015.

2015 Corporate Governance Survey

Shearman & Sterling, [excerpt, pp. 34-35]

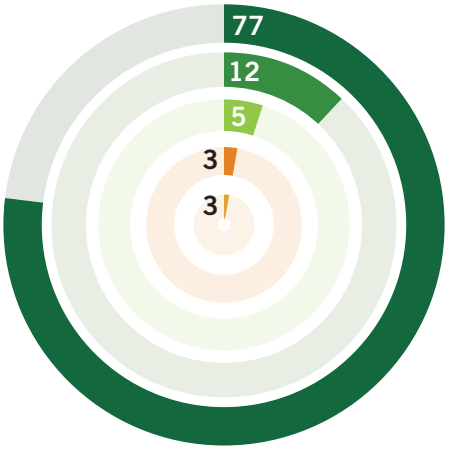
November 2015

Majority Voting Standards

Voting Standards in Uncontested Director Elections

The number of Top 100 Companies that use a majority voting standard, as compared to the plurality standard, in uncontested director elections has increased dramatically, from:

11 companies in 2006 to **94** in 2015



Of the **94** with Majority Voting:

- Directors elected by majority of votes cast AND any holdover incumbent director who receives more votes against than votes for his or her election must tender his or her resignation
- Directors elected by majority of votes cast (no resignation requirement for incumbent directors)
- Directors elected by majority of votes cast AND any holdover incumbent director who receives more votes against than votes for his or her election ceases to be a director after 90 days (or, if earlier, the date the board selects a replacement director)

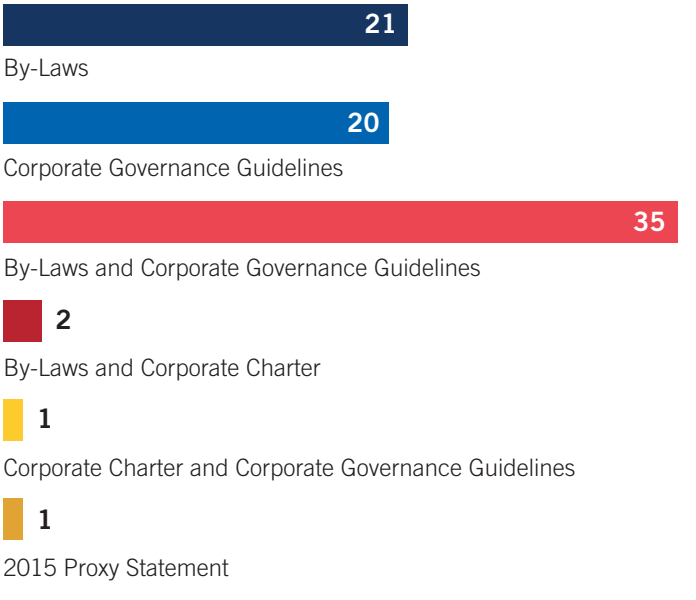
Of the **6** with Plurality Voting:

- Directors elected by plurality of votes cast AND any director who receives more votes withheld than votes for his or her election must tender his or her resignation
- Directors elected by plurality of votes cast (no resignation requirement for incumbent directors)

Director Resignation Policies

have policies requiring an incumbent director to tender a resignation if the director receives more "against" or "withhold" votes than votes for his or her election. This group of companies is comprised of 77 companies that have a majority voting standard and three that have a plurality voting standard. In addition, five other Top 100 Companies have majority voting policies that provide that any holdover incumbent director who receives more votes against than votes for his or her election ceases to be a director after 90 days (or, if earlier, the date that the board selects a replacement director).

Which corporate documents contain director resignation policies?



Who decides whether to accept or reject a tendered resignation?

Is there a presumption that a tendered resignation should be accepted?

that have adopted director resignation policies presume that a tendered resignation should be accepted unless the board finds a "compelling reason" or a "significant reason" to reject the resignation or finds rejecting the resignation is in the best interest of the company

How long does the relevant decision-making body have to determine whether to accept or reject a tendered resignation?

66

Top 100 Companies require that the decision-making body either make a decision on the tendered resignation or publicly disclose its decision within 90 days after the certification of the election results. For the remaining companies that specify a time period, most require a decision or disclosure within 60 to 120 days, while eight companies provide until the next regularly scheduled board meeting to make the decision.

Policy Variations for Holdover Directors

Incumbent directors who do not receive the majority of votes required for re-election are referred to as "holdover" directors while they remain in office.

Delaware law provides that a holdover director will remain in office until a successor is elected, or until he or she resigns or is removed.

The corporate law of a number of other states follows The Model Business Corporations Act ("MBCA") published by the American Bar Association, which provides that a holdover incumbent director ceases to be a director after 90 days, or earlier if the board selects a replacement director. The MBCA provides an alternative to the approach taken by Delaware law by permitting companies to adopt a by-law provision that empowers the board to replace a holdover director and otherwise provides a limit on the amount of time a holdover director may remain in office.

Consequently, Delaware corporations implementing a majority voting policy will typically include a resignation requirement to ensure that a director who fails to be re-elected can actually be removed from office.

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Does Majority Voting Improve Board Accountability?

Posted by Edward B. Rock, University of Pennsylvania Law School, on Friday, November 27, 2015

Editor's note: Edward B. Rock is the Saul A. Fox Distinguished Professor of Business Law at University of Pennsylvania Law School. This post is based on a paper, Does Majority Voting Improve Board Accountability?, authored by Professor Rock, Stephen J. Choi, Murray and Kathleen Bring Professor of Law at the New York University School of Law, Jill E. Fisch, Perry Golkin Professor of Law at the University of Pennsylvania Law School, and Marcel Kahan, George T. Lowy Professor of Law at the New York University School of Law.

Directors have traditionally been elected by a plurality of the votes cast (the Plurality Voting Rule or PVR). This means that the candidates who receive the most votes are elected, even if a candidate does not receive a majority of the votes cast. Indeed, in uncontested elections, a candidate who receives even a single vote is elected. Proponents of "shareholder democracy" have advocated a shift to a Majority Voting Rule (MVR), under which a candidate must receive a majority of the votes cast to be elected. This, proponents say, will make directors more accountable to shareholders.

Over the past decade, the shift to majority voting has been one of the most popular and successful governance reforms. As recently as 2005, only nine of the S&P 100 companies used majority voting in director elections. As of January 2014, almost 90% of S&P 500 companies have adopted some form of majority voting.

Yet critics are skeptical as to whether majority voting improves board accountability. Tellingly, directors of companies with majority voting rarely fail to receive majority approval—even more rarely than directors of companies with plurality voting. A striking finding in our article is that under plurality voting, the likelihood that a director fails to receive a majority "for" vote is 20 times higher than under majority voting (0.6% versus 0.03%). Of over 24,000 director nominees at S&P 1500 companies who were subject to the majority voting rule in elections between 2007 and 2013, only eight failed to receive a majority of "for" votes. Even when a director fails to receive a majority, that director may not actually leave the board. Rather, the director stays on until he or she resigns, is removed or a successor is elected. In fact, of the eight directors at majority voting firms who failed to receive a majority, only three actually left the board following the election. This poses a puzzle: why do firms switch to majority voting, and what effect does the switch have, if any, on director behavior?

At first blush, it may appear that majority voting could generate substantial indirect effects and that the reason directors fare better under majority voting is because they are more responsive to shareholders (the "deterrence/accountability" hypothesis). Thus, for example, as we detail in the article, directors subject to a majority voting are more likely to attend board meetings regularly

and less likely to receive a withhold recommendation from ISS than directors subject to plurality voting.

There are, however, alternative explanations for these differences. For example, causality may run in the other direction: companies that are more responsive to shareholders may be more likely to adopt majority voting, and majority voting may have no effect on director actions (the "selection" hypothesis). Or companies subject to majority voting may lobby ISS more heavily to avert a withhold recommendation (the "electioneering" hypothesis). Finally, shareholders may posit that a "no-vote" under MVR will have more of an effect than under PVR and pull their punches (the "shareholder restraint" hypothesis).

We empirically examine the adoption and impact of a majority voting rule using a sample of uncontested director elections from 2007 to 2013. We test and find partial support for all four hypotheses. However, our results suggest that the reasons for and effects of adopting majority voting may differ between early and later adopters of majority voting. We find that early adopters of majority voting were more shareholder-responsive than other firms even before they adopted majority voting. These firms seem to have adopted majority voting voluntarily, and the adoption of majority voting has made little difference in their subsequent responsiveness to shareholders. By contrast, for late adopters, we find stronger evidence that majority voting changed the actions of adopting firms.

Differences between early and late adopters have important implications for understanding the spread of corporate governance reforms and evaluating their effects on firms. Advocates of majority voting, rather than targeting the firms that, by their measures, are most in need of reform, instead seem to have targeted the firms that are *already* most responsive, the "easy targets." They then may have used the widespread adoption of majority voting to create pressure on the non-adopting firms.

As far as we know, this is the first time that differences between early and late adopters of governance reforms has been examined empirically. Our results show that empirical studies of the effects of governance changes need to be sensitive to the possibility that early adopters and late adopters of reforms differ from each other and that the reforms may have different effects on these two groups of firms. In particular, future research on the effect of other governance reforms such as proxy access, bylaws enabling shareholders to request a special meeting, and the separation of chair and CEO, should examine whether these effects differ for early and late adopters.

The full paper is available for download here.

Tab 3: Division of Power between Shareholders and Boards

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The Long-Term Value of the Poison Pill

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Friday, December 18, 2015

Editor's note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Daniel A. Neff, David A. Katz, Mark Gordon, and William Savitt. This post is part of the Delaware law series; links to other posts in the series are available here. Related research from the Program on Corporate Governance about poison pills includes Toward a Constitutional Review of the Poison Pill by Lucian Bebchuk and Robert J. Jackson, Jr. (discussed on the Forum here), and The Case Against Board Veto in Corporate Takeovers by Lucian Bebchuk.

Nearly six years ago, Air Products made an unsolicited all-cash bid to acquire Airgas for $60 per share (later increased to $70), to which the board of directors of Airgas said "no." Based on the Airgas directors' unanimous judgment—informed by months of thoughtful review and analysis—that Airgas was worth more than Air Products was offering, whether on a standalone basis or in the hands of another industry player, this "no" was made possible by bedrock principles of Delaware law. These principles recognize that it is the role of the board, and not raiders or short-term speculators, to determine whether and when a company should be sold, and authorize the use of appropriate measures—most notably, the poison pill—to ensure the board has the opportunity to perform this essential function.

Last month, in vindication of the Airgas board's judgment and confirmation of the wisdom of the Delaware case law (particularly the Delaware Chancery Court's 2011 *Airgas* opinion validating the use of the poison pill), Airgas agreed to be sold to Air Liquide at a price of $143 per share, in cash, nearly 2.4x Air Products' original $60 offer and more than double the final $70 offer, in each case *before* considering the more than $9 per share of dividends received by Airgas shareholders in the intervening years.

The value created by the Airgas board can be seen in this table comparing the benefit of having held a single share of Airgas continuously from the time of Air Products' bid vs. the value of having accepted Air Products' bid and then reinvesting the proceeds in the S&P 500, in each case with all dividends reinvested. The results are shown on a total shareholder return ("TSR") and current value basis:

		Airgas Standalone, without Air Products Deal		Investor Receiving Air Products' Offer Price, with proceeds invested in the S&P 500
Measured from termination of final $70 bid (2/15/11)*	TSR	143%	*vs*	88%
	Current Value	$156	*vs*	$121
Measured from start of original $60 bid (2/5/10)**	TSR	264%	*vs*	205%
	Current Value	$158	*vs*	$133

Airgas' success reminded us of the long term success of McGraw-Hill, which rejected a high-premium, all-cash takeover bid in 1979 (See our memo Just Say No, December 5, 2014). In the 35 years following that rejection, McGraw-Hill's shareholders experienced TSR of 13,263% compared to approximately 5,280% for the S&P 500.

The Airgas and McGraw-Hill results provide clear rebuke to critics of the poison pill and to critics of board-primacy generally, who have argued that takeover defenses lead to board entrenchment and that boards do not possess the judgment and skill to know better than "the market" the long-term value of the corporation. To the contrary, in our experience, boards work very hard to do the right thing in takeover situations, carefully assessing industry and general economic conditions, their company's probability-weighted prospects and the associated risks and uncertainties, and the timing of—and possibility of opportunism in—the unsolicited bid.

While Airgas' and McGraw-Hill's respective successes from saying no (and other such successful examples) do not mean that saying no is always the right answer to every unsolicited takeover bid, it does show that the points we have been making since 1979 remain true today:(1) boards have proven remarkably adept and successful in exercising their discretion in the takeover context; (2) this success discredits those who claim their studies "prove" that board discretion in any individual situation leads to the wrong outcome for shareholders; and (3) because each context is different, it is wrong to adopt one-size-fits-all policies that restrict or undermine the ability of a board to "just say no" (or that attack a board merely for doing so) in a situation where the board, exercising its fiduciary duties, determines the bid is not in the best interest of the shareholders.

* TSR from February 16, 2011 (the date after the Chancery Court decision upholding Airgas' use of the poison pill) through November 18, 2015, with dividends reinvested, and assuming an initial investment of $64.35, the Airgas closing price on February 16, 2011. Current value assumes ownership from February 16, 2011 through November 18, 2015, with dividends reinvested. Current value of continuous Airgas investment is based on Air Liquide deal price of $143 per share. Offer proceeds assumed to be $70 per share, in cash.

** TSR from February 5, 2010 (the date of first public announcement of Air Products' all-cash $60 bid) through November 18, 2015, with dividends reinvested, and assuming an initial investment of $43.53, the Airgas closing price on February 4, 2010. Current value assumes ownership from February 5, 2010 through November 18, 2015, with dividends reinvested. Current value of continuous Airgas investment is based on Air Liquide deal price of $143 per share. Offer proceeds assumed to be $60 per share, in cash.

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Shareholder Returns of Hostile Takeover Targets

Posted by Sabastian V. Niles, Wachtell, Lipton, Rosen & Katz, on Friday, October 24, 2014

Editor's note: Sabastian V. Niles is counsel in the Corporate Department at Wachtell, Lipton, Rosen & Katz, where he focuses on rapid response shareholder activism, takeover defense and corporate governance. This post is based on a Wachtell Lipton firm memorandum by Mr. Niles and Eric S. Robinson.

This morning [October 22, 2014], Institutional Shareholder Services (ISS) issued a note to clients entitled "The IRR of 'No'." The note argues that shareholders of companies that have resisted hostile takeover bids all the way through a proxy fight at a shareholder meeting have incurred "profoundly negative" returns following those shareholder meetings, compared to alternative investments. ISS identified seven cases in the last five years where bidders have pursued a combined takeover bid and proxy fight through a target shareholder meeting, and measured the mean and median total shareholder returns from the dates of the contested shareholder meeting through October 20, 2014, compared to target shareholders having sold at the closing price the day before the contested meeting and reinvesting in the S&P 500 index or a peer group.

A close look at the ISS report shows that it has at least two critical methodological and analytical flaws that completely undermine its conclusions:

- ISS's analysis refers to Terra Industries as one of the seven cases in the last five years where a target had resisted a hostile bid through a shareholder vote on a bidder's nominees, but the analysis then excludes Terra from its data analysis, by limiting it to targets that ultimately remained standalone. Terra is one of the great success stories of companies that have staunchly resisted inadequate hostile takeover bids, even after the bidder succeeded in electing three nominees to its board, and ultimately achieved an outstanding result for shareholders. As ISS notes, if the pre-tax cash proceeds of the final cash-and-stock offer for Terra had been reinvested in shares of the bidder, Terra shareholders would have seen a total return of 271% from the date of the initial shareholder meeting through October 20, 2014, significantly beating the S&P 500 Index and the median of peers by 181 and 211 percentage points, respectively. Had ISS properly included Terra in its analysis of "The IRR of 'No'", the mean return of the seven companies would have beaten the S&P index by 18.4 percentage points (compared to a shortfall of 8.7 percentage points when Terra was excluded) and beaten the ISS peer groups by 10.0 percent (compared to a shortfall of 23.6 percentage points excluding Terra).
- Of the seven cases discussed in the analysis, one was a micro-cap company with a market cap of $250 million (Pulse Electronics) and one was a nano-cap company with a market cap of $36 million (Onvia). The other five companies, including Terra, had market caps between approximately $2 billion – $8 billion, yet ISS treats them all equally. A

market-cap weighted analysis would have had dramatically different results. Excluding the micro-cap and nano-cap companies from the analysis, the mean and median returns for the five companies (including Terra) exceeded the S&P Index by 65.4 percentage points and 1.4 percentage points, respectively, and exceeded the respective peer groups by 57.6 percentage points and 20.8 percentage points, respectively.

More broadly, the real world of corporate takeover practice demonstrates that prudent use of structural protections and “defensive” strategies provides boards—and shareholders—with the benefits of substantial negotiating leverage and enhanced opportunity to demonstrate that the company’s stand-alone strategy can deliver superior value.

The IRR of "No"

Statistically speaking, one of the worst strategies for buying a company is to push your hostile bid all the way to a vote of your target's shareholders.

In the past five years, only one hostile bidder which has gone all the way to a shareholder vote—CF Industries—walked away with the prize. In each of the other six contests—including the other one where, like CF, the bidder's nominees were elected by shareholders—the target remained independent.

But this much is already widely known. What is less well-known is how all this has worked out for the potential sellers—not the executives and directors who lead the "Just Say No" defense, but the shareholders themselves who, in five of these six cases, voted to continue saying No.

Measured on an absolute basis, the median cumulative Total Shareholder Return (TSR) for targets which remained independent through Oct. 20, 2014 following an M&A proxy contest was 50.4%. But absolute return is a naïve view of the issue: the real question is what return shareholders might have had by redeploying their capital into the next best alterative to keeping the target standalone.

Relative to those next best alternatives, it turns out, the median return to shareholders of saying No is profoundly negative.

Had shareholders in these six firms sold at the closing price the day before the contested meeting and reinvested in:

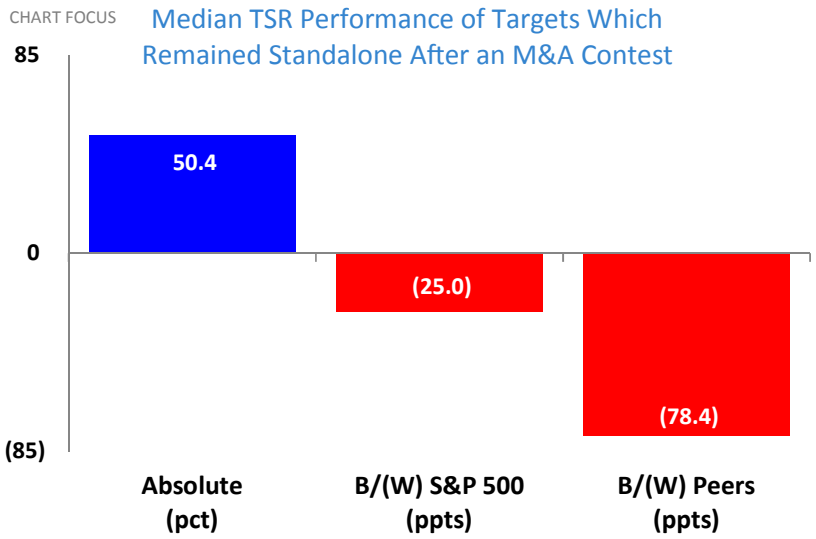
- the broader market, as through an S&P 500 Index fund, they would have earned at the median an additional 25.0 percentage points through Oct. 20, 2014;
- the sector, through a group of close peers, they would have realized at the median an additional 78.4 percentage points through the same date.

In the case of all six of these targets, the underperformance relative to investors' next-best alternatives began immediately after the show-me moment of the M&A proxy contest, and was generally sustained throughout the first 1, 3, 6 and 12 months after the contested election. At the median, the six firms underperformed the broader market by 2.0, 7.1, 21.5, and 10.6 percentage points over these periods, respectively. Despite mitigating measures like post-contest buybacks, moreover, these firms generally posted negative absolute performance over most of those four measurement periods.

COMPANIES DISCUSSED IN THIS NOTE:

- AGN Allergan
- ILMN Illumina
- ARG AirGas
- PULS Pulse Electronics
- NRG NRG Energy
- CASY Caseys Gen. Stores
- ONVI Onvia
- TRA Terra Industries

CHART FOCUS



From date of contested election rough Oct. 20, 2014. Sources: Bloomberg Finance LP (TSR), ISS (peers).

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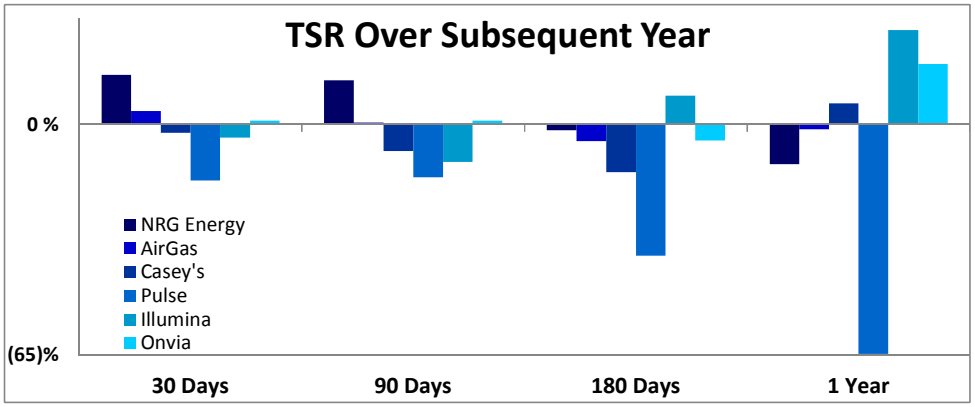
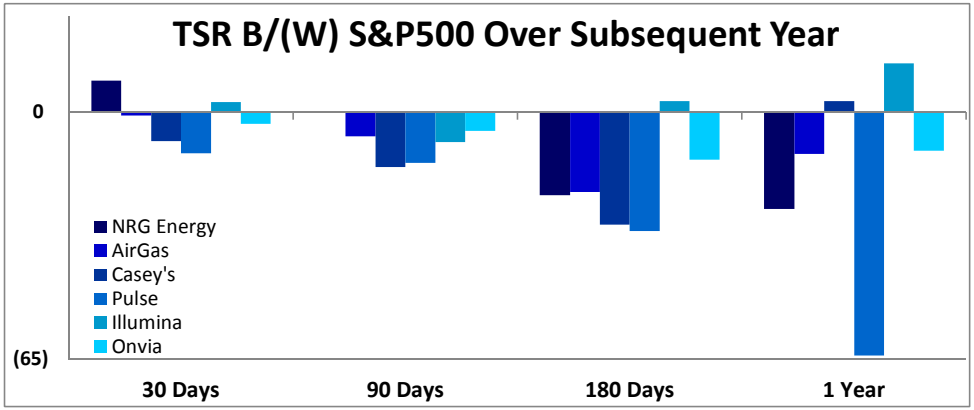
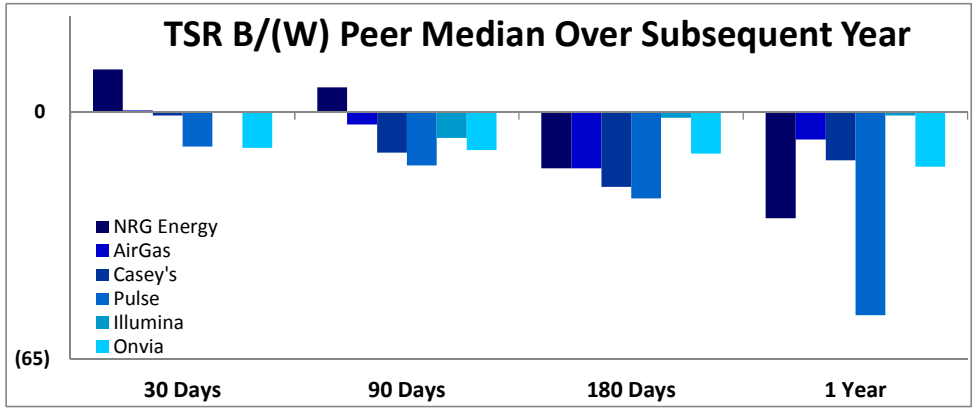


Only a small amount of this underperformance appears to have been due to the sector in which they operated. The six targets underperformed the median of their peers, over the same four time periods, by 0.5, 8.4. 14.9, and 13.6 percentage points, respectively.

For the full period from the contested election through Oct. 20, 2014 (which ranged from 2.4 to 5.3 years), three of the six eventually recovered some ground versus the broader market performance. Only two of them—Illumina and AirGas—reversed the negative trend relative to the median of their peers.





How Saying "No" Compared to S&P500 Index Performance

	Contested Meeting	TSR B/(W) S&P500 Index After: 30 Days (ppts)	90 Days (ppts)	180 Days (ppts)	1 Year (ppts)	TSR B/(W) Index to date* (ppts)	(years)
NRG Energy	7/21/2009	8.2	0.1	(21.9)	(25.5)	(107.4)	5.3
AirGas	9/15/2010	(0.9)	(6.4)	(21.1)	(11.0)	(5.2)	4.1
Casey's	9/23/2010	(7.7)	(14.4)	(29.6)	2.8	1.4	4.1
Pulse	5/18/2011	(10.8)	(13.4)	(31.3)	(64.1)	(153.5)	3.4
Illumina	4/18/2012	2.6	(7.9)	2.9	12.7	257.2	2.5
Onvia	5/31/2012	(3.1)	(5.0)	(12.5)	(10.2)	(44.8)	2.4
Median		(2.0)	(7.1)	(21.5)	(10.6)	(25.0)	3.8
Mean		(2.0)	(7.9)	(18.9)	(15.9)	(8.7)	3.6

**Data as of: 10/21/2014*

How Saying "No" Compared to Peer Median Performance

	Contested Meeting	TSR B/(W) Peer Median After: 30 Days (ppts)	90 Days (ppts)	180 Days (ppts)	1 Year (ppts)	TSR B/(W) Peers to date* (ppts)	(years)
NRG Energy	7/21/2009	11.2	6.5	(14.8)	(28.0)	(99.1)	5.3
AirGas	9/15/2010	0.4	(3.3)	(14.9)	(7.2)	20.8	4.1
Casey's	9/23/2010	(0.9)	(10.7)	(19.7)	(12.7)	(91.8)	4.1
Pulse	5/18/2011	(9.1)	(14.1)	(22.7)	(53.5)	(153.0)	3.4
Illumina	4/18/2012	(0.0)	(6.8)	(1.5)	(0.9)	246.9	2.5
Onvia	5/31/2012	(9.5)	(10.0)	(11.0)	(14.4)	(65.1)	2.4
Median		(0.5)	(8.4)	(14.9)	(13.6)	(78.4)	3.8
Mean		(1.3)	(6.4)	(14.1)	(19.5)	(23.6)	3.6

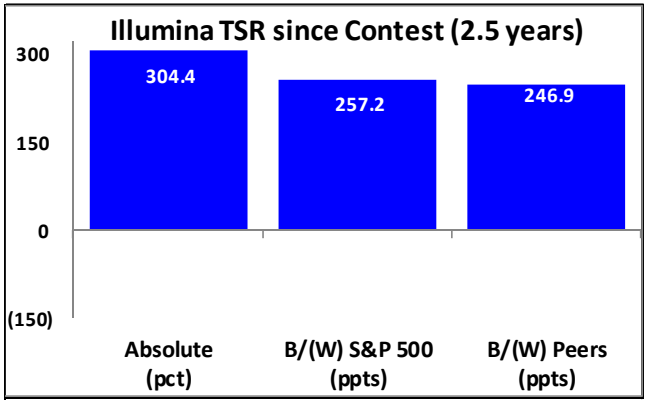
**Data as of: 10/21/2014*

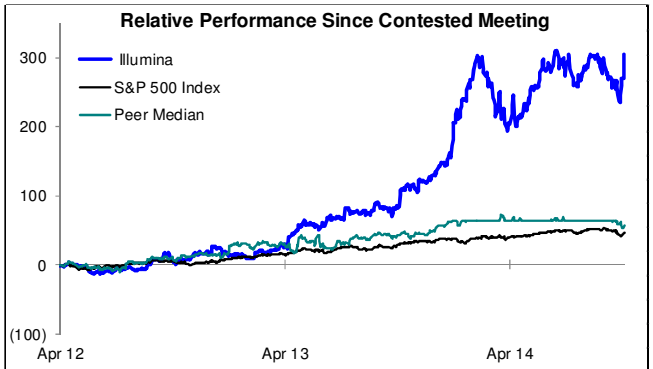
What Differentiates Good Bets from Bad?

The conventional wisdom is that giving additional time to a board facing a hostile bid improves the outcome for shareholders. This makes some intuitive sense, if the board uses that time to better inform the market about sources of hidden value: ideally, the target board convincingly demonstrates higher intrinsic value to investors, or wins a more compelling offer after initially saying No, or both, without ever going to a contested vote.

For those which do go all the way to a vote yet remain independent, however, the abysmal subsequent returns relative to shareholders' next best alternatives suggest something in the process has gone awry.

The real question for shareholders looking at this data—or considering their voting strategies in upcoming M&A contests, such as the expected Dec. 18 special meeting at Allergan—is what differentiates the good bets from the bad?





Source: Bloomberg Finance LP. Peers: Myriad Genetics Inc, Life Technologies Corp, Thermo Fisher Scientific Inc, Perkinelmer Inc, Bruker Corp

Verifiable Scarcity Value Matters

In only one of the six cases was leaving the company standalone a clear homerun—though in the heat of the contested election, that may not have been so obvious from outside the boardroom.

In 2012, **Illumina**, a leading equipment maker in the nascent DNA sequencing market, faced a hostile tender offer from Roche Holding Ltd. Approximately one-third of Illumina's revenues came from the National Institutes of Health, but in the wake of the 2011 government shutdown, the ongoing uncertainty about the nature and extent of forthcoming federal budget cuts drove a steep decline in Illumina's stock price. At the point of the shareholder vote, the $51.00 in cash per share which the hostile bidder was offering represented an 88% premium to the undisturbed price from six months earlier. It also appeared to represent a significant premium when measured by traditional M&A metrics, such as LTM EV/EBTIDA multiples.

Illumina argued, however, that its true value was intimately tied to the development of the broader genetic sequencing market, which it contended was much closer to viability than Roche had argued. As much as the stand-alone strategy held risk for Illumina shareholders, moreover, the risk for Roche of not having Illumina—a market leader already on its way to ubiquity in the first sequencing market, and with all the beneficial network effects that implies—was likely still larger, and should thus drive a much headier valuation. Completely aside from its stand-alone prospects and valuation, Illumina argued, it had significant scarcity value for a strategic bidder—and for this bidder in particular.

The arguments about the potential addressable market, and particularly about the scarcity value of the asset, resonated with shareholders, who overwhelmingly rejected the bidder's nominees.

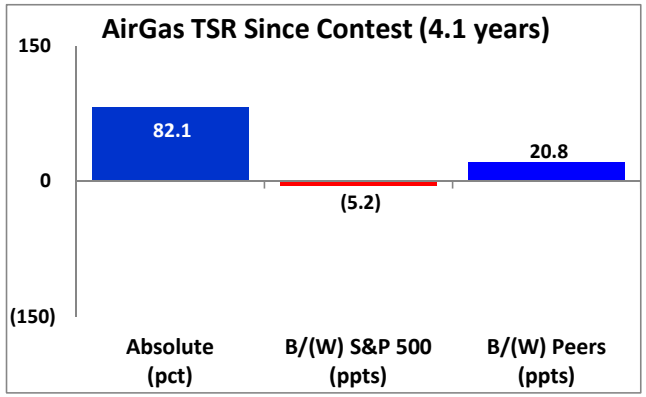
And though Illumina's shares did not begin to outperform the next best alternatives—the S&P 500 and the median of its peers—for as much as a year, both arguments have since been borne out in the company's operating results.

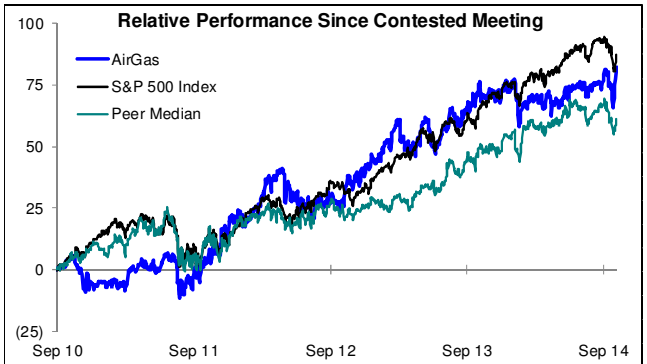
As a consequence, saying No—and remaining invested in Illumina as a standalone entity over the subsequent two-and-a-half years—has delivered TSR of 304%, significantly outperforming the next best alternatives of the broader market (by 257 percentage points) and sector peers (by 247 percentage points).

Credibility on Business Dynamics Matters

Two years before Illumina, the board at **AirGas**, the largest U.S. distributor of industrial, medical, and specialty packaged gases, made a similar argument about scarcity value in resisting a $65.50 all-cash bid from Air Products, which was looking for a "highly efficient re-entry into the U.S. packaged gas market."

AirGas, its board argued, had a singular, and not easily replicated, position atop a fragmented U.S. packaged gas market. Through approximately 400 acquisitions over the previous quarter century–including the acquisition of Air Product's packaged gas business eight years earlier—AirGas had accumulated a 25% share of the $12.5 billion U.S. packaged gas and welding hardgoods market, approximately equal to the combined market share of the four major producers still competing in that market. For any major producer to enter the market, the choices were to roll up the best of the approximately 900 small independents, or to buy AirGas.





Source: Bloomberg Finance LP. Peers: Praxair Inc, Air Liquide SA, Linde AG, Air Products & Chemicals Inc

But "scarcity value" is not something that drives higher standalone value unless, as with Illumina, there is also considerable market opportunity on the horizon from which the target company is unusually well-positioned to benefit. At AirGas, the board also argued that the retail business was just emerging from a cyclical trough, in which operating performance would grow rapidly.

EBITDA margins had climbed above 18% in its most recent quarter, and the board was projecting substantial EPS growth over the opening few years of the cycle. For CY 2012 the board projected EPS of $4.20. Analyst consensus , immediately before the emergence of the Air Products offer, was just $3.69 for FY 2012, and $4.16 for FY 2013 (three quarters of which were in CY 2012).

At the contested meeting in September, shareholders elected the bidders' three nominees but did not approve the bidder's proposal to pull ahead the next annual meeting—at which it could have nominated enough additional candidates to change control of the board—to the following January. While two companies sparred over that and other tactical issues in the Delaware courts, the new directors dug in—and ultimately declared they also believed, based on the evidence from inside the boardroom, that the Air Products offer undervalued the company.

Though AirGas has not enjoyed the runaway success of Illumina, it has posted a cumulative TSR of 82% over the four years since the contested meeting. This was marginally below the S&P 500 Index (5.2 percentage points) by Oct. 20, 2014, but for much of those 4.1 years AirGas shares had performed in line with, or above, the broader market index. AirGas also significantly outperformed (21 percentage points) the median of peers through Oct. 20, 2014.

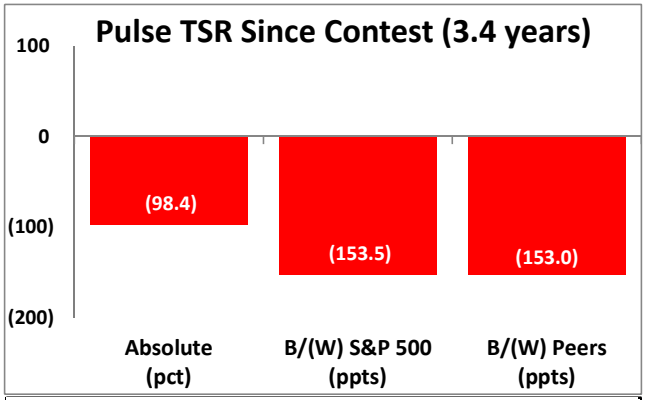
Moreover, shareholders retain the full rights of ownership—bearing out the board's point in 2010 that the Air Products offer at the time of the vote carried no meaningful premium for the change in control.

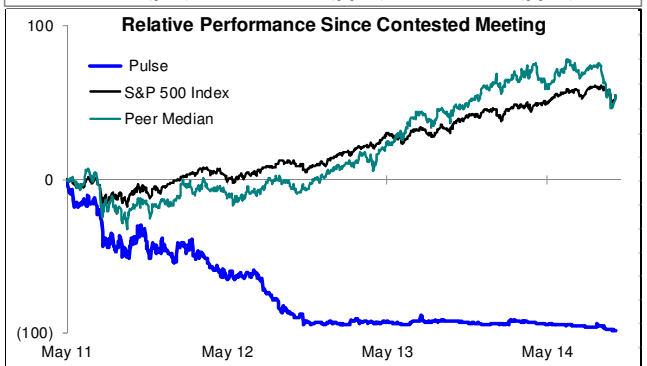
"Self-Help" Strategies Don't Help

By contrast with both Illumina and AirGas, the board of **Pulse Electronics** fell back on the argument that, having just revamped its management team, it simply needed enough time to demonstrate what it could do.

It was likely helped in this argument by the fact that shares had been falling for some time, but the $6 unsolicited offer from Bel Fuse which resulted in an M&A contest at the 2011 annual meeting still represented only a meager premium to trading prices—and that the bidder itself hadn't made any definitive offer directly to shareholders, or even specified the final form. The bidder, moreover, nominated two candidates on a platform of operating and governance reform—not, as in the case of every other hostile bidder in the sample, on the platform of getting a fair hearing for its offer.

Though shareholders rejected the bidder's nominees, the performance since then has been spectacularly poor—a loss of 98% of value on an absolute basis, and a 153 percentage point underperformance of both the broader market and the median of peers over the ensuing 3.4 years.





Source: Bloomberg Finance LP. Peers: Littelfuse Inc, Espey Mfg & Electronics Corp, Cognex Corp, Chase Corp, General Cable Corp, Coleman Cable Inc, TE Connectivity Ltd, Bel Fuse Inc

For shareholders looking for lessons to apply in the future, Pulse stands out for two reasons:

1. Its performance since the contested election, which is the mirror image of Illumina's, suggests shareholders should be particularly wary of any "defense" built around a board which has only recently begun to see the light, changing executives or strategic plan or both.

   Much of this post-contest performance appears to be due to the dire financial straits into which Pulse had slid: by January 2013, shareholders were being asked to approve a massively-dilutive recapitalization with Oaktree Capital, which now controls the company with 70% of outstanding shares.

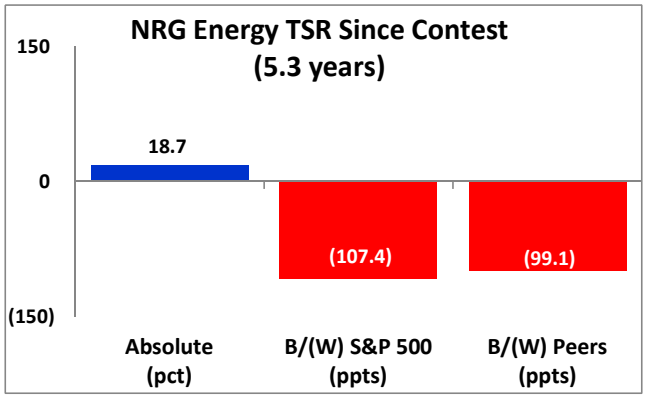
2. It is not clear shareholders had a truly viable alternative from a bidder that refused to make a firm offer, in cash or in stock, and presented itself in the proxy contest—despite being a competitor—as interested primarily in improving the business and corporate governance.

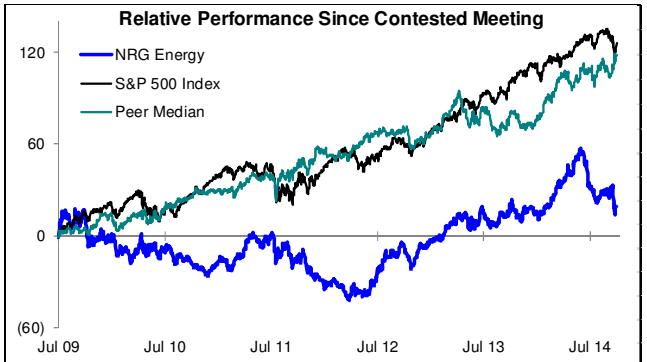
As a special bonus for those with an interest in karma, Pulse is also interesting for having appointed a new CEO just weeks before the hostile bid who had himself been a nominee in another M&A contest, at **NRG Energy**, two years before.

By NRG's July 2009 contested meeting, Exelon Corp's all-stock bid offered a premium of 44% to the undisturbed price of the previous October.

In the interim, however, NRG had taken a number of self-help initiatives, to demonstrate it could achieve higher value while remaining independent. These included an accretive opportunistic acquisition of Reliant Energy, whose retail operations gave it countercyclical earnings power; R&D initiatives in nuclear, wind and solar energy which hadn't yet blossomed; and launching significant cost and operating performance improvements which, the board projected, had it on track to post a six-year EBITDA CAGR of 21% and a free cash flow yield of 23%.

At the annual meeting, shareholders rejected the bidder's nominees, putting their faith in the self-help narrative.



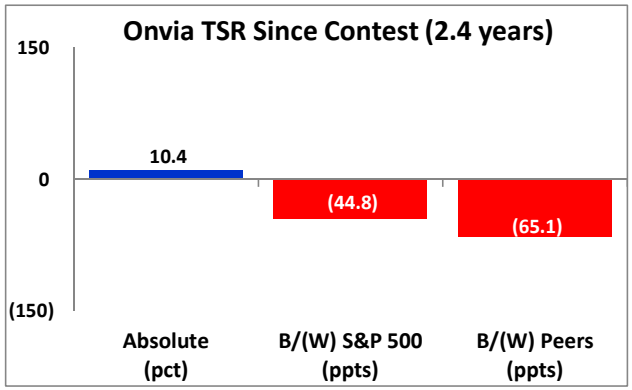


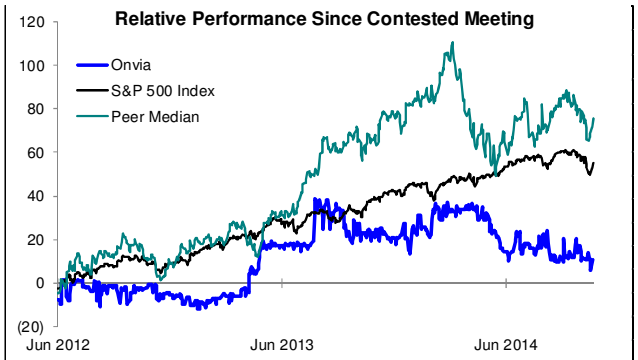
Source: Bloomberg Finance LP. Peers: American Electric Power, Calpine Corp, The Southern Co, Edison International, Xcel Energy Inc, NV Energy Inc, Alliant Energy Corp, Exelon Corp

Over the subsequent 5.3 years, they saw a cumulative TSR of just 18.7%. This was 107 percentage points worse than the next best alternative of reinvesting in the broader market, and 99 percentage points worse than reinvesting in peers. Though performance was positive on an absolute basis, the lesson from an investor's perspective– based on the perspective of return relative to the next best alternative—is similar to Pulse: a board's own self-help plan, particularly if launched in response to or amid a hostile bid, is unlikely to return strong value over a sustained period.

When **Onvia** received an unsolicited offer cash offer from 14.6% shareholder Symphony Technology Group in early 2011, the board—which had just hired a new CEO for its turnaround plan a year earlier—rejected the offer as undervaluing the company's potential. When the same shareholder made another, lower offer a year later, the board also rejected that offer—and the bidder launched a proxy contest for the three seats up for election in May.

The bidder did not make a public tender offer, but its last offer to the board did appear to undervalue the company on key M&A valuation multiples. The bidder emphasized that its offer represented a premium of 41% to the 30-day average trading price before its offer became known—but the company was so thinly traded (on 27% of trading days over the previous year, no shares were traded at all) that premium to market appeared to be less relevant than valuation multiples.





Source: Bloomberg Finance LP. Peers: Ultimate Software Group Inc, Ptc Inc, Dealertrack Technologies Inc, Netsuite Inc

The board emphasized, in its defense, that it was not against selling the company, it merely believed pursuing a sale before the turnaround plan was completed was unwise. The hostile offer, it believed, did not account for the additional value to be created under that strategic plan. Shareholders generally agreed, rejecting the bidder's nominees at the annual meeting.

Over the subsequent 2.4 years through Oct. 20, 2014, as it executed on its strategic plan the company posted a cumulative TSR of just 10.4% - worse than the next best alternatives of reinvesting in the S&P 500 Index or in peers by 45 and 65 percentage points, respectively.

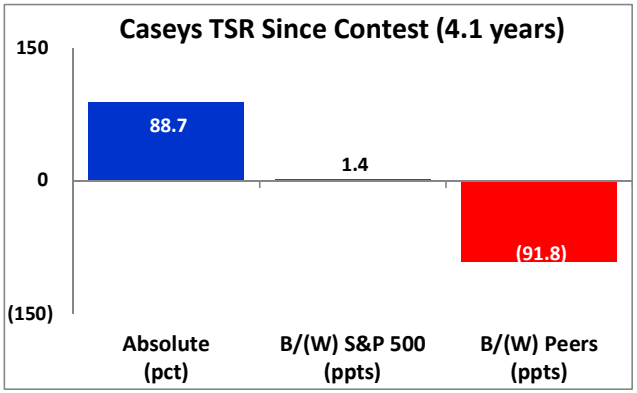
Defensive Tactics May Signal Greater Issues

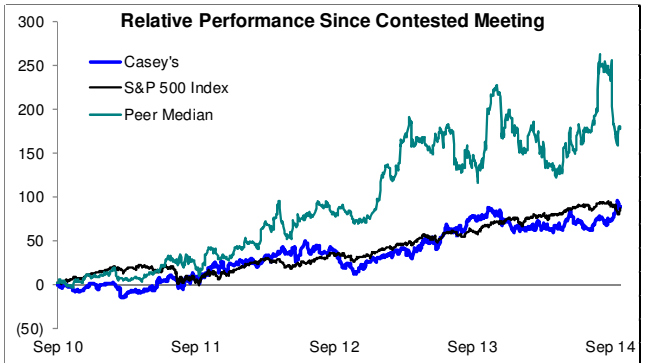
When Canadian issuer Alimentation Couche-Tard made its initial $36.00 per share offer for **Caseys General Stores** in 2010, it explained its interest as the ability to leverage Caseys operational expertise in rural locations and food service, which would better position the combined company to compete. But Couche-Tard made its initial offer without any committed financing—and then took the opportunity of the subsequent run-up in the target's stock to sell its 3.9% toehold for $38.43 per share, a peculiar move for any bidder trying to convey commitment to the marketplace. Compared to precedent transactions, its offer appeared undervalued both on EV/EBITDA and PE multiples, and was below the historical average premium of hostile deals generally.

Against this backdrop, the Caseys board demonstrated its conviction that the Couche-Tard offer significantly undervalued the company by completing a Dutch self-tender at $38 per share, with 53% of shares tendered by mid-August. In one mutually-agreeable transaction, this handily removed from the shareholder base any shareholders who might have felt the Couche-Tard offer a compelling starting point for negotiations.

Those who remained, however, discovered that the debt agreements which funded the buyback contained a "poison put" provision which, in the event of a sale in the near term, would transfer a significant portion of the firm's value—more than 16% of par value, or greater than $2 per share after accounting for the self-tender—from equity holders to debt holders through a "make-whole" payment. Make-whole provisions are not uncommon in debt agreements, but they are generally in the range of 1-3% of par. Offering such a significant make-whole in the midst of an M&A contest, with the company already in play and the probability of payout significantly higher, is also uncommon. A few weeks later, when 7-Eleven made a preliminary indication of interest at around $40, the wisdom of that poison put began to seem even more questionable.

Ultimately shareholders rejected the bidder's nominees, and the potential bidder in the shadows faded away, as potential bidders, their usefulness at an end, are sometimes wont to do. Over the





Source: Bloomberg Finance LP. Peers: Susser Holdings Corp, Pantry Inc, Travelcenters Of America LLC, Alimentation Couche-Tard

subsequent 4.1 years through Oct. 20, 2014, Caseys posted a TSR of 89%, 1.4 percentage points above the next-best alternative of the S&P 500 Index. But it also underperformed peers by 92 percentage points, underscoring the point that defensive tactics beget of one's own balance sheet, or the evanescent hint of a better deal in the offing (despite new hurdles introduced by other defensive tactics), may speak volumes about a board's focus.

Other Notable Factors

On average—and including CF's ultimately successful pursuit of **Terra Industries** in this data set—hostile bids took about six months between first public announcement and the contested shareholder vote.

Over that period some boards won significant increases through a number of successive "bumps" and valuation increases. Terra, with four bumps and a total increase in offer value (fueled by a rising CF share price)—of 117% over the more than 10 months prior to the shareholder vote, was the most notable of these. At the median, however, shareholders saw only 1 bump, for an increase of just 9.2%, prior to the proxy contest itself. If the purpose of saying No is to win the target board more time, it does not often, apparently, win the target shareholders a much richer bid to consider when the matter finally comes to a shareholder vote.

Among the six firms which remained independent after the M&A contest, four had classified and two had declassified boards. Only one of the declassi-

Structural Challenge (US M&A Contests, 2009-14)

Target	Voted	Bidder	Shares Held: Bidder [a] (%O/S)	Shares Held: Board (%O/S)	Shares Held: CEO (%O/S)	GICS Sector	Public Campaign (months)	Control Slate?	Target's Board
Terra Industries	11/20/09	CF Industries	7.0%	0.9%	0.6%	Agricultural Chemicals	10.3	No	Classified
NRG Energy	7/21/09	Exelon Corp	0.0%	0.8%	0.6%	Independent Power Prod.	8.4	Yes [b]	Classified
Airgas Inc.	9/15/10	Air Products	0.0%	11.0%	10.2%	Industrial Gases	7.4	No	Classified
Casey's Gen. Stores	9/23/10	Alimentation Couche Tard	3.9%	0.4%	0.1%	Food & Staples Retailing	5.6	Yes	Declassified
Pulse Electronics	5/18/11	Bel Fuse	0.8%	0.3%	0.0%	Electronic MFG Svcs	2.6	No	Declassified
Illumina, Inc.	4/18/12	Roche Holding Ltd	0.0%	3.3%	1.8%	Life Sciences Tools & Svcs	2.8	Yes [b]	Classified
Onvia	5/31/12	Symphony Technology Grp	14.6%	11.4%	0.7%	Internet Software & Svcs	4.1	No	Classified
		mean	3.8%	4.0%	2.0%		5.9		
		median	0.8%	0.9%	0.6%		5.6		

Sources: SEC filings, ISS data

Notes:
[a] Exelon: 500 NRG shares; Air Products: no ARG shares; Roche: 100 Illumina shares.
[b] Other ballot proposals would have expanded board and elected additional bidder nominees, enabling a change in control of the board despite the classified structure.

Offer and Outcome (US M&A Contests, 2009-14)

Target	Voted	Bidder	Offer on Date of Shareholder Vote: Market Value (per share)	Market Value (mils)	Form	Bumps	Dissidents Elected?	Ultimate Resolution
Terra Industries	11/20/09	CF Industries	$ 40.64	$ 4,057	Cash/Stock	Four (117%)	Yes	Sweetened & sold
NRG Energy	7/21/09	Exelon Corp	$ 28.37	$ 7,915	All Stock	One (10.2%)	No	Remained standalone
Airgas Inc.	9/15/10	Air Products	$ 65.50	$ 5,478	All Cash	Two (9.2%)	Yes	Remained standalone
Casey's Gen. Stores	9/23/10	Alimentation Couche Tard	$ 38.50	$ 1,962	All Cash	Two (6.9%)	No	Remained standalone
Pulse Electronics	5/18/11	Bel Fuse	$ 6.00	$ 250	TBD [a]	None	No	Remained standalone
Illumina, Inc.	4/18/12	Roche Holding Ltd	$ 51.00	$ 6,286	All Cash	One (14.6%)	No	Remained standalone
Onvia	5/31/12	Symphony Technology Grp	$ 4.25	$ 36	All Cash	None	No	Remained standalone
		mean		$ 3,712		1.4 (22.6%)		
		median		$ 4,057		1.0 (9.2%)		

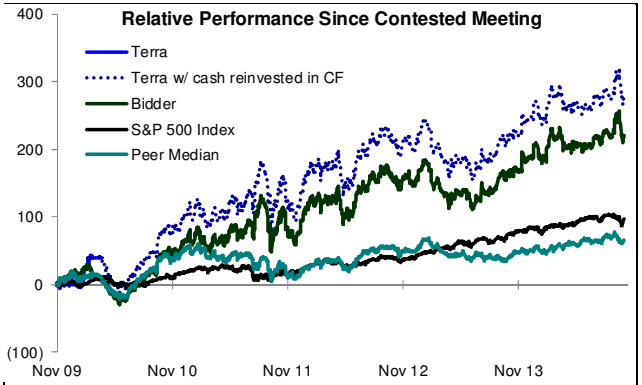
Sources: SEC filings, ISS data

Notes:
[a] No formal tender offer at time of contest; public statements indicated offer would be in cash, non-voting shares of bidder, or both.

fied boards faced a control slate contest, however— while two of the four classified board faced a change in control through other ballot proposals which would have completed an end-run around the structure.

The two firms which remained independent, and whose post-contest performance validated that outcome, were the only firms with significant shareholdings by the CEO. At AirGas, the founder/CEO held 10.4% of shares. At Illumina, the CEO held 1.8% of shares. At the remaining target firms, however, the CEO held only a fraction of a percent of shares: at the median, CEOs of the targeted companies held just 0.6% of outstanding shares.

It is tempting to highlight the fact that the two firms which proved to be better investments relative to shareholders' next best alternatives were both firms whose CEOs had significantly larger economics at risk. The fly in that ointment, however, is Terra—whose CEO held just 0.6% of shares, but which delivered significant shareholder value by garnering a higher bid from a third party, then forcing the initial bidder to top it with a cash-and-stock offer. If all pre-tax cash proceeds had been reinvested in shares of the bidder, shareholders would have seen a total return of 271% through Oct. 20, 2014, significantly beating the S&P 500 Index and the median of peers by 181 and 211 percentage points, respectively.



Source: Bloomberg Finance LP. Peers: Agrium Inc, The Mosaic Co, Yara International ASA, CF Industries Holdings Inc

Even including shares held by CEOs, the median shareholding of the target boards was just 0.9%. Only at Onvia did the independent directors have significant shareholdings, at 10.7% of outstanding shares. Yet even with significant economics at risk, that board's faith in the turnaround and strategic plan has not been borne out after more than 2 years.

Bidder toeholds, on the other hand, varied significantly, from 14.6% at microcap Onvia to a nominal few hundred shares at the three largest target firms (NRG Energy, AirGas, and Illumina). At the fourth largest—Terra—the bidder took a toehold of 7%, however, bucking the trend for multibillion dollar hostile bids.

* * *

We will continue to monitor this situation and market trends, speak with interested parties and, where relevant, issue additional *M&A Edge* notes to provide further information and guidance for clients.

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Special Meeting Proposals

Posted by Avrohom J. Kess, Simpson Thacher & Bartlett LLP, on Thursday, August 13, 2015

Editor's Note: Avrohom J. Kess is partner and head of the Public Company Advisory Practice at Simpson Thacher & Bartlett LLP. This post is based on a Simpson Thacher memorandum by Mr. Kess, Karen Hsu Kelley, and Yafit Cohn. The complete publication, including footnotes, is available here.

Shareholders petitioning the board for the special meeting right propose either to create the right or, in circumstances where the right already exists, to lower the minimum share ownership threshold required to exercise the right. As of June 30, 2015, 339 companies in the S&P 500 and Fortune 500 already provided their shareholders with the right to call a special meeting outside of the usual annual meeting. During the 2015 proxy season, 20 special meeting shareholder proposals went to a vote at Russell 3000 companies. Of these, six proposed to create the right, and 14 proposed to lower the ownership threshold with respect to an existing right. Only four special meeting shareholder proposals received majority support: three created the right for the first time and one lowered the threshold for an existing right to 25%. Overall, shareholder proposals relating to special meetings received average shareholder support of 43.6% this proxy season.

Positions of the Proxy Advisory Firms

Institutional Shareholder Services Inc. ("ISS")

ISS prefers a 10% minimum shareholding threshold as opposed to the 20%-25% threshold typically favored by management. Notwithstanding its preference, ISS recommended a vote "for" nearly all shareholder proposals in 2015, even those that proposed a threshold greater than 10%. Likewise, ISS recommended a vote "for" nearly all (12 of 14) management proposals in 2015, even though none of them proposed a threshold of 10% and some were submitted together with a directly conflicting shareholder proposal. Presumably, ISS takes the position that some right is better than no right.

Equally important is ISS's policy on substantial implementation—if ISS determines that a proposal that received majority support was not substantially implemented by the board, ISS will recommend a vote "against" one or more directors the following year. Failure to substantially implement the proposal includes situations where the board implements the proposal at a different ownership threshold than the one proposed and/or where the board imposes significant limitations on the right.

In addition, ISS takes into account the "inability of shareholders to call special meetings" as a factor in considering whether to recommend a vote against an entire board of directors where the

board “lacks accountability and oversight, coupled with sustained poor performance relative to peers.”

Finally, ISS considers the special meeting right when calculating its Governance QuickScore in both the Board Structure Pillar and the Shareholder Rights & Takeover Defenses Pillar. For the former pillar, ISS considers a unilateral board action that diminishes shareholder rights to call a special meeting an action that “materially reduces shareholder rights,” which could affect a company’s score. In calculating the latter pillar, ISS takes into account “whether shareholders can call a special meeting, and, if so, the ownership threshold required.” It also considers whether there are “material restrictions” to the right, which include restrictions on timing, “restrictions that may be interpreted to preclude director elections,” and restrictions that effectively raise the ownership threshold.

Glass Lewis

Glass Lewis provides specific guidelines for voting on special meeting rights. Generally, Glass Lewis is in favor of providing shareholders with the right to call a special meeting, preferring an ownership threshold of 10-15%, depending on the size of the company, in order to “prevent abuse and waste of corporate resources by a small minority of shareholders.” In forming its recommendation, Glass Lewis also takes into account several other factors, including whether the board and management are responsive to proposals for shareholder rights policies, whether shareholders can already act by written consent and whether anti-takeover measures exist at the company.

In addition, Glass Lewis considers the right to call special meetings an “important shareholder right” and recommends voting against members of the governance committee who hold office while management infringes upon “important shareholder rights,” such as when the board unilaterally removes such rights or when the board fails to act after a majority of shareholders has approved such rights.

Positions of Large Institutional Shareholders

While their current positions on special meeting proposals vary, the major institutional investors generally favor shareholders having the right to call special meetings and usually focus on a few key variables, e.g., the minimum ownership threshold associated with the right. Some investors, like State Street Global Advisors, recommend voting for a proposal if the threshold is 25% or less, while others, like Fidelity Management & Research Co., recommend voting for a proposal if the threshold is 25% or more. Sometimes, investors’ policies take into account whether or not the company already provides for a shareholder right to act by written consent. In addition, some investors support management proposals outright but are more wary of shareholder proposals that may support the narrow interests of one or few shareholders.

SEC No-Action Letters

On January 16, 2015, Securities and Exchange Commission (“SEC”) Chair Mary Jo White announced that she had directed the staff of the SEC’s Division of Corporation Finance (the “Division”) to review the scope of Rule 14a-8(i)(9) under the Securities Exchange Act of 1934,

which permits the exclusion of a shareholder proposal from a company's proxy statement if it "directly conflicts" with a management proposal to be submitted to shareholders at the same meeting. Also on January 16, 2015, the Division announced that it would not express any view with respect to requests for exclusion based on Rule 14a-8(i)(9) during the 2015 proxy season.

While the Division's announcement was a reaction to controversy over a no-action letter issued on the basis of Rule 14a-8(i)(9) with regard to a proxy access proposal (and the subsequent influx of similar no-action requests), the announcement impacted no-action requests pertaining to other shareholder proposals, including those relating to special meetings. Out of a total of 17 no-action requests seeking exclusion of special meeting shareholder proposals for the 2015 season, 12 were predicated on Rule 14a-8(i)(9). Three companies—BorgWarner Inc., Illinois Tool Works Inc., and Deere & Company—submitted no-action requests based on Rule 14a-8(i)(9) prior to the Division's announcement and were granted relief. In response to the respective proponents' requests for reconsideration after the Division's announcement, the SEC subsequently revoked the no-action relief it had granted BorgWarner and Illinois Tool Works, causing each of these companies to include the special meeting shareholder proposal in its proxy materials. Deere & Company, however, excluded the proposal; the proponent never requested reconsideration, perhaps because the company's annual meeting was scheduled to be held shortly after the Division's announcement. In addition, AGL Resources, another company among the 12 that had requested no-action relief under Rule 14a-8(i)(9) and received no response, later implemented the shareholder proposal unilaterally and requested an exclusion under Rule 14a-8(i)(10) due to its "substantial implementation" of the proposal. The SEC granted this request. Thus, 11 of the 12 no-action requests originally arguing for exclusion under Rule 14a-8(i)(9) ultimately received no substantive response, though AGL Resources later received no-action relief under Rule 14a-8(i)(10). This is in stark contrast to 2014, in which 66.7% of no-action requests (or 12 of 18) pertaining to special meeting proposals were granted on the basis of Rule 14a-8(i)(9), and 2013, in which 76.9% of no-action requests (or 10 of 13) were similarly granted.

Of the five remaining no-action requests pertaining to special meeting proposals during the 2015 proxy season, two were based on substantive grounds. As in the case of AGL Resources, one of these requests was granted on the basis that the company had substantially implemented the proposal. In that case, Windstream Holdings, Inc. had received a shareholder proposal seeking the right to call special meetings for holders of 20% of the company's outstanding stock, and the company's board later approved and planned to "submit for a shareholder vote at the upcoming annual meeting, an amendment to the company's certificate of incorporation and bylaws to permit shareholders who have held at least a 20% net-long position in the company's outstanding common stock for at least one year to call a special meeting." Based on this information, the Division agreed that the company could omit the proposal from its proxy materials.

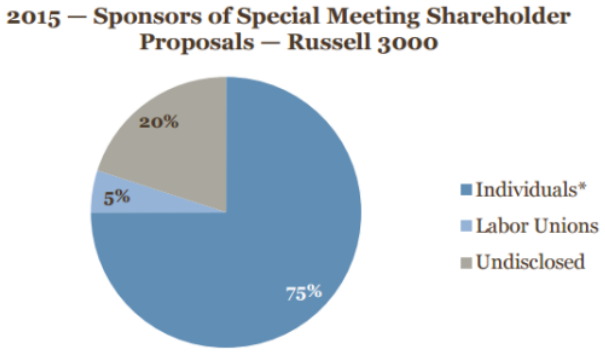
The second substantive request for exclusion was based on Rule 14a-8(i)(3), which permits the exclusion of proposals that are contrary to any of the SEC's proxy rules, "including Rule 14a-9, which prohibits materially false or misleading statements in proxy solicitation materials." In that case, AT&T Inc. had argued that the proposal and its supporting statement contained two material misstatements of fact and one material omission, rendering the proposal excludable. The Division, however, did not agree, and AT&T included the shareholder proposal in its proxy materials.

Special Meeting Proposal Trends

Overall Trends

- **This proxy season saw the highest number of special meeting proposals since 2011.** The number of proposals submitted by shareholders seeking either to create the right to call special meetings or to lower the threshold requirement for share ownership spiked during 2015, with 20 proposals going to a vote at Russell 3000 companies, 14 compared with 13 such proposals going to a vote in 2014. This marked increase in the prevalence of special meeting shareholder proposals has not been seen since 2011, when 28 proposals went to a vote among the Russell 3000.

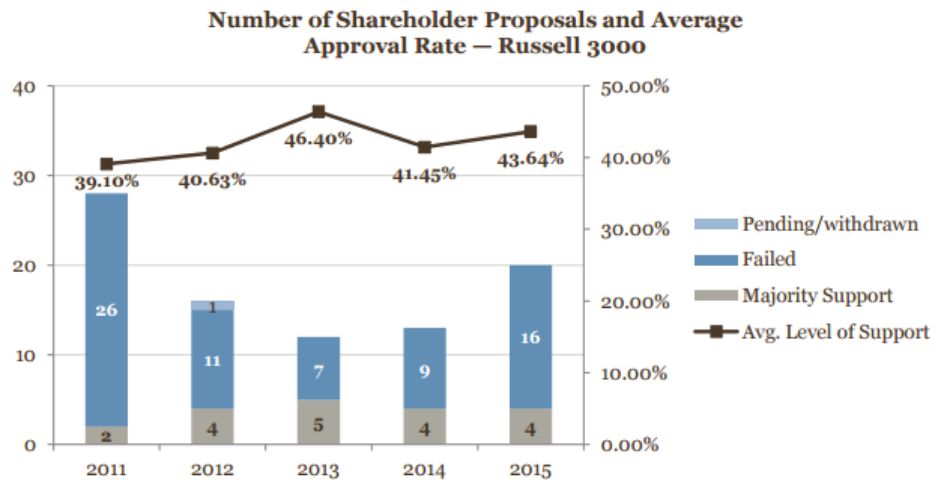
- **The majority of proposals were submitted by individual activist shareholders.**



*Three people submitted 100% of the individual proposals.

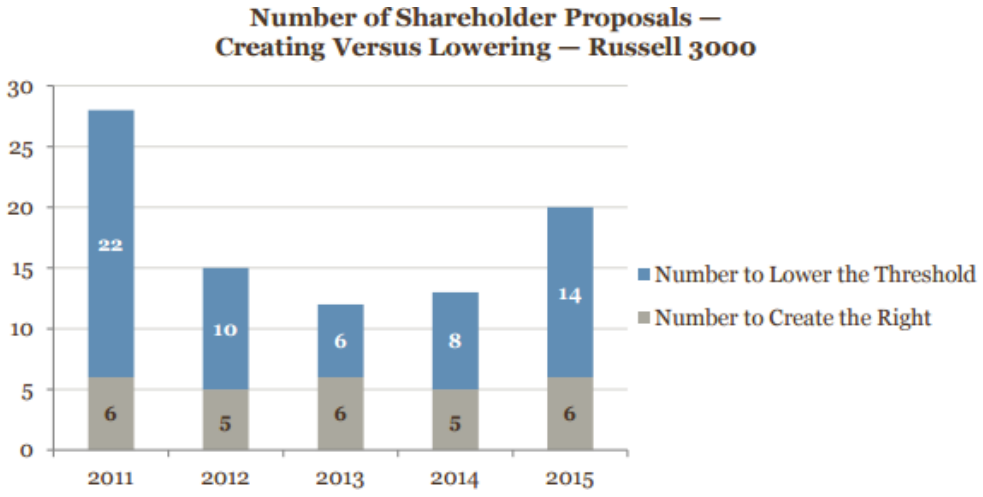
- **Fewer proposals received majority support, as compared with previous years.** While more special meeting shareholder proposals were submitted to a vote during 2015, the proposal's success rate decreased compared to the past three years—20.0% (or four of 20) received majority support in 2015, while 41.7% of proposals received majority support in 2013 and 30.8% received majority support in 2014. This decrease in success rate may be due to this season's relatively high proportion of proposals to lower the threshold for an already existing right, as discussed further below.

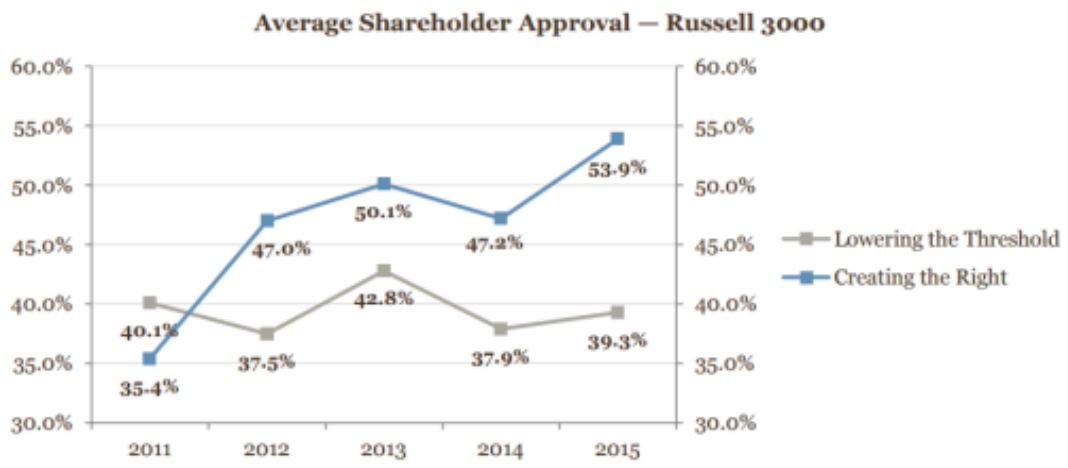
- **Shareholder approval rates remain high, consistent with past years.** The average approval rate for special meeting shareholder proposals in 2015 was 43.6%, slightly higher than last year's average approval rate of 41.5% and generally consistent with average shareholder support for special meeting proposals over the last five years.



Creating the Right Versus Lowering the Threshold

Shareholder proposals to create the right to call a special meeting have historically been more likely to receive majority or close-to-majority support than shareholder proposals to lower the threshold. Over the past five years, 10% of all proposals (or six of 60) to lower the threshold of an existing right have passed, whereas 46.4% of proposals (or 13 of 28) to create the right have passed.

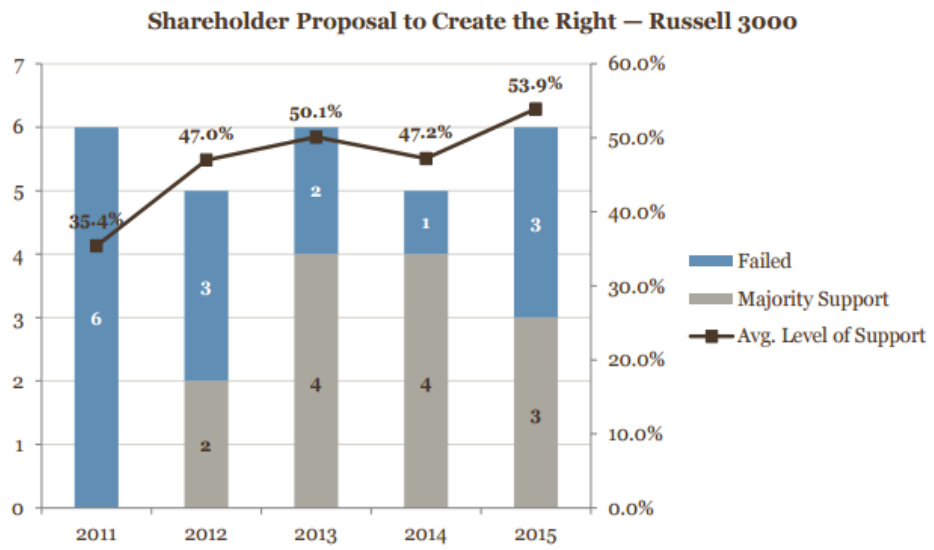




Creating the Right

Of the 20 proposals that went to a vote in 2015, six sought to create the special meeting right for the first time. Three out of six proposals to create the right received majority support this proxy season, consistent with previous years.

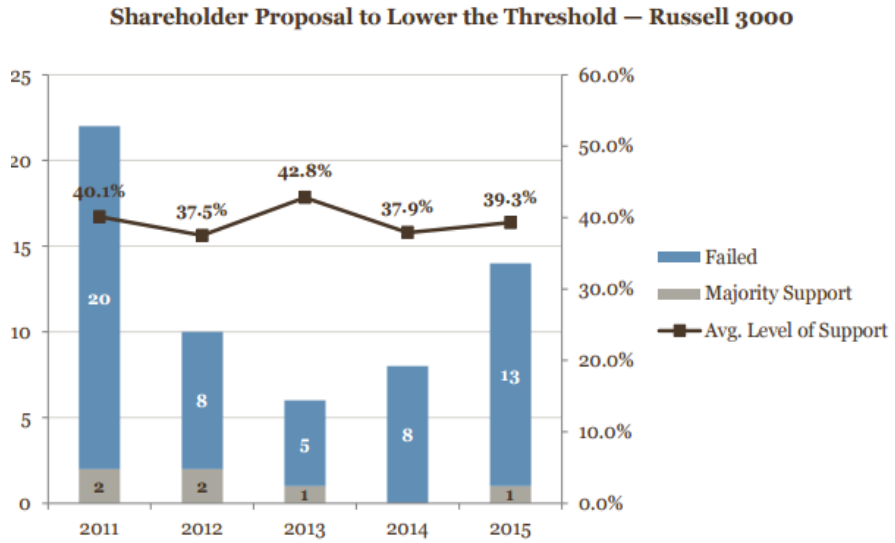
This year, the average level of shareholder support for proposals seeking to create the right was 53.9%, representing an increase compared with previous years.



Lowering the Threshold

Of the 20 special meeting shareholder proposals that went to a vote in 2015, 14 proposed to lower the ownership threshold of an existing right. This is a marked increase compared to 2013, in which six such proposals went to a vote, and 2014, in which eight such proposals went to a vote. Notwithstanding the increase in proposals, only one of these proposals (submitted to The Timken Company) received majority support, which is consistent with the low success rate of these proposals in previous years.

The average level of shareholder support in 2015 for proposals seeking to lower the threshold was 39.3%, generally comparable to the shareholder support these proposals received over the past five years, which ranged from 37.5% to 42.8%.



Management Responses to Special Meeting Shareholder Proposals

Following the Division's announcement that it would not consider no-action requests on the basis of Rule 14a-8(i)(9), issuers that received special meeting shareholder proposals were left with three options, aside from negotiating with the proponents. These options are represented in the chart below, along with the companies that chose each option, the breakdown of which proposals sought to create the right and which sought to lower the threshold, and the results of the vote.

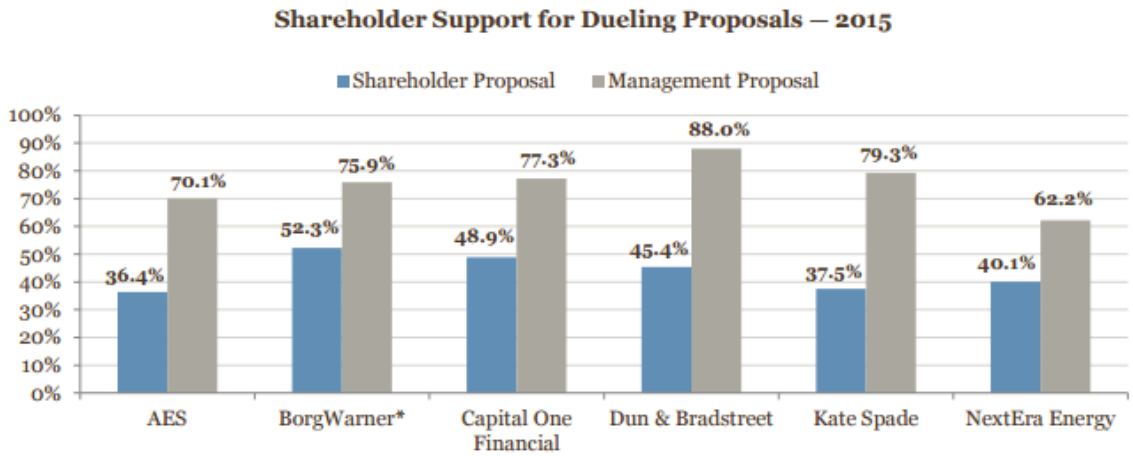
Option	Companies	Results
1) Include the shareholder proposal with an opposition statement from management (13 companies)	AT&T Inc.; L-3 Communication Holdings, Inc.; Alexion Pharmaceuticals, Inc.; The Timken Company; Kansas City Southern; Newell Rubbermaid Inc.; Morgans Hotel Group Co.; Ford Motor Company; JP Morgan Chase & Co.; Southwestern Energy Company; ITC Holdings Corp.; The Home Depot, Inc.; Chevron Corporation	Two of the 13 proposals sought to create the right; one received majority support (Average Support = 49.2%) 11 of the 13 proposals sought to lower the threshold; one received majority support (Average Support = 38.8%)

2) Include the shareholder proposal with directly conflicting management proposal (6 companies)*	The AES Corporation; BorgWarner Inc.; Capital One Financial Corporation; The Dun & Bradstreet Corporation; Kate Spade & Company; NextEra Energy, Inc.	Three of the six proposals sought to create the right; one received majority support (Average Support = 45.9%) Three of the six proposals sought to lower the threshold; none received majority support (Average Support = 41.0%)
3) Include and support the shareholder proposal (1 company)	Illinois Tool Works, Inc.	One proposal sought to create the right (Received 87.3%)

** In each case where the company submitted a directly conflicting management proposal, the management proposal garnered majority support, receiving average support of 75.5%.*

Trends Among Companies Submitting Dueling Proposals

Of the six shareholder proposals that were submitted with conflicting management proposals, five failed, and one received majority support.



** BorgWarner's bylaws require 80% of the vote to amend its certificate of incorporation, which is what BorgWarner's management proposal suggested. Accordingly, as a technical matter, the management proposal did not pass despite receiving higher shareholder support.*

Trends Among Companies That Have Adopted the Proposal

Four companies that faced shareholder-sponsored special meeting proposals chose to unilaterally amend their certificates of incorporation and bylaws to adopt the proposal and did not submit the shareholder proposal to a vote. As noted above, two of them petitioned the SEC for exclusion pursuant to Rule 14a-8(i)(10) for having "already substantially implemented the proposal." While not publicly disclosed, it is likely that the other two companies that excluded the shareholder proposal from their proxy materials negotiated exclusion with the shareholder proponent.

Threshold Levels

As noted above, 14 of the special meeting shareholder proposals that went to a vote in 2015 sought to lower the ownership threshold of an existing right. Twelve of these proposals sought to lower the higher existing ownership threshold to a 10% ownership threshold. All of these failed, receiving average support of 37.8%. This represents a departure from prior years; in 2011 through 2014, 29 shareholder proposals sought to lower the threshold of an existing right to 10%, three of which received majority support. At two of these three companies, the existing special meeting right was set at 50%; at the remaining company, the existing right was set at 25%.

Based on current voting trends, it seems that shareholders are likely to support some right to call a special meeting. This year's voting results indicate, however, that shareholders may not necessarily believe that a 10% threshold is the most appropriate. At 18 of the 20 companies that received a shareholder proposal in 2015, shareholders seemed to prefer thresholds of at least 15%, but most often 20-25%. The voting results at these 18 companies can be broken down as follows:

- **Dueling Proposals.** When confronted with a shareholder proposal that directly conflicted with a management proposal, five companies' shareholders supported management-sponsored thresholds of 20-25% and rejected shareholder-sponsored thresholds of 10% or even 20%.

- **Shareholder Proposals Seeking to Create the Special Meeting Right.** When confronted with a shareholder proposal to create the special meeting right, two companies' shareholders voted to create a special meeting right for holders of 20-25% of the company's stock.

- **Shareholder Proposals Seeking to Lower the Threshold of an Existing Right.** When confronted with a shareholder proposal to lower the threshold of an existing right in the absence of a competing management proposal, the vast majority of shareholders rejected entreaties to lower the existing thresholds, which ranged from 15-50%. Of the eleven companies affected:
    - At ten companies, shareholders opted to retain the companies' preexisting thresholds of 15-50% and voted against shareholder proposals seeking to lower the threshold. Five of these existing thresholds were set at 20-25%.
    - At one company, shareholders voted in favor of a shareholder proposal to lower the threshold to 25%.

These results suggest that companies that have a special meeting right in the 15-25% range could, depending on the circumstances, be more successful in warding off potential future attempts to lower the threshold.

Takeaways

If faced with a shareholder proposal relating to the ability of shareholders to call a special meeting, management should take into consideration whether the proposal seeks to create the right for the first time or to lower the threshold of an existing right. In addition, the likelihood of a proposal garnering majority support depends, in part, on the proposal's thresholds for triggering the right.

Depending on the results of the SEC's pending review of Rule 14a-8(i)(9), some issuers may determine to submit a management-sponsored proposal to their shareholders with a higher threshold that it deems appropriate for the company and its individual circumstances. Some companies may find it advantageous to adopt the right to call special meetings unilaterally, permitting the company to maintain control over the specifics of the bylaw and, in certain circumstances, allowing the issuer to petition the SEC for no-action relief to exclude the shareholder proposal under Rule 14a-8(i)(10) for having "substantially implemented" the proposal. Regardless, as with many governance proposals, it is critical to engage with the company's shareholders and understand their positions prior to deciding on an approach. In addition, issuers should take into account the possibility that failure to substantially implement a special meeting shareholder proposal that received majority support can yield negative vote recommendations from the proxy advisory firms against one or more of the company's directors.

The complete publication, including footnotes, is available here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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New Guidance on Advance Notice By-Laws

Posted by Alexander M. Kaye, Milbank, Tweed, Hadley & McCloy LLP, on Tuesday, August 4, 2015

Editor's Note: Alexander M. Kaye is the Practice Group Leader of the Global Corporate Group of Milbank, Tweed, Hadley & McCloy LLP and is a partner resident in the New York office. This post is based on a Milbank client alert by Mr. Kaye, Dean W. Sattler, and Monica Arduini. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

Hill International, Inc. ("Hill"), a publicly traded company, and one of its stockholders, Opportunity Partners L.P. ("Opportunity"), recently engaged in a dispute regarding whether Opportunity had timely submitted two proposals for items of business for consideration and two director nominations for election at Hill's 2015 annual meeting. On appeal from the Delaware Chancery Court, the Delaware Supreme Court was called on to analyze the interpretation and application of Hill's advance notice by-law.

On July 2, 2015, in *Hill International, Inc. v. Opportunity Partners L.P.*,[1] the Delaware Supreme Court affirmed the Court of Chancery's holding that: (i) Hill's board of *directors only set the date of its annual meeting of stockholders when it announced the actual date of its annual meeting in its 2015 proxy statement*, rather than a range of possible dates provided in Hill's proxy statement from the preceding year, and (ii) Opportunity's proposals were timely submitted in compliance with Hill's advance notice by-law.

The Dispute Between Hill and Opportunity

The dispute arose on May 7, 2015 when Opportunity delivered to Hill a notice of intent to present two stockholder proposals and two director nominees at Hill's 2015 annual meeting (the "May 7th Notice"). The May 7th Notice was delivered seven days after the Company disclosed the actual date of the annual meeting in its 2015 definitive proxy statement.

Hill rejected the May 7th Notice, arguing that it was not timely under Hill's advance notice by-law, which states that the following time frames apply for business to be properly and timely brought before the corporation's annual meeting by a stockholder:

- if Hill provides at least 70 days' notice or prior public disclosure to stockholders of the date of the annual meeting, the stockholder must deliver notice to Hill not less than 60 days nor more than 90 days prior to the meeting; or
- if Hill provides less than 70 days' notice or prior public disclosure of the date of the annual meeting, the stockholder must deliver notice to Hill no later than 10 days following

[1] Del. Supr., No. 305, 2015 (Del. July 2, 2015).

> the day on which such notice of the date of annual meeting was mailed or such public disclosure was made.

The by-laws contained similar time frames for stockholder nominations of directors.

To assess whether the May 7th Notice was timely, the Delaware Supreme Court first had to determine when Hill provided notice of the date of its 2015 annual meeting. Hill sent two notices that were in dispute.

The first notice was provided in Hill's 2014 definitive proxy statement, dated April 30, 2014, where Hill stated that it anticipated holding its 2015 annual meeting "on or about June 10, 2015". The 2014 proxy went on to state that in order for a proposal to be properly brought before the 2015 annual meeting, it had to be submitted no earlier than March 15, 2015 and no later than April 15, 2015.

The second notice was included in Hill's 2015 definitive proxy statement, delivered on April 30, 2015, where Hill announced that the 2015 annual meeting would be held at 9:00 a.m. on Tuesday, June 9, 2015. The court found that the timeliness of Opportunity's May 7th Notice rested on whether Hill's board of directors properly notified stockholders of the 2015 annual meeting date in the 2014 definitive proxy statement or the 2015 definitive proxy statement.

Hill argued that it had provided notice of the 2015 annual meeting date on April 30, 2014, when it was publicly disclosed in its 2014 definitive proxy statement. If Hill's interpretation was correct, it would have provided at least 70 days' notice to its stockholders, and Opportunity's May 7th Notice would have been delivered outside of the 60-to-90 day time frame required by the by-laws.

Opportunity, however, argued that Hill only announced the 2015 annual meeting date on April 30, 2015, when the specific date and time of the meeting was disclosed in its 2015 definitive proxy statement. If Opportunity's interpretation was correct, Hill would have provided less than 70 days' notice of the meeting, and the May 7th Notice would have been properly delivered within the 10 day time period following such notice.

The Court's Analysis

Agreeing with the Court of Chancery's "plain meaning" construction of the advance notice by-law, the Delaware Supreme Court found that *"[t]he plain meaning of 'the date' means a specific day—not arange of possible days."* As such, the Delaware Supreme Court found that Hill's board of directors announced the actual date of its 2015 annual meeting for the first time on April 30, 2015, when it disseminated its 2015 annual proxy statement.

Because April 30th was less than 70 days before the date of the 2015 annual meeting, Opportunity only had to provide notice containing its proposals and nominations within 10 days of receiving such notice. Accordingly, the Delaware Supreme Court found that Opportunity's May 7th Notice was timely and upheld the Court of Chancery's order enjoining Hill from conducting any business at the June 9, 2015 annual meeting (other than adjourning the 2015 annual meeting for a minimum of 21 days).

In addition, the Delaware Supreme Court noted in dicta that although Hill's board of directors internally fixed the time and date of the 2015 annual meeting on March 12, 2015, that decision did not qualify as "notice" for purposes of the advance notice by-law because it was not disclosed to stockholders.

Important Takeaways

The takeaways for Delaware corporations in light of the *Hill* decision are as follows:

- **By-laws are a contract.** It is an axiom of Delaware corporate law that a corporation's by-laws are a contract and Delaware courts will analyze and construe them as such, including by applying the "plain meaning" doctrine, when called on to interpret ambiguities.
- **Review your by-laws.** A Delaware corporation's advance notice by-law should be carefully and critically reviewed by the corporation and its counsel periodically, with a view to identifying and remedying any weaknesses or ambiguities that may be exploited by stockholders.
- **By-laws will be construed against the drafter.** The Hill decision should also serve as a reminder that Delaware courts will generally construe ambiguities in a corporation's advance notice by-laws against the corporation and in favor of the stockholder seeking to make a proposal.
- **Consider amending by-laws if advance notice is keyed to the date of public notice of the next annual meeting.** Many Delaware corporations use an advance notice by-law that is keyed to the anniversary of the immediately preceding annual meeting, or the anniversary of the mailing of the proxy for the immediately preceding meeting, as opposed to, as was the case in Hill, the date of public notice of the next annual meeting; if a Delaware corporation's advance notice by-law uses the public notice formulation, the board should consider amending it to base the notice deadline on the anniversary of the immediately preceding annual meeting or the mailing of the proxy.

Building Meaningful Communication and Engagement with Shareholders

Mary Jo White, [excerpt, from remarks at the Society of Corporate Secretaries and Governance Professionals]

June, 2015

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Building Meaningful Communication and Engagement with Shareholders

Posted by Mary Jo White, U.S. Securities and Exchange Commission, on Thursday, June 25, 2015

Editor's note: Mary Jo White is Chair of the U.S. Securities and Exchange Commission. The following post is based on Chair White's remarks at the national conference of the Society of Corporate Secretaries and Governance Professionals, available here. The views expressed in this post are those of Chair White and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

Shareholder Proposals

My final topic is another area of shareholder engagement that is near and dear to all of you—shareholder proposals. As you know, it has been a busy and interesting season. The staff received more than 300 requests from over 200 companies to exclude shareholder proposals addressing a wide range of topics from human rights to proxy access. Overall, the number of requests was up approximately 10% from the prior season, but down slightly from two years ago.

This season, the matter that received the most attention was Rule 14a-8(i)(9), particularly as it related to proxy access proposals.

Rule 14a-8(i)(9), as you know, allows a company to exclude a shareholder proposal that "directly conflicts" with one of the company's own proposals. After an initial no-action letter was issued by the staff, questions, from me and others, were raised about the proper scope and application of the rule. After I directed the staff to review the application of the rule, the Division of Corporation Finance decided to express no view on the application of Rule 14a-8(i)(9) during this proxy season. These decisions were not made lightly as we fully recognize the need for clarity and certainty in the proxy process during every season. But it is important to get these issues right.

The suspension of staff views on the application of Rule 14a-8(i)(9) this season did give a window into some private ordering at work. More than 100 companies received proposals to adopt some form of proxy access. Proxy access proposals received majority support at more than 40 companies, as compared to four last year. At seven companies, the company's proxy access proposal was included alongside a proxy access proposal offered by a shareholder. Shareholders preferred management's proposals at three companies, and at three others, they preferred the shareholder's proposal. At one company, the shareholders did not approve either proposal and there were no instances where shareholders approved both proposals. While all of these results are informative, this last one may be of particular interest to you.

The Society and others were very concerned that shareholders would be confused by two "competing" proposals and that companies would not know what to do if shareholders voted in favor of both proposals. Based on this year's experience, that did not occur. It seems that shareholders were able to sort it all out and express their views. The staff is considering that fact and the other results of the season as it completes its review of Rule 14a-8(i)(9)—obviously with the goal of providing clarity for next year's proxy season.

Like the controversy about Rule 14a-8(i)(9), the issues that generally get the most attention each proxy season are those that are the subject of requests for no-action letters. But I would like to focus some attention on the shareholder proposals our staff never sees.

Each proxy season, SEC staff gets involved in roughly 300 to 350 proposals that companies seek to exclude. The staff generally does not track the proposals that companies do not seek to exclude, but we estimate that another 300 to 400 proposals are included in management's proxy statement without any staff involvement. Even with respect to the no-action requests, companies consistently withdraw 15 to 20% of them before the staff ever provides its views. We do not always know precisely what happens, but it is our understanding that management and the shareholders generally have arrived at some resolution on their own. That is good and evidence that the company/shareholder relationship is working.

I am not suggesting that management should never object to or oppose a shareholder proposal. Company management in good faith can believe that particular proposals are not in the best interests of their shareholders and there are also costs involved in processing shareholder proposals. But companies in many cases should consider other possible steps they could take in response to a proposal rather than just saying no. Sometimes, foregoing technical objections could be the right response. Letting shareholders state their views on matters may be a relatively low cost way of sounding out and preventing potential problems down the line.

More thoughtful treatment of shareholder proposals is not a one-way exercise. Briefing boards, analyzing issues and determining how to communicate the company's views to shareholders and markets take time and resources, as does hiring lawyers to analyze the proper interpretation of the Commission's grounds for exclusion and preparing communications with the staff. And I would urge shareholder proponents to be mindful of the costs they can cause to be borne by their companies—and thus, by their fellow shareholders—and to use the shareholder proposal process responsibly. Seek engagement with the company on an issue first before turning to a shareholder proposal. Direct engagement with a company is likely to be more meaningful than a precatory vote on a 500-word proposal. Some companies are better at engagement than others, but I would urge more companies to embrace it so that more shareholders will be incentivized to choose direct engagement as their preferred first approach.

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SEC Rulings on Shareholder Proposals and Ordinary Business Rule

Posted by Elizabeth A. Ising, Gibson, Dunn & Crutcher LLP, on Thursday, November 5, 2015

Editor's note: Elizabeth Ising is a partner and Co-Chair of the Securities Regulation and Corporate Governance practice group at Gibson, Dunn & Crutcher LLP. This post is based on a Gibson Dunn client alert by Ms. Ising, Sarah E. Fortt, Julia Lapitskaya, Ronald O. Mueller, Kasey Levit Robinson, and Lori Zyskowski.

On October 22, 2015, the Securities and Exchange Commission's ("SEC" or "Commission") Division of Corporation Finance (the "Division") issued Staff Legal Bulletin No. 14H ("SLB 14H"), setting forth a dramatically different standard for when it will concur that a shareholder proposal that conflicts with a company proposal can be excluded from the company's proxy statement under Rule 14a-8(i)(9). The Division also reaffirmed its views on the application of the "ordinary business" standard in Rule 14a-8(i)(7). SLB 14H is available here.

Rule 14a-8(i)(9)

Background

Pursuant to Rule 14a-8(i)(9), a company may exclude a shareholder proposal if the proposal "directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting." Since the adoption of this exclusion in 1967, the staff of the Division (the "Staff") consistently has permitted companies to exclude a shareholder proposal where the proxy statement also contained a company proposal that would "present alternative and conflicting decisions for shareholders" and "create the potential for inconsistent and ambiguous results." However, in response to concerns raised by some shareholders over the application of Rule 14a-8(i)(9) in the context of proxy access shareholder proposals, in January 2015, SEC Chair Mary Jo White announced that she was directing the Staff to review Rule 14a-8(i)(9) and report to the SEC on its review.[1] Concurrently with this announcement, the Staff announced that pending its review, it would no longer express a view during the 2015 proxy season on the availability of Rule 14a-8(i)(9).[2] The Staff received 19 comment letters related to its review.[3] We discussed these

[1] The Division has not publicly issued a report to the Commission on its review other than the announcements in SLB 14H, and SLB 14H states that the Commission "has neither approved nor disapproved its content."

[2] Statement from Chair White Directing Staff to Review Commission Rule for Excluding Conflicting Proxy Proposals (Jan. 16, 2015), *available at* http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html; Division of Corporation Finance Will Express No Views under Exchange Act Rule 14a-8(i)(9) for Current Proxy Season (Jan. 16, 2015), *available at*http://www.sec.gov/corpfin/announcement/cf-announcement—rule-14a-8i9-no-views.html.

[3] These comment letters are available at http://www.sec.gov/comments/i9review/i9review.shtml.

developments in detail in our January 16, 2015 blog post and July 15, 2015 client alert (discussed on the Forum here).

"Mutually exclusive" proposals

In a reversal of decades of Staff interpretations of Rule 14a-8(i)(9), the Division takes the position in SLB 14H that a direct conflict exists for purposes of Rule 14a-8(i)(9) only if "a reasonable shareholder could not logically vote in favor of both proposals, i.e., a vote for one proposal is tantamount to a vote against the other proposal" because "they are, in essence, mutually exclusive proposals." In contrast, a direct conflict will not exist if a shareholder proposal and a company proposal contain different terms but "generally seek a similar objective." This approach is significantly more restrictive than the Staff's prior approach and, as demonstrated by the examples included in SLB 14H and described below, essentially will eliminate the availability of Rule 14a-8(i)(9) as a basis for excluding shareholder proposals.

Examples

As set forth in SLB 14H:

- **Proxy access**. Where a company does not allow shareholder nominees to be included in the company's proxy statement, a proxy access shareholder proposal with specific terms (such as 3% ownership/3 years/20% of the board) would not be viewed as directly conflicting with a company proxy access proposal with different terms (e.g., 5% ownership/5 years/10% of the board) because "both proposals generally seek a similar objective" (i.e., to give shareholders the ability to include their director nominees in the company's proxy statement) and thus "do not present shareholders with conflicting decisions such that a reasonable shareholder could not logically vote in favor of both proposals."
- **Vesting of equity awards**. Similarly, a shareholder proposal asking the compensation committee to implement a policy that equity awards would have no less than four-year annual vesting would not be viewed as directly conflicting with a company proposal to approve an incentive plan that gives the compensation committee discretion to set the vesting provisions for equity awards. This is because "a reasonable shareholder could logically vote for a compensation plan that gives the compensation committee the discretion to determine the vesting of awards, as well as a proposal seeking implementation of a specific vesting policy that would apply to future awards granted under the plan."
- **Chairman/CEO separation**. Conversely, a shareholder proposal that asks for the separation of the roles of chairman and CEO would directly conflict with a company proposal seeking approval of a bylaw amendment that requires the CEO to be the chair at all times.

Binding vs. non-binding proposals

The Division observes that a binding company proposal and a non-binding shareholder proposal may nevertheless directly conflict if a vote in favor of the shareholder proposal "is tantamount to a vote against" the company proposal, despite the non-binding nature of the shareholder proposal.

Where this is the case, the non-binding shareholder proposal would be excludable under the new standard announced in SLB 14H. However, if a binding company proposal and a binding shareholder proposal would directly conflict solely because, if implemented, the proposals would present two mutually exclusive alternatives, the Division now will allow the shareholder proposal to be revised to be non-binding, and therefore not excludable under Rule 14a-8(i)(9).

Staff discretion

Notably, the standard introduced by the Division in SLB 14H is, to a large degree, highly subjective and gives the Staff discretion to speculate as to what a reasonable shareholder would view as the objective of a proposal and as to the comparability of alternative approaches to an issue, which may lead to results that are inconsistent with the views of shareholder proponents and shareholders voting on a proposal. For example, while some shareholders have voted for proxy access proposals with a 5% ownership standard and against proxy access proposals with a 3% ownership standard, the Division's new standard represents a potentially unfounded judgment that these shareholders instead reasonably *could* support a 3% ownership standard.

Similarly, in the example from SLB 14H discussed above regarding differing standards for vesting terms of equity awards, the Staff appears not to view the proposals as directly conflicting on the issue of whether a compensation committee should or should not have discretion in setting vesting terms on equity awards. Instead, the Staff concludes that "a reasonable shareholder could logically vote for a compensation plan that gives the compensation committee the discretion to determine the vesting of awards, as well as a proposal seeking implementation of a specific vesting policy that would apply to future awards granted under the plan."

The Division acknowledges that the standard it has promulgated in SLB 14H "may be a higher burden for some companies" to meet, but the Division indicates that it "believe[s] it is most consistent with the history of the rule" and its intention to "prevent shareholders from using Rule 14a-8 to circumvent the proxy rules governing solicitations." Nevertheless, the new standard shifts the analysis away from whether there are competing views by a shareholder proponent and a company's board on how to address a particular topic. As a result, the Division's new standard effectively creates the situation that Rule 14a-8 was designed to prevent by permitting shareholders to use the company's proxy materials to compete with the company's board on how to address any topic. The best example of this occurred during the 2015 proxy season when, as a result of the Division declining to issue no-action letters under Rule 14a-8(i)(9), seven companies included both a shareholder proposal and a company proposal on proxy access in the company proxy statement. In all seven of those contests between a shareholder and a company proxy access proposal, the company in its proxy statement recommended voting against the shareholder proposal and in five of those contests the shareholder proponent filed soliciting materials recommending that shareholders vote against the company proposal.[4]

[4] *See* the Notice of Exempt Solicitation on form PX14A6G jointly filed by the shareholder proponent and another institutional shareholder with respect to AES Corp. (filed on Apr. 17, 2015), Chipotle Mexican Grill, Inc. (filed on Apr. 28, 2015), Cloud Peak Energy Inc. (filed on Apr. 28, 2015), Exelon Corp. (filed on Apr. 20, 2015), and Visteon Corp. (filed on May 20, 2015).

Rule 14a-8(i)(7) and Trinity Wall Street v. Wal-Mart Stores, Inc.

Background

Under SEC Rule 14a-8(i)(7), a company may exclude from its proxy materials shareholder proposals relating to the company's ordinary business operations. Under SEC Rule 14a-8(i)(3), a company may exclude proposals that are so vague or indefinite that neither shareholders voting on the proposal nor a company in implementing the proposal would know exactly what actions or measures the proposal requires. As discussed in our July 2015 post, on April 14, 2015, the U.S. Court of Appeals for the Third Circuit ruled in *Trinity Wall Street v. Wal-Mart Stores, Inc.* that a shareholder proposal submitted to Wal-Mart was excludable under Rule 14a-8(i)(7) and Rule 14a-8(i)(3), reversing a December 2014 judgment by the U.S. District Court for the District of Delaware.[5]

Different analyses for significant policy exception to ordinary business exclusion.

The Third Circuit's three-judge panel unanimously held that the proposal was excludable under Rule 14a-8(i)(7). The Third Circuit panel also unanimously held that the proposal did not fall within the significant policy exception to the Rule 14a-8(i)(7) exclusion, although one judge wrote a concurring opinion to explain that she applied a different analysis to reach that conclusion. In the majority opinion, the Third Circuit employed a two-part test to assess whether the significant policy exception to the ordinary business exclusion applied, stating that "a shareholder must do more than focus its proposal on a significant policy issue; the subject matter of its proposal must 'transcend' the company's ordinary business."[6] In contrast, the concurring opinion noted that "whether a proposal focuses on an issue of social policy that is sufficiently significant is not separate and distinct from whether the proposal transcends a company's ordinary business."[7] On September 11, 2015, Trinity Wall Street filed a petition seeking the United States Supreme Court's review of the Third Circuit's opinion. Wal-Mart has until November 16, 2015 to file its response to Trinity Wall Street's petition.[8]

Division's view: business as usual

In SLB 14H, the Division reaffirmed its view that its earlier determination that the Trinity Wall Street proposal properly was excludable under Rule 14a-8(i)(7) is consistent with the views the SEC has expressed on how to analyze proposals under the ordinary business exclusion. The Division also stated that the two-part test applied in the majority opinion differs from the Division's practice, and that the Division "intends to continue to apply Rule 14a-8(i)(7) as articulated by the Commission and consistent with the Division's prior application of the exclusion, as endorsed by the concurring judge, when considering no-action requests that raise Rule 14a-8(i)(7) as a basis for exclusion."

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[5] *See Trinity Wall Street v. Wal-Mart Stores, Inc.*, No. 14-4764 (3d Cir. July 6, 2015). Gibson Dunn represented Wal-Mart in obtaining the SEC no-action letter, before the district court and on appeal before the Third Circuit.

[6] *Trinity Wall Street v. Wal-Mart Stores, Inc*. at *50 (citation omitted).

[7] *Id.* at *3 (Schwartz, J., concurring).

[8] *See* Supreme Court of the United States, Docket, *available at* http://www.supremecourt.gov/Search.aspx?FileName=/docketfiles\15-323.htm (accessed on Oct. 22, 2015).

Business Roundtable℠

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April 14, 2015

Mr. Brent Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Mr. Fields:

Re: File No. 4-675, Request for Rulemaking to Amend Exchange Act Rule 14a-8 under the Securities Exchange Act of 1934 Regarding Resubmission of Shareholder Proposals

This letter is submitted on behalf of Business Roundtable, an association of chief executive officers of leading U.S. companies working to promote sound public policy and a thriving U.S. economy. Business Roundtable's CEO members lead U.S. companies with $7.2 trillion in annual revenues and nearly 16 million employees. Business Roundtable member companies comprise more than a quarter of the total value of the U.S. stock market and invest $190 billion annually in research and development—equal to 70 percent of U.S. private R&D spending. Our companies pay more than $230 billion in dividends to shareholders and generate more than $470 billion in sales for small and medium-sized businesses annually. Business Roundtable companies give more than $3 billion a year in combined charitable contributions.

The U.S. Chamber of Commerce and other national organizations submitted a petition to the Securities and Exchange Commission (the Commission or SEC) on April 9, 2014 for rulemaking to amend the provisions under Rule 14a-8 of the Securities Exchange Act of 1934 (the Exchange Act) regarding the excludability of previously submitted shareholder proposals from company proxy materials (the Petition), and we are writing in support of the Petition. As an initial matter, the Roundtable has long been a strong advocate for good corporate governance and supports efforts by the SEC to protect investors and preserve effective mechanisms for shareholder communication. Moreover, the Roundtable is cognizant of the many legislative mandates that the SEC is in the process of responding to and the significant demands these mandates have placed on the Commission's resources. Nevertheless, we have been urging the Commission for over a decade to address the issues inherent in the

current proxy voting system,[1] and we encourage the Commission to seek comment on amendments to the existing rules.

As set forth in our 2012 Principles of Corporate Governance,[2] we believe "it is the responsibility of the corporation to engage with long-term shareholders in a meaningful way on issues and concerns that are of widespread interest to long-term shareholders, with appropriate involvement from the board of directors and management." Our member companies take shareholder communications seriously, and we believe that the responsibility to communicate effectively with shareholders is critical to the functioning of the modern public company and the public markets. The Commission's proxy rules play a role in this process by providing and regulating a channel of communication among shareholders and companies.[3] However, the current resubmission thresholds in Rule 14a-8(i)(12)[4] (the "Resubmission Rule"), are largely ineffective at cultivating this channel of communication and do little to protect shareholders and companies from needless expense and effort. Moreover, changes over the past decade in the proxy voting process have exacerbated the ineffectiveness of the Resubmission Rule, increasing the likelihood that companies will be required to repeatedly provide, and shareholders repeatedly review and vote on, proposals that are of no interest to a significant majority of shareholders.

Today, companies and their shareholders and the Commission and its staff spend substantial time, effort and other resources on proposals that previously have only been supported by a very small minority of shareholders. A shareholder proposal currently may be excluded under the Resubmission Rule if a proposal dealing with "substantially the same subject matter" was included recently in the company's proxy statement and failed to achieve more than a specified minimum percentage of the shareholder vote. Specifically, the Resubmission Rule permits exclusion only if a similar proposal was last included in the proxy materials within the preceding three years and if, the last time it was included: (1) it received less than three percent support, if proposed once within the last five years; (2) less than six percent support, if proposed twice within the last five years; or (3) less than ten percent support, if proposed three or more times within the last five years. Effectively, this means that once a proposal is required to be included in a company's proxy statement, it can be resubmitted repeatedly even if the vast majority of shareholders consistently vote against it.

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[1] See our "Request for Rulemaking Concerning Shareholder Communications," submitted to the Commission on April 12, 2004, in which we urged the Commission to conduct a thorough review of the current shareholder communications system. *Available at* https://www.sec.gov/rules/petitions/petn4-493.htm.

[2] *Available at* http://businessroundtable.org/resources/business-roundtable-principles-of-corporate-governance-2012.

[3] Release No. 34-40018 (1998), Amendments to Rules on Shareholder Proposals, Final Rule; *available at* http://www.sec.gov/rules/final/34-40018.htm.

[4] 17 C.F.R. §240.14a-8(i)(12).

The Resubmission Rule should strike a balance between allowing holders of relative minor amounts of company stock to participate in shareholder discussions, while limiting the degree to which they can divert corporate resources—and those of other shareholders—to matters that failed to garner the interest of even a meaningful minority of shareholders.[5] However, due in large part to changes in the proxy voting system over the past ten years discussed below, the Resubmission Rule has become ineffective at achieving this goal. Instead, under current Rule 14a-8, a shareholder need only own $2,000 of company stock for at least one year in order to submit a proposal that will necessarily require the company, and its shareholders, to dedicate significant time, effort and resources to a matter that has previously been opposed by a large majority of shareholders. The Commission adopted the current Resubmission Rule thresholds in 1954. The proxy voting process has changed substantially in the last 60 years. For example, today there is increased concentration of stock ownership by institutional shareholders and those institutional shareholders are more likely to support shareholder proposals. In addition, as indicated in the Petition, the number of shareholder proposals submitted to public companies has increased.[6] Finally, companies are providing shareholders with more options for communicating and are engaging with shareholders more often.[7] As a result, many shareholder concerns can be addressed in a manner that is less costly and time-consuming for companies and shareholders than the Rule 14a-8 process.

The petition does not recommend a specific change to the Resubmission Rule. Instead, it correctly advocates for determining new parameters only after the Commission conducts a rigorous cost-benefit analysis. We strongly support this approach and, given the time necessary to undertake such an analysis, encourage the Commission to consider the petition promptly. In conclusion, we believe that the Resubmission Rule is increasingly becoming ineffective at cultivating an effective channel of communication between shareholders and companies. Moreover, the changing landscape has exacerbated the ineffectiveness of the Resubmission Rule, increasing the likelihood that companies will be required to repeatedly provide, and shareholders repeatedly review and vote on, proposals that are of no interest to the majority of shareholders. Therefore, we urge the Commission to address this pressing issue by commencing

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[5] See, for example, Release No. 34-39093 (1997), Amendments to Rules on Shareholder Proposals, Proposed Rule; *available at* http://www.sec.gov/rules/proposed/34-39093.htm, in which the Commission stated that a proposed increase in the resubmission thresholds to 6%, 15%, and 30%, would "continue to permit [a company's] shareholders an opportunity to see otherwise proper proposals at least once," but would also limit the number of "proposals of little or no relevance" to the company's business.

[6] Although, as discussed in the Petition, public sources reported the total increase in proposals from 1997 to the peak in 2008 as approximately 350 proposals, we believe these numbers do not fully represent the number of proposals companies have received in recent years because of companies' increased shareholder engagement efforts and the number of early withdrawals.

[7] One result of this engagement is that an increasing number of shareholder proposals are withdrawn by proponents early in the process in response to discussions with the company. The increasing number of withdrawals may suggest that proposals that are actually included in the proxy statement are less likely to garner significant support. Obtaining a withdrawal may also be quite costly for the company, as it engages in negotiations that require both internal and external expertise.

rulemaking proceedings to raise the resubmission thresholds and consider whether other amendments to the rule are appropriate. Thank you for considering our comments. We would be happy to discuss our concerns or any other matters that you believe would be helpful. Please contact Michael J. Ryan, Jr. of the Business Roundtable at (202) 496-3275.

Sincerely,

John A. Hayes
Chairman, President and Chief Executive Officer
Ball Corporation
Chair, Corporate Governance Committee
Business Roundtable

JH/mr

C: The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner
Mr. Keith F. Higgins, Director, Division of Corporation Finance
Ms. Anne K. Small, General Counsel and Senior Policy Director

Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law

Leo Strine, [excerpt, pp. 488-491]

March 2014

ISSN 1936-5349 (print)
ISSN 1936-5357 (online)

HARVARD

JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS

CAN WE DO BETTER BY ORDINARY INVESTORS? A PRAGMATIC REACTION TO THE DUELING IDEOLOGICAL MYTHOLOGISTS OF CORPORATE LAW

Leo E. Strine, Jr.

As prepared for publication in *Columbia Law Review*, Vol. 114 (2014)

Discussion Paper No. 766

03/2014

Harvard Law School
Cambridge, MA 02138

bothered to examine carefully the terms of the plan. Neither scenario reflects well on our corporate governance system, especially when that system gives stockholders an annual right to vote for directors. The strong empirical evidence that the most influential explanatory factor for the outcome of say on pay votes is the recommendation made by the most influential proxy advisory firm, instead of any factor directly related to the design of a pay plan,[110] suggests that the capacity of investors to think carefully about how to vote currently is overwhelmed by having annual say on pay votes at almost all listed companies. If the say on pay vote was really intended by its advocates to just be an outlet for stockholders to express generalized dismay, then they should say so and confess that they did not share their real motivations with Congress. By contrast, if the purpose of the say on pay vote was to provide stockholders with a powerful and reasoned voice about a key area of corporate decisionmaking that has an important incentive effect on corporate policy—the terms on which top managers are paid—its advocates should want a system of say on pay voting that optimizes the chances that compensation committees will develop sound long-term compensation plans for consideration by stockholders. These advocates should want stockholders themselves—and not just proxy advisory services—to give thoughtful feedback about them, both in advance of and in the form of a vote.

E. *Ensuring that Proponents of Corporate Action Share in the Costs They Impose on Other Stockholders*

Law and economics adherents like Bebchuk understand that when someone can take action that is personally beneficial and shifts the costs to others, he will tend to do so more than is optimal for anyone other

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recommendation from the proxy advisory service ISS, indicating that ISS's recommendations were more important than corporate total stock return or specific features of executive compensation in explaining stockholder votes); id. (suggesting that institutional investors rely upon ISS to identify compensation plans that should be voted down because corporations with performances and pay plans similar to those voted down receive affirmative support in the absence of an ISS negative recommendation). Another recent empirical study concludes that ISS is the most influential factor in the say on pay voting outcome, that corporations often change their compensation plans to avoid a negative ISS recommendation, that the stock market's reaction to the changed plans was "statistically *negative*," and that the "most parsimonious and plausible conclusion is that the [proprietary SOP policies] of proxy advisory firms . . . induce the boards of directors to make compensation decisions that *decrease* shareholder value." David F. Larcker, Allan L. McCall & Gaizka Ormazabal, Outsourcing Shareholder Voting to Proxy Advisory Firms 8–9, 44–45 (Rock Ctr. for Corporate Governance at Stanford Univ. Working Paper No. 119, 2013), available at http://ssrn.com/abstract=2101453 (on file with the *Columbia Law Review*).

110. See supra notes 107, 109 (citing empirical evidence which shows that the ISS recommendation is the most influential explanatory factor for the outcome of say on pay votes).

than himself.[111] Most investors would prefer that corporate managers not be distracted by the need to address shareholder votes unless those votes are about issues, such as a merger, that are economically meaningful to the corporation's bottom line. Under current law, however, a stockholder need only own $2,000 of a corporation's stock to put a nonbinding proposal on the ballot at the annual meeting of an American public corporation and need pay no filing fee.[112] By putting a proposal on the ballot in this way, a stockholder will necessarily require the corporation to spend hundreds of thousands of dollars on legal, administrative, and other costs,[113] and require all other investors to bear the costs of having to have their money manager agents spend time and money considering how to vote and ultimately casting a vote. And even a stockholder whose proposal has failed miserably can resubmit an identical proposal at the expense of the company's other stockholders.[114] The SEC requires the company to put a proposal that has failed once before on the ballot again unless it has been defeated within the past five calendar years by a vote of more than ninety-seven percent[115]—redolent of Ceausescu-style vote rigging.

These nonbinding votes, of course, come on top of the plethora of other votes shareholders are called upon to cast each year, including the annual vote on directors, the say on pay vote, votes to approve perfor-

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111. See Garret Hardin, The Tragedy of the Commons, 162 Science 1243, 1244 (1968) (explaining the tragedy of the commons with the classic example of herdsmen sharing a pasture, in which each will maximize his personal gain by increasing his herd until overgrazing depletes pasture); id. (observing that "[r]uin is the destination toward which all men rush, each pursuing his own best interest in a society that believes in the freedom of the commons"); see also Romano, Less Is More, supra note 43, at 230 ("When a party does not bear the full cost of its activity, it will engage in more of the activity, for in equating the marginal benefits and costs of the enterprise, a lower level of benefit from the activity suffices to meet the reduced cost.").

112. 17 C.F.R. § 240.14a-8(b)(1) (2013); see also Leo E. Strine, Jr., Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward, 63 Bus. Law. 1079, 1100 (2008) (citing 17 C.F.R. § 240.14a-8(b)(1) (2008)).

113. For a thoughtful article that considers the inefficiencies and costs imposed by the current shareholder proposal regime, see Romano, Less Is More, supra note 43, at 182–219.

114. 17 C.F.R. § 240.14a-8(i)(12) (2013) (detailing requirements for resubmission).

115. Id. The SEC permits a company to exclude a submission from its proxy materials only in very limited circumstances. If the proposal has only been proposed once within the preceding five calendar years and received less than three percent of the vote, then it can be excluded. Id. § 240.14a-8(i)(12)(i). If the proposal has failed twice within the preceding five calendar years, and on its last submission received less than six percent of the vote, the company can exclude the proposal. Id. § 240.14a-8(i)(12)(ii). The company can also exclude a proposal that has failed three times within the preceding five calendar years if on its last submission it received less than ten percent of the vote. Id. § 240.14a-8(i)(12)(iii). No matter how many times a proposal has failed in the more distant past, a company cannot exclude a proposal if it has not been submitted within the preceding five calendar years. Id. § 240.14a-8(i)(12).

mance-based compensation required by federal tax law,[116] binding votes on certain equity issuances that are required by the stock exchanges,[117] votes to retain the company's auditors,[118] as well as state law requirements that stockholders approve certain key transactions, such as mergers[119] and very substantial asset sales.[120]

In many states, candidates for office are required to pay a filing fee tied to a percentage of the salary of the office they seek. In California, for example, a United States Senate candidate must pay a fee equal to two percent of the salary of a Senator, or $3,480, and a candidate for even the State Assembly must pay a filing fee equal to one percent of her salary, or nearly $1,000.[121] Given the economic motivation of investors and the absence of larger reasons that exist to foster candidacies in election in actual polities, requiring sponsors of economic proposals filed under Rule 14a-8 to pay a reasonable filing fee to bear a tiny fraction of the much larger costs their proposal will impose on the corporation (and therefore other stockholders) seems a responsible method to better recalibrate the benefit-cost ratio of Rule 14a-8.[122] For example, the SEC could impose a

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116. 26 U.S.C. § 162(m) (2012) (prohibiting public companies from deducting more than $1 million in compensation for the CEO and four highest-paid employees unless such compensation is performance-based and approved by shareholders).

117. E.g., N.Y. Stock Exch., supra note 61, § 312.03(c) (requiring a shareholder vote to approve an issuance of common stock equal to or in excess of twenty percent of the voting power outstanding before the issuance).

118. Although the SEC does not require shareholders to vote on the retention of the company's auditors, such a vote has become standard. See Ernst & Young, Audit Committee Reporting to Shareholders: Going Beyond the Minimum 1 (2013), available at http://www.ey.com/Publication/vwLUAssets/Audit_committee_reporting_to_shareholders:_going_beyond_the_minimum/$FILE/Audit_committee_reporting_CF0039.pdf (on file with the *Columbia Law Review*) (reporting that more than ninety percent of Fortune 100 companies seek annual shareholder ratification of the auditor chosen by the audit committee).

119. Del. Code Ann. tit. 8, § 251(c) (2011).

120. Id. § 271.

121. Frequently Asked Questions—2012 Candidate Filing, Cal. Sec'y of State, http://www.sos.ca.gov/elections/statewide-elections/2012-primary/faq-2012-candidate-filing.htm (on file with the *Columbia Law Review*) (last visited Feb. 2, 2014); see also Tex. Elec. Code Ann. § 172.024 (West 2010) (charging a filing fee of $5,000 to be a candidate for U.S. Senate, and $750 to be a candidate for state representative); 2014 Qualifying Fees, Div. of Elections, Fla. Dep't of State, available at https://doe.dos.state.fl.us/candidate/pdf/2014_Qualifying_fees.pdf (on file with the *Columbia Law Review*) (last visited Feb. 2, 2014) (charging a filing fee of $10,440 to be a candidate for U.S. representative, and $1,781.82 to be a candidate for state representative). It is common for a state to charge one percent of the salary of the office sought as a filing fee, as is done in Delaware, Kansas, Nebraska, North Carolina, and Washington. Del. Code. Ann. tit. 15, § 3103 (2007); Kan. Stat. Ann. § 25-206 (2000); Neb. Rev. Stat. § 32-608 (2008); N.C. Gen. Stat. § 163-107 (2011); Wash. Rev. Code Ann. § 29A.24.091 (West 2005 & Supp. 2013). In Virginia, the fee is two percent. Va. Code Ann. § 24.2-523 (2011).

122. Roberta Romano has also advanced well-reasoned arguments in support of a proposal that would recalibrate the benefit-cost ratio of Rule 14a-8. See Romano, Less Is More, supra note 43, at 230 (suggesting that "eliminat[ing] the subsidy of losing proposals

modest filing fee of $2,000, or even $5,000, for any stockholder proposal addressing economic issues and increase the holding requirement to a more sensible $2,000,000[123] while still allowing proposing stockholders to aggregate holdings if they make appropriate disclosures.[124] If the advocates of a proposal cannot put up $2,000 to $5,000 and find other investors with an ownership interest of at least $2,000,000, they have no right to force other stockholders to subsidize the cost of their desire for voice, when our free society gives them many other ways to exercise their free expression rights. Likewise, corporations should be permitted to exclude from the proxy Rule 14a-8 proposals in later years if they do not get at least twenty percent affirmative support in their first year, and if after the first year, they obtain less than thirty percent support.[125] None of these proposals, of course, would preclude proponents from using their own resources to fund a proxy contest to propose a bylaw, but it would reduce the ability of stockholders to use corporate funds (and thus indirectly the capital of other stockholders) on a subsidized basis to press initiatives that the electorate has soundly rejected and help to temper the proliferation of votes that overwhelm the institutional investor community's capacity for thoughtful deliberation.[126]

F. *Creating a More Credible and Responsible Director Election Process*

Stockholders now have considerable, undisputed authority to adopt reforms to the electoral processes of Delaware corporations.[127] These

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under the SEC's proxy proposal rules" could incentivize cost-effective activism because fund managers would "scrutinize . . . the fund's corporate governance program, to determine which proposals are most likely to attract voting support, because their cash position will be affected if they do not").

123. In reality, this number could be rationally increased to $20 million or higher so long as aggregation was permitted.

124. Strine, One Question, supra note 91, at 23 (suggesting this approach).

125. See supra note 115 (discussing the very limited circumstances in which companies are permitted to exclude submissions from their proxy materials).

126. Respected scholars have recommended even stronger medicine than what I have recommended here, including allowing investors to vote to have their funds opt out of the SEC shareholder proposal apparatus entirely. See Romano, Less Is More, supra note 43, at 238 (explaining a potential reform to the shareholder proposal system that would "permit firms, by shareholder vote, to choose their proxy proposal regime, opting from among full, partial, or no subsidy regimes, for all or some proposals or proposal sponsors").

127. E.g., Del. Code Ann. tit. 8, § 112 (2011) ("The bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required . . . to include in its proxy solicitation materials . . . , in addition to individuals nominated by the board of directors, 1 or more individuals nominated by a stockholder."); id. § 113 ("The bylaws may provide for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors . . . ."); id. § 216 ("A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.").

Tab 4: Board Composition

2015 Corporate Governance Survey

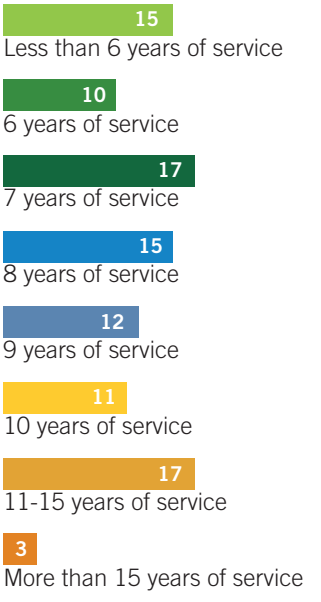
Shearman & Sterling, [excerpt, pp. 20-24]

November 2015

Board Refreshment

In today's constantly evolving and complex global business environment, board composition is increasingly in the spotlight. "Board refreshment" includes issues facing nominating/governance committees related to director tenure, experience, diversity and performance, all of which contribute to board effectiveness. While director continuity provides many benefits, nominating/governance committees are tasked with the responsibility of balancing those benefits with the need for fresh perspectives, diverse views, specialized experience and independence. The average board tenure at the Top 100 Companies is 8.44 years.

Average Tenure of Directors



Director Independence

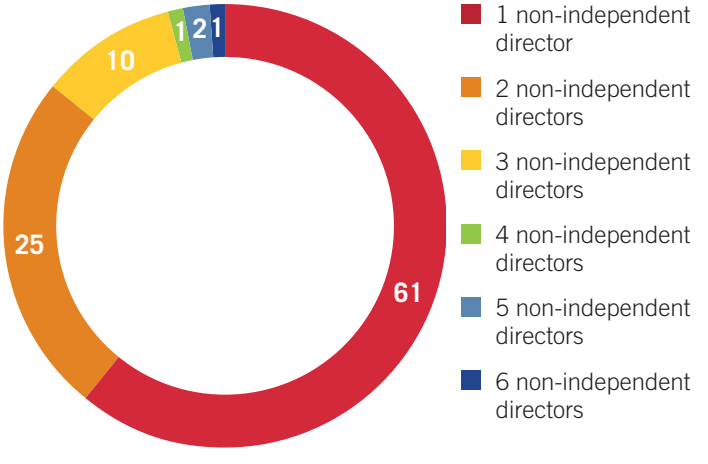
Independent directors constituted 75% or more of the directors on the boards of most of the Top 100 Companies. Over the last 10 years, the number of companies at which the CEO is the only non-independent director has increased significantly. COOs served on the boards of five companies and a CFO served on the board of one company.

94 companies have boards composed of 75% or more independent directors

61 companies have the CEO as the only non-independent director

30 companies have non-management directors who are not independent

Non-Independent Board Members

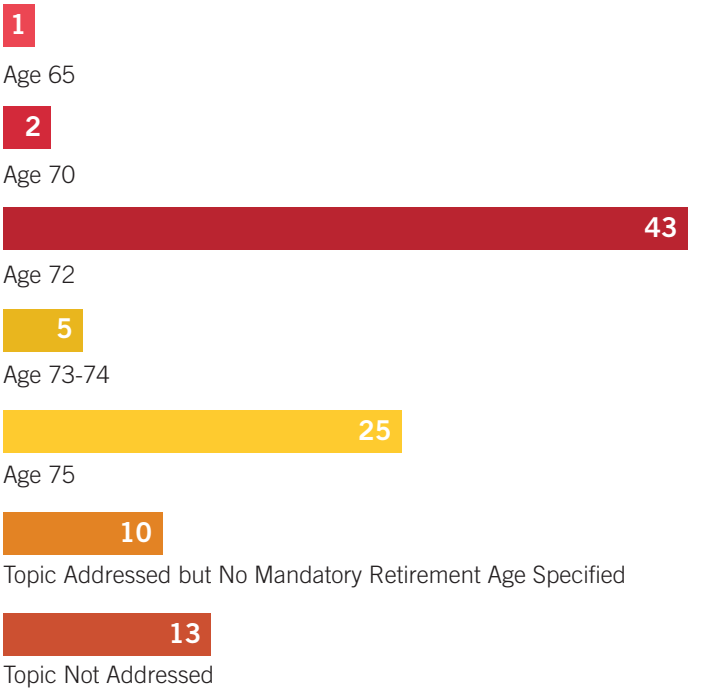


Mechanisms to Encourage Board Refreshment

Refreshing the board is often accomplished by adopting a mandatory retirement age for non-employee directors or, less frequently, by imposing mandatory term limits on service. Bright-line standards can eliminate the need to make difficult decisions about the continued service of an individual director, but they often do not take into account whether the directors are functioning effectively and can prolong the tenure of under-performing directors or cut short the tenure of directors who continue to make a contribution. The NYSE mandates board self-evaluations and many companies rely on them as a more effective means for ensuring board composition is appropriate and the board is functioning effectively.

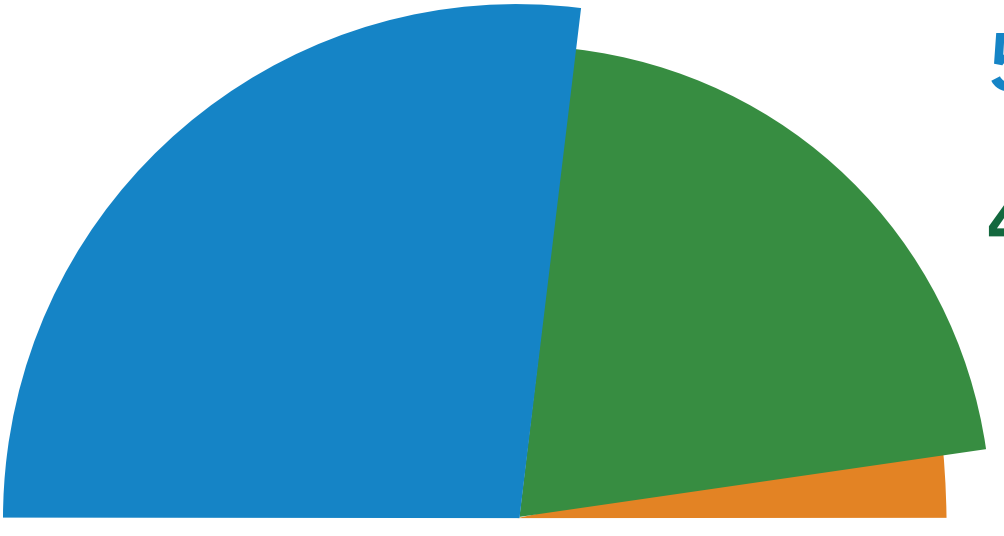
Retirement Age

Although not required by either the NYSE or NASDAQ listing standards, 77 of the Top 100 Companies have disclosed a mandatory retirement age for their non-management directors. Of these, 38 companies expressly permit the board or a committee of the board to make exceptions to the retirement age policy. Age 72 continues to be the most commonly selected age for mandatory retirement of non-management directors. Common practice requires management directors (other than chairs in certain instances) to retire from the board when they retire from employment with the company.



Term Limits

Only four of the Top 100 Companies have adopted mandatory term limits for their directors. The mandatory term limits apply only to non-management directors at three of these companies. Fifty-five of the Top 100 Companies specifically state that term limits have not be adopted, most citing the value of the insight and knowledge that directors who have served for an extended period of time can provide about the company's business. Many of these companies also state that periodic reviews by the board or a board committee of each director's performance serve as an appropriate alternative to mandatory term limits. One company has a 20-year term limit.



55 companies specifically state that term limits should not be adopted

41 companies do not address the topic of term limits

4 companies have terms limits ranging from 12 to 20 years

Board Structure and Practices

Size of Board

The size of the boards of directors of the Top 100 Companies ranged from seven to 17 members, with an average of 12 members. The board size of 74 of the Top 100 Companies ranged from 10 to 13 members.

2 8 or fewer members

3 9 Members

14 10 Members

23 11 Members

22 12 Members

15 13 Members

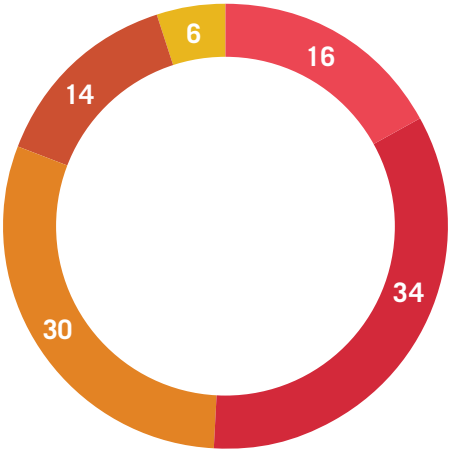
8 14 Members

5 15 Members

8 16 or More Members

Size of Audit Committee

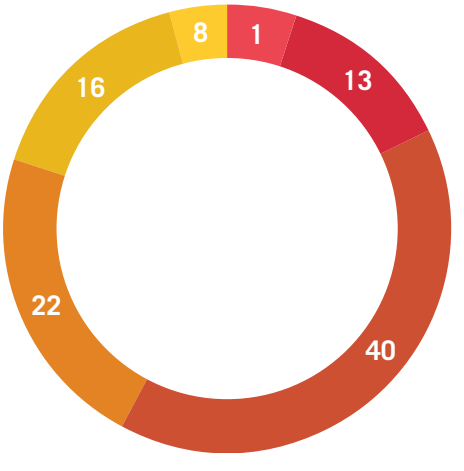
The number of members of the audit committees of the Top 100 Companies ranged from three to seven members. The number of financial experts on the audit committees of the Top 100 Companies ranged from one to ten. The median number of financial experts was four.



- 3 Members
- 4 Members
- 5 Members
- 6 Members
- 7 Members or more

Size of Nominating/ Governance Committee

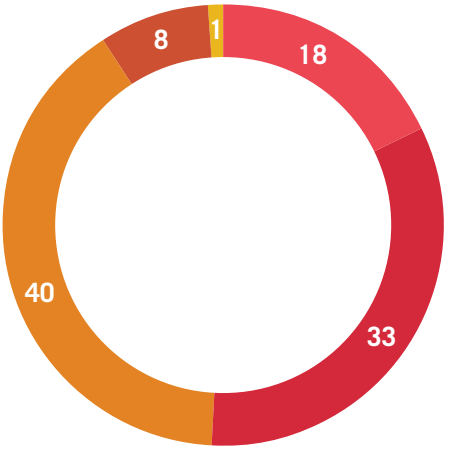
The size of the nominating/ governance committees of the Top 100 Companies ranged from two to twelve members.



- 1 Member
- 3 Members
- 4 Members
- 5 Members
- 6 Members
- 7 Members or more

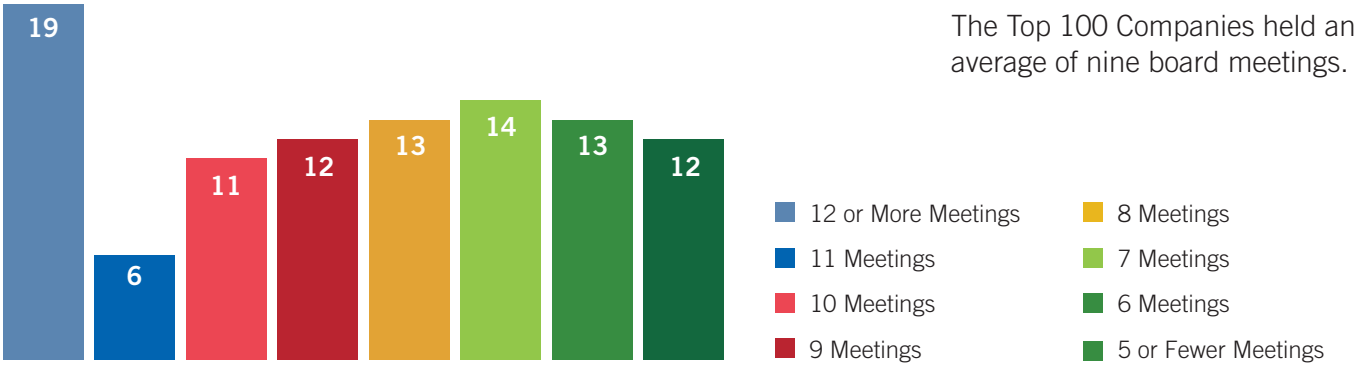
Size of Compensation Committee

The size of the compensation committees of the Top 100 Companies ranged from three to seven members.



- 3 Members
- 4 Members
- 5 Members
- 6 Members
- 7 Members

Number of Board Meetings

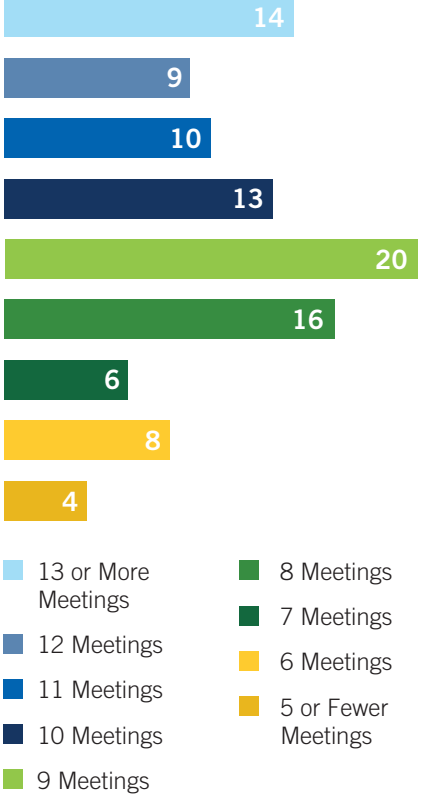


Fast Facts

The Top 100 Companies held an average of nine board meetings.

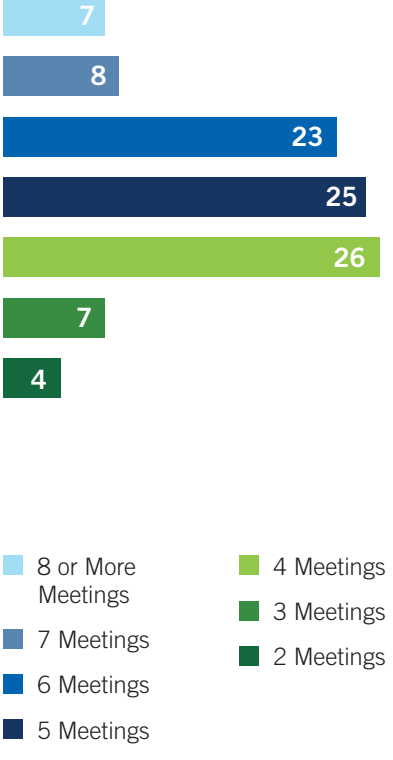
Number of Audit Committee Meetings

The Top 100 Companies held an average of 10 audit committee meetings.



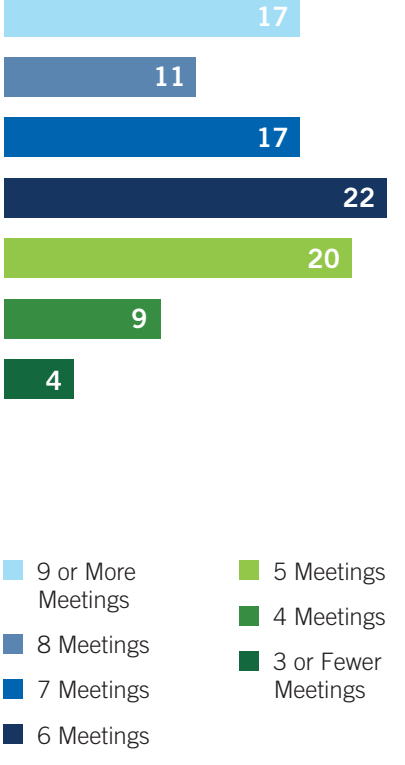
Number of Nominating/ Governance Committee Meetings

The Top 100 Companies held an average of five nominating/ governance committee meetings.



Number of Compensation Committee Meetings

The Top 100 Companies held an average of seven compensation committee meetings.



Audit Committee Financial Experts

Listed companies must disclose whether at least one member of the audit committee is an audit committee financial expert and, if not, why not. Although SEC rules require companies with an audit committee financial expert to disclose the identity of only one expert, 70 of the Top 100 Companies voluntarily disclosed the identity of more than one audit committee financial expert.

3

of the 27 companies that identify all audit committee members as financial experts are financial institutions (including insurance companies)

identify two or more (but less than all) audit committee members as audit committee financial experts

identify only one audit committee member as an audit committee financial expert

identify all audit committee members as audit committee financial experts

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The Trend Towards Board Term Limits is Based on Faulty Logic

Posted by Robert C. Pozen, Harvard Business School, on Monday, June 1, 2015

Editor's Note: Robert Pozen is a senior lecturer at Harvard Business School and a senior fellow at the Brookings Institution. This post is based on an article by Mr. Pozen and Theresa Hamacher that originally appeared in the *Financial Times*.

In the business world, experience is generally considered to be positive. When it comes to corporate directors, however, tenure is increasingly viewed with suspicion. Yet the trend towards board term limits is based on faulty logic and threatens performance.

The movement towards director term limits is global. In France, directors are not considered independent if they have served on the company's board for more than 12 years. In the UK, publicly traded companies must either comply or explain: terminate a director after nine years of service, or explain why long tenure has not compromised director independence.

In the US, the Council of Institutional Investors, which represents many public pension funds, urges its members to consider length of tenure when voting on directors at corporate elections. The council is concerned that directors become too friendly with management if they serve for extended periods.

Institutional Shareholder Services, the proxy voting advisory firm that is a powerful force in corporate governance, penalises companies with long-serving directors by reducing their "quick score" governance rating. Under the current methodology, a company loses points if a substantial proportion of its directors has served for more than nine years. Although ISS recognises that there are divergent views on this, it concluded that "directors who have sat on one board in conjunction with the same management team may reasonably be expected to support that management team's decisions more willingly."

But the assumption that lengthy director service means cozy relationships with management simply is not supported by the facts.

First, there is a lot of turnover in executive ranks. According to Spencer Stuart, the recruitment firm, in 2013 chief executive officers of S&P 500 companies held their jobs for just seven years on average. This figure has been falling over the past few decades.

Second, new research has found that experienced directors add value. In a study, economists at the University of New South Wales defined an experienced director as one with more than 15 years of service on the same board. This is superior to the typical definition in other studies,

which look at average or median tenure for the entire board. They then looked at the performance of 1,500 companies from 1998 to 2013, including those with and without experienced directors.

The study found that experienced directors were more likely to attend board meetings and become members of board committees. Companies with a higher proportion of experienced directors paid their chief executives less, were more likely to change chief executives when performance faltered and were less likely to misreport earnings intentionally. These companies were also less likely to make acquisitions, which often expand a chief executive's power while diminishing shareholder value. When they did, the acquisitions were of higher quality.

So, term limits do not increase director independence. Just the opposite: long tenure appears to help directors counterbalance chief executive authority. While term limits help companies refresh the boardwith new faces and talents, which can be desirable, they can lead to the loss of considerable experience and knowledge. This expertise is especially important in a complex company with global operations.

Of course, some directors may lose interest in a company, stop contributing to board discussions or start missing board meetings. They should be replaced regardless of their tenure.

Each year the nominating committee should make an inventory of the skills, experiences and characteristics the company needs. This analysis should take into account changes in the relevant industry and board norms, including director diversity. Then the nominating committee should evaluate whether these needs are being met by current board members or whether board composition should be adjusted.

In addition, the committee should conduct a rigorous annual review of the performance of each director. Unfortunately, some performance reviews of directors are superficial; others suppress criticisms of individual directors. If it does an effective review, it will be prepared to ask an underperforming director to step down, regardless of length of board service.

Careful assessments of board composition and director behaviour are more likely to contribute to corporate performance than mechanistic term limits.

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The "New Insiders": Rethinking Independent Directors' Tenure

Posted by Yaron Nili, Harvard Law School, on Tuesday, February 16, 2016

Editor's note: Yaron Nili is a fellow at the Harvard Law School Program on Corporate Governance. This post is based on Mr. Nili's recent article, The "New Insiders": Rethinking Independent Directors' Tenure, forthcoming in the *Hastings Law Journal.*

Director independence has become a key element of modern corporate governance in the United States. Regulators, scholars, companies and shareholders have all placed a strong emphasis on director independence as a means to ensure that investors' interests in their companies are well-served. Surprisingly, however, their treatment of director independence has generally failed to consider the impact of director tenure on the independence of boards. Indeed, although legislation, listing rules and state law mandate director independence, none of these rules take into account director tenure.

Recently, however, board tenure has been getting increased attention from investors, companies and shareholder advisory firms. Investors are becoming increasingly concerned with the potential negative impact that long tenure of directors may have on their independence. In a recent survey, ISS found that 74 percent of investors were concerned with the negative impact that long tenure may have on independent directors. Similarly, several institutional investors have recently amended their voting policies and guidelines to address the issue of director tenure. For instance, the Council of Institutional investors (CII) now encourages boards to weigh whether a "seasoned director should no longer be considered independent." Similarly, on December 16, 2015, CalPERS' Global Governance Policy Ad Hoc Subcommittee approved proposed revisions to the pension fund's Global Governance Principles to require that companies take a comply-or-explain approach on the issue of long-tenured directors. Under the proposed revised principles, a company would have two options with respect to a director who has served on the board for more than 12 years: either classify the director as non-independent or annually disclose a basis for continuing to deem him or her independent.

In my Article, The "New Insiders": Rethinking Independent Directors' Tenure, forthcoming in the*Hastings Law Journa*l (volume 67), I explore these issues and the potential impact of director tenure on director independence. The Article starts by delineating the key channels through which long director tenure may impact director independence. I demonstrate how longer tenure of directors can tighten their social ties and further augment the structural bias they may suffer from; how longer tenure increases the financial stake that directors have in the company, which in the context of director independence may not be optimal; and how the option to serve for long tenure increases the dependence of directors on management for re-election.

In addition to arguing that long tenure may, in itself through the aforementioned channels, directly impact the efficacy of current board independence standards, I also provide new empirical evidence regarding the significance, scope and prevalence of long tenured directors in large public companies. The data presented in the Article reflects that not only a significant portion of S&P 500 boards have long tenured directors but also that the tenure of directors has seen a steady and significant increase over the last twelve years. This documented increase in average tenure, juxtaposed against additional changes to board structure—such as the increased hiring of directors with strong "insider" background, including retired executives and insiders from other corporations—further underscores the importance of addressing the issue of board tenure and its potential impact on director independence.

The Article then situates this trend in the larger context of transformations in board structure. Specifically, I suggest that the rise in director tenure reflects a market attempt to push back against the regulatory emphasis on director independence that has forced companies to remove many of their high ranked executives from the boardroom. This reaction is manifest in the prevalence of what I term the "new insider," a hybrid board member who complies with current independence requirements but, through longer tenure and other attributes, possesses many of the traits that corporate insiders previously brought to the board table.

By allowing directors to accumulate specific business knowledge and to develop social and professional investment in the firm, public companies can now retain many of the benefits that inside directors possessed, while still appeasing regulatory and public requirements. However, at the same time, these long tenures and insider backgrounds might also erode the true independence of the board that the independence rules were intended to ensure.

This transformation in the composition of corporate board rooms and the need for truly independent directors in some key positions begs a rethinking of current independence standards. Coupling this market movement with the impact it might have on board independence, I explore the benefits and risks of this "new insider" model as well as the potential need for regulatory intervention. Specifically, I suggest that the current trend of increasing tenure on the board as a whole, and on key committees in particular, might threaten director independence. However, recognizing that increased tenure also carries with it several advantages for companies, particularly in light of the regulatory push for independent directors, I advocate for a soft regulatory fix that would allow companies to retain long tenured directors but would ensure that key committee members do not continue to increase their tenure. By limiting the amount of time a director could be considered independent for purposes of serving on key committees, namely the audit and compensation committees, the proposed solution balances the concerns regarding the impact long tenure might have on board members' independence with the benefits such directors might provide to the board as a whole.

The full article is available for download here.

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North America's Board Refreshment Challenge

Posted by Clare Payn, Legal & General Investment Management, on Sunday, February 21, 2016

Editor's note: Clare Payn is Head of Corporate Governance North America at Legal & General Investment Management. This post is based on a LGIM publication.

In the US, the board refreshment process is under scrutiny yet remains focused on retirement age limits. LGIM suggests a better way for US companies to refresh their boards.

Board term guidelines are scarce. Existing term limits are lengthy.

Board refreshment and director succession planning are key board tasks and the foundations of a well-functioning board. A board should remain relevant and diverse in terms of perspective, experience and skill sets. This ensures that the board can respond to risks and opportunities in order to sustain profit growth, maximize long term returns and guide the company successfully into the future.

To enable successful director succession planning and board refreshment:

LGIM EXPECTS:

- The Lead Independent Director (LID) along with the Chair of the Nomination Committee to periodically review the independence, expertise and skills on the board in the context of the company's long term strategy.
- Companies to illustrate through disclosure how board tenure is actively managed and assessed.
- Companies to demonstrate a robust succession planning process including how potential directors are identified and on-boarded.
- Key board committee memberships and the LID role to be held by directors who have not served on the board for an extended number of years.
- Companies to declassify their boards to allow for the annual election of directors.

A long-tenured board can be an indication of a poorly managed succession planning process and a lack of refreshment of skills and perspectives which then calls into question the quality of its members and the effectiveness of the board as a whole.

Only 3% of the S&P 500 specifies a term limit for directors, while the longest term limit is 20 years and the longest tenured director has served 48 years.

The longer tenure of a board director may also indicate a lack of independence from management. In the UK, for example, the independence of a non-executive director is re-assessed once they reach 9 years on the board and a company must explain after this period why it believes the director in question remains independent and still able to challenge. Such best practices have helped to lower average board tenure alongside strong independent board Chairs.

The mix of tenures and levels of experience on a board is fundamental and we do want long term experience on the board as corporate memory is vital to help the company navigate through cycles it may have seen before. Longer tenured directors are not necessarily ineffective to serve on a board as experience is important, but LGIM would discourage such directors serving as a LID or as members on key board committees where independence is essential. The independence of longer tenured directors should also be robustly re-assessed to ensure they remain independent with these assessments being disclosed to shareholders.

A board should be comprised of approximately a third relatively new directors, a third mid-tenured and a third longer-tenured directors.

This balance would allow a company to utilize the experience of the longer tenured directors whilst limiting the risk of high director turnover over a short period. Aside from independence potentially being compromised, lengthy board tenure can stifle the board in terms of replacing key skill sets and perspectives, limiting the board's ability to bring on new directors with relevant expertise. The world is dynamic and fast moving and boards need to be able to adapt to changes in technology, consumer trends and globalization and an active refreshment process and mix of tenures will provide newer experience.

The LID or Independent Chair should closely assess the independence, expertise and skills among the directors in the context of the company's strategy. This is not a personal critique, but rather an honest assessment of what is in the long-term interests of the company. A LID who successfully manages board rotation out into the long term is able to more easily identify skill sets that may need to be replaced in future as he or she will be aware of and able to manage those directors rotating off the board.

Over 100 companies in the S&P 500 have an "independent" board director who has served for 25 years or more.

As the LID actively engages in board refreshment planning they should take into account any tenure policies as well as input from board discussions and from the board and committee evaluation processes regarding the specific backgrounds, experiences and skills that will contribute to overall board effectiveness. Also considered should be the future needs of the board and its committees in light of the company's current and future business strategy and the qualifications and skills of directors who are expected to retire and rotate off the board in the future. This simple and thoughtful process will enable the LID to identify director talent with the preferred skills and background required. As a final part of this process a robust director onboarding and training process will allow new directors to contribute quickly.

This process will help recruitment as the potential director knows in advance that they are signing up for a finite period and will also empower the LID or Independent Chair to ask a board member to not submit for re-election, taking strength of character which we would expect in such a role. To be able to have regular, open and honest conversations on board composition can aid both the LID and the director when it may be time for an individual to rotate off the board. This is why LGIM are such strong proponents of a formal external board evaluation process.

LGIM considers the board evaluation process to be a positive exercise to help identify strengths and weaknesses of board composition which should be used to ensure successful board dynamics. This is a process designed not to reveal the shortcomings of board members but rather to help identify skills mismatches, expertise gaps and potential opportunities for succession and director training to help companies stay ahead of the curve.

Retirement ages are not enough. Yet the use of these is increasing.

It is common for companies in this market to have in place retirement age limits for directors. However, a company should have a more active refreshment process, as described here, not least as age limits are often extended once a director is approaching the set limit. Additionally, as demographics and lifestyles change, a director may join a board at a younger age and in today's world of people living longer, where a company has an age limit of 75 an individual could, under such a policy, be able to serve on a board for 25-35 years. There will be significant differences between different directors of the same age. It is often argued that companies do not want to lose the skill sets of a quality director who may be long tenured yet if succession and refreshment is being handled thoughtfully and appropriately, these skill sets and qualities will already have been identified in a replacement. A retirement age is simply a number and does not in fact allow or encourage the continual assessment of the ability, independence, or relevance of skills of a director.

Board refreshment is a key driver of a well-functioning board and it should be undertaken thoughtfully and regularly in order to create the best board and foster the understanding amongst its members that positions are not indefinite.

* * *

As LGIM continues to engage on this topic with companies, our voting policy will evolve over time but as we look towards how we shall begin to vote on this issue in 2017 and beyond:

LGIM WILL VOTE AGAINST:

- The Chair of the Nomination Committee if the average tenure of the board is 15 years or more.
- The Chair of the Nomination Committee if there has not been any new board appointments for 5 years or more.
- Key board committee members and/or the LID if they have been serving for 15 years or more.

2015 Corporate Governance Survey

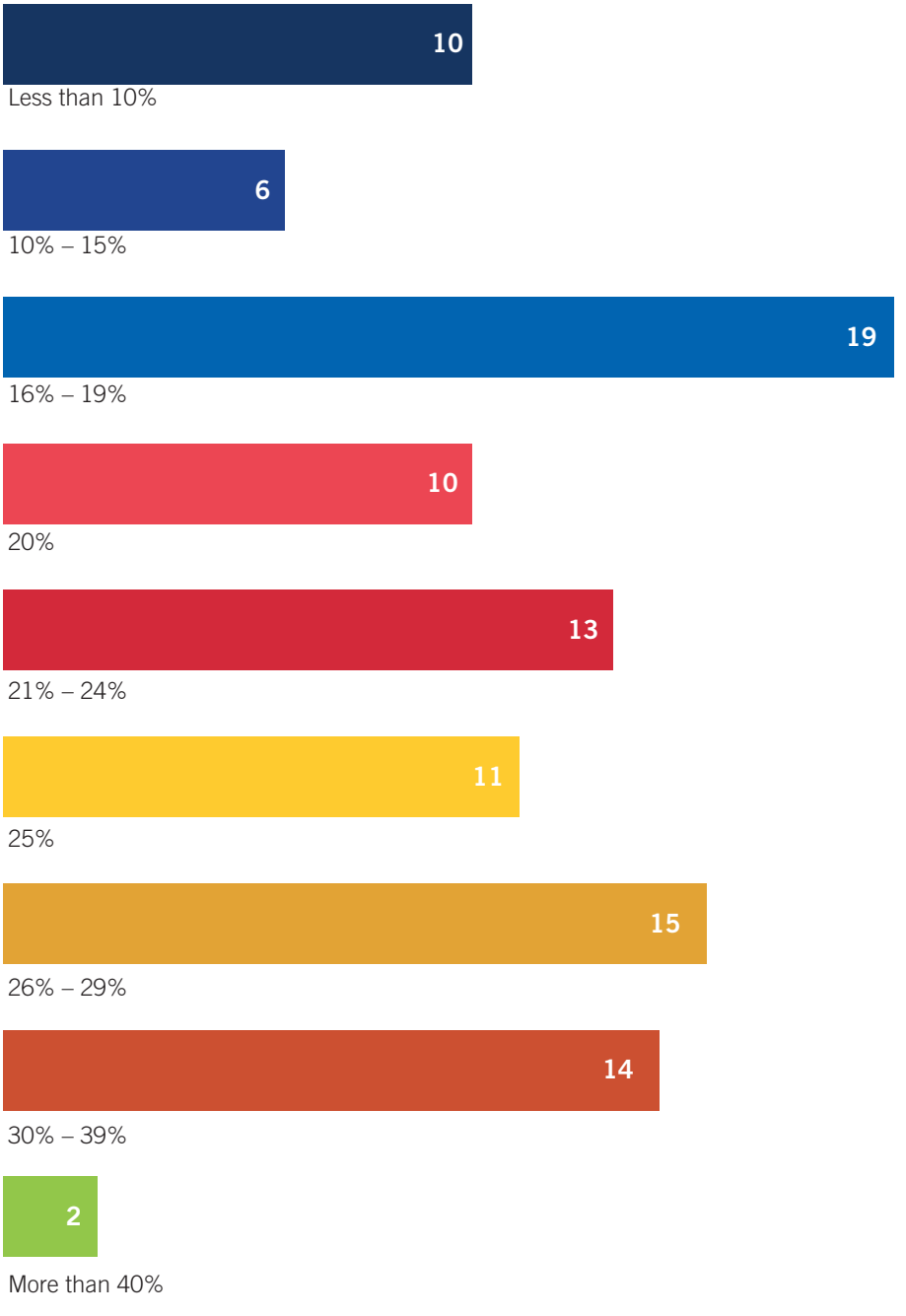
Shearman & Sterling, [excerpt, pp. 18-19]

November 2015

Women in Leadership

Women held approximately 22% of the total number of board seats at the Top 100 Companies in 2015. Only 16 of the Top 100 Companies have boards composed of 30% or more women members, and only two of these companies have a board of more than 40% women members.

Board Gender Diversity (% of Women on the Board)

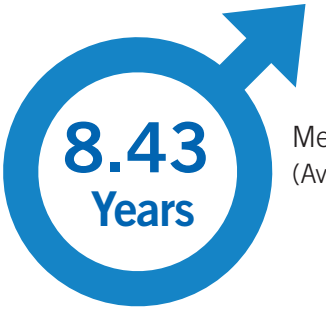


Women in the C-Suite

A woman served as the CEO at 11 of the Top 100 Companies and as both CEO and chair of the board at seven of those companies. A woman served as the CFO at 14 of the Top 100 Companies.

Fast Facts
Average Board Tenure

The average board tenure of male and female directors is about the same.



Men
(Average Age: 63.4)

Women
(Average Age: 60.8)

Increasing the Pace of Adding Women to Boards

Quotas have been implemented in a number of European countries as a means to achieve board gender diversity, but that approach has not gained much momentum in the US. A few states — Massachusetts, California and Illinois — have taken action to encourage gender-diverse boards by approving non-binding resolutions calling for minimum numbers of women directors on corporate boards, something short of imposing quotas. Looking to the quotas in place in Germany (30%) and Norway (40%) as a benchmark, the US is lagging far behind, with 84% of the Top 100 Companies having boards with less than 30% women members.

With the percentage of board seats held by women hovering around 22% for the past three years of our Survey, more needs to be done to increase the pace at which women are joining boards. For example, in 2015 a total of 46 new directors were added to the boards of the Top 100 Companies, and only eight (or 17.4%) of those new directors were women.

18

Top 100 Companies have women serving as chair of the audit committee

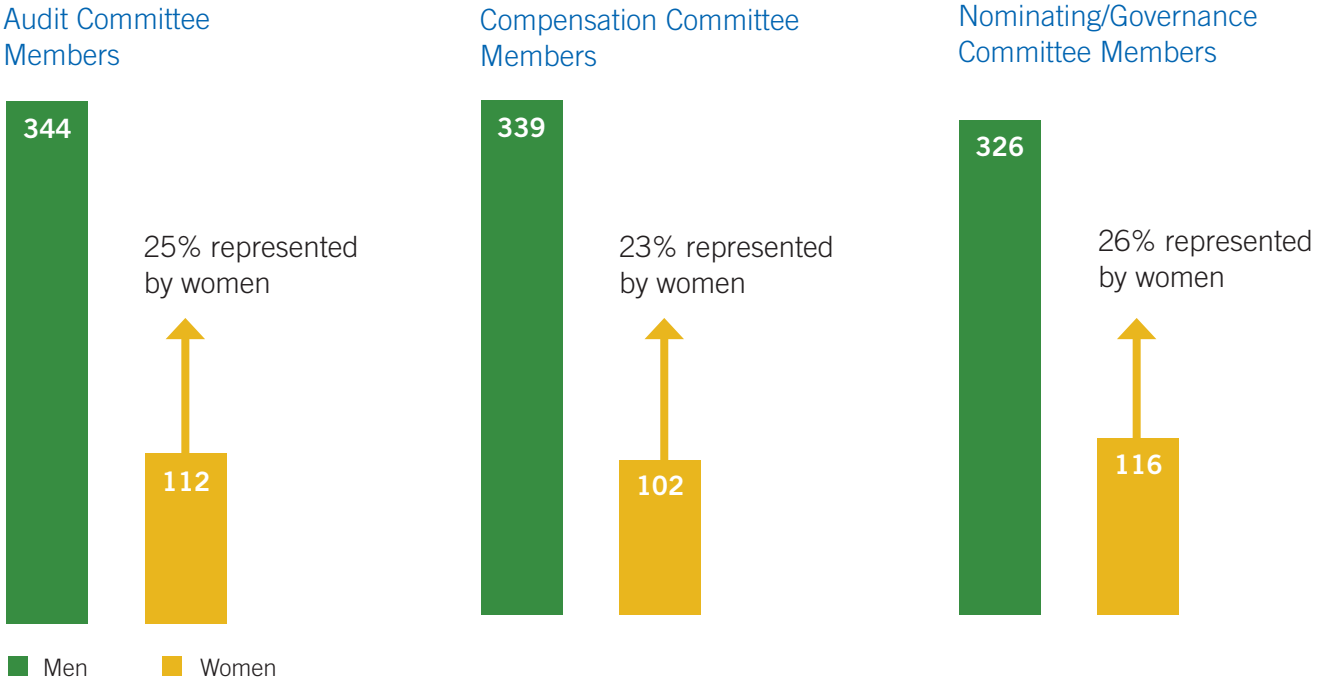
20

Top 100 Companies have women serving as chair of the compensation committee

26

Top 100 Companies have women serving as chair of the nominating/ governance committee

Composition of Board Committees



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The Pursuit of Gender Parity in the American Boardroom

Posted by Mary Jo White, U.S. Securities and Exchange Commission, on Tuesday, November 24, 2015

Editor's note: Mary Jo White is Chair of the U.S. Securities and Exchange Commission. The following post is based on Chair White's recent Keynote Remarks at the Women's Forum of New York; the full text, including footnotes, is available here. The views expressed in this post are those of Chair White and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

The Women's Forum of New York remains the critical, groundbreaking organization for successful women that it was when it held its first meeting in 1974. That was, by coincidence, the year I graduated from Columbia Law School. As one benchmark of progress, that year's graduating class was only 17 percent women. Today that number is 45 percent and, in some years, it is higher.

We all have indeed come a long way since 1974. Today, women receive more than half of all bachelors', masters' and doctorate degrees, and more than a third of MBAs. Women are approximately half of the total workforce and half of all managers. But there remain areas stubbornly resistant to the progress that objectively should have already occurred. One in the legal profession is the percentage of women who are equity partners at law firms—18 percent. That number has only increased two percent since 2006, and we had achieved 12.9 percent back in 1994. Another resistant area is the financial arena—we now account for 29 percent of senior officials in finance and insurance, and no woman has, for example, ever been CEO of one of the 22 largest U.S. investment banks or financial firms. A third critical area that has been a particular priority for the Women's Forum of New York is the focus of today's event: gender diversity in U.S. boardrooms.

Let us be clear at the outset, this is not a pipeline issue. We are here—in numbers, and we are qualified—in numbers. And yet, there are comparatively very few of us in corporate boardrooms—17.5 percent in Fortune1000 companies and 19.2 percent for the S&P 500.

This event, however, is proof positive that greater diversity in the boardroom is achievable. There are more than twenty U.S. companies being honored today whose boards are at least 40 percent women, and these are companies of all sizes and industries: Alaska Air, Macy's, Frontier Communications Corporation, Pacific Life Insurance Company, and TIAA-CREF. The percentage of women on Avon's board exceeds 60 percent and six companies, including Xerox and The Estée Lauder Companies, are over 50 percent.

We should all be extraordinarily impressed by these companies as well as by those exceeding the 20 and 30 percent marks that are also rightly being recognized today. Keep going. As a growing body of research confirms, it is smart business to have your board diversified to reflect the marketplace and benefit from broader perspectives. It is also the right thing to do.

But we do have a significant gap to close and should not minimize the extent or importance of that challenge. Only three percent of Fortune 1000 companies have at least 40 percent women in their boardrooms. While quotas are not the path we follow in the United States, the target goal of a minimum of 40 percent women on the boards of all Fortune1000 and S&P 500 companies by 2025 set by the Women's Forum of New York is within reach and an imperative. But it will not be easy.

Keeping a laser-like focus on gender parity by 2025 and vocally measuring progress each year, company-by-company, are essential. Reject any notion that there is a shortage of highly qualified candidates. If needed, excellent recommendations are there for a board's governance or nominating committee from, for example, the Women's Forum's database.

For those who may still doubt the wisdom and importance of gender parity on boards and for those who may despair because of the slow pace of progress, we have answers for you and are of no mind to be deterred.

A Bit of History

First, a bit of history to inspire us and to show how truly far we have come. Not all that long ago, women were on corporate boards only by virtue of birth or marriage. Largely in the 1950s, Abbott, IBM, Marriott International, and PepsiCo all had wives of the founder or former CEO become their first female directors.

Lettie Pate Whitehead was one of the first female directors of a major U.S. company. In 1899, Whitehead's husband Joseph was one of the first bottlers of Coca-Cola. When he died unexpectedly in 1906, Lettie took over both his bottling business and his real estate interests. With her at the helm, both were quite successful. And in 1934, Coca-Cola appointed Lettie Whitehead to its board where she served with distinction for nearly two decades.

Another trailblazer was Catherine Cleary. Cleary, who died in 2010 at the age of 93, became the first woman board member of AT&T, Kraft, and General Motors, and worked her way up through the ranks independent of her family ties. After graduating from law school in 1943, Cleary was hired by a trust company but told she might never be an officer because she was a woman. No was not an acceptable answer. Cleary went on to head that trust company, First Wisconsin Trust Co.

In 1974, President Ford summoned her to the White House to be considered for a position in his administration. According to the President's briefing memo, Cleary was considered a "big league player" who did "more than is required of the ordinary director." She was described as alert, inquisitive, articulate and poised, but it was also noted, and confirmed by several sources in the memo, that she could "cuss like a man" —apparently, a useful and important qualification at the time.

Another pioneer I would like to mention may be known to some of you, G.G. Michelson. When G.G. passed away last January at the age of 89, she had shattered more very high glass ceilings than most of us will ever see. She grew up partially in orphanages, graduated from Columbia Law School in 1947—the year I was born—and worked her way up to being a top executive at Macy's and deputy chairwoman of the New York Federal Reserve. She was also often the first or only woman on boards of major companies, including General Electric, Goodyear Tire & Rubber, and Quaker Oats. In 1989, she became the first woman to ever chair the board of trustees at an Ivy League institution when she was elected to that position at Columbia University. When the New York Times called her a trailblazer, G.G. replied with characteristic humility, "Sometimes it's better to let others view what you've achieved in historical terms while you just do the best you can as an individual."

I met G.G. in the 1990s when we both served on the Board of Visitors of the Columbia Law School. I was immediately struck by her integrity, clarity of vision, quiet strength, and concern for other people. She was not only one of the most impressive people I have ever known, but also one of the few women (or men) I have ever met whose passion for and knowledge of the New York Yankees rivaled my own. G.G.'s mission was to do her job well; she certainly did that and indeed set the gold standard for all of us who followed.

Where We Are Today

I think that G.G. Michelson, Catherine Cleary, and Lettie Pate Whitehead would be immensely proud of the celebration and discussion here today [November 19, 2015]. This room is full of women and men who want to see gender parity in the boardroom and have had a lot to do with bringing it about at their own companies. At our current pace, however, we would not achieve boardroom gender parity overall until 2090. A more acceptable, albeit still overly delayed, major milestone would be at least 40 percent by 2025. Let's take a closer look at the numbers to see where we are and where we have to go.

Today, at S&P 500 companies, women are 45 percent of the employees, nearly 37 percent of mid-level managers, a quarter of senior-level managers, 4.4 percent of the CEOs, and 19.2 percent of board members. As a point of reference again, the percentage of board members is only slightly better than the percentage of women in my law school class more than 40 years ago.

Despite the intense focus in recent years, we have not seen nearly enough progress in the boardroom for women or minorities. The number of women on U.S. boards of S&P 500 companies has, for example, increased only four percent over the past five years. To be sure, 19.2 percent represents an impressive increase from 1.8 percent in 1981. But it does not begin to approach parity and the U.S. also lags behind many other developed countries.

For large listed companies in the EU, women board members hit 20.2 percent in 2014 after being at only 11.9 percent in 2010. While much of that impressive, short-term jump is attributable to countries instituting quotas, significant progress has also occurred in countries without mandatory quotas. It can be done. And our slow progress, in the face of highly qualified, diverse candidates, the demands of investors, and the tangible benefits of greater diversity on boards, is not defensible.

Study after study shows that diversity of all kinds among members makes for stronger boards and companies. Recent research has, for example, found that women board members tend to better understand the perspectives of non-management stakeholders, including consumers and employees. One study also shows that women tend to use cooperation, collaboration and consensus-building more frequently, and they are more likely to make consistently fairer decisions among competing interests.

We have also seen a growing body of academic research demonstrating that having men and women together around the same conference table is associated with enhanced stock price and shareholder value. According to the 2012 Credit Suisse Research Institute study, companies with women on the board had higher average returns on equity and higher net income growth from 2005 to 2011. A more recent Reuters study found that globally, boards with female members tend to see better returns and less volatility compared to a benchmark index. And the list goes on. The powerful correlation drawn by these studies cannot be ignored. To borrow a phrase from the law enforcement realm, follow the evidence wherever it leads. And that place is parity in boardrooms.

Probably all of the women here today know from personal experience what it is like to be the only, or nearly only, woman in the room. When I became a partner in my law firm in the early 1980s, I was one of only two women partners, out of 75. You feel that kind of disparity, but do not always appreciate the kind of impact it may have your performance and progress.

It was not until about twenty years into my legal career that I saw firsthand the dramatic difference the numbers make. I call this my “Earth to Mary Jo” moment. It occurred in 1993. I was the newly-appointed U.S. Attorney for the Southern District of New York and had also been elected to chair a committee of other U.S. Attorneys from around the country who advised Attorney General Janet Reno. In that capacity, I attended General Reno’s weekly senior staff meetings, and, for the first time in my career, I was in a high-powered setting where there were more women than men. The impact was palpable.

The folks in the room, all Presidential appointees, were an impressive and powerful group of senior leaders. And it was the women who forcefully advocated their ideas and spoke freely, while the men seemed much more reticent. The lesson I learned there obviously carries over to the C-suite and the boardroom. The numbers do matter.

After completing my nine year tenure as U.S. Attorney in 2002, I was elected to the NASDAQ board. At that time, I was the first and only woman on the board. Happily, not too long after, I was joined by another woman, Deborah Wince-Smith, but I would have liked to have seen the dynamic if there had been at least three or four of us. At the time I was on the NASDAQ board, Adena Friedman, who spoke earlier, was the Executive Vice President of Corporate Strategy and Data Products and an obvious star. Adena is a great example of a woman who worked hard to rise in the ranks from a NASDAQ intern, to its CFO, to today, Co-President.

Board membership for women is itself a major professional achievement; it also leads to other career opportunities. The experience and the knowledge I gained as a NASDAQ board member also served me well both in my private sector life as a lawyer advising boards and in my current position as Chair of the Securities and Exchange Commission. By the way, I am pleased to say that I am the third, not first, woman to serve as SEC Chair. That is progress. And the President recently nominated two more women to the five-member Commission. If they are confirmed by

the Senate, the SEC would have four female commissioners for the first time in its history. That too is progress, and frankly sounds like a lot more fun.

I am also very happy, as Chair of the SEC, to have joined the ranks of many other women leaders in financial regulation. This “sorority,” if you will, includes Chair Janet Yellen of the Federal Reserve Board, Chairwoman Edith Ramirez of the Federal Trade Commission, Chairman Debbie Matz of the National Credit Union Administration, and Managing Director Christine LaGarde of the International Monetary Fund. It has also recently included Sheila Bair, the former Chair of the FDIC, and now president of Washington College. And this impressive list does not include agency heads like Attorney General Loretta Lynch, the first African-American woman to serve as the United States Attorney General.

So, women have more than arrived in the ranks of senior leaders in finance and government, but there is still a long way to go. We are, for example, working very hard at the SEC to achieve more diversity in the ranks of our most senior officers. The other financial regulators are doing the same. In both the public and private sectors, we must embrace and maintain a sense of urgency to expand senior-level opportunities for qualified women and minorities, including in the corporate boardroom.

The Path to Parity

Gender diversity—all diversity—deserves much more than lip service. Results are what matter. So, how do we get from A to B, “B” being gender parity on U.S. boards? There are a few direct and then more subtle ways to do this.

First, we should continue to strongly encourage governance and nominating committees to consider diverse candidates and urge CEOs to sponsor women and minorities they believe would make good board members. We can, as we are doing today, recognize and celebrate the leaders of progress. We can also, along with investors, continue to call out those companies and their boards that do and do not proactively reach forward. We also need to continue to use best practices to build supportive work environments.

On a more subtle front, this month’s Harvard Business Review showcased a research finding that companies whose CEOs have daughters may offer different perspectives on a range of issues. Those companies, for example, rank 12 percent higher in terms of social responsibility than those companies whose CEOs have only sons and, more generally, scored higher on diversity, employee relations and eco-friendliness. One of the study’s authors said that those CEOs “with girls may, for example, have seen their daughters discriminated against in the labor market, which could have an impact on their attitudes about equality.”

For fun, I looked at the CEOs (both women and men) on your 50 percent plus honor roll, and guess what? All of them who have children have at least one daughter. In the interest of full disclosure, Sheri McCoy, the CEO of the 60 percent plus Avon, has three sons. She obviously did not need the extra enlightenment of raising daughters. But perhaps we are onto another criteria for executive search firms and boards as they seek out gender progressive CEOs and other corporate executives.

Conclusion

Opportunities for women in the United States have never been greater—thanks to the trailblazers—thanks to those of you in this room—who have paved the way for more equality for women in education, business, the military and government service. The boardroom is a vital, remaining frontier where the playing field has just begun to level. And it is a critical playing field because corporate directors are among the most important gatekeepers in our financial system.

Strong boards are indeed key to the success of the SEC's mission to protect investors, maintain fair and efficient markets, and facilitate the capital formation that allows for the growth and innovation that sustains America's economic strength. None of us wants qualified women to be denied their place in such a critical role. Not only do women deserve to be corporate directors in numbers by virtue of our qualifications, but we are also demonstrated adders of value once we get there. Achieving gender parity by 2025 will require deep commitment and concerted efforts by all of us. But make no mistake, however challenging, the goal is attainable. It is also a business and moral imperative.

Thank you for listening.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Do Women Stay Out of Trouble?

Posted by Anup Agrawal, University of Alabama, on Thursday, August 20, 2015

Editor's note: Anup Agrawal is Professor of Finance at the University of Alabama. This post is based on an article authored by Professor Agrawal; Binay Adhikari, Visiting Assistant Professor of Finance at Miami University; and James Malm, Assistant Professor of Finance at the College of Charleston.

Does the presence of women in a firm's top management team affect the risk of the firm being sued? A large literature in economics and psychology finds that women tend be more risk-averse, less overconfident, and more law-abiding than men. As more women reach top management positions, these gender differences have implications for firms' policies and performance. As Neelie Kroes, then European Competition Commissioner provocatively asked in a speech at the World Economic Forum, "If Lehman Brothers had been *Lehman Sisters*, would the financial crisis have happened like it did?" (see *New York Times*, February 1, 2009).

Recent studies in financial economics and accounting find that behavioral attributes of key managers can affect how responsibly firms behave with various stakeholders and their tendency to bend the law (see, e.g., Hutton, Jiang and Kumar (2014), Di Giuli and Kostovetsky (2014), Schrand and Zechman (2012)). Motivated by well-known behavioral differences between men and women executives, in our paper, Do Women Stay out of Trouble? Evidence from Corporate Litigation, which was recently made publicly available on SSRN, we examine whether the presence of women in top management matters for corporate lawsuits.

Lawsuits are clearly a very important concern for corporations. An estimate by John B. Henry in the*Metropolitan Corporate Counsel* (February 2008, p. 28) suggests that the annual direct litigation cost of Fortune 500 companies was a whopping $210 billion in 2006, i.e., about one-third of their after-tax profits that year. Apart from direct litigation cost, lawsuits also hurt firms' reputations. Not surprisingly, companies lose significant market values upon the filing of lawsuits against them. Given the substantial impact of litigation, it is rather puzzling that little research has been done to identify the determinants of various types of lawsuits against firms. Our paper aims to fill this gap by examining the relation between the presence of women in top management and the number of lawsuits filed against a firm.

We hand-collect a novel dataset on various types of lawsuits against firms. Importantly, these lawsuits extend beyond securities class actions that most existing papers focus on. Our sample spans the years from 1996 to 2010 and covers firms in the S&P 1500 group in the year 2005. We measure gender diversity as the ratio of women among the top five managers of a firm. We find a negative relation between gender diversity and the number of lawsuits a firm faces. In particular, we estimate that a one standard deviation increase in the proportion of female executives in a firm's top management team leads to an average decrease of slightly more than one lawsuit per

year. This effect is economically significant given that the mean annual number of lawsuits faced by a firm is 2.37. This negative relation holds for most types of lawsuits we analyze, including lawsuits related to product liability, environment, medical liability, labor or pension, contracts, and intellectual property.

The presence of women in the top management of a firm is obviously not a random occurrence. For example, it is possible that women self-select into firms which are less likely targets of litigation. Similarly, firms that face greater litigation risk may avoid putting women in top management positions due to reservations about women's ability to deal with litigation. Moreover, our empirical specifications predicting lawsuits can have important omitted variables that simultaneously affect both the presence of women in the top management team of a firm and its litigation risk. This endogeneity poses a challenge in establishing a *causal* relation between the presence of women in top management and lawsuits against firms.

To deal with such endogeneity concerns, we employ instrumental variable techniques. Our first instrument for female representation in the top management team is the proportion of eligible males in a state who were drafted to serve in the Second World War. This instrument is motivated by prior findings that the war drew many women to the workforce permanently due to a decline in the domestic supply of male labor induced by the war. Importantly, the influence of the draft on the female labor supply for the later cohort persisted and varied across the states. Our second instrument is state-level gender equality index, which measures how equal women are to men in economic, political, and legal spheres of life for each of the 50 U.S. states. Results from our instrumental variable techniques point to a causal effect of gender diversity on lawsuits against firms.

We also examine a financial implication of the effect of gender diversity on lawsuits, and find that greater female representation in top management leads to a higher value of cash holdings in firms that are more susceptible to lawsuits. Among firms with high litigation risk, a firm with the mean proportion of women in top management enjoys 7 to 8 cents higher market value per dollar of cash it holds, compared to a firm without female top executives.

Our research contributes to at least two strands of the literature. First, we contribute to the literature on corporate litigation. Scant research examines the underlying causes of corporate litigation, especially lawsuits not related to securities. We help fill this gap by examining the effect of gender diversity on a variety of lawsuits faced by a firm. Second, this study contributes to the growing literature on gender diversity and corporate policies and performance. Overall, our paper sheds light on an important and previously unidentified benefit of the presence of women in the top management team.

The full paper is available for download here.

Automotive News

Naming GM's Barra chairman was 'tone deaf,' activist investor says

By Larry P. Vellequette | January 13, 2016

2016 AUTOMOTIVE NEWS WORLD CONGRESS

Wilson praises her performance as CEO

DETROIT — Harry Wilson, the activist investor who last year prodded General Motors to buy back $5 billion in stock, says that GM's recent move to make CEO Mary Barra board chairman was "remarkably tone deaf."

During questions at the Automotive News World Congress, Wilson said Barra is "doing a great job as the CEO."

But he added, "Being chairman of the board is a different job. Some people have characterized it as a promotion. It's not a promotion — it's a different job."

Wilson is both chairman and CEO of MAEVA Group, a suburban New York City boutique investment and corporate restructuring firm he founded in 2011. He was also a former member of the U.S. task force that restructured GM and Chrysler, and a self-styled champion of good corporate governance.

Raise, not new title

GM's board named Barra, 54, its chairman on Jan. 4, nearly two years after she took over the CEO role from Dan Akerson. Akerson held both titles when he retired from GM in January 2014.

At the time GM expanded Barra's role to include chairman, Theodore "Tim" Solso, immediate past chairman and the new lead independent director, said "the board concluded it is in the best interests of the company to combine the roles of Chair and CEO in order to drive the most efficient execution of our plan and vision for the future."

Wilson said it would be more appropriate to give Barra a raise for her "great job" as CEO. "I'd be in favor of that," Wilson said. "I think to get the best out of the board, the chairman should

be incredibly engaged in maximizing the knowledge base of the board members. That is a distraction, in my opinion, for Mary."

During his prepared remarks, Wilson said companies are best served by having five things: good products, good corporate governance, the right goals, the right incentives, and the right people.

"If the last seven years has taught us anything, it's that any business can fail," Wilson said. And the reason they fail is usually because one or more of the five things he listed is neglected or ignored.

'Long-term greedy'

Wilson said companies and their shareholders are best served by management and corporate boards which are focused more on the quality of their products and the character of their employees than on quarterly profits.

He said corporate officers need to be "long-term greedy" with their companies, which he defined as making decisions that are in the best interest of their companies and products over the long term, even if it means short-term pain.

Wilson is a director of Visteon Corp. and Sotheby's. He has a bachelor's degree in government from Harvard College and an MBA from Harvard Business School.

Harvard Law School Forum on
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Independent Chair Proposals

Posted by Avrohom J. Kess, Simpson Thacher & Bartlett LLP, on Tuesday, August 4, 2015

Editor's Note: Avrohom J. Kess is partner and head of the Public Company Advisory Practice at Simpson Thacher & Bartlett LLP. This post is based on a Simpson Thacher memorandum by Mr. Kess, Karen Hsu Kelley, and Yafit Cohn.

During the 2015 proxy season, 64 independent chair proposals were submitted to Russell 3000 companies, 62 of which reached a shareholder vote. This statistic is generally consistent with the number of proposals brought to a vote in 2014 and 2013, respectively. Issuers that received an independent chair proposal this year, however, may have found it more challenging to assess their chances of defeating the proposal, given that, for annual meetings occurring on or after February 1, 2015, Institutional Shareholder Services Inc. ("ISS") changed its voting policy with regard to independent chair proposals. ISS previously applied a more objective six-factor test, which gave issuers some measure of predictability and allowed them to conform their governance features to ISS's guidelines in an attempt to obtain an "against" recommendation. This year, however, ISS replaced this policy with a balancing test that takes a more "holistic" approach, which appears to have resulted in an increase in ISS recommendations in favor of independent chair proposals. Interestingly, ISS's increasing support of independent chair proposals has not had a material impact on the overall outcome of the voting results: only 3.2% of independent chair proposals passed this year, as compared to 5% and 8% in 2014 and 2013, respectively.

Positions of the Proxy Advisory Firms

ISS

Prior to this proxy season, ISS applied an objective six-factor test to determine its position with regard to independent chair proposals. Under this policy, ISS generally supported independent chair proposals unless the company counterbalanced the combined chairman/CEO structure through specified governance features.

Pursuant to ISS's newly revised policy guidelines, however, ISS generally recommends voting for independent chair proposals, taking into consideration the following factors, which it looks at "in a holistic manner": (1) the scope of the proposal; (2) the company's current board leadership structure; (3) the company's governance structure and practices; (4) the company's performance; and (5) any other relevant factors that may be applicable.[1]

[1] ISS, United States Proxy Voting Guideline Updates: 2015 Benchmark Policy Recommendations (Nov. 6, 2014).

This updated policy adds “new governance, board leadership, and performance factors to the analytical framework” for evaluating proposals. These include “the absence/presence of an executive chair, recent board and executive leadership transitions at the company, director/CEO tenure, and longer (five-year) TSR performance period.”

ISS has made clear that under its new “holistic” approach, any single factor that previously may have been determinative of a “for” or “against” recommendation may now be counterbalanced by other features of the company’s corporate governance. Consequently, under this holistic approach, companies have found it difficult to predict whether ISS will make a “for” or “against” recommendation.

Glass Lewis

Glass Lewis’s 2015 proxy voting guidelines on independent chair proposals remain unchanged from last year’s guidelines. As the proxy advisory firm takes the position that an independent chair is in the long-term best interests of shareholders and the company, Glass Lewis usually supports reasonably crafted shareholder proposals that seek to separate the roles of CEO and chair. That being said, Glass Lewis will not support proposals that contain “overly prescriptive” independence definitions and “may consider recommending against proposals where the company makes a compelling case for combining the two roles, has a clearly defined lead independent director role, has indicated that it intends to separate the two roles, and has strong performance and governance provisions.”[2]

Positions of Large Institutional Shareholders

The major institutional shareholders tend to be interested in a company’s governance structure, but vary in their positions on independent chair proposals. For example, Fidelity Management & Research Company generally votes against shareholder proposals calling for an independent chair unless it will further the interests of shareholders and promote effective oversight of management.[3] Other investors, such as State Street Global Advisors, analyze the proposals on a case-by-case basis, considering the presence of a lead director, the company’s performance and the general governance structure of the company.[4] Accordingly, when evaluating potential responses to a shareholder proposal to separate the chair and CEO positions, it is important to understand the positions of the company’s largest shareholders.

Independent Chair Proposal Trends

Overall Trends

- **Independent chair proposals were second in popularity among corporate governance-related proposals, though their number remains relatively steady**. From 2012 through 2014, independent chair proposals were the most popular among the corporate governance-related shareholder proposals submitted to Russell 3000 companies. In 2015, independent chair proposals were the second-most prevalent type

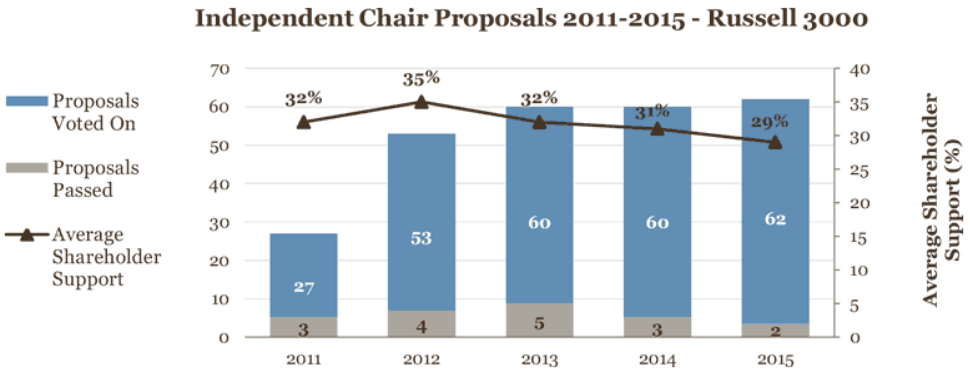
[2] Glass Lewis, Proxy Paper Guidelines, 2015 Proxy Season: An Overview of the Glass Lewis Approach to Proxy Advice, Shareholder Initiatives.

[3] *See* Fidelity Investments, Corporate Governance and Proxy Guidelines (Nov. 2014).

[4] *See* State Street Global Advisors, Proxy Voting and Engagement Guidelines: United States(Mar. 2015).

of governance-related proposal, after proxy access proposals.[5] Independent chair proposals have not always been so prevalent, however. Their popularity increased sharply in 2012, when the number of proposals submitted to a vote at Russell 3000 companies doubled from the previous year. For each of 2013 and 2014, the number of independent chair proposals voted upon at Russell 3000 companies has hovered around 60, with this proxy season yielding 62 proposals—the most submitted to a vote in the last five years.

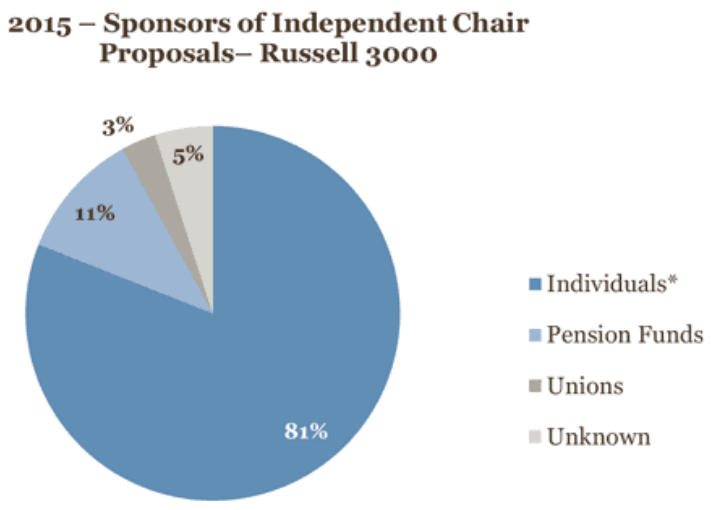
- **Fewer proposals passed, as compared with previous years.** During the 2011 through 2014 proxy seasons, between five and 11 percent of independent chair proposals submitted to a vote passed each year. This year, passage rates dropped, as only 3.2% of independent chair proposals passed.[6]
- **Average shareholder support remains relatively constant.** From 2011 through 2014, independent chair proposals received average shareholder support of 31-35%. This proxy season, independent chair proposals received average support of 29%.



- **The vast majority of proponents of independent chair proposals were individuals.** Activist investor John Chevedden, for example, was responsible for 24 of the 62 independent chair proposals (or 39%) put to a vote at Russell 3000 companies this proxy season.

[5] *See* Veritas Executive Compensation Consultants, U.S. Proxy Season Halftime Report—Governance Trends (May 26, 2015).

[6] *See* Appendix A for the list of companies at which an independent chair proposal passed.



* Ten people submitted 100% of the proposals submitted by individuals.

Impact of ISS Recommendations on Vote Results

ISS's policy change likely impacted the proxy advisory firm's rate of support for independent proposals this year. In contrast to 2013 and 2014, during which ISS supported 50% and 48% of independent chair proposals, respectively, ISS supported 63% of these proposals among Russell 3000 companies during the 2015 proxy season.

In 2015, the proposals supported by ISS received average shareholder support of 35%, as opposed to 19% average shareholder support for those proposals that received a negative ISS recommendation. Nonetheless—and despite the higher levels of ISS support noted above—the average voting results for independent chair proposals overall this proxy season generally paralleled those of recent years.

SEC No-Action Letters

Of the 35 no-action requests submitted to the Securities and Exchange Commission ("SEC") this proxy season with regard to independent chair proposals, three were granted on substantive grounds, 23 were denied on substantive grounds, and one was withdrawn by the company. The remaining no-action requests were based on procedural grounds. This proxy season, issuers made two successful arguments for no-action relief pursuant to Rule 14a-8's substantive bases for exclusion:

1. The proposal's language is inherently vague, so as to render the proxy statement misleading under Rule 14a-8(i)(3).
2. The corporation lacks the authority to implement the proposal under Rule 14a-8(i)(6).

The no-action requests that were denied on substantive grounds similarly made arguments based on Rule 14a-8(i)(3) and Rule 14a-8(i)(6). Several of these requests also included the argument

that the proposal was already substantially implemented and could, therefore, be properly excluded under Rule 14a-8(i)(10).

Vagueness under Rule 14a-8(i)(3)

Pfizer

The no-action letter issued to Pfizer was among the most unusual this season in that, after issuing the letter to Pfizer, the SEC staff reversed course in responding to similar no-action requests submitted by other companies, thereby generating uncertainty in the corporate community.[7]

The main argument presented by Pfizer in its initial no-action request and accepted by the staff was that the proposal was vague and indefinite such that it rendered the proxy statement misleading under Rule 14a-8. Specifically, Pfizer argued that the proposal failed to define the term "independent director." The proposal purported to define an independent director as one "whose only nontrivial professional, familial or financial connection to the company or its CEO is the directorship." Because Pfizer's non-employee board members are subject to stock ownership guidelines requiring them to own a certain amount of stock (worth $687,000 as of the date Pfizer drafted its request), the company maintained that it was unclear whether the proposal would disqualify all of its non-employee directors from serving as the independent chairman of the board. Accordingly, Pfizer argued, neither Pfizer nor its shareholders would be able to determine with any reasonable certainty exactly what actions or measures the proposal requires. Pfizer relied on a no-action letter issued in early 2014 to Abbott Laboratories, permitting the company to exclude a shareholder proposal calling for an independent lead director and defining independence as "a person whose directorship constitutes his or her only connection to our company."[8] The SEC concurred that the proposal submitted to Pfizer was similarly excludable from the company's proxy materials pursuant to Rule 14a-8(i)(3).

Interestingly, however, after several other companies with similar stock ownership guidelines as Pfizer requested no-action relief on the same ground as a result of identical language in the proposal, the SEC backpedaled. Approximately two months after issuing the *Pfizer* letter, the SEC declined to provide relief to Union Pacific Corporation, stating that "[a]lthough the staff has previously agreed that there is some basis for your view, upon further reflection, we are unable to conclude that the proposal, taken as a whole, is so vague or indefinite that it is rendered materially misleading."[9] The SEC issued nearly identical letters to another 16 companies that requested no-action relief on the basis of Rule 14a-8(i)(3) due to substantially the same language as that at issue in the Pfizer proposal. In the case of Pfizer, however, the SEC denied the proponent's request for reconsideration, allowing the initial no-action letter to stand, since the company had already sent its proxy statement to the printer.

General Electric

The independent chair proposal submitted to General Electric ("GE") asked the Board to separate the roles of CEO and Chair. Among other things, the proposal stated that the board could cure a

[7] *See Pfizer Inc.* (*avail*. Dec. 22, 2014; *recon. denied* Mar. 10, 2015).
[8] *Abbott Laboratories* (*avail*. Jan. 13, 2014).
[9] *Union Pacific Corp*. (*avail*. Feb. 26, 2015).

violation of independence by "follow[ing] SEC Staff Legal Bulletin 14C."[10] In its request for no-action relief, GE argued that this sentence refers to an external standard that cannot reasonably be understood by shareholders reading the proposal and its supporting statement. Accordingly, GE, citing Staff Legal Bulletin No. 14B (Sept. 15, 2004), maintained that "neither the stockholders voting on the proposal, nor the company in implementing the proposal (if adopted), would be able to determine with any reasonable certainty exactly what actions or measures the proposal requires." The SEC agreed with GE that the proposal was vague and indefinite and could be properly excluded from GE's proxy statement pursuant to Rule 14a-8(i)(3).

Lack of Authority to Implement the Proposal under Rule 14a-8(i)(6)

The Goldman Sachs Group

Goldman Sachs received an independent chair proposal that requested "that the Chairman of our board of directors shall be an independent director. For the purpose of this proposal, an independent director is defined as at page 23 of the firm's Proxy Statement for the 2014 Annual Meeting of Shareholders."[11]

In support of its no-action request to exclude this proposal, Goldman Sachs argued that the company lacks the power or authority to implement the proposal under Rule 14a-8(i)(6) because it could not "guarantee that an independent director would (1) be elected to the Board by the Company's shareholders, (2) be elected as Chairman by the members of the board, (3) be willing to serve as Chairman, and (4) remain independent at all times while serving as Chairman." Goldman Sachs also argued that the proposal did not "provide the Board with an opportunity or mechanism to cure a situation where the Chairman … fails to maintain his or her independence." The SEC concurred with the company that the board does not have the power to ensure that its chairman remain independent at all times, and the proposal did not provide the board with an opportunity or mechanism to cure any violation of the independence standard proposed. Accordingly, the SEC agreed that Goldman Sachs could omit the shareholder proposal from its proxy materials.

Takeaways

Though independent chair proposals continue to be among the most prevalent governance-related proposals, they seldom garner majority support, regardless of proxy advisory firm support. Boards should be prepared to receive independent chair proposals, but should keep in mind that, absent systemic governance or performance failures at the company, these proposals are unlikely to pass. Boards should take a firm stance against an independent chair proposal if they believe combining the positions of chair and CEO is in the best interest of the company at the time the proposal is received. As is the case with all shareholder proposals, however, a board's failure to implement a successful independent chair proposal puts the directors at risk of receiving an "against" recommendation from ISS.

[10] *General Electric Co*. (*avail*. Jan. 15, 2015).
[11] *The Goldman Sachs Group, Inc*. (*avail*. Jan. 28, 2015).

Appendix A

Companies At Which Independent Chair Shareholder Proposals Have Passed

2011	2012	2013	2014	2015
Aetna Inc.	KeyCorp	Freeport-McMoRan Inc.	Healthcare Services Group, Inc.	Omnicom Group Inc.
Moody's Corporation	Kindred Healthcare, Inc.	Healthcare Services Group, Inc.	Staples, Inc.	Vornado Realty Trust
Vornado Realty Trust	McKesson Corporation	Kohl's Corporation	Vornado Realty Trust	
	Sempra Energy	Netflix, Inc.		
		Vornado Realty Trust		

Tab 5: Engagement

New Investor Guide on Engaging on ESG Issues

Gibson, Dunn & Crutcher LLP, [excerpt, pp. 3-10, 18-20, 30]

June 2015

ENGAGEMENT STRATEGIES

The consideration of environmental, social and governance (ESG) matters in investment decision making and post-investment engagement has many names. References to responsible investment, impact investing, ESG engagement, stewardship, socially responsible investment (SRI) and sustainability investment will imply different activities for different parties. And, confusingly, sometimes the same term is used to mean different things by different commentators. However, the common thread is that, in addition to financial or economic performance, the way in which companies manage the ESG aspects of their business is vital to the investor.

The Significance of ESG Engagement

Michelle Edkins, BlackRock

Engagement—direct communication between investors and companies—on environmental, social and governance matters is on the rise in the United States. A number of factors seem to be driving this change. First, companies seem more interested in understanding their shareholders' views. Many are engaging with the ESG specialists at their long-term investors as part of their broader investor relations programs, which have historically focused solely on Wall Street. Second, investors are developing specialist teams to conduct those conversations, in recognition of the connection between sound ESG management and corporate resilience. And third, there is today much greater public scrutiny of companies and investors and the role they play in the economy and society more generally.

> *"The key is to make conscious decisions about whether, and where, engagement fits into the investment strategy."*

It's difficult to precisely quantify the value created by shareholder engagement. But it is easy to see the problems created in its absence—evidence of value destroyed or unattained—arguably by disengaged shareholders enabling companies' poor management of ESG matters. Even so, the value proposition for shareholders will depend on the investment mandate and consequent investment strategy. There will always be investors who determine that selling is their best option when signs of poor management emerge, just as there will be investors who see a path to long-term growth driven in part by their engagement and influence. The key is to make conscious decisions about whether, and where, engagement fits into the investment strategy.

For those inclined to engage, active investors—those analyzing companies individually to identify the better investment alternative—can use engagement to their benefit, both before and after investing. Understanding ESG business drivers at a company helps investment decision-making by enabling portfolio managers to identify the full range of potentially unrewarded risks and otherwise unidentified opportunities.

Once an investment is made, engagement is often the preferred option to selling shares in underperforming companies, particularly for those with large stakes or a long investment horizon. For investors in indexed strategies, engagement (including proxy voting) is the only option for signaling concern to companies and is often seen as a fundamental part of fiduciary responsibilities. For some, the concept of stewardship responsibilities is intertwined with investment style, requiring engagement over passivity regardless of how the investment is made.

While engagement is fundamentally about communication, it can take a variety of forms. The approach taken by an investor will be influenced by the way they invest, by their investment time frame, by their philosophy around shareholder responsibilities and, often, by the level of interest from clients or others to whom they are accountable. When there is engagement, the technique used will also be influenced by the urgency of the situation and by the responsiveness of the company.

Some investors define "engagement" as any communication with a company that enhances mutual understanding. Others believe engagement, by definition, is intended to bring about a change of approach or behavior at a company. Many see it as a continuum covering all this and more, including full-blown activism. The point is to express views and concerns to those who can do something to address them—a company's board and management.

This variety of perspectives and techniques is expertly covered in the pages that follow. They reflect not only the influences mentioned above, but also the nuanced interaction that engagement tends to be. Underpinning them all is a framework of well-thought-through policies, specific to each investor's circumstances, and the objective of protecting long-term shareholder value. Nonetheless, it is clear that ESG engagement is more an art than a science. We hope this collection of experiences provides some guidance and helps inform your own approach.

REASONS TO ENGAGE ISSUERS ON ESG TOPICS

- *Inform your proxy voting and voting guidelines*
- *Augment your research*
- *Clarify public information*
- *Identify quality of management indicators*
- *Gauge sophistication of a company's strategy*
- *Understand peer performance indicators*
- *Identify potential vulnerabilities*
- *Develop insights into investment and growth opportunities*
- *Understand potential regulatory impacts and threats*
- *Identify how companies are positioned to mitigate risks or leverage opportunities*
- *Improve your reputation as an active and engaged owner*

Laying the Foundation for Successful Engagement

Anne Sheehan and Brian Rice, California State Teachers Retirement System (CalSTRS)

Step One: "The Plan"

The first step in deciding whether an engagement program is right for you and your firm is to solicit buy-in from key decision makers, and then to memorialize your engagement approach in documentation that can be shared with the companies with which you will be engaging. For example, at the California State Teachers Retirement System (CalSTRS), we lay the foundation for our engagement program through our Investment Management Plan (Plan). This Plan is the foundation for all our investment efforts at CalSTRS, and it identifies at a high level that we will "engage corporate management to seek information and understanding of the corporate decision and its ramifications on ESG issues." Our Environmental-Social-Governance (ESG) policy serves as an overlay to the Plan, and is applied across all asset classes. The Plan is updated through internal staff analysis and recommendations to our Board. Our Board then uses independent fiduciary counsel and fiduciary consultants to fully review all investment considerations and to ensure alignment of the Plan with our fiduciary duty to beneficiaries.

Our Plan is publicly available at: www.calstrs.com/sites/main/files/file-attachments/a_-_investment_policy_and_management_plan_9-2013.pdf

> *"The first step in deciding whether an engagement program is right for you and your firm is to solicit buy-in from key decision makers..."*

Each asset class integrates the CalSTRS ESG policy into its investment implementation. We have formed high-level, cross-asset teams consistent with our total portfolio approach. These teams consist of directors, portfolio managers and investment officers from each asset class within the total CalSTRS portfolio. Each representative must consider ESG opportunities and risks not only for their own asset class but also for the total fund. These teams do not rely entirely on internally generated data, but are also responsible for working collaboratively with other members of the global investment community to further the Board's goals. Notably, we've successfully engaged with companies on issues of diversity, climate change, stranded assets, energy efficiency and sustainable business practices, all intended to produce economic growth, profits and positive cash flows across all asset classes and fully consistent with our Plan.

Step Two: Practical Implementation

Many forms of engagement can be used to potentially increase the value of your assets and to mitigate risk, including:

1. Holding **direct conversations** with portfolio companies, regulators and issue experts
2. Doing **educational outreach** with the marketplace
3. **Collaborating** with other investors, companies and advocates
4. **Convening summits** to identify and reach tipping points
5. **Soliciting** shareholder proposals
6. **Sponsoring** academic and other intellectual **analysis** on the issues, to increase market participant awareness

You will need to decide for your organization which of these forms of engagement is most appropriate for you and your beneficiaries or clients. However, it's important to note that these forms of engagement can be used for all types of investment funds and products, and may also be leveraged within specific investment allocations, or with funds intending either to capture positive impact or to explicitly mitigate risk from ESG factors, in what might be called SRI funds or products.

> *"Notably, we've successfully engaged with companies on issues of diversity, climate change, stranded assets, energy efficiency and sustainable business practices, all intended to produce economic growth, profits and positive cash flows..."*

Step Three: Develop a Focus List

Some public pension funds may have their list of ESG engagement efforts developed externally, as when they are mandated by state legislatures through prohibited or restricted investments. Other funds may have their ESG efforts developed by a fund board of directors working to establish ESG priorities that address portfolio risk issues or respond to concerns raised by beneficiaries. Finally, some funds may develop their engagement candidate lists through internal staff analysis.

Formulating a focus list can be done in several ways. A common way is to review the financial return of identified companies and then look at the worst performers over a specific period, generally one, three and five-year periods for long-term investors. CalSTRS uses a blend of both the bottom-up (or specific company) approach, and the top-down (or systemic issues) method, in designing its annual engagement plan. It is important to note that some companies do remain on engagement lists for a number of years.

For additional information on the CalSTRS approach on ESG issues, please visit: www.calstrs.com/corporate-governance-overview

METHODS FOR SELECTING COMPANIES FOR ENGAGEMENT

- *Select a consistent review period each year for the portfolio to identify outliers in terms of financial/ESG performance where it is possible to influence change.*
- *Review these factors at the companies:*

1. **Financial performance**—Are they a financial outlier?
2. **ESG ratings**—How do they measure compared to their industry?
3. **Ownership structure**—How much do you own? Is it a controlled company, or how much is owned by insiders or your peers? (i.e., to determine your ability to affect change)
4. Which ESG practices are of concern at the companies, and of those, which are most important to your organization or your clients or beneficiaries?
5. Has there been a controversial proxy vote or a controversy in general?
6. Has the company been unresponsive to majority votes on shareholder proposals?
7. Has the company worked against shareholder rights (e.g., through bylaw amendments) without shareholder approval?

Determining the Initial Approach to a Company

Anne Simpson, California Public Employees Retirement System (CalPERS)

Communication is the simple key to enable shareowners to effectively engage with companies. Yet the question of with whom, when and how to engage is not so simple. Here are some thoughts on terms of engagement for owners—how to navigate the dialogue on sustainability.

Who

When investors are concerned with sustainability issues, with whom should they engage? It is important to consider where it is appropriate to direct the issue. Is it a matter for the board of directors in its entirety? The chair or the lead director? Or a particular committee that may be responsible for the issues of concern, such as risk or audit? Is it better to address concerns to the company's staff, such as its General Counsel or Corporate Secretary? Should the matter be channeled though an Investor Relations Chief or the Sustainability Officer? Is it an issue for Public Affairs or Stakeholder Relations? Circumstances will vary according to company size, policy and circumstance.

Investors need to engage the company board, for a straightforward reason: The board of directors is appointed by and should be accountable to the company's owners. The board's chief is its chair or lead independent director, who has the role of ensuring that the board fulfills its critical role of overseeing management. One of the most important tasks for the chair or the lead independent director is setting the agenda for board meetings. If a sustainability issue seems of strategic importance, then it is entirely appropriate that the investor ask that the matter be discussed by the board and a full response be provided.

> *"Investors need to engage the company board, for a straightforward reason: The board of directors is appointed by and should be accountable to the company's owners."*

An example is climate change risk and opportunity. The Ceres-led Carbon Asset Risk Initiative is posing tough questions to fossil fuel–based energy majors about their risk scenarios, and plans to devote new capital to further the development of carbon intensive fuels, which may pose hazards to their balance sheets. These are not questions for staff, however well-intentioned. Rather, they are fundamental, strategic questions about the companies' long-term future success and critical issues in both risk management and scenario planning. As such, they are properly matters for the board.

Other issues of concern to investors may arise that are equally valuable for the board to be aware of. An example is seen in Duke Energy, which saw a massive coal ash spill at a time when precious few of its board members had any coal industry experience. Questions were raised primarily by just two investors—the New York City Comptroller and CalPERS. An investor protest can signal serious issues that a board needs to address. Massey Energy is another example, where the state of North Carolina, CalPERS and other funds engaged around the company's poor governance. This was an early cause of investor protest. When these and other health and safety disasters strike, it often becomes clear that poor governance allowed lax standards, and human tragedy followed.

(See page 28 for the case study Lessons Learned from the Massey Energy Engagement*.)*

An investor may have questions that can be answered by an explanation of current operations—for example, the company's record of compliance with particular environmental regulations. In this case, the company staff will be ready to provide information. As such, that information should be made public; which is why CalPERS supports integrated reporting in order that the ESG factors which drive value and risk are fully presented to investors, and we support initiatives like the Global Reporting Initiative and the Sustainability Accounting Standards Board which provide useful guidance. In turn, CalPERS publishes its own sustainability report[1] and our engagement guidelines in our Global Governance Principles.

Investor inquiries can be a tremendous advantage to companies. They serve as a vital early warning on issues. BP saw such an earthquake in its share price after the Gulf oil spill disaster prompted engaged investors to use their voting rights to call for the removal of the chair of the board's risk committee.

1 *CalPERS Towards Sustainable Investment & Operations: Making Progress*

> *"Investor inquiries can be a tremendous advantage to companies. They serve as a vital early warning on issues."*

When

Companies' own flow of announcements is in part governed by the regulatory regime, which quite properly means that certain times are not conducive to conversation. Investors should take advantage of the period after companies' annual general meetings (AGMs) to have conversations about the longer term, which cannot always be addressed in the intensely busy period in the run up to the AGM. Or they should have the conversations before announcements when companies are in a closed period. It is also important to note announcements concerning retirements and appointments. In making contact with a board, check first with the Corporate Secretary whether board meetings are held monthly, quarterly or otherwise. It will be important to know when the board might discuss your issue of concern and whether it will do so before filing of the company's annual proxy statement.

How

It is always helpful to companies to have advance warning of concerns. A call is usually appreciated, be it to the General Counsel, the Corporate Secretary or the Investor Relations Chief. Better still, a letter of concern to the board can be delivered via the General Counsel or the Corporate Secretary, although addressed to the board chair or lead independent director. CalPERS usually sends hard-copy letters to board members through registered mail, and does not rely solely on email, to ensure that concerns are seen. As needed, we translate letters into local languages to facilitate communication.

Some investors use this moment to inform the press. A company's board may well be reading about the issue in the media before it has had a chance to respond to the investors' letters. CalPERS prefers to raise the issue with companies first so that boards have an opportunity to respond.

Another issue is discretion. Once discussions have begun, it is important that investors exercise discretion and, at minimum, clearly state their intentions. On occasion, investors have spoken to the media during discussions, thereby losing trust. If an investor intends to speak to the media, they should tell the company that is their plan before discussions begin.

It is important the investors set out their views clearly in advance. CalPERS has a framework of Investment Beliefs[2] which explains where ESG issues factor into our fiduciary duty to foster long-term, sustainable, risk-adjusted returns. We state that value is created from the effective management of three forms of capital: financial, human, and physical, hence our concern with integrated reporting. We also state that risk is multifaceted, and that our long-term investment horizon is both an advantage and a responsibility. Engaging with companies, intermediaries and policy makers is part of that responsibility.

If diplomacy breaks down and an agreement cannot be reached, investors will often turn to more formal methods, such as shareholder proposals. They will argue that filing a proposal is a clear way to get management's attention, if not the board's, and once investors have that attention, progress can likely be made.

The situation can vary both at the company and with the shareowner. If both sides navigate with care, then engagement can be fruitful. Shareholder votes on sustainability resolutions are rising, year after year, so there is good reason to engage with companies before the voting season begins.

2 CalPERS Beliefs

Tailoring Your Engagement Plan

Tracey C. Rembert, Ceres

No matter the level of resources you can devote to engaging with companies, there are situations where certain strategies are more appropriate to use than others. Engagement strategies range from sending letters and making phone calls to informed proxy voting, filing a shareholder proposal or attending an annual meeting and making remarks. They can also include dialogue with a company or with a large group of shareholders, having private communication with company experts or targeting directors through "vote no" campaigns and other board-focused strategies. Whichever strategy is used, research, follow-through and setting clear expectations are a must for successful engagement.

Fitting the right engagement strategy to the relevant corporate context can be tricky, but a few questions can help guide you in selecting the strategy that might be most effective:

1. **Has the company or its board ignored repeated attempts by yourself (or other shareholders) to discuss needed improvements, increased disclosure or greater risk oversight?** Then perhaps shareholder collaboration or public strategies are actually what are needed.
2. **Has the C-suite become so entrenched and recalcitrant that private measures no longer have traction?** If so, the board may be a better target for communication.
3. **Do you know if other shareholders share your concerns?** If so, collaboration with other investors will be easier and more effective.
4. **Are investors already engaging on the company or industry and topic?** Do your homework to make sure you are not duplicating effort, or that companies are not approaching an issue with a divide-and-conquer strategy.
5. **Is your engagement focused on multiple asset classes?** If so, you will need different tools for them and must set different expectations for outcomes.
6. **Are you worried that public knowledge of your engagement might harm the company's reputation or impact the share price?** Then keeping dialogue confidential might be your best option.
7. **Do you prioritize deep and long-term relationships with some of your core holdings?** Then holding an in-person meeting with the Chief Executive or board members might get you further than meeting merely with a company expert.
8. **Do you have access to a company's board or the CEO?** It might be more effective, and use fewer resources, to start at the top.
9. **Does the company have a respected internal advocate on the topic of concern?** If so, meeting with junior staff might produce more lasting results if that person can help build buy-in internally.
10. **Have you held the company for a number of years, and do you plan to continue holding for years more?** Again, this might prioritize more direct and high-level contact with a company, even if you are a smaller shareholder.

> *"Whichever strategy is used, research, follow-through and setting clear expectations are a must for successful engagement."*

Once you have figured out which companies you'd like to focus on, you've lined up support internally to engage them, and you've determined how you want to initially approach a company, then it's time to jump in and test the waters. The strategies on the following pages, shared by leading experts in governance and ESG engagement, are only a few of many well-tested methods for communicating your concerns to corporate leaders.

We have chosen not to focus on three strategies in this guide—lawsuits, books and records requests, and proxy access—because these have, to date, either been used largely for financial or corporate governance matters, or regarding proxy access, do not have a multi-year track record of use on ESG matters (as a substantial proxy access campaign tied to diversity and carbon asset risk was just launched in late 2014 by the New York City Comptroller).

ENGAGEMENT CHECKLIST

- *Develop your institutional plan and garner internal buy-in.*
- *Do your research—both internal and hiring external—to prepare you for the engagement to come.*
- *Fine tune your issues focus and any pertinent sectors involved.*
- *Develop a focus list.*
- *Establish which types of engagement you are likely to employ as well as your level of resources to achieve your goals.*
- *Determine how you will initiate communications with the company or entity.*
- *Give the company clear guidance on what to respond to, and by what date.*
- *Be explicit about why you need the information you seek, or why you are suggesting specific management or performance changes.*
- *Prepare to measure outcomes or impacts, and plan early for needed follow-through and staff time and resources.*

HIGH RESOURCES/MULTI-YEAR COMMITMENT

Books and records request

Vote no campaign against director(s) or key committee(s)

Proxy access/running a candidate for the board

Lawsuit

Reaching Out to the Board of Directors

Brandon Rees, American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)

Shareowner engagement with boards of directors is one of the best ways to advocate for attention to material ESG issues. Here are some tips and ideas for engaging with directors effectively:

1. **Identify the best director to engage.** Research your company's board of directors and evaluate each director's background and professional experience. Generally, the best director to engage with is an independent director who is in a leadership position on the board (e.g., the lead director or a committee chair).

2. **Write a letter.** Send a letter addressed to the director articulating your concerns. Explain why your ESG issue is a concern for shareowners more broadly. Do not assume that the director is aware of the issue you are raising. Let the facts speak for themselves, and try to write persuasively, rather than argumentatively.

3. **Send the letter.** You should refer to the company's proxy statement for instructions on how to communicate with the board. You may wish to copy the entire board. In addition to sending the letter via the company, send your letter to the director's primary place of business or hand deliver the letter at the annual general meeting (AGM). Registered mail works well.

4. **Follow up.** If a satisfactory response is not received after a reasonable time, contact the director by telephone, or engage a director privately at a public forum, such as an investor conference. Or try an annual meeting of another company where the director serves on the board.

5. **Meet with the director.** If the director responds to your letter, offer to meet in person or arrange a telephone call. Consider including other shareowners in the conversation (but make that transparent to the director). Usually, a representative of company management (e.g., a Corporate Secretary or General Counsel) will also want to participate.

> *"Shareowner engagement with boards of directors is one of the best ways to advocate for attention to material ESG issues."*

In some cases, shareowner engagement with directors may not be successful. In these cases, you may decide to run a "vote no" campaign to urge shareowners to withhold their vote from the director's re-election. Alternatively, consider nominating a new director to the board by suggesting names to the nominating committee or conducting a proxy solicitation.

Here are some key steps for running a successful "vote no" campaign:

1. **Identify your fellow shareowners.** Research the proxy voting policies and contact information for key decision-makers at the company's major shareowners.

2. **Send shareowners a "fight letter."** Circulate your campaign materials as soon as practical after the company publishes its proxy statement. Consider using Broadridge Financial Solutions to forward your materials to beneficial owners who are bank and broker clients.

3. **Comply with the SEC's solicitation rules.** Under Rule 14a-2(b)(1), "vote no" campaigns are generally exempt from certain SEC proxy rules so long as you do not seek to act as a proxy for other stockholders. However, if you own more than $5 million in shares, you must file your materials and a "notice of exempt solicitation" with the SEC under Rule 14a-6(g).

4. **Educate proxy voting advisors.** Share your campaign materials with key proxy voting advisors, such as Institutional Shareholder Services and Glass, Lewis.

5. **Contact the proxy voters.** Although many institutional investors will not disclose how they plan to vote, call their proxy voting staff to explain your concerns.

6. **Publicize your campaign.** Talk to reporters who follow the company, industry, or issue area, and use social media, like blogs and networking sites.

7. **Attend the annual general meeting.** Speak from the floor at the company's AGM to voice the concerns of shareowners that supported your campaign.

Engagement Through the Proxy Vote

Michael McCauley, State Board of Administration (SBA) of Florida

The State Board of Administration (SBA) of Florida frequently attempts to influence and make improvements in the corporate governance structures and ESG practices of individual companies we own. We achieve these objectives through a number of different, but integrated, strategies. One element of these efforts includes the development of comprehensive corporate governance principles and proxy voting guidelines. Managing stock ownership rights and the proxy vote includes the establishment of written proxy voting guidelines, which must include voting policies on issues likely to be presented, procedures for determining votes that are not covered or that present conflicts of interest for plan sponsor fiduciaries, procedures for ensuring that all shares held on the record date are voted, and procedures for documentation of voting records and making them transparent. The SBA's proxy voting guidelines reflect internationally recognized governance practices for well-managed public companies, covering the independence of boards of directors, performance-based executive compensation vehicles, high-quality accounting and audit practices, and emerging ESG issues of concern, as well as transparent board procedures.

> *"We achieve these objectives through a number of different, but integrated, strategies. One element of these efforts includes the development of comprehensive corporate governance principles and proxy voting guidelines."*

Through the development and implementation of comprehensive principles and proxy voting guidelines, the SBA ensures that our proxies are voted consistently across all portfolios and market structures. We are reliant on our Corporate Governance Principles to direct our activities related to ESG engagement and proxy voting. These principles, in conjunction with other relevant policies, set the parameters for company engagement and provide a framework for our initiatives. The SBA's Proxy Voting Guidelines are formulated and revised in accordance with these principles, on at least an annual basis.

Our voting guidelines are based on rigorous empirical research, industry studies, investment surveys, and other general corporate finance literature. SBA proxy voting policies are based on both market experience and balanced academic and industry studies, which aid in the application of specific policy criteria, quantitative thresholds, and other qualitative metrics. Empirical citations provide evaluation of specific items over long time frames, in excess of three years—and also are applied extensively, analyzing companies of various sizes and geographic locations.

Although we believe that it is essential to confront corporate boards with poor oversight practices, we also recognize the necessity of allowing boards to direct the businesses that they have been entrusted to oversee without excessive interference; therefore, we do not attempt to impose highly prescriptive procedures upon the companies we own. However, to balance our position, we vote "against" any proposal that limits shareowner rights or makes it more difficult for shareowners to have a voice in company practices, as well as certain board structures, super-majority requirements, and others.

Frequently, the SBA discusses proxy voting issues and specific ESG topics directly with owned companies. For example, we may write letters to members of a board to communicate our general or specific concerns. Less frequently, we may seek opportunities to meet with individual directors or committees of the board to express similar views or submit shareowner proposals for approval on a company's proxy statement. Incorporating the information achieved through direct engagement helps the SBA to make better voting decisions, with an opportunity to apply timely and nuanced factors within our decision-making process.

The SBA discloses all proxy voting decisions once they have been made, several days before the date of the shareowner

> *"Although we believe that it is essential to confront corporate boards with poor oversight practices, we also recognize the necessity of allowing boards to direct the businesses that they have been entrusted to oversee..."*

meeting. Disclosing proxy votes prior to the meeting date improves the transparency of our voting. Disclosing votes in advance of their effective dates emphasizes the SBA's position on corporate governance and ESG practices.

Our votes across all primary ballot items and topics of focus are compared to other major investors' voting decisions (generally the largest or top five shareowners) as well as to the entire voting market. In addition to benchmarking voting against other market participants, the SBA regularly evaluates the policy frameworks implemented by our external proxy advisors. Vote benchmarking helps shareowners identify new topics requiring policy treatment within their own guidelines. Finally, a comprehensive report is published for our stakeholders annually, providing a detailed summary of voting results across a variety of topics and highlighting significant trends in company engagement and regulatory changes.

VOTING: IT'S ALL ABOUT COMMUNICATION

Vicki Bakhshi, F&C Investments (Part of BMO Financial Group)

Proxy voting is one of the main levers investors have to promote high standards of governance at the companies they own. Yet too often, as long as their resolutions are passed, company attention to shareholder views fades the day the AGM ends. At F&C Investments, we believe there is great value in engaging with companies not only ahead of the ballot, but also afterward, by highlighting to companies when we have voted against management, and telling them the reasons why.

When we cast a vote, we record comments, summarizing the rationale behind our voting decisions. These comments are entered into our service provider's platform when the vote is executed, and are published the day after the meeting.

In principle our commitment could end there. Some particularly diligent companies might then go to F&C's website and look up the reasons for our voting decision; but realistically this will be a small minority. We believe we have a duty to go further, and that it is part of our responsibility as shareholders to actively alert companies to the decisions we have taken.

We therefore write to all companies where we have opposed at least one resolution or board nomination to alert them to this, and to direct them to our online vote reporting where they can find out the reasons why. In 2014, this meant contacting over 3,500 companies, by email and letter. We receive responses from companies keen to secure our support in future years—some reassuring us about their commitment to good governance and sound ESG practices, and others asking for further dialogue about our voting decision and the standards we apply.

Where our vote was accompanied by active engagement, we will often write a more personalized letter directly to the Chairman, summarizing the reasons for our final decision. This helps to put our engagement definitively on the record and serves as a point of reference for the next year's vote. Such letters can also help to provide internal leverage for those within companies pressing for improved standards, by giving them evidence of investor support.

Escalation Strategies: The Council of Institutional Investors' Ignored Majority Votes Initiative

Matthew Frakes, Council of Institutional Investors (CII)

The Council of Institutional Investors (CII) has long held that if a majority of investors support a shareholder proposal, the board should adopt the recommended action. Similarly, CII's policies call for directors who fail to win majority support to step down from the board. In short, CII believes that boards should take shareholder votes seriously—and act on them.

To advocate for these long-held policies and to hold boards accountable, CII has written since 1996 to all Russell 3000 companies reporting majority votes on shareholder proposals. The letters ask them to adopt the majority-recommended action and report back to CII. In 2010, CII expanded its letter campaign to call on any Russell 3000 director who failed to win majority support—a so-called "zombie director"—to step down from the board. Both efforts were launched following concerns that boards were simply disregarding these majority votes.

Company responsiveness to CII's outreach has markedly improved over the years. In the earliest days, a 10 percent response rate was considered high, and the tone of at least some responses was less than cordial. However, times have changed. By 2014, when CII sent letters to 65 companies with 78 majority votes, the company response rate had climbed to 43 percent—the same rate as in 2012 and 2013, when the majority votes included a sustainability reporting proposal that received 67 percent support at CF Industries Holdings.

> *"By 2014, when CII sent letters to 65 companies with 78 majority votes, the company response rate had climbed to 43 percent..."*

Real results have followed these increasingly robust response rates. By the start of the 2015 proxy season, companies had taken substantive action to implement 75 percent of the majority-supported shareholder proposals from 2012, 74 percent of the 2013 majority-vote-winning proposals, and 31 percent of the majority votes from 2014.

> *"By the start of the 2015 proxy season, companies had taken substantive action to implement 75 percent of the majority-supported shareholder proposals from 2012..."*

Still, more than half of the contacted companies do not respond to CII or fail to adopt the majority-recommended action. To spotlight these non-responders, CII tracks all letters sent—including the reason for the letter and the number of consecutive years similar letters have been sent to the company—and makes all responses and follow-up actions available to CII members, who frequently use this data to identify companies for special attention in the following year.

CII plans to continue this program, which it believes has been highly successful in holding boards accountable for their actions and keeping shareholders informed of company responsiveness.

Harvard Law School Forum on
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The Changing Dynamics of Governance and Engagement

Posted by David A. Katz, Wachtell, Lipton, Rosen & Katz, on Thursday, July 23, 2015

Editor's note: David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz specializing in the areas of mergers and acquisitions and complex securities transactions. The following post is based on an article by Mr. Katz and Laura A. McIntosh that first appeared in the *New York Law Journal*; the full article, including footnotes, is available here. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here), The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here), The Law and Economics of Blockholder Disclosure by Lucian Bebchuk and Robert J. Jackson Jr. (discussed on the Forum here), and Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

As anticipated, the 2015 proxy season has been the "Season of Shareholder Engagement" for U.S. public companies. Activist attacks, high-profile battles for board seats, and shifting alliances of major investors and proxy advisors have created an environment in which shareholder engagement is near the top of every well-advised board's to-do list. There is no shortage of advice as to how, when, and why directors should pursue this agenda item, and there is no doubt that they are highly motivated to do so. Director engagement is a powerful tool if used judiciously by companies in service of their strategic goals. As companies and their advisors study the lessons of the recent proxy season and look ahead, it is worth examining recent shifts in corporate governance dynamics. With an awareness of the general trends, and by taking specific actions as appropriate, boards can prepare and adapt effectively to position themselves as well as possible to achieve their strategic objectives.

Governance Dynamics Trends

Since 2000, the corporate environment has changed in many ways. A thoughtful white paper by The Conference Board discusses five of the most significant legal, social, and market trends during this time period that have contributed to the changing dynamics of corporate governance. These trends have been transformative, and, taken together, they are foundational to shareholder-director engagement today. The first is the increased influence of institutional investors. This is due primarily to the concentration of stock ownership in institutionally-held investment and savings accounts, and to a lesser extent to changes in voting rules and practices and proactive steps by institutional investors to influence corporate governance and direction. The second trend is a shift toward a purely commercial understanding of the purpose of a corporation. Though mid-20th century America generally agreed that a corporation had

responsibilities to society as well as to its shareholders, in recent years the prevailing view held by many investors is that public corporations exist primarily to maximize shareholder value. Conflicting interpretations of this goal have produced a further debate as to whether the appropriate timeframe for doing so is the long- or short-term horizon.

The third trend is declining public trust in business and its leaders. Public confidence in corporate America plummeted with the collapse of Enron and WorldCom and the financial scandals that followed, and it was further undermined by the bankruptcies, bailouts, and stock market losses that accompanied the 2008-2009 financial crisis.

The fourth trend, largely a reaction to the third, is the expansion in federal regulations designed to increase the accountability of directors and senior management and provide shareholders with greater power. Federal regulations over the last decade and a half have, among other things, expanded the range of mandatory company disclosures, provided the U.S. Securities and Exchange Commission (SEC) with authority to introduce proxy access, diminished companies' ability to exclude shareholder proposals from their proxy statements, required regular shareholder advisory votes on executive compensation, and identified shareholder fiduciary duties in certain types of proxy voting by some institutional investors.

This shift in the SEC's focus recently was clearly articulated by SEC Commissioner Dan Gallagher in his last public speech as a Commissioner: "Part of the SEC's tripartite mission is to protect investors. But too often, our concept of 'investor protection' reflects a prejudgment that a corporation is a democracy, where shareholders participate directly in the governance of the corporation." Commissioner Gallagher went on to argue for a more traditional view of federal versus state regulation:

> But, like the United States itself, a corporation can also be a republic, where shareholders elect directors, who in turn govern the corporation. The choice of a shareholder- or director-centric model is properly left to state law. The SEC increasingly has been disrespecting this distinction by interjecting opportunities for shareholder direct democracy into the securities laws. But the director-centric model is at least equally-well suited to the protection of investors, and so the SEC's rules should provide enough flexibility to accommodate either approach.

The fifth trend is the growing influence of proxy advisory firms. Proxy advisors successfully capitalized on the loss of public confidence in business leaders, the rise in share ownership of institutional investors, and the wide array of new regulations and governance requirements. Large investors turned to proxy advisors for guidance, smaller investors followed suit, and the soft power of proxy advisors has become disproportionately strong. Fortunately, over the last year or two, institutions and other large, influential investors have begun to distance themselves from proxy advisors. One factor in this reversal is the SEC's issuance of Staff Legal Bulletin 20 in 2014. SLB 20 contained a number of elements that together have prompted institutional investors to take responsibility for their proxy votes rather than outsourcing them to advisors such as Institutional Shareholder Services Inc. (ISS). Some large institutional investors have created internal departments to handle much of the work they previously outsourced to proxy advisors. Investment advisors are evaluating and overseeing the work of their retained proxy advisory firms more closely. As Commissioner Gallagher might put it, institutional investors are starting to move from a "compliance mindset" on proxy voting to a "fiduciary mindset."

The "Active" Investor

As they begin to retake the reins from proxy advisory firms and step into leadership roles in the governance community, institutional investors are becoming more active stockholders than they have ever been. This could be a welcome development for American business, for unlike the "activist" shareholders seeking to enrich themselves through short-term profits, many of the most influential institutional investors are deeply committed to maximizing long-term growth and prosperity. BlackRock chief executive Laurence D. Fink, for example, has made numerous public statements emphasizing the importance of consistent and direct shareholder-company engagement on issues of corporate governance and strategies for long-term growth. He recently noted, in a letter to chief executives, that BlackRock "engage[s] actively with companies on the key governance factors that in our experience support long-term, sustainable, financial performance." In a recent letter to independent directors of portfolio companies, Vanguard Chairman and CEO F. William McNabb III wrote, "We're indifferent as to how a board chooses to engage. What's important to us is *that* it engages. And when they engage, boards should be prepared to enter into a dialogue on appropriate issues of interest to significant, long-term investors."

BlackRock, State Street Global Advisors, Fidelity, Vanguard, and other large asset managers maintain their own proxy voting guidelines; because these investors have a vested interest in the success of the subject companies, these guidelines are far less rigid and agenda-driven than those of leading proxy advisors. State Street's guidelines, for example, are explicitly predicated on the notion that State Street expects to engage with companies on the factors that lead to its voting decisions and to proactively raise concerns with companies in order to resolve them in a manner advantageous to the company and its shareholders.

Over the past several years, there has been a well-documented upswing in the amount and quality of contact between companies and investors. Increased shareholder engagement may initially have been spurred by the requirement of say-on-pay votes every three years, but it has taken on new dimensions as it has grown in scale and deepened in quality. Major institutional investors increasingly expect that companies will provide access to independent directors as well as to other corporate contacts, and not only in times of crisis (*e.g.*, when the company is facing an activist attack or a disappointing earnings release) but on an ongoing basis. An effective shareholder relations program in today's environment will include opportunities for directors and senior management to build substantive relationships with investors over an extended period of time. Corporate secretaries play an important role in coordinating effective director engagement with shareholders.

One lesson to be drawn from the recent attempt by Trian Fund Management, L.P. to obtain four seats on the board of the E.I. du Pont de Nemours & Co. (DuPont) is that the increasingly active role of institutional investors in governance and engagement is good news for companies. In May 2015, DuPont defeated Trian's proxy campaign, thanks to strong support from an unusually large retail shareholder base and, notably, because all three of its largest institutional shareholders—Vanguard, BlackRock, and State Street—declined to follow the recommendations of ISS and Glass, Lewis & Co. to vote in favor of the activist nominees. The independence of its shareholders from the hegemony of the proxy advisors enabled DuPont to continue to pursue its strategic transformation. DuPont effectively communicated its strategic direction by engaging with its investors (including the activists) over a period of years and responding quickly and

convincingly to public critiques by Trian. The independent directors, along with the chief executive and members of senior management, were personally involved in DuPont's shareholder engagement efforts and were key elements to DuPont's success.

DuPont did exactly what investment community leaders such as Laurence Fink have encouraged corporations to do—"engage with a company's long-term providers of capital; … resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners; and, most importantly, … clearly and effectively articulate their strategy for sustainable long-term growth." In his April 2015 letter to chief executives, Fink promised that "[c]orporate leaders and their companies who follow this model can expect our support." In the DuPont-Trian proxy fight, he and a sufficient number of other institutional shareholders held up their end of the bargain.

Some institutional investors have expressed concerns regarding the rapid increase in director engagement and how they, as large shareholders whose attention is much in demand, will allocate their resources to engage meaningfully. There is some concern that companies with smaller market capitalizations may find it difficult to engage the attention of large shareholders, as these investors are likely to prioritize engagement with companies in which they have more significant investments. Smaller companies may need to seek engagement earlier in the proxy season (or before the proxy season) in order to obtain meaningful access to their institutional investors.

The Corporate Secretary

The preeminence of corporate governance and the rise of shareholder engagement have resulted in a fundamental shift in the role of the corporate secretary. As the Society of Corporate Secretaries and Governance Professionals has observed, "In recent years the Corporate Secretary has emerged as a senior, strategic-level corporate officer who plays a leading role in the company's corporate governance." In addition, many corporate secretaries have become, as one commentator put it, "the primary point of information and influence between the executive management and the board." A 2014 U.K. study concluded that "[t]he role is changing: it is increasingly outward-focused (incorporating investor engagement and corporate communications), and not just about internal administration." A 2014 ISS report found that when investors reach out to engage with boards, they most frequently contact the corporate secretary. The second-most frequent point of initial contact for investor-driven engagement is the board chair (or lead director), with the investor relations office a weak third. When it is the company that initiates engagement, the investor relations office is most often the initial point of contact, with the corporate secretary the second-most frequent point of initial contact.

As a primary liaison with investors who is also close to the board and senior management, the corporate secretary is ideally positioned to help directors and chief executives understand and respond to shareholder concerns. Corporate secretaries are expected to monitor corporate governance developments generally and assist the board in regularly updating and refining the company's governance practices as appropriate. It may be advisable for corporate secretaries to purposefully build relationships with large shareholders, institutional investors, and proxy advisors, in order to be fully up-to-date on the general trends and specific issues that concern both active and activist shareholders, as well as the agendas of key participants in the corporate governance debate.

The 2014 U.K. study found that, for high-performing corporate secretaries, heightened responsibilities may result in complicated reporting structures. Many corporate secretaries report primarily to the non-executive chair of the board or lead independent director, while maintaining close ties to the CEO and senior management; some report primarily to the CEO, while still serving as a significant company contact for the lead independent director or non-executive chair. As a state-law-mandated corporate officer who is appointed by the board but typically hired by senior management, the corporate secretary has a foot in each sphere. Indeed, many corporate secretaries in the U.K. study described themselves as "the third person in the chairman/CEO relationship." Internal direct and indirect reporting lines are best determined in the context of a company's particular structure. The centrality of the role of the corporate secretary will depend in large part on the person occupying that role, on his or her capabilities, and on the quality of his or her relationships with the chairman and the other non-executive directors as well as the CEO and senior management.

When corporate secretaries have taken on significant responsibilities as liaisons between investors and directors, and as the face of the company in outward-focused corporate governance matters, boards and companies may consider splitting the roles of general counsel and corporate secretary, which traditionally have been combined at many companies. The two roles may simply become too large for one person to handle. Moreover, at some companies, the general counsel may be perceived to be more closely aligned with the CEO, while the corporate secretary is perceived to be the board chairman's or lead director's right-hand person, and, in certain situations, it may be simpler and more effective to separate the roles. When the roles are separated, the corporate secretary often reports to the general counsel, while in other situations, the corporate secretary may report to either the CEO or the board chairman, depending upon the particular company and circumstances.

Role of the Board

Corporate governance trends have wrought many significant changes in the management and oversight of U.S. corporations. The priorities and responsibilities of directors, investors, and senior executives have changed to varying degrees as all of the corporate actors adapt to new requirements, societal trends, and the increasingly interconnected corporate environment. Through mechanisms such as majority voting—which is becoming more widespread each year—shareholders are increasing the accountability of directors in annual elections. The hope is that these changing dynamics will have a beneficial effect. As Chief Justice Leo Strine of the Delaware Supreme Court has written:

> [I]t is clear that stockholders have more tools than ever to hold boards accountable and the election process is more vibrant than ever. The election of more accountable boards should come with less tumult, not more. More accountable boards should be given more, not less, leeway to make decisions during their term. This does not mean that corporation law should strip stockholders of their substantive rights to vote on mergers or major asset sales. But it does mean that the costs of further distracting corporate managers from focusing on managing the business to generate profit would outweigh the benefits that come from more corporate referendums.

Perhaps one outcome of increased independent director engagement with shareholders will be a decline in corporate referenda, allowing directors to focus on creating value in the long term. To date, unfortunately, that has not been the case.

Though certain aspects of the role of the board may be changing, the fundamental role and responsibilities of the board hold constant. As a matter of state law, the board is charged with managing, or directing the management of, the affairs of the corporation. No matter how active or activist a company's shareholders may become, their legal responsibilities extend only to the election of directors, votes on certain fundamental matters, and advisory votes on compensation. Some academics and activists argue that state law should be revised to expand the legal rights of shareholders; the merits of this suggestion are debatable, and in any event, it has not been implemented.

Shareholder influence likely will continue to grow, but the legal rights of shareholders remain limited, and the U.S. corporate model remains managerial and director-centric. Directors cannot allow their business judgment to be usurped or overly influenced by investors, advisors, or other board outsiders. Boards are encouraged to interact strategically with investors, to address their concerns, and to reinforce the company's long-term goals, and at the same time to keep in mind that activism, corporate governance, and engagement change nothing about the fundamental fiduciary duties of directors.

2016 Proxy Season:
Engagement, Transparency, Proxy Access

Weil, Gotshal & Manges LLP, [excerpt, pp. 2-5]

February 2016

1. Achieving Greater Engagement and Transparency

The paradigm of a company's senior management, investor relations team and/or corporate secretary serving as the only points of contact for shareholders, with communications limited to regularly scheduled meetings, conference calls or investor days, or discussions with analysts and portfolio managers at only a few major institutional investors, is fast becoming a relic of the past. Recent high profile proxy fights and activist attacks, the continuing influence of proxy advisory firms, the power and growing advocacy of institutional investors, the SEC's continuing attention to the relationship between directors and shareholders,[1] the impact of social media and the public's wavering confidence in corporations have combined to highlight the need for effective communication throughout the year. BlackRock Chairman and CEO Laurence D. Fink urged this approach in an April 2015 letter to the CEOs of the S&P 500 and the largest companies around the world in which BlackRock invests, calling for "consistent and sustained" engagement – not just during proxy season or at the time of earnings reports.[2]

Some companies are heeding this call and publicly disclosing their programs. Many of these companies are encouraging shareholders to communicate with them at any time of the year through online feedback forms, creating annual engagement calendars, and scheduling regular meetings with their shareholders to hear their concerns and provide meaningful information about the company.[3] Other companies are expressly assigning engagement efforts to existing board committees, such as the nominating and governance committee or, as suggested by Vanguard, to new committees with a sole focus on engagement (*e.g.*, Tempur Sealy International, Inc.'s Stockholder Liaison Committee[4]). Companies such as Allstate, Coca-Cola, EMC, PepsiCo and Prudential Financial have been noted as providing informative disclosure about their engagement programs.[5]

Engagement is not just an issue for large corporations; smaller companies are also facing shareholder pressure to engage. Since 2011, The California State Teachers' Retirement System (CalSTRS) has been targeting and engaging with Russell 2000 companies on majority voting, with an increasing number of companies adopting majority voting in response to a CalSTRS' letter sent in advance of the submission of a shareholder proposal.[6]

Should Directors Engage?

From their vantage point as long-term equity holders of nearly every publicly traded company in the U.S., institutional investors and large asset managers such as BlackRock and Vanguard have advocated that engagement – at least with investors such as themselves – should consist not only of interactions with management but also with the company's lead director or other independent members of the board. In a February 2015 letter to the independent board leaders of 500 of its funds' largest U.S. holdings, Vanguard Chairman and CEO F. William McNabb III encouraged enhanced discussion between directors and shareholders, emphasizing that boards that do this are "more likely to have stronger support of large long-term shareholders."[7] Vanguard's update on its proxy voting and engagement efforts for the 12 months ended June 30, 2015 described the goal of these efforts as providing "constructive input that will better position companies to deliver sustainable value over the long term for all investors."[8] While some boards remain hesitant, proponents of board engagement argue that it can help a board hear directly what shareholders are saying, articulate directly to shareholders the board's commitment to long-term strategy and, in the final analysis, establish a level of confidence in the integrity and independence of the board's stewardship that may help the company weather a future storm.

Transparency goes hand-in-hand with engagement. Just as there is no one mode of engagement, there is no one topic as to which greater transparency will satisfy the expectations of all investors all of the time. Different investors may seek enhanced disclosure regarding the company's business strategy, capital allocation plans, risk tolerance and management, board composition and refreshment, executive compensation, the impact of climate change on short- and long-term corporate performance, or a myriad of other ESG concerns. There are also a variety of vehicles for dissemination of these disclosures. To illustrate, some shareholders want to see social and environmental (sustainability) performance metrics applied and included in periodic reports (primarily the Form 10-K), while others are content with enhanced supplemental disclosure in the form of web-posted sustainability reports. Throughout this Alert, we offer suggestions for increasing transparency about ESG matters. *See Parts 5,6,7,8 and 9 below.*

As investors continue to make their case for engagement, the SEC Staff has made it clear that Regulation FD's ban on selective disclosure of material, non-public company information should not impede constructive engagement between directors and shareholders if desired by all concerned.[9] We provide some guidance in this respect immediately below.

What To Do Now:

- ***Design and Update Shareholder Outreach Programs.*** More and more companies are developing and disclosing formal shareholder engagement programs that extend throughout the year, not only in anticipation of proxy season. In developing such a program, a company should consider its governance profile and potential vulnerabilities, its shareholder base, and its most effective management and board participants. Engagement efforts should be individually tailored to what is of most importance to a specific shareholder. The engagement strategy should be assessed and updated periodically to reflect evolving practice and changes in the company's circumstances.
- ***Use Your Proxy Statement as a Communications Tool—Including about Outreach Itself***. A key opportunity for effective engagement is to use the upcoming proxy statement to put the company's best foot forward on governance. The proxy statement should clearly and concisely discuss matters that shareholders consider important in formulating voting decisions, including the qualifications of the board's nominees, board refreshment policies, oversight activities and the link between corporate performance and executive compensation. This year, if the company has not done so previously, consider highlighting the nature and results of shareholder outreach, including the number of times it took place during the year, who participated on behalf of the company, the total percentage of shares represented at these discussions, a general indication of the topics discussed, how shareholder feedback was conveyed to the board and taken into account (including, importantly, any changes in governance made in response to the feedback) and the channels of communication open to shareholders for engagement in the future. Proxy statement innovations such as the use of charts, figures and images help companies bring to life the story of the company's management, oversight, compensation practices, business practices and shareholder engagement.
- ***Understand Your Shareholder Base and the Positions of Shareholders***. It is critical for companies to understand the sometimes distinct positions of pension funds and other institutional investors on various governance issues. Not every institution follows the position of ISS or Glass Lewis on every issue. In addition, outreach to retail investors (who tend to vote at lower levels and to be less concerned with governance issues than institutions) should not be overlooked.
- ***Ensure Information Flow to the Board***. Particularly where directors do not participate directly in shareholder outreach, it is essential that the board regularly obtain information on any concerns expressed by major shareholders during the company's outreach efforts. A process should be in place to facilitate and organize an unfiltered flow of information from shareholders to directors, giving the board a more direct understanding of how shareholders have responded, or are likely to respond, to their decision-making.
- ***Engage with the Appropriate Contacts at Shareholders.*** Ensure that the person with whom the company is engaging on governance issues is the most appropriate contact to address these issues. The decision-making roles at institutions often are split between voting and investment.
- ***Select and Prepare Directors who will Communicate with Shareholders***. When director involvement is desirable, give thought to selecting the particular director or directors who will communicate with particular shareholders. In some cases, the selection will reflect position (e.g., independent chair or lead independent director); in others, relevant expertise to address the shareholder's key concern (e.g., chair of the compensation or nominating/corporate governance committee). Once identified, these directors should be briefed on the "dos and don'ts" of meeting with shareholders, including Regulation FD. Directors should be cautioned not to "go it alone" and instead to include in the discussion at least one other company representative, such as inside or outside counsel or someone from investor relations, human resources or finance.[10]

- ***Consider Regulation FD and Proxy Rules.*** Be mindful of Regulation FD, but do not use it as a shield or barrier to director-shareholder communication if you otherwise decide that such communication is in the company's best interests. For those companies that opt to authorize one or more directors to meet with shareholders, the SEC Staff recommends consideration of "implementing policies and procedures intended to help avoid Regulation FD violations, such as pre-clearing discussion topics with the shareholder or having company counsel attend the meeting."[11] To give their directors and/or other representatives ample FD protection when meeting with shareholders, whether in person or by telephone or videoconference, companies should provide full and fair disclosure of their key governance practices and any pertinent corporate performance metrics in their proxy statements and/or periodic reports.[12] (In this connection, companies should keep in mind the SEC Chair's recent admonition to ensure that non-GAAP financial measures are used appropriately in both SEC-filed documents and other, less formal communications such as earnings calls and releases.)[13] Equally important, companies should consider the need to file, as proxy materials, any written communications prepared by or on behalf of directors that are provided to shareholders in this context, depending on the timing of these communications and their relationship to any matters to be submitted to a shareholder vote at an annual or other meeting of shareholders.

2. Understanding the Spectrum of Shareholder Views

To understand the increasing shareholder emphasis on engagement and transparency, particularly as these twin objectives come into play in drafting the upcoming annual report and proxy statement and in preparing for the annual meeting, it is important for a company's board and management to recognize the spectrum of views likely to be found within the company's own shareholder base on such issues as corporate objectives, the time horizon for realizing these objectives and a variety of ESG issues. In this connection, it may be helpful to step back and consider how current trends in shareholder activism and recent public stands by major institutions may influence the voting and investment behavior of your shareholders.

Current Trends in Activism

Today the term "activism" encompasses a wide variety of investor priorities and views – from "traditional" governance matters such as separation of the roles of CEO and board chair, elimination of classified boards and now proxy access, to changes in capital allocation policies and the more immediate realization of economic returns, to a host of sustainability issues such as disclosure of corporate political contributions and lobbying expenses, human rights and sustainability reporting. It is becoming increasingly difficult to divide shareholders into the traditional categories of those focused on long-term equity ownership and therefore long-term corporate performance goals; hedge funds and others seeking short-term profitability and a quick exit; single-issue governance activists; and those primarily concerned with environmental/social/human rights issues. For example, a combination of specific ESG concerns prompted the New York City Comptroller to launch an unprecedented proxy access campaign last year and to expand this campaign in 2016.[14] *See Part 3 below*.

Activist hedge funds launched 360 publicly announced campaigns during 2015, compared to 301 during 2014.[15] The actual number of activist campaigns is likely much higher, as it is estimated that less than a third become public.[16] During 2015, activists focused on promoting M&A transactions and strategic corporate alternatives such as spin-offs, split-offs, or divestitures; operational improvements; changes in the board and/or management; and immediate returns of value to shareholders through special dividends or share buybacks. One estimate of the "success rate" of publicly announced campaigns finds 62.5% of such campaigns at least partially successful in achieving their desired outcomes in 2015, up from 59.9% in 2014.[17]

Contributing to that success was support from mutual funds and public pension funds, which, in some cases, even partnered with activist investors in their campaigns. For example, the percentage of dissident proxy cards that BlackRock, T. Rowe Price and Vanguard have voted to support has increased every year since 2011.[18] Mutual funds sided with Starboard in a successful campaign to replace the entire board of Darden Restaurants and in a campaign at General Motors.[19] Furthermore, CalSTRS, the second largest pension fund in the US, is increasingly investing in, or

co-investing with, activist funds that targeted individual companies such as DuPont, PepsiCo and Perry Ellis International.

Perhaps the most significant development in shareholder activism during 2015 has been the increase in settlements between activists and target companies. In a recent survey, over 90% of the most prolific activists noted that they found it less difficult to reach a resolution with management than in prior years.[20] In particular, companies increasingly are granting activists board seats as part of a settlement. Recent high-profile settlements include ConAgra Foods agreeing to a board settlement with Jana Partners, and Trian naming an advisor to the board of PepsiCo and gaining two board seats at Sysco and a board seat at BNY Mellon.

In some instances, companies have even welcomed activists as significant investors. In October 2015, Trian Partners (founded by activist Nelson Peltz) announced that it had invested $2.5 billion to become a top ten shareholder of GE, the result of dialogue between Mr. Peltz and members of GE management.[21] Mr. Peltz, who reportedly did not request a board seat for Trian, issued a white paper faulting the stock market for undervaluing GE.[22]

The Institutional View

While the interests of hedge funds and institutional investors may align in certain circumstances, major institutional shareholders and asset managers have taken a public stand on the importance of companies taking a long-term approach to creating value. For example, in his April 2015 letter to CEOs, BlackRock Chairman and CEO Laurence D. Fink strongly advocated this approach despite "the acute pressure, growing with every quarter, to meet short-term financial goals." Mr. Fink acknowledged that returning capital to shareholders can be "a vital part of a responsible capital strategy," and that some activists take a long-term view and foster productive change. However, he expressed deep concern that many companies have undertaken actions such as stock buybacks or increased dividends to deliver immediate returns to shareholders "while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth." He indicated that BlackRock's "starting point" is to support management, particularly during difficult periods. Making a compelling case for enhanced transparency, however, Mr. Fink emphasized that this is more likely to occur where management has articulated its strategy for sustainable long-term growth and has offered credible metrics against which to assess performance.[23]

BlackRock and Vanguard have both publicly cautioned that they will actively engage with companies on governance factors that, in their view, detract from long-term, sustainable financial performance."[24] For example, in his February 2015 letter to independent board leaders (also discussed in *Part 1 above*), Vanguard Chairman and CEO McNabb stated that "some have mistakenly assumed that our predominately passive management style suggests a passive attitude with respect to corporate governance. Nothing could be further from the truth." Vanguard espouses six governance principles: (1) a substantially independent board with independent board leadership; (2) accountability of management to the board and of the board to stockholders; (3) shareholder voting rights consistent with economic interests (one share, one vote); (4) annual director elections and minimal anti-takeover devices; (5) executive compensation tied to the creation of long-term shareholder value; and (6) shareholder engagement. The voting record of the Vanguard funds for the 12 months ended June 30, 2015 indicates that the funds largely supported management's nominees and say-on-pay and other proposals. However, there are clear instances in which the funds used their voting power to signal a need for improvement or to effect changes in the board.

Because the pace and pressures of shareholder activism continue to escalate, it is all the more important for a company's management and board to meet the institutional calls for meaningful ongoing engagement and to prepare for activism even during periods of relative calm and corporate profitability. We offer some suggestions below for anticipating and addressing an activist challenge, recognizing that each company must formulate its own approach in light of the relevant facts and circumstances.

Tab 6: Political Spending Resolutions

Proxy Monitor 2015 Mid-Season Report

Manhattan Institute, [excerpt]

June 2015

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY pwc

Proxy Monitor 2015 Mid-Season Report

Posted by James R. Copland, Manhattan Institute, on Thursday, June 11, 2015

Editor's Note: James R. Copland is the director of the Manhattan Institute's Center for Legal Policy. The following post is based on a memorandum from the Proxy Monitor project, available here.

III. Political Spending or Lobbying Proposals

In 2012, 2013, and 2014, a plurality of all shareholder proposals involved corporate political spending or lobbying. In 2015, there have been significantly fewer such proposals introduced: 47 to date, compared with 67 in 2014 (Figure 8). So far this year, more investors have sponsored shareholder proposals related to environmental concerns (57 proposals) than corporate political spending.

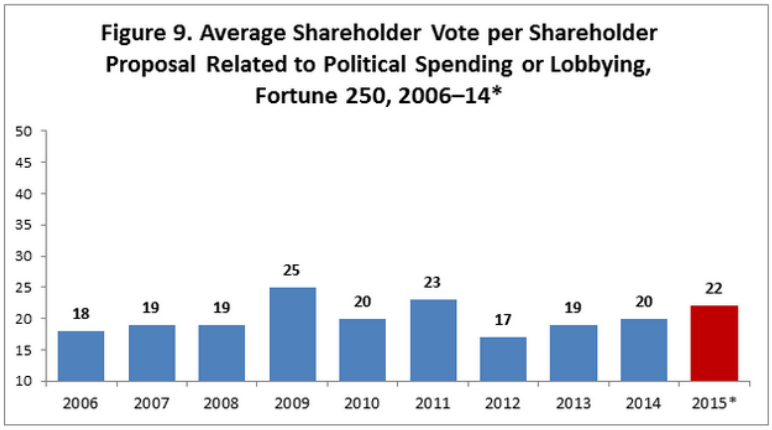
The decrease in the filing of political-spending-related shareholder proposals is not due to a decline in interest among social-investing funds and other socially oriented investors: such investors have already introduced 23 such proposals in 2015, as many as in all of 2014. Labor-affiliated pension funds, however, have significantly reduced the number of such proposals introduced: only 15 to date in 2015, compared with 32 in all of 2014. The New York State Common Retirement Fund[1] introduced 14 shareholder proposals related to corporate political spending or lobbying in 2014 but only four thus far in 2015, among Fortune 250 companies.

[1] The New York State Common Retirement Fund holds assets in trust for the New York State & Local Retirement System (NYSLRS), which includes the Police and Fire Retirement System (PFRS) and the Employees' Retirement System (ERS). The fund does not provide for teacher pensions, which are separately managed by the New York State Teachers' Retirement System (NYSTRS).

*211 of 250 companies had filed proxy documents by May 27, 2015.
Source: Proxy Monitor

Whatever the reason for the drop in the number of shareholder proposals related to political spending, support for these proposals remains tepid. No such proposal has received majority shareholder support over board opposition in the ten years covered in the ProxyMonitor.org database. To date in 2015, shareholder support for these proposals has averaged 22 percent, in line with historical trends (Figure 9).

Although this percentage is up marginally from 2014, when such proposals received just over 20 percent support, the variation is largely attributable to a different mix of proposal types and sponsors than to a shift in shareholder support. In 2014, six proposals called for either a prohibition on corporate political spending or a 75-percent shareholder vote to authorize corporate political spending—proposals which, in contrast to proposals oriented only around disclosure, receive low-single-digit support. No such proposals have been introduced in 2015. In addition, in 2014, seven shareholder proposals were sponsored by individuals, with varying provisions; these individual-sponsored proposals received, on average, the support of less than 10 percent of shareholders. To date, there have been no individual-backed shareholder proposals relating to political spending or lobbying introduced at a Fortune 250 company in 2015.



*186 of 250 companies had held annual meetings by May 22, 2015.
Source: Proxy Monitor

2015 Annual Corporate Governance Review

Georgeson Inc., [excerpt]

February 2016

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY pwc

2015 Annual Corporate Governance Review

Posted by Rajeev Kumar, Georgeson Inc., on Friday, February 12, 2016

Editor's note: Rajeev Kumar is a senior managing director of research at Georgeson Inc. This post is based on the executive summary of a Georgeson report; the full report is available here.

Environmental and Social (E&S) Proposals: Fewer Political Activity Proposals See Increased Support

In 2015, shareholder proposals relating to political activity fell from their perch as the leading topic for shareholder proposals, replaced by proxy access. However, when considered by category, environmental and social topics continued to represent the largest proposal type. In 2015, there were 63 political activity proposals, a 25 percent reduction in volume from 84 in 2014. All the other prominent subcategories of E&S proposals saw an increase: climate change and greenhouse gas emissions (34 proposals in 2015 versus 28 proposals in 2014), labor and human rights (10 in 2015 versus eight in 2014), and sustainability reporting (19 in 2015 versus 13 in 2014).

As in prior years, political activity proposals generally requested more robust disclosure of company political spending, lobbying activities and board oversight policies. Political spending proposals averaged shareholder support of 24 percent compared with an average of 20 percent in 2014, while the support level for lobbying activity proposals remained unchanged at 22 percent. None of the political activity proposals this year managed to receive majority support, although four such proposals did in 2014.

The CPA-Zicklin Index, which ranks companies based on their political transparency and oversight practices, expanded its benchmarking from the top 300 to all of the S&P 500 companies (using the same 24 indicators as in 2013 and 2014). The Center for Political Accountability (www.politicalaccountability.net) again partnered with the Sustainable Investments Institute, a nonprofit that conducts impartial research on companies' ESG practices, to collect the data and to score companies based on their political disclosure practices. The CPA's index findings were released in early October and in the past companies with low scores have found themselves the targets of shareholder resolutions.

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2015 CPA-Zicklin Index of Corporate Political Disclosure

Posted by Bruce F. Freed, Center for Political Accountability, on Friday, February 26, 2016

Editor's note: Bruce F. Freed is president and a founder of the Center for Political Accountability. This post is based on the 2015 CPA-Zicklin Index of Corporate Political Disclosure and Accountability by Mr. Freed and Marian Currinder, CPA's associate director. The full report is available here. Related research on corporate political spending from the Program on Corporate Governance includes Originalist or Original: The Difficulties of Reconciling *Citizens United* with Corporate Law History, by Leo Strine and Nicholas Walter (discussed on the Forum here), andShining Light on Corporate Political Spending and Corporate Political Speech: Who Decides?, both by Lucian Bebchuk and Robert Jackson (discussed on the Forum here and here).

On the eve of a blockbuster election year for political spending, more of America's largest publicly traded companies are disclosing their corporate expenditures on politics and are starting to place restrictions on their political spending. These are key findings of the fifth annual CPA-Zicklin Index of Political Disclosure and Accountability that, for the first time, measures the transparency and accountability policies and practices of the entire S&P 500.

Released on October 8, the 2015 Index also reveals that:

- companies included in previous Indexes have shown steady improvement;
- those companies that reached agreements after engagement by shareholders received sharply higher scores;
- 25 percent of companies place some type of restriction on their political spending; and
- almost nine out of 10 companies recognize the importance of adopting political spending policies.

The Index was developed by the Center for Political Accountability in conjunction with the Carol and Lawrence Zicklin Center for Business Ethics Research at The Wharton School of the University of Pennsylvania.

This year's Index provides the first portrait of how the largest and most influential public companies are navigating political spending, and how this is changing five years after the Supreme Court's *Citizens United* decision allowed much greater corporate political spending. These companies are dominant political spenders and establish the best practices for American business.

The additional transparency has come despite fierce opposition from leading business trade associations. It also comes as recent polling shows that Americans are voicing alarm over the power of corporations and other wealthy donors to influence politics.

The Index identifies the following 23 S&P 500 companies as receiving top-five rankings for political transparency and accountability: Becton, Dickinson and Co.; CSX Corp.; Noble Energy Inc.; Edison International; Microsoft Corp.; Unum Group; Capital One Financial Corp.; Exelon Corp.; Intel Corp.; Monsanto Co.; Norfolk Southern Corp.; PG&E Corp.; Qualcomm Inc.; United Parcel Service Inc.; AFLAC Inc.; Biogen Idec Inc.; General Mills Inc.; JPMorgan Chase & Co.; Bristol-Myers Squibb Co.; EMC Corp.; Gilead Sciences Inc.; Mylan NV; and Prudential Financial Inc.

Data from the 2015 Index, which is based on a survey of information publicly available on company websites, has been added to a one-stop database recently launched at the CPA website. Here are details of the Index's major findings:

- Shareholder engagement brought higher company scores. Companies engaged by shareholders that reached an agreement had notably better disclosure and accountability policies. The average overall score in 2015 was 72.6 for companies with an agreement. The average overall score was 43.1 for companies that were engaged but did not reach an agreement. For companies that were not engaged at all, the overall score was 24.4.
- Steady improvement has occurred. For 83 companies studied by the Index since 2011, the overall average score improved to 71.3 in 2015 from 45.2 in 2011. For 186 companies studied since 2012, the overall average score rose to 59.4 this year from 38.1 in 2012.
- Most companies now have policies addressing political spending. Companies recognize the importance of adopting these policies. Eighty-seven percent of the S&P 500 companies, or 435, had a detailed policy or some policy governing political spending on their websites. Over half, 52 percent or 259 companies, had a detailed policy; 35 percent, or 176 companies, had a brief or vague policy.
- Companies increasingly have placed restrictions on their political spending. This is a major change since 2004 when few companies imposed such restrictions, or had policies about how they would spend on politics. The Index found that 124 companies, or 25 percent, placed some type of restriction on their political spending. This included restrictions on direct independent expenditures; contributions to candidates, parties and committees, 527 groups, ballot measures, or 501(c)(4) groups; and payments to trade associations for political purposes.

Media coverage of the 2015 Index has been extensive and positive and included the *Washington Post*, *Huffington Post*, NPR, *San Francisco Chronicle*, the Center for Public Integrity, CQ Roll Call, the St. Louis Post-Dispatch, the *Baltimore Sun* and Politico's Influence newsletter. Also, Covington & Burling issued a release on the Index.

Here are coverage highlights:

"I, quite honestly, think [the Index] has helped drive behavior. There is an increasing race to the top here," Dan Bross, Microsoft's senior director for corporate citizenship, told *The Huffington Post* for its article, headlined "This Ranking System Is Increasing Corporate Political Disclosure."

The Center for Public Integrity quoted Monsanto spokeswoman Charla Lord as calling the Index "highly credible."

"Top companies from General Mills to Merck & Co. are more fully disclosing their campaign activities and a growing number have even started voluntarily putting the brakes on their political spending, according to a report released Thursday," CQ Roll Call reported.

Covington's special report said the Index "will result in more pressure on public companies to voluntarily disclose information about their political spending."

The annual benchmarking study examines policies and practices published on corporate websites. Its accompanying report does not make any judgments about a company's political spending or whether its disclosure is complete. The complete publication, entitled *The 2015 CPA-Zicklin Index of Corporate Political Accountability and Disclosure: S&P 500 Review Shows Political Disclosure Enters Corporate Mainstream*, is available here.

CENTER FOR POLITICAL ACCOUNTABILITY

Corporate Political Disclosure and the Mutual Fund Vote
2015 PROXY SEASON ANALYSIS SHOWS STEADY SUPPORT

DECEMBER 2015

Mutual funds support for corporate political spending disclosure resolutions held firm in the 2015 proxy season, according to the Center for Political Accountability's latest survey of mutual fund voting records. This year, funds voted for disclosure 42 percent of the time on average, slightly above the 40 percent vote last year.

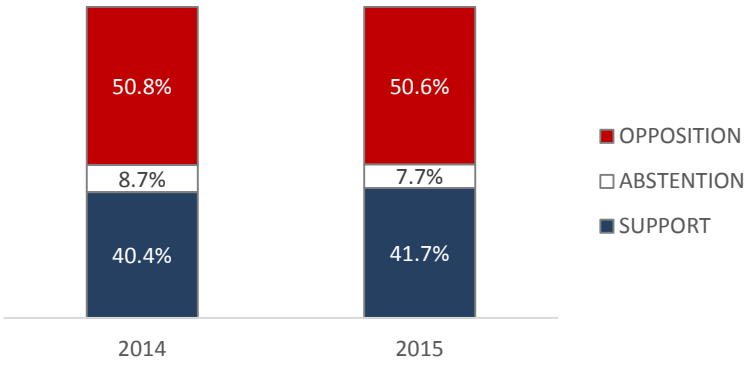
CPA's model shareholder resolution asks companies to disclose and have board oversight of their political spending from corporate funds.

In 2014, CPA's survey of mutual fund voting on corporate political spending was expanded from an original set of 40 large fund families surveyed in previous years, to include 69 large and well-known mutual fund groups. Across their portfolios of funds, all of these groups had cast votes on at least 10 of the model resolutions that were voted upon in both the 2013 and 2014 proxy seasons.

This year's survey continues the analysis that was expanded in 2014. It examines the votes of 68 large fund families, where at least 10 resolutions were voted on by the funds in the 32 and 34 resolutions that came to vote in each of the 2014 and 2015 proxy seasons, respectively. [1]

These fund groups collectively manage in excess of $10 trillion, according to Morningstar® fund data. Approximately 40-45 percent of that amount is invested in domestic stocks. These groups therefore control a significant portion of the shareholder vote and provide a good indicator of how institutional shareholders view the need for corporate political spending disclosure.

Figure 1: Mutual Fund Voting Trend on Political Contributions Resolutions 2014-2015[2]



[1] This covers resolutions voted on at meetings taking place between July 1, 2013 and June 30, 2014, for the 2014 proxy season, and between July 1, 2014 and June 30, 2015, for the 2015 proxy season.

[2] For this review, CPA counted the numbers of votes cast for, against, and abstained by the mutual funds, not taking into account how many shares the funds voted with for each resolution. Hence, CPA is looking only at the funds' *decision* on each resolution, in the three possible options of "for, against, and abstain."

The fund groups included in the survey were selected from among those tracked by the Fund Votes project each year, where at least 10 of the model resolutions had come to vote across the constituent funds of the fund family in each of the 2014 and 2015 proxy seasons (32 and 34 resolutions, respectively).[3]

Key Findings:

1. In 2015, the 68 mutual fund families included in the survey supported the 34 shareholder resolutions calling for corporate political spending disclosure around 42 percent of the time, on average. Their votes on the 32 resolutions that were voted on in the 2014 proxy season also averaged just over 40 percent support.

2. Seven fund groups supported corporate political disclosure resolutions 100 percent of the time in 2015: Alger Mutual Funds (managed by Fred Alger Management, Inc.); Deutsche Funds (managed by Deutsche Asset & Wealth Management); Calvert Funds (Managed by Calvert Investments); Bridgeway; Praxis Mutual Funds, advised by Everence Capital Management; RS Funds, managed by RS Investments; and Oppenheimer Funds. In 2014, Deutsche, Bridgeway, Calvert, Praxis and TCW Funds supported all resolutions that were voted upon.

3. In 2015, 29 of the 68 mutual fund families, or 43 percent, supported corporate political disclosure at least half of the time. In 2014, 28 of the 69 fund families surveyed supported disclosure at least half of the time

4. In 2014 and 2015, mutual fund families in the survey opposed corporate political spending disclosure resolutions about half of the time: 51 percent on average across both years. Abstentions averaged 9 and 8 percent of the vote, respectively.

5. Eight mutual fund families in this study opposed every resolution voted on in the past two years. They were American Century, Blackrock, BNY Mellon, Calamos, Dreyfus, Gabelli, Steward and Wisdomtree.

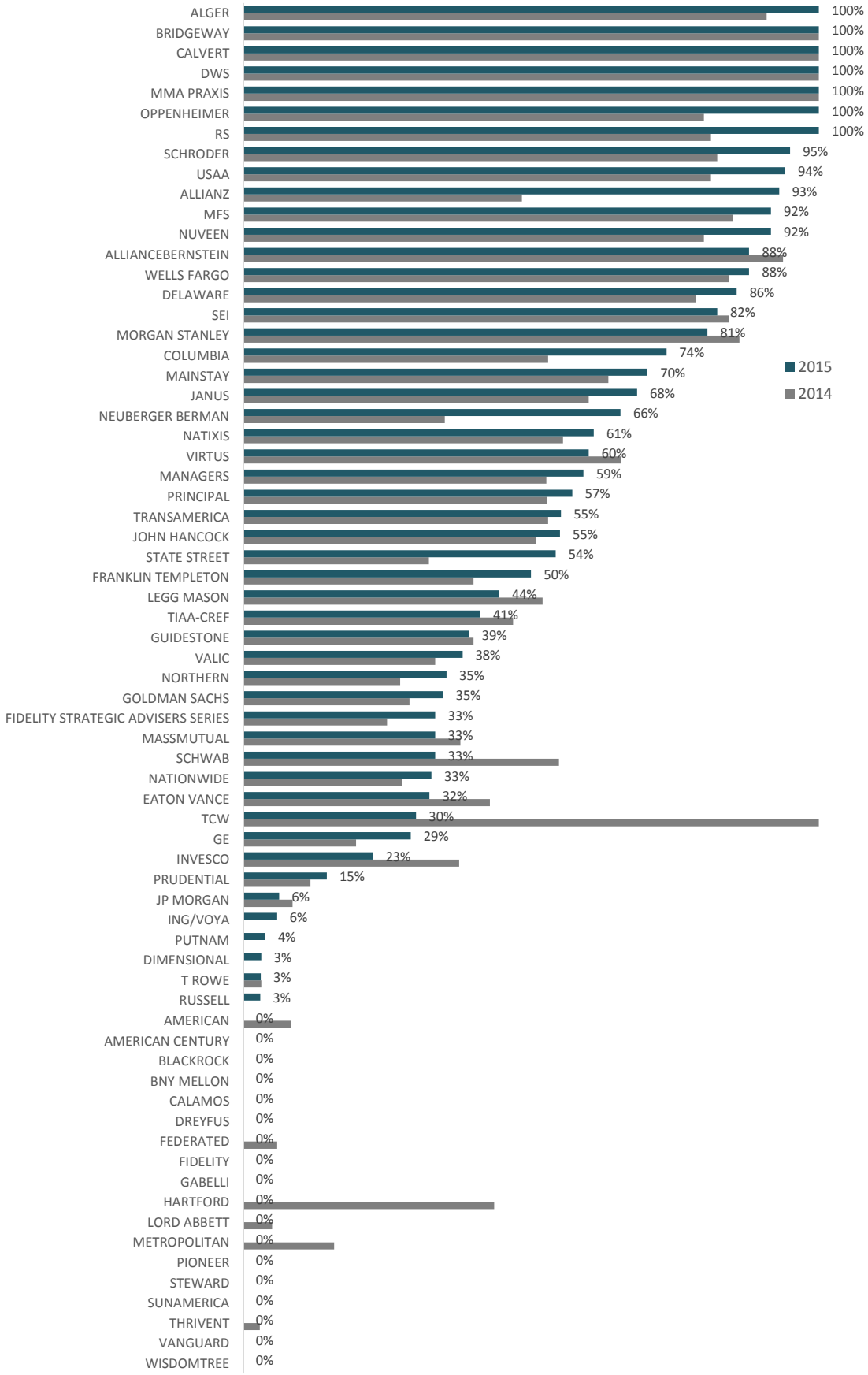
6. Fidelity, Pioneer, SunAmerica and Vanguard abstained all or most of the time in 2015, while failing to support a single resolution. Pioneer and SunAmerica Asset Management abstained on all resolutions voted in 2014 and 2015.

7. Fund groups Allianz and Neuberger Berman increased their support for corporate political spending disclosure by 45 and 31 percentage points, respectively, between 2014 and 2015.

8. While 32 fund groups increased their support for political contributions disclosure resolutions, 20 decreased their support. Notable amongst the latter are Schwab, Harford and TCW, which decreased their support considerably between the two reporting periods. By contrast, Neuberger Berman and Allianz increased their support by more than 30 percent each.

[3] For this review, CPA counted the numbers of votes cast for, against, and abstained by the mutual funds, not taking into account how many shares the funds voted with for each resolution. Hence, CPA is looking only at the funds' *decision* on each resolution, in the three possible options of "for, against, and abstain."

Figure 2: Mutual Fund Families Ranked by 2015 Support for Corporate Political Disclosure Resolutions



This year's survey considered 22,000 votes cast by 69 and 68 large U.S. mutual funds on 32 and 34 shareholder-sponsored resolutions voted on during the 2014 and 2015 proxy seasons, respectively.[4]

The Resolutions: Appendix I lists all 34 resolutions based on the CPA model resolution that came to vote in the 2015 proxy season. In 2015, a typical CPA-model resolution asked the company to report and update semiannually on the following:

> *1. Policies and procedures for making, with corporate funds or assets, contributions and expenditures (direct or indirect) to (a) participate or intervene in any political campaign on behalf of (or in opposition to) any candidate for public office, or (b) influence the general public, or any segment thereof, with respect to an election or referendum.*
>
> *2. Monetary and non-monetary contributions and expenditures (direct and indirect) used in the manner described in section 1 above, including:*
>
> > *a. The identity of the recipient as well as the amount paid to each; and*
> >
> > *b. The title(s) of the person(s) in the Company responsible for decision-making.*

The 34 resolutions earned an average 34 percent shareholder support (counting only votes cast for and against by the general shareholder body, regardless of individual companies' vote counting methods) and were filed by a range of state-run pension funds, socially responsible asset managers, labor funds, faith-based investors and foundations. The resolution with the highest level of shareholder support in 2015 was filed at Smith & Wesson Holding Corp (SWHC), Inc. by Amalgamated Longview Bank, which is the largest union-owned bank in the US. This resolution was voted upon by shareholders on September 22, 2014, and it received 56 percent shareholder support. In addition, nine resolutions received over 40 percent shareholder support, and 24 received over 30 percent support.

Mutual funds looking to update their proxy voting policies with more specific guidance on corporate political disclosure and oversight may draw on Appendix 2 of the Conference Board's *Handbook on Corporate Political Activity*, in which sample proxy voting guidelines are provided. In addition, CPA's one-page summary on the key elements of meaningful corporate political disclosure provides concise guidance to proxy voters as they try to determine where the gaps may lie in a company's policies and disclosure.

Data Source

This report is based on data provided by Fund Votes, an independent project started in 2004 by Jackie Cook (CookESG Research). Fund Votes tracks institutional proxy voting. The database of over 60 million proxy voting decisions by large financial institutions spans 12 years of mutual fund proxy voting disclosure. The data has been indexed to facilitate analysis of investment institutions' voting patterns on a wide range of issues proposed by both management and shareholders.

[4] In order not to overweight large companies that tend to be more widely held across fund groups' portfolios, only unique votes were counted for the survey. Where a single resolution was voted across multiple funds within a single fund family, each holding the corresponding security in their fund portfolios, only one vote is recorded against the corresponding fund family. In the case of inconsistent voting within a fund family, i.e. conflicting votes on a single resolutions, each unique fund family-vote combination is recorded. The 22,000 individual votes cast across two years' of voting by the funds of the 68 fund groups surveyed were condensed to around 5,000 unique votes.

Appendix I:
2015 Shareholder-Sponsored Political Spending Disclosure Resolutions Using CPA Model Resolution

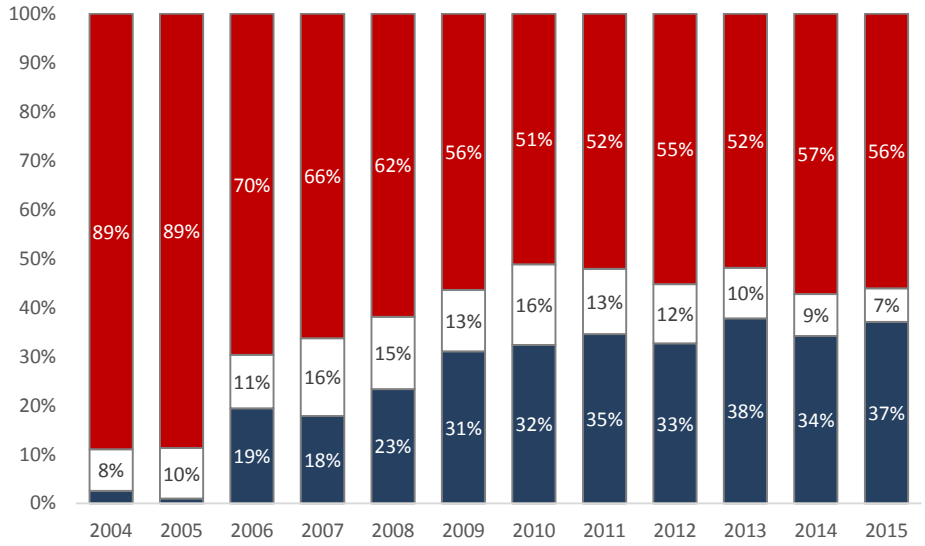
Company	AGM	Shareholder Proponent	Support
AMAZON COM INC	10-Jun	Investor Voice on behalf of Bryce Mathern	20.28%
AT&T INC.	24-Apr	Domini	25.60%
AUTOZONE INC	18-Dec	New York City Pension Funds and Retirement Systems	34.00%
BB&T CORP	28-Apr	Massachusetts Laborers' Pension Fund	34.10%
CABOT OIL & GAS CORP	23-Apr	New York City Pension Funds and Retirement Systems	41.28%
CARDINAL HEALTH INC	05-Nov	International Brotherhood of Teamsters General Fund	41.01%
CHESAPEAKE ENERGY CORP	22-May	City of Philadelphia Public Employees Retirement System	14.85%
DANAHER CORP	07-May	Mercy Investment Services	33.30%
DARDEN RESTAURANTS INC	10-Oct	Unitarian Universalist Service Committee	35.13%
DTE ENERGY CO	07-May	New York City Pension Funds and Retirement Systems	32.63%
DUKE ENERGY CORP	07-May	Nathan Cummings Foundation	27.16%
EMERSON ELECTRIC CO	03-Feb	Trillium Asset Management	30.42%
EXPRESS SCRIPTS HOLDING CO.	06-May	New York State Common Retirement Fund	29.77%
FEDEX CORP	29-Sep	New York City Pension Funds and Retirement Systems	27.85%
FLUOR CORP	30-Apr	City of Philadelphia Public Employees Retirement System, Firefighters' Pension System of the City of Kansas City	35.89%
H&R BLOCK INC	11-Sep	New York State Common Retirement Fund	50.63%
MCKESSON CORP	30-Jul	Miami Firefighters' Relief and Pension Fund	37.57%
NEXTERA ENERGY INC	21-May	New York State Common Retirement Fund	39.57%
NISOURCE INC	12-May	New York State Common Retirement Fund	44.52%
NORTHERN TRUST CORP	21-Apr	Massachusetts Laborers' Pension Fund	28.32%
NUCOR CORP	14-May	City of Philadelphia Public Employees Retirement System	31.53%
PPL CORP	20-May	New York City Pension Funds and Retirement Systems	44.60%
RAYTHEON CO	28-May	New York State Common Retirement Fund	45.90%
RYDER SYSTEM INC	01-May	City of Philadelphia Public Employees Retirement System	39.28%
SCHWAB CHARLES CORP	13-May	New York City Pension Funds and Retirement Systems	26.41%
SMITH & WESSON HOLDING CORP	22-Sep	Amalgamated Bank's LongView Broad Market Fund	55.78%
SPECTRA ENERGY CORP.	28-Apr	Nathan Cummings Foundation	31.90%
SPRINT CORP	06-Aug	New York City Pension Funds and Retirement Systems	1.48%
TECO ENERGY INC	29-Apr	City of Philadelphia Public Employees Retirement System	34.16%
TRAVELERS COMPANIES, INC.	20-May	New York State Common Retirement Fund	34.97%
VERIZON COMMUNICATIONS INC	07-May	Domini Social Investments	31.86%
WASTE MANAGEMENT INC	12-May	New York State Common Retirement Fund	46.72%

WESTERN UNION CO	15-May	New York State Common Retirement Fund	41.47%
WYNN RESORTS LTD	24-Apr	New York State Common Retirement Fund	19.98%

Appendix II: 12-Year Average Support Analysis by the Largest 40 Mutual Fund Families

Until issuance of CPA's annual mutual funds voting report in November 2014, the review of mutual fund votes looked at how 40 of the largest U.S. fund families voted on 305 shareholder requests for disclosure of corporate political contributions, filed at U.S. companies over proxy seasons from 2004 to 2013 (covering shareholder meetings from July 1, 2003 to August 31, 2013). Together, these fund families control a large portion of the shareholder vote in U.S. securities. The following graph shows the 12-year voting trend using the original set of fund families.

Figure 3: Mutual Fund Voting Trend on Political Contributions Resolutions 2004-2015



Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Responding to Corporate Political Disclosure Initiatives

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Friday, January 30, 2015

Editor's note: The following post comes to us from Robert K. Kelner, partner in the Election and Political Law Practice Group at Covington & Burling LLP, and is based on a Covington Alert by Mr. Kelner, Keir D. Gumbs, and Zachary Parks. Recent work from the Program on Corporate Governance about political spending includes: Shining Light on Corporate Political Spending by Lucian Bebchuk and Robert J. Jackson, Jr. (discussed on the Forum here). Posts related to the SEC rulemaking petition on disclosure of political spending are available here.

Despite recent setbacks, efforts by activist groups to pressure companies to disclose details of their political activities are not going away. As these groups become increasingly sophisticated, 2015 looks to be their most active year to date. In fact, for the first time ever, the Center for Political Accountability plans to issue a report this year ranking the political spending disclosure practices of all 500 companies in the S&P 500 Index. This post highlights recent developments regarding corporate political spending disclosure efforts, looks ahead to what public companies can expect in the near future, and provides strategies and tips for those grappling with disclosure issues.

Corporate Political Spending Disclosure 101

Although Federal, state, and local laws and regulations already require companies to disclose information about their lobbying and political activities, activists have long maintained that those required disclosures do not go far enough. While laws require companies and their PACs to disclose direct contributions to candidates, they do not, for example, require companies to disclose payments to trade associations and 501(c)(4) social welfare groups even though those groups may use the funds to influence elections. Early last decade, emboldened by their role in passing the McCain-Feingold campaign finance reform law, activists began mobilizing to pressure companies to publicly disclose more information about their political activities. Although some have argued that these efforts are primarily intended to force companies to scale back their lobbying and political activities—not to promote transparency—they continue unabated. This decade, as the courts have loosened restrictions on corporate political activity, corporate political spending disclosure efforts have picked up significant steam. In the past few years, activists have focused on four vehicles to compel corporations to publicly disclose more of their political and lobbying spending: shareholder resolutions, SEC rulemaking, "voluntary" website disclosure, and litigation.

Shareholder Resolutions

The most prominent tool in the disclosure advocate's toolbox is the shareholder proposal. While shareholder resolutions are generally non-binding, they still have teeth. If a company fails to take action on a shareholder resolution that received a majority of votes cast, influential proxy advisory firms like Institutional Shareholder Services will, the following year, recommend a vote against the company's directors.

In recent years, a conglomeration of groups have increasingly called for shareholders to vote on resolutions that would require companies to disclose more information about their political spending on their websites. Sometimes coupled with resolutions requiring enhanced disclosure of lobbying activities, political spending resolutions call for corporations to publicly disclose their internal procedures for spending funds for political purposes, the amount of these contributions, and the names of the recipients. Some even call for corporations to prohibit political spending altogether. Often led by the New York State Common Retirement Fund, shareholders bringing these proposals include other public pension funds, labor unions, religious groups, and individual "corporate gadflies." These proposals have been voluminous; for the last several years, more shareholder proposals have focused on political spending than any other topic.

SEC Rulemaking

Activists behind these shareholder resolutions have also attempted to make shareholder political spending resolutions unnecessary by pressuring the SEC to adopt a rule that requires public companies to disclose information about their political spending. In 2011, a group of academics filed a petition for rulemaking with the SEC asking the commission to develop rules related to "corporate political spending." Although the details of what disclosure would look like are not fleshed out, the petition has prompted a record number of largely cookie-cutter comments from labor unions and members of the campaign finance reform community. (The rulemaking petition is discussed on the Forum here.)

The CPA-Zicklin Index

First issued in 2011, the annual CPA-Zicklin index is a report jointly issued by the Center for Political Accountability—a non-profit group promoting corporate political spending disclosure—and the Zicklin Center for Business Ethics Research at the Wharton School of the University of Pennsylvania. The report ranks the top 300 companies in the S&P 500 Index based on political spending scores, according to a metric created by CPA and the Zicklin Center. Companies receive up to 70 "points" for disclosing their political expenditures and spending practices on their websites. For example, they can receive 6 points for disclosing "payments to trade associations that the recipient organization may use for political purposes" and 6 points for disclosing similar payments to 501(c)(4) social welfare organizations. The two-dozen criteria in the Index are often arbitrary and vague. Moreover, they are moving targets year-to-year. Companies with low scores, however, can find themselves targets of litigation, shareholder resolutions, or public criticism. (The CPA-Zicklin Index is discussed on the Forum here.)

Litigation

Activists have also recently looked to the courts for help in forcing companies to disclose more information about their political spending. In early 2013, the New York State Common Retirement Fund sued Qualcomm in Delaware chancery court seeking access, as a Qualcomm shareholder, to Qualcomm's records related to political spending. The complaint cited a provision of Delaware law that, in certain narrow cases, requires companies to give shareholders access to the "books and records" of the company.

Later that year, shareholder activists at Citizens for Responsibility and Ethics in Washington ("CREW") tried another tactic. They filed a lawsuit against Aetna claiming that Aetna misled shareholders when it published a Proxy Statement opposing a political spending shareholder resolution. The complaint used the Proxy Statement's reference to prior company political contribution reports on its website as a hook for asserting that alleged inaccuracies in those reports derivatively resulted in a false and misleading Proxy Statement.

Recent Setbacks for Disclosure Activists

Despite the many tools in their toolbox, to date, the activist efforts described above have been largely unsuccessful. The New York State Common Retirement Fund's dubious legal theory in the *Qualcomm*litigation was never tested because the lawsuit was promptly dismissed after Qualcomm agreed to disclose more information on its website, something it already planned to do before it was sued. (Covington represented Qualcomm in that suit.) And the *Aetna* lawsuit is still working its way through the courts.

Moreover, the SEC has put the political spending rulemaking petition on the back-burner. In 2012, the SEC added the potential rule to the semi-annual, federal government-wide "Unified Agenda." Adding the rule to the Unified Agenda was a first step in formally proposing a rule for public comment, but it did not obligate the SEC to act. In any case, in late 2013, the SEC dropped corporate political spending disclosure from its list of regulatory priorities, a move that suggests that, at least in the short term, the SEC is unlikely to force public companies to disclose their political expenditures.

Despite their frequency—the number of such resolutions has more than doubled since 2010—shareholder resolutions on political activity have almost always failed. In 2014 proxy season, none received a majority of votes cast. In fact, according to Conference Board, in 2014, overall support fell slightly (from 20.7 percent of votes cast in 2013 to 19.5 percent of votes cast in the examined 2014 period).

The most effective initiative to date has been the CPA-Zicklin Index, and even that initiative has failed to achieve one of its primary objectives—widespread disclosure of payments to trade associations and to 501(c)(4) social welfare organizations. Although the Index has prompted more companies to disclose their political spending, over half of all companies surveyed (153) still receive no points for disclosing information about their trade association dues payments and only one-third (100) receive points for disclosing information about contributions to 501(c)(4) social welfare organizations. In fact, after the number of surveyed companies grew to 300 in 2014, the

overall percentage of companies surveyed receiving points in these categories *declined* slightly from 2013.

The Increasingly Sophisticated Methods Employed By Activists

These setbacks should not, however, be seen as an excuse for in-house counsel to move on to worrying about other issues. As described below, activists have learned from their losses and are deploying increasingly sophisticated strategies to turn the tide.

Shareholder Resolutions

Today, shareholder resolutions on political spending are more frequent, are less likely to be dismissed, and, in some ways, are generating more support. More shareholder resolutions were submitted in 2014 than any other year (103, according to the most recent data) and a higher percentage proceeded to a vote (83.5 percent versus 77.2 percent in 2013). This increase can be attributed to several factors. First, the SEC has generally taken the position that such proposals cannot be excluded from company proxies unless they focus on lobbying activities specifically related to company products or services, focus on political spending and lobbying activities relating to specific areas or legislative activity, or have already been substantially implemented. Consequently companies have few legal bases upon which they

can rely in order to exclude these proposals from their proxy materials. In addition, in 2013, the CPA wrote and promoted key elements of a “political disclosure and oversight resolution” for shareholders to use to pressure companies to increase their disclosure. Moreover, activist groups are becoming increasingly sophisticated at working together on these issues. In February 2014, for example, a coalition of 60 activist investors announced the submission of political spending shareholder proposals targeted at 48 public companies.

While overall support for political spending resolutions remains low, some warning signs suggest that trend may not last. For example, in 2014, seven proposals reached the 40 percent support level (based on a percentage of votes cast) versus only two in 2013. And the influential proxy advisory firm Institutional Shareholder Services (“ISS”) announced in late 2013 that it will now consider whether companies provide disclosure about trade associations when evaluating how it will recommend clients vote on lobbying disclosure proposals. This was seen as an implicit endorsement of one of the key objectives of political spending disclosure activists—enhancing disclosure of corporate payments to trade associations. ISS’s shifting support for trade association disclosures might therefore result in more recommended “yes” votes on political and lobbying disclosure proposals.

SEC Rulemaking

While dormant for now, the petition for an SEC political spending disclosure rulemaking continues to build momentum. In April 2014, CREW helped re-energize efforts to pressure the SEC to adopt a political spending disclosure rule by submitting its own rulemaking petition to the SEC. A well-funded grassroots campaign has generated more than a million signatures for these petitions. And the SEC continues to face pressure from Members of Congress and activists to move

forward. So, while we do not expect action in the near-term from the SEC, it is difficult to predict how the rulemaking might develop after the next election.

CPA-Zicklin Index

CPA's role as the major player in the political spending disclosure arena will continue to grow this year. We expect that it will increasingly promote its CPA-Zicklin Index with op-eds, media campaigns, and press releases. Most significantly, the scope of the Index will expand dramatically this year. In 2014, the index surveyed the top 300 companies in the S&P 500, as opposed to the top 200 from 2013. We have learned that, in 2015, CPA plans to survey the *entire* S&P 500. Those companies in the S&P that missed the cut in 2014 will therefore be scored and ranked this year. Highly-ranked companies should also keep an eye on their scores in the years to come. As companies move up the ranks and as scoring metrics in the CPA-Zicklin Index become more refined, former "poster-children" for disclosure may find themselves on CPA's "bad actor" list.

What To Do In Response to Political Spending Disclosure Pressure

Companies must respond deliberately to targeted efforts to compel them to disclose more information about their political spending. When a company receives a shareholder proposal, a request to inspect its political "books and records," or a proposed score from the CPA, the worst thing the company can do is tuck it away in a file drawer and ignore it.

Handling Shareholder Proposals

A company that has received a political spending shareholder proposal should research whether the shareholder has submitted the proposal previously to any other company and determine how the proposal fared at that company's annual meeting of shareholders. Companies should also coordinate with the various departments that may be implicated by the proposal, including, for example, the government affairs office, the Corporate Secretary, the legal department and senior management to identify what activities the company may engage in that may be implicated by the proposal.

A company that has received a political spending shareholder proposal also should consider initiating a dialogue with the shareholder regarding the proposal. This would demonstrate that the company is focused on enhancing shareholder value and maintaining an open dialogue with shareholders. More importantly, as suggested above, SEC interpretive positions suggest that the SEC is often unwilling to allow companies to exclude political spending shareholder proposals from their proxy materials on substantive grounds. Consequently, a company has a limited ability to exclude a political spending shareholder proposal from its proxy materials unless the shareholder failed to comply with the eligibility or procedural requirements for a shareholder proposal. This strategy of opening a dialogue can prove fruitful. According to one study in 2012, as of August 2012, of the 71 proposals relating to political spending that were submitted, 30 were withdrawn by proponents, and 16 were allowed to be omitted from company proxy statements by the SEC.

Increase Your CPA-Zicklin Score

Companies can also take simple steps to increase their score on the CPA-Zicklin Index, sometimes without altering current practices. These steps can help companies be perceived by these groups as “good corporate citizens,” removing them from activist crosshairs.

First, there are some easy “pick-up” points on the CPA-Zicklin Index that companies can earn without implementing burdensome internal reporting systems or disclosing invasive details about corporate political activities. For example, companies can receive points for posting to their websites a list of candidates and political committees supported by the corporation, something that is already publicly available on state campaign finance agency websites. They can also receive points for adopting and publishing a policy that states that political contributions must “promote the interests of the company” and must “be made without regard for the private political preferences of executives.” There are many other similar examples of easy ways to pick up points.

Second, CPA’s ambiguous factors leave room for judgment and negotiation. CPA typically sends companies a document with their “preliminary grading” in the summer and invites them to comment. Companies should take advantage of the invitation. The Index scorers make mistakes and we have seen many cases where a call from counsel to the CPA can help increase a low score.

Third, companies should be aware of what others are doing to receive points. CPA has awarded full credit to companies that report only those expenditures that exceed a certain threshold or that are made out of a specific department. Companies also vary significantly in the level of detail they provide about trade association dues payments (*i.e.*, reporting the total amount of the payment, reporting the percentage of the payment that is not deductible as a business expense for tax purposes, or reporting both). We have compiled a database reflecting the disclosure practices of all companies that received points for trade association and 501(c)(4) disclosures in the most recent CPA-Zicklin Index. By consulting this database, we can provide clients with the least invasive and least intrusive disclosures they can make and still receive full credit. This “lowest common denominator” approach can help companies increase their scores without adding unnecessarily burdensome compliance and information gathering systems and without providing an unnecessarily intrusive level of detail about their activities.

Tab 7: Social Responsibility Resolutions

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Corporate Investment in ESG Practices

Posted by Matteo Tonello, The Conference Board, Inc., on Wednesday, August 5, 2015

Editor's Note: Matteo Tonello is managing director at The Conference Board, Inc. This post relates to an issue of The Conference Board's Director Notes series and was authored by Mr. Tonello and Thomas Singer. The complete publication, including footnotes and Appendix, is available here.

Corporate investment in environmental, social, and governance (ESG) practices has been widely investigated in recent years. Studies show that a business corporation may benefit from these resource allocations on multiple levels, ranging from higher market and accounting performance to improved reputation and stakeholder relations. However, poor data quality and the lack of a universally adopted framework for the disclosure of extra-financial information have hindered the field of research. This post reviews empirical analyses of the return on investment in ESG initiatives, outlines five pillars of the business case for corporate sustainability, and discusses why the positive correlations found by some academics remain disputed by others.

Corporate sustainability can be broadly defined as the pursuit of a business growth strategy by allocating financial or in-kind resources of the corporation to ESG practices. Examples of ESG investments that would comprise a corporate sustainability program include: hiring additional auditing specialists to strengthen an internal control or risk management process; engaging a search firm to recruit new female board members; introducing an Ombudsman's office to address ethical concerns by employees; adopting a procurement policy that increases outsourcing costs but ensures the highest level of compliance with human rights standards; or spending on technology that reduces greenhouse gas (GHG) emissions.

When made, these investments are typically justified as a means to satisfy financial or operational needs or to respond to an explicit stakeholder request. For instance, improving internal control and risk management practices may become a financial priority for a company that experienced difficulties in forecasting its future cash flow.

Similarly, an organization may recognize that the lack of a cohesive ethical culture among its employees is hindering its productivity or that its reputation as an environmental offender is preventing its expansion into a segment of the consumer market. Finally, a company may choose to appoint an independent board chairman in response to a resolution filed by one or more activist shareholders.

The question then arises as to whether this type of resource allocation should be made even when it does not respond to an immediate business concern, based on the consideration that the ESG practice in question will serve the corporation as an intangible asset, reinforcing the trust of stakeholders in the business, and ultimately generating a return in terms of better firm

performance. For example, should a company introduce more stringent procurement standards that would require it to sever its ties with a cost-efficient supplier, in the absence of a specific reputational incident or an explicit stakeholder demand? Similarly, should a company (continue to) invest in its employee engagement program in the absence of any indication of employee dissatisfaction? Should a board of directors adopt a diversity policy that could require one or more of its well-performing current members to step down?

A review of empirical research regarding the return on investment in ESG initiatives identifies five pillars of the business case for corporate sustainability:

1. Corporate investment in ESG enhances market and accounting performance
2. Corporate investment in ESG lowers the cost of capital
3. Corporate investment in ESG is a means of engagement with key shareholders
4. Corporate investment in ESG improves business reputation
5. Corporate investment in ESG channeled to product innovation fosters new revenue growth

The Search for Evidence that ESG Pays Off

The return on ESG investment has been widely investigated in the last decade. Even though there is great variation in the methodologies deployed, the data sources used, and the time horizon examined, many research projects have explored the link between this type of resource allocation and key measures of firm performance. The Appendix (available in the complete publication here) lists the most noteworthy publications in the field that were considered in the preparation of this report. All articles listed in the appendix were published in peer-review journals by academics affiliated with accredited universities; a separate section enumerates the main meta-studies or literature reviews conducted on the subject, including by non-academic organizations. The selection is limited to empirical analyses of the performance of securities (including studies of market indexes) or socially conscious investment funds.

A heterogeneous group of studies

It is important to recognize that this is a heterogeneous group of studies. Some review a wide range of corporate activities across the ESG spectrum, while others are thematic and choose to limit their analysis to one of the three areas of ESG activity (for example, the effect of a series of social policies on firm performance) or to individual practices within an area of ESG activity (for example, the correlation between a board diversity policy and firm performance). Their universe varies, with some studies focusing on firms incorporated or listed in a certain country and others drawing information from large companies included in global indexes. Studies on corporate governance practices, for example, tend to be concerned with the proof of lower capital constraints enjoyed by companies in developed countries, and compare mandatory practices at companies operating in a modern system of securities regulations with their counterparts operating in a bank-centric capital market; for this reason, these studies are of limited or no use to assess the impact of additional governance practices voluntarily adopted by a subgroup of companies in the United States. Moreover, even though many studies show significant variations of their findings depending on the business sector that is scrutinized, others aggregate results without offering sector-specific insights.

The limitations of meta-studies

Considering these studies as a single body of work can lead to major simplifications. In particular, it runs the risk of overemphasizing the conclusions about a phenomenon that remains difficult to analyze empirically, primarily due to the lack of a universally adopted framework to capture and disclose ESG practices. Other research organizations have conducted meta-studies to categorize these empirical analyses, calculating the percentage of them that prove a link between ESG investment and certain metrics of performance. It should be noted, however, that such a meta-analytical approach does have its shortcomings, as it puts the studies on a par with one another, without fully validating individual methodologies and data sources. It also ignores a publication bias, given that studies that show a negative or insignificant correlation are less likely to be published.

While this report brings to the fore some of the publications that corroborate the business case for corporate investment in ESG, readers should note that, perhaps with the exception of the link between ESG investment and a lower cost of capital, none of the "pillars" of the business case for ESG investment described in this report is undisputed in academic research. For example, despite a number of persuasive studies on the correlation between ESG and stock performance conducted on securities, conclusions are far less consistent when the investigation is conducted on socially responsible investment funds using ESG factors as portfolio composition criteria.

An evolving business context

Readers should also be aware that these studies have been conducted over a period of time in which the business context has evolved tremendously. Fifteen years ago, when the first of the projects were undertaken, terms such as ESG or "sustainability" were still largely unknown to a business and investment community that had yet failed to recognize the strategic relevance of these activities and qualified them as an extracurricular "social responsibility" of the corporation.

Today, many market participants are committed to the multiple reputable attempts to codify ESG measurement and reporting, including the Global Reporting Initiative, the Sustainability Accounting Standards Board, and the International Integrated Reporting Council. As documented by The Conference Board, the demand for assurance services in this field has also grown steadily.[1] The empirical investigation of the link between corporate investment in ESG and firm performance must therefore continue, as harmonized reporting and standardized verification practices will help to address the limitations of academic research conducted so far.

[1] In 2014, 30 percent of companies in the S&P Global 1200 and 12 percent of those in the S&P 500 issued sustainability reports that include third-party verification and assurance. The finding compares to the 25 percent and 8 percent respectively reported for the two indexes in 2013. The scope of assurance that companies include in their reports can vary widely and extend to the entire sustainability report, only specific sections, or just greenhouse gas (GHG) emissions. See *Sustainability Practices Dashboard—2015 Edition Key Findings*, The Conference Board, Research Report No. 1573, February 2015.

Defining Corporate Sustainability

There is a persuasive school of thought on the need for the business community to abandon the "corporate social responsibility" (CSR) term to illustrate the allocation of business resources to ESG. It is based on the argument that CSR inadequately emphasizes the notion of responsibility instead of the strategic, long-term growth rationale that should motivate a corporate sustainability program. In recent years, The Conference Board has endorsed this perspective and chose "sustainability" over "CSR" to name several of its initiatives—including an Institute on Sustainable Value Creation (a distinguished group of CEOs committed to reinforcing trust in business through long-term investment in a wide range of intangible assets), two councils of sustainability officers, an annual conference, a Dashboard of ESG practices adopted by corporations across the globe, and a periodic Sustainability in the Boardroom survey of director oversight practices. For more information, click here.

The Five Pillars of the Business Case for Corporate Sustainability

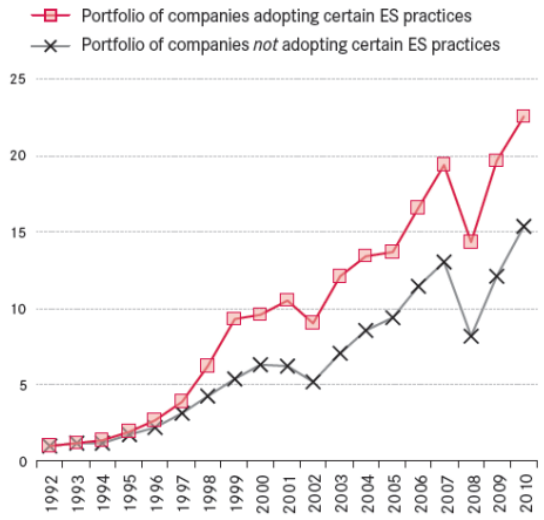
Empirical research from respected institutions outlines five pillars of the business case for corporate investment in ESG practices:

Corporate investment in ESG enhances market and accounting performance

Multiple empirical studies conducted in the last decade show that companies adhering to strong ESG standards enjoy high profits, low capital expenditures, and high stock return. Even though such conclusions are disputed by other research, the few analyses revealing negative correlations between corporate investment in ESG and firm performance tend to be the oldest and to rely on smaller data samples.

One of the most recent studies proving a positive correlation is a Harvard Business School article first circulated as a working paper in 2011 and released in *Management Science* in late 2014.[2] The project consisted in the observation of the long-term market and accounting performance of a matched sample of 180 companies, some of which had voluntarily established a range of environmental and social practices many years before. The study found that the subset of more sustainable companies significantly and consistently outperformed, over time, others in the sample that had introduced none of the environmental and social policies in question. The authors suggest that such outperformance may be a function of certain governance traits that appear to be commonly adopted in conjunction with those environmental and social policies—namely,

Evolution of $1 Invested in the Stock Market in Equal-Weighted Portfolios of Companies Adopting/Not Adopting Certain Environmental and Social Practices



Source: Robert G. Eccles, Ioannis Ioannou, and George Serafeim, "The Impact of Corporate Sustainability on Organizational Processes and Performance," *Management Science* 60, no. 11, November 2014.

[2] Robert G. Eccles, Ioannis Ioannou, and George Serafeim, "The Impact of Corporate Sustainability on Organizational Processes and Performance," *Management Science* 60, no. 11, November 2014, pp. 2835-2857.

the explicit assignment to the board of directors of the responsibility for sustainability oversight, the use of sustainability metrics as objectives in executive compensation packages, and the propensity to engage with stakeholders and disclose non-financial information to the market.

Another notable article, published in 2006 by the *Journal of Marketing*, ranked companies based on their performance across a range of environmental and social issues and quantified that a single-unit increase in the rating would result on average in approximately $17 million of additional annual profit in the years following the increase.[3]

The study argued that customer satisfaction mediates the relationship between ESG factors and performance, given the increasing sensitivity to these factors displayed by the consumer market. For this reason, the correlation can be observed more prominently among companies in the business-to-consumer segments of the market.

Analyses of market performance typically use stock return data and Tobin's Qs (a stock valuation measure calculated by dividing the market value of a company by the replacement value of its assets). Instead, the correlation between ESG factors and other, non-equity asset classes remains largely unexplored.

Corporate investment in ESG lowers the cost of capital

It is shown that publicly traded firms may reduce their cost of capital by adopting strong ESG practices. The relationship has been studied more extensively for corporate governance practices, with research building on the undisputed observation that companies listed in countries with advanced securities regulations and well-funded enforcement agencies benefit from easier access to the financial market.

Most of the analyses attribute the finding to the mitigation of business risks resulting from the adoption of superior governance practices (including a diversified and independent board of directors, a system of shareholder rights, and the elimination of unreasonable barriers to takeovers that would hinder a competitive market for corporate control). In general, lenders believe that better-governed companies are subject to fewer cases of shareholder suits or government investigations, and that they are less exposed to disruptions by activist investors. Studies published in 2003 and 2007, for example, found that firms with more elements of shareholder-centric corporate governance enjoyed higher ratings on their bonds issues and lower yields.[4]

More recently, the investigation has extended to the environmental and social area. According to an article published in 2011 by the *Journal of Banking and Finance*, firms publicly exposed to environmental and social concerns faced shorter maturities and higher loan spreads—paying for their borrowed capital, on average, 7 to 18 basis points more than companies that were more

[3] Xueming Luo and C.B. Bhattacharya, "Corporate Social Responsibility, Customer Satisfaction, and Market Value," *Journal of Marketing* 70, no. 4, 2006, pp. 1-18.

[4] Lucian A. Bebchuk, Martijn Cremers, and Urs Peyer, "CEO Centrality," NBER Working Paper no. w13701, December 2007 and Sanjeev Bhojraj and Partha Sengupta, "Effect of Corporate Governance on Bond Ratings and Yields: The Role of Institutional Investors and Outside Directors," *The Journal of Business*, vol. 76, no. 3, 2003 pp. 455-476.

socially responsible.[5] Two other studies published in the same year reached similar conclusions for the cost of equity; they argued that socially responsible companies tended to voluntarily disclose this information, which led to more accurate coverage by analysts and better company valuations.[6]

Corporate investment in ESG is a means of engagement with key shareholders

Socially responsible investment (SRI) funds first made their appearance in the 1970s, when some faith-based institutions began excluding from their investment vehicles securities from military defense contractors and other business activities contrary to their values. Today, SRIs have evolved from a negative screening practice to a series of sophisticated ESG incorporation strategies spanning a wide range of asset classes (equity and fixed income but also alternative investments such as arbitrage, event-driven investing and activism, and asset-backed securities). Moreover, thanks in particular to initiatives such as the United Nations' Principles for Responsible Investment (PRI),[7] an increasing number of public pension funds and investment entities affiliated with labor unions have become receptive to ESG-driven investment strategies, either by launching their own SRI vehicles or by exercising pressure on companies to introduce environmental and social reforms to their business practices (see "Shareholder Proposals on Social and Environmental Issues—A 2014 Update" in the next section).

Even though there is no convincing evidence that SRI funds outperform the market in the long term, most academic studies published in the last decade found that these investments are competitive with non-SRI strategies.[8] The staggering growth of this segment of the asset management industry corroborates the empirical findings. According to the latest official survey of the industry, as of early 2014, assets managed by US-based firms considering corporate ESG practices as investment criteria had grown to $4.8 trillion, or more than two fold since the level registered in early 2012 ($1.4 trillion).[9]

For these reasons, corporate investment in ESG may help to attract to the company's shareholder base a class of long-term investors that is increasingly gaining influence. It also offers new opportunities for companies to engage with large institutional investors sensitive to these issues.

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[5] Allen Goss and Gordon S. Roberts, "The Impact of Corporate Social Respons bility on the Cost of Bank Loans," *Journal of Banking & Finance* 35, no. 7, 2011. In the social area, in particular, a 2009 study by Bauer et al. found that debt financing tends to be less expensive to companies with stronger employee relations.

[6] Ghoul et al. "Does Corporate Social Responsibility Affect the Cost of Capital?" *Journal of Banking& Finance* 35, no. 9, September 2011, pp. 2388-2406 and Dhaliwal et al., "Voluntary Nonfinancial Disclosure and the Cost of Equity Capital: The Initiation of Corporate Social Responsibility Reporting," *The Accounting Review*, 86, no. 1, 2011.

[7] Established in 2005 response to an invitation by then UN Secretary General Kofi Annan, the Principles for Respons ble Investment are based on the notion that ESG issues such as climate change and human rights can affect the performance of investment portfolios and should therefore be considered alongside more traditional financial factors if investors are to properly fulfill their fiduciary duties. As of December 2014, PRI signatories include 285 asset owners and 863 investment managers, including large US public pension funds such as CalPERS and TIAA-CREF. For more information, visit unpri.org.

[8] Jeroen Derwall, Kees C.G. Koedjijk, and Jenke Ter Horst, "A Tale of Values-Driven and Profit-Seeking Social Investors," *CFA Digest*, CFA Institute 41, no. 3, August 2011.

[9] *Report on US Sustainable, Responsible, and Impact Investing Trends 2014*, US SIF Foundation, November 20, 2014.

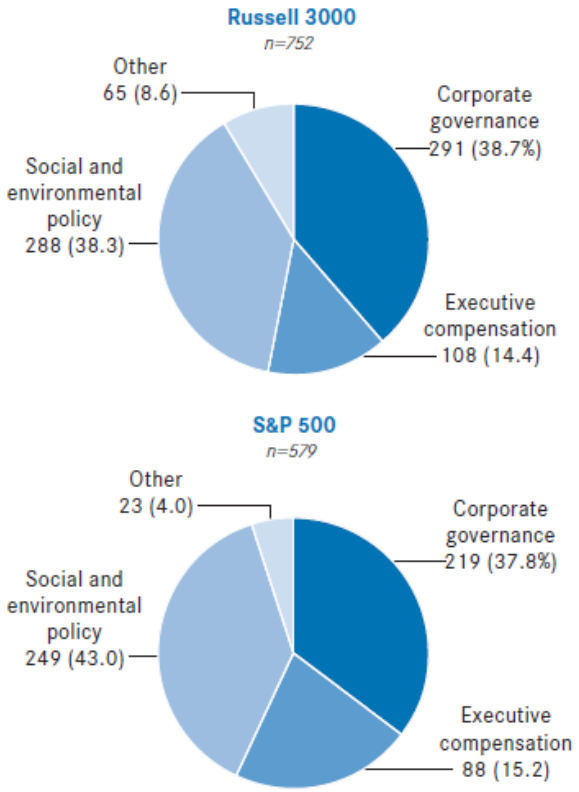
Shareholder Proposals on Social and Environmental Issues

While their voting support remains far below the majority threshold, the volume of proposals on social and environmental policy issues rose to unprecedented levels in 2014. These requests represented the single most frequent subject of shareholder resolutions filed in the S&P 500 in the January 1-June 30, 2014 period (249 proposals, or 43 percent of the total filed at companies in that index) and more than one-third of the total submitted at Russell 3000 companies (288 proposals, or 38.3 percent).

Widely diversified (ranging from political contribution disclosure to compliance with human rights and from sustainability reporting to the adoption of a climate change policy), these issues are pursued by multiple investor types, with the highest concentration among individuals (58 filed proposals in 2014), public pension funds (49 proposals), and other stakeholders like the Humane Society of the united States and the National Center for Public Policy Research.[10]

Shareholder Proposal Volume by Subject (2014)

Number of shareholder proposals (percentage of total)

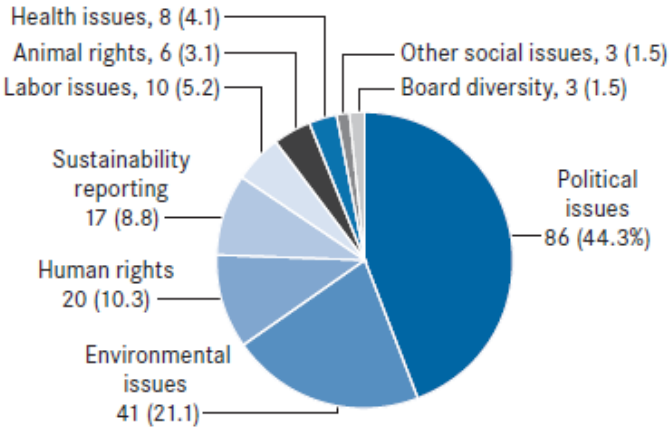


Note: Percentages may not add to 100 due to rounding.

Source: The Conference Board/FactSet, 2014.

Shareholder Proposals on Social and Environmental Policy in the Russell 3000, by Topic (2014)

Number of shareholder proposals (percentage of total)



Source: The Conference Board/FactSet, 2014.

[10] Matteo Tonello and Melissa Aguilar, *Proxy Voting Analytics (2010-2014)*, Research Report No. 1560, The Conference Board, November 2014. Also see Thomas Singer and Melissa Aguilar, "Shareholder Proposals on Social and Environmental Issues," *Director Notes* No. 16/2014, The Conference Board, December 2014.

Corporate investment in ESG improves business reputation

When it does not satisfy immediate operational and financial needs, corporate investments in ESG can be strategic and long-term, as it enhances relations with key stakeholders (whether employees, customers, suppliers, or local communities where the company operates). Over time, the perception of the corporate brand benefits from these improved relationships: talent recruitment and retention, customer satisfaction, and the quality of media coverage are areas of intangible business success where, thanks to today's technology, the effects of an ESG program can be easily monitored. Research published in 2014 by The Conference Board in collaboration with CSRHub explored the link between sustainability performance and Brand Finance's Brand Strength Index (BSI), a proprietary methodology to calculate the brand value of more than 5,000 leading global companies. The study revealed that about 22 percent of the variation in BSI can be explained by changes in perceived ESG performance.[11] Corporate reputation and sustainability are therefore related, and a company that seeks to do well in one area should also consider investing in the other.

Rating and ranking providers are also more likely to recognize companies committed to standardized sustainability disclosure. In fact, an empirical review conducted by G&A—Governance & Accountability Institute[12] showed a positive correlation between a firm's adoption of the GRI guidelines on ESG reporting and its performance vis-a-vis prominent indicators of corporate reputation, such as:

- Inclusion in Ethisphere's World Most Ethical Companies
- Inclusion in the Dow Jones Sustainability Index
- Inclusion in CR 100 Best Corporate Citizens (*CR Magazine*)
- Inclusion in *Newsweek*'s Greenest Companies
- More favorable Glassdoor ranking
- More favorable CSRHub ranking
- Higher Bloomberg ESG Disclosure Scores

Corporate investment in ESG channeled to product innovation fosters new revenue growth

There is ample literature on the benefits of a corporate sustainability strategy as an initiative to improve efficiencies, reduce costs, and minimize a firm's environmental impact. However, there are also significant benefits associated with top-line growth that receive far less attention. An increasing number of companies recognize that ESG initiatives can yield new market opportunities, stimulate innovation in products and services, and ultimately be an important source of revenue.

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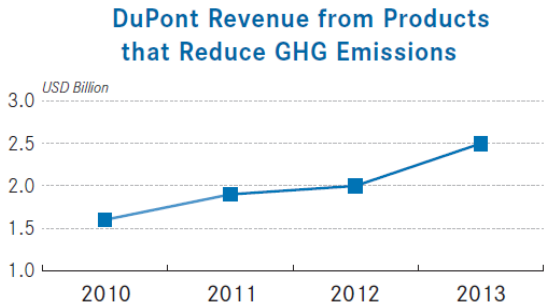
[11] Bahar Gidwani, "The link between Sustainability and Brand Value," in Thomas Singer (Ed.),*Sustainability Matters 2014*, Research Report, R-1538-14-RR, 2014, p. 25.

[12] *2012 Corporate ESG/Sustainability/Responsibility Reporting. Does It Matter? Analysis of S&P 500 Companies' ESG Reporting Trends and Capital Markets Response, and Positive Association with Desired Rankings & Ratings*, G&A—Governance & Accountability Institute, December 2012 (http://www.ga-institute.com/fileadmin/user_upload/Reports/SP500_-_Final_12-15-12.pdf).

In fact, recent research by The Conference Board examines the extent to which a sample of S&P Global 100 companies generate revenue from sustainability initiatives.[13] There are several examples of companies that have developed successful products or new lines of business built on sustainability considerations. The development of these products can be motivated by a variety of factors, such as cost savings and efficiencies (e.g., using fewer materials), customer demand (e.g., longer-lasting products, products free of hazardous materials),or regulatory developments (products with lower GHG emissions). In many cases these products represent a rapidly growing source of revenue and an increasingly larger share of a company's total revenue.

General Electric's often cited *Ecomagination*SM initiative provides a good example. The initiative was launched in 2005 as the company's commitment to technology solutions that save money and manage environmental impact for GE's customers and the company's own operations. Since its launch, *Ecomagination*SM has generated about $200 billion in revenue for GE. In 2014 alone, revenue from *Ecomagination*SM totaled $34 billion, accounting for 31 percent of the company's total industrial revenue. Revenue from *Ecomagination*SM increased 89 percent from 2010 to 2014, about three times the growth rate of the company's total industrial revenue over the same period.



Source: 2014 DuPont Sustainability Progress Report (2013 data); 2013 DuPont Sustainability Progress Report (2012, 2011, 2010 data).

Source: Figures were calculated by The Conference Board with data provided by GE. 2014, 2013, and 2012 data: GE email communication to The Conference Board, April 20, 2015. 2011 data: *GE Ecomagination℠ Report 2011*, http://files.gecompany.com/ecomagination/progress/GE_ecomagination_2011 AnnualReport.pdf. 2010 data: *GE Ecomagination℠ Report 2010*, http://files.gecompany.com/ecomagination/progress/GE_ecomagination_2010AnnualReport.pdf.

DuPont is another example of a company that has generated significant revenue growth from investment in ESG initiatives. In 2011 DuPont set a 2015 goal to increase annual revenue from products that increase energy efficiency and/or significantly reduce greenhouse gas emissions by at least $2 billion. By 2013, these products generated $2.5 billion in revenue for DuPont—a 56 percent growth since 2010, compared to the company's overall revenue growth of 29 percent in the same period.

A corporate sustainability strategy can be an effective way to manage risks, reduce environmental impacts, improve efficiencies, and lower costs. As evidenced by examples from a number of leading companies, a sustainability strategy can also pave the way for product innovation and new sources of significant revenue growth.

Conclusions

Corporations have been investing in ESG practices more frequently in the last decade. However, these resource allocations often respond to immediate business needs rather than a strategic and

[13] See Thomas Singer, *Driving Revenue Growth Through Sustainable Products and Services,*Research Report No. R-1583-KBI, The Conference Board, June 2015.

cohesive sustainability program intended to enhance for the long-term key intangible assets in the environmental, social, and governance spheres.

While empirical research on the link between corporate investment in ESG and firm performance is far from undisputed, several studies led by respected institutions have shown that a company can be rewarded for adopting these practices: higher profits and stock return, a lower cost of capital, and better corporate reputation scores are the key benefits enjoyed in return for this type of investment. As companies continue to adhere to harmonized reporting standards and verified data becomes more readily accessible, researchers will be able to continue this course of investigation and find the definitive proof that ESG-related corporate expenditures do pay off.

The complete publication, including footnotes and Appendix, is available here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Active Ownership

Posted by Oğuzhan Karakaş, Boston College, on Tuesday, October 6, 2015

Editor's Note: Oğuzhan Karakaş is Assistant Professor of Finance at Boston College. This post is based on an article authored by Professor Karakaş; Elroy Dimson, Professor of Finance at London Business School; and Xi Li, Assistant Professor of Accounting at Temple University. Related research from the Program on Corporate Governance includes Socially Responsible Firms by Allen Ferrell, Hao Liang, and Luc Renneboog (discussed on the Forum here).

In our paper, Active Ownership, forthcoming in the *Review of Financial Studies*, we analyze highly intensive engagements on environmental, social, and governance (ESG) issues by a large institutional investor with a major commitment to responsible investment (hereafter "ESG activism" or "active ownership"). Given the relative lack of research on environmentally and socially themed engagements, we emphasize the environmental and social (ES) engagements throughout the paper and use the corporate governance (CG) engagements as a basis for comparison.

Our primary sample consists of 2,152 engagement sequences (1,252 ES-, and 900 CG-based sequences) for 613 U.S. public firms between 1999 and 2009. The success rate for engagements in our sample is 18%, and, on average, it takes a sequence of 2–3 engagements before success can be recorded. The elapsed time from initial engagement to success averages nearly one-and-a-half years; the median time is one year. In comparison to CG themes, the chance of achieving success for ES themes is lower (13% vs. 24%), and the number of engagements per sequence is higher (3.7 vs. 2.2).

Compared to a matched sample of companies, firms are more likely to be engaged if they are large, mature, and performing poorly. The likelihood of being engaged is further increased if the asset manager and other socially conscious institutional investors (such as pension activists and SRI funds) have high shareholdings in the firm. Engagement is also more likely if reputation is important for the target company and if the company has inferior governance. The asset manager's ownership plays a less important role in relation to ES engagements than to CG engagements. On the other hand, reputational concerns are a more important determinant of engagement with firms on ES themes. These last two results indicate the importance of potential collaborations with other stakeholders and of customer opinion and loyalty, notably in consumer-facing industries, for the active ownership.

Conditional on being engaged, which firms are more likely to implement the asset manager's proposed changes? We refer to cases in which changes are implemented as successful engagements. Success is more likely if the target firm has reputational concerns, a capacity to implement change, economies of scale, and headroom for improvement. For the ES

engagements, we find reputational concerns and a capacity to change play a more important role in achieving success. This may be attributed to the costly nature of improvements in areas related to ES dimensions.

Analyzing the engagement features and tactics, we find that successful prior engagement experience with the same target firm increases the likelihood of subsequent engagements being successful. In addition, we find collaborations among the asset manager and other active investors and/or stakeholders to contribute positively to the success of engagements, particularly for the ES engagements. This suggests that it requires more coordinated effort to convince an engaged company's management regarding the ES issues, in comparison to CG issues.

How does the market react to ESG activism? We find that ESG engagements generate a cumulative size-adjusted abnormal return of +2.3% over the year following the initial engagement. Cumulative abnormal returns are much higher for successful engagements (+7.1%) and gradually flatten out after a year, when the objective is accomplished for the median firm in our sample. We do not find any market reaction to unsuccessful engagements. The abnormal return patterns and magnitudes are similar for the subsamples of CG and ES engagements. This suggests the existence of a threshold for success to be pursued and achieved for both types of engagements. We then examine the cross-section of abnormal returns and find that the positive market reaction to successful engagements is most pronounced for the themes of corporate governance and climate change. For these themes, the cumulative abnormal return of an additional successful engagement over a year after the initial engagement averages +8.6% and +10.3%, respectively.

To investigate the sources of the positive market reaction to successful engagements, we take a difference-in-differences approach and examine the subsequent changes in target firms' operating performance, profitability, efficiency, institutional ownership, stock volatility, and governance after successful engagements relative to after unsuccessful engagements. We observe significant improvements in all these measures (i.e., an increase in firm performance, investor base, and governance, and a decrease in stock return volatility) following successful engagements, as compared to the unsuccessful ones. Particularly focusing on the ES and CG subsamples, we first find that the return on assets and the ratio of sales to the number of employees improves significantly one year after successful ES engagements, as compared to the unsuccessful ones; but such improvements are less pronounced for successful CG engagements. These findings support the view that successful ES initiatives enhance customer and employee loyalty. Second, we observe an increase in shareholdings by the asset manager, pension activists, and SRI funds one year after successful ES engagements; but such an increase is not apparent for successful CG engagements. These results support the view that ES initiatives generate a clientele effect among shareholders. Third, we find improvements in the corporate governance structure of targeted firms, as measured by the Bebchuk, Cohen, and Ferrell (2009) entrenchment index, two years after successful engagements on all ESG issues. This suggests that good ESG practices signal improving governance quality.

We conclude that environmental, social, and governance activism of the type that we study improves social welfare to the extent that it increases stakeholder value when engagements are successful and does not destroy firm value even when engagements are unsuccessful. We note that, after successful engagements (particularly on ES issues), firms with inferior governance subsequently improve their governance and performance. Our interpretation is that active ownership attenuates managerial myopia and hence helps to minimize intertemporal losses of

profits and negative externalities (see Benabou and Tirole 2010). This approach is differentiated from other styles of shareholder action, particularly hedge fund activism. Responsible investment initiatives are less confrontational, more collaborative, and more sensitive to public perceptions; yet they achieve success.

The full paper is available for download here.

Tab 8: The Debate on Buybacks, Capital Allocation, and Short-Termism

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March 31, 2015

Over the past several years at BlackRock, we have engaged extensively with companies, clients, regulators and others on the importance of taking a long-term approach to creating value. We have done so in response to the acute pressure, growing with every quarter, for companies to meet short-term financial goals at the expense of building long-term value. This pressure originates from a number of sources—the proliferation of activist shareholders seeking immediate returns, the ever-increasing velocity of capital, a media landscape defined by the 24/7 news cycle and a shrinking attention span, and public policy that fails to encourage truly long-term investment.

As I am sure you recognize, the effects of the short-termist phenomenon are troubling both to those seeking to save for long-term goals such as retirement and for our broader economy. In the face of these pressures, more and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth.

In 2014, dividends and buybacks in the U.S. alone totaled more than $900 billion, according to Standard & Poor's—the highest level on record. With interest rates approaching zero, returning excessive amounts of capital to investors—who will enjoy comparatively meager benefits from it in this environment—sends a discouraging message about a company's ability to use its resources wisely and develop a coherent plan to create value over the long term.

There is nothing inherently wrong with returning capital to shareholders in a measured fashion, as part of a broader growth strategy—indeed, it can be a vital part of a responsible capital strategy. Nor are the demands of activists necessarily at odds with the interests of other shareholders; some activist investors take a long-term view and have pushed companies and their boards to make productive changes.

It is critical, however, to understand that corporate leaders' duty of care and loyalty is not to every investor or trader who owns their companies' shares at any moment in time, but to the company and its long-term owners. Successfully fulfilling that duty requires that corporate leaders engage with a company's long-term providers of capital; that they resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners; and, most importantly, that they clearly and effectively articulate their strategy for sustainable long-term growth. Corporate leaders and their companies who follow this model can expect our support.

We fully appreciate that the business ecosystem has evolved significantly and presents a daunting challenge for companies working to resist short-term market pressures. But a clear, effective articulation of long-term strategy and goals will help your company explain to shareholders the short-term accommodations that businesses invariably do need to make at times to adapt to a changing environment. Overall, companies' ability to resist short-term pressures—and attract long-term stakeholders—will rest on their ability to both develop and communicate their plans for future growth.

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Companies should not have to fight this battle alone. We believe that government leaders around the world—with a concerted push from both investors and companies—must act to address public policy that fosters long-term behavior. We believe that U.S. tax policy, as it stands, incentivizes short-term behavior. For tax purposes, the U.S. currently defines a long-term investment as one held for one year. Since when was one year considered a long-term investment? A more effective structure would be to grant long-term treatment only after three years, and then to decrease the tax rate for each year of ownership beyond that, potentially dropping to zero after 10 years. This would create a profound incentive for more long-term holdings and could be designed to be revenue neutral. In short, tax reform that promotes long-term investment will benefit both the companies who rely on capital markets and the hundreds of millions of people saving for retirement.

Asset managers like BlackRock also have an important role to play, which is why we engage actively with companies on the key governance factors that in our experience support long-term, sustainable, financial performance. Chief among these is board leadership—in our view, the board is management's first line of defense against short-term pressures. Our starting point is to support management, particularly during periods where performance has deviated from the long-term trajectory. But this is more difficult to do where management has not articulated a clear long-term vision, strategic direction and credible metrics against which to assess performance. In such cases, we will take action to ensure that the owners' interests are effectively served.

To that end, we have revised our proxy voting guidelines this year to make clear our expectations of boards and set out when we may vote against directors, such as instances where we see evidence of board entrenchment or other signs of ineffective governance. But we also believe that engagement by firms such as ours should not be overly concentrated on proxy season or around earnings reports—rather, it should be consistent and sustained, and cover issues broader and deeper than board elections or earnings per share.

Throughout 2015, BlackRock will continue to focus on these issues, because we recognize that although much of the financial and business community is in agreement on the need for a more long-term atmosphere, more concrete steps must be taken to achieve it. We urge you to join us and with your fellow corporate leaders to invest in the future and thereby lay the foundation for stronger, more sustainable, and more stable economic growth.

Yours sincerely,

Laurence D. Fink
Chairman & CEO

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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What the 2016 Blackrock Letter Means for Shareholder Engagement and Disclosure Practices

Posted by Ethan A. Klingsberg, Cleary Gottlieb Steen & Hamilton LLP, on Wednesday, February 24, 2016

Editor's note: Ethan A. Klingsberg is a partner in the New York office of Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb publication by Mr. Klingsberg and Elizabeth Bieber.

In February 2016, Blackrock CEO Laurence Fink issued his annual letter to the CEOs of S&P 500 companies. In addition to repeating themes from prior years (the value of long-termism and the need for more thoughtfulness before allocating capital to buybacks and special dividends), this year's letter had one notable omission and four of areas of specific emphasis that merit the attention of boards and managements.

Blackrock, with trillions of dollars of investments in equity markets, is the top stockholder for one in five U.S. public companies and the largest institutional investor in U.S. public stock markets. Moreover Blackrock has an in-house team prepared to engage with public companies directly on issues and assure that its influential votes are cast accordingly at stockholder meetings. The recommendations of ISS and Glass Lewis remain a variable, and institutional investors, including Blackrock, still subscribe to proxy advisory services and consider their views. However, institutional investment managers are increasingly independent thinkers when it comes to voting and Blackrock has publicly stated that it does not follow the recommendations of any single provider. Thus, consideration of the significance of the letter is worthwhile by both the recipients and other market constituents.

Notably absent from the 2016 letter is a call for CEOs or directors to have more direct engagement with stockholders. Letters over the past couple of years from Vanguard and Blackrock, as well as the alarmism of some advisors, have led to some overloading of the lines of communication between public companies and many institutional investors, especially during the second half of 2015. Despite packed agendas, direct engagement should still be a priority for a company with a foreseeable contested situation. Institutional investors will let companies know when a special meeting with directors or the CEO is advisable to support the usual IR check-ins.

The 2016 letter emphasized specific requests for:

- **Less Short-Term Guidance. Movement away from provision of quarterly EPS guidance.**
- **Long-Term Plan Disclosure. Disclosure of clearly articulated, long-term strategic plans, including the financial metrics relevant to measuring the success of these plans and an express confirmation that the board has reviewed these plans**.
- **Linked Compensation Metrics. Linkage of long-term compensation programs to the metrics cited as relevant to the long-term strategic plan**.
- **ESG. Sharper focus on so called "ESG" (environmental/social/governance) matters.**

Against the backdrop of the trends identified in the chart below surveying the approaches to disclosure over the last ten years by some large cap retailers, these requests give rise to the following considerations and expectations:

1. **Guidance**. The ongoing pressure on IR departments from analysts will likely impede significant movement away from quarterly guidance. However, in recent years we have seen companies enhance their disclosures of short-term guidance by couching their expectations in the context of progress towards long-term goals, which is a nice way of bridging the hunger of analysts for short-term guidance with the demands of institutional investors, like Blackrock, for a bigger picture perspective; although it is far from clear that Blackrock views this approach as optimal. In addition, while quarterly guidance may be a distraction from long-term goals and, when missed, provide fodder for hedge fund activist campaigns, the continuation of quarterly guidance is unlikely to serve as a bar against support from Blackrock.
2. **Long-Term Plan Disclosure**. Long-term plan disclosure has evolved in recent years from a theme underlying MD&A to becoming relevant to the contents of the annual proxy statement and a centerpiece of a number of investor relations websites with detail and color that goes beyond the typical investor power point deck containing historical and short-term details and non-specific long-term aspirations. However, the inclusion of long-term financial target numbers is most commonly seen in turn-around situations or where there is an imminent contested situation. Moreover, there is a sense among legal practitioners that the provision of quantified long-term targets puts unnecessary pressure on companies from a liability perspective due to the risk of "duty to update" claims, despite some protection under the Private Securities Litigation Reform Act and the inclusion of appropriate qualifying language. Nevertheless, as boards continue to position themselves preemptively against the risk of activist hedge fund attacks, we expect many companies to continue enhancing their long-term plan disclosure and starting to include more quantifiable targets. This movement will require attention to the "duty to update" risk, but may well enhance shareholder focus on long-term strategy, aligning companies more closely with influential institutional investors and help keep activists at bay.
3. **Compensation Metrics**. The integration of the work of the compensation committee with the implementation of the strategic plan has been a theme for both hedge fund activists—for whom presence on the compensation committee is often a priority—and good governance types and has given rise to more innovative disclosure in annual proxy statements. Working through the relationship between the big picture strategic plan and

the compensation plans and assuring clear disclosure on this relationship should be a focus of every board.

4. **ESG**. Stockholder proposals on ESG matters rarely receive majority approval and we do not expect this trend to change. Many of the ESG shareholder proposals are either impractical or submitted to companies that have actually already done a decent job of taking into account the goals of the proposal. Nevertheless, even though approval of ESG proposals over management's objections may not be a serious risk, the focus on ESG by boards and managements will continue to become more serious and necessary for positive stockholder relations. Much of corporate America has already gotten the message from Blackrock and other institutional shareholders that disclosing details of a company's commitment to ESG matters is a way of signaling "operational excellence" or, as one investment manager recently stated to us, akin to having appropriate insurance policies and processes in place. Increasingly, investors see ESG matters as an enterprise risk that must be anticipated, assessed and managed.

The emergence of Blackrock and other index funds as active players on the shareholder landscape offers companies an opportunity to build relationships that function as a bulwark against threats of hedge fund activism. Consideration of the roadmap to their support, as provided by the latest Blackrock letter and analogous policy statements by other institutions, is an important component of being able to take advantage of this opportunity.

To view the full chart, please click here.

Harvard
Business
Review

Stock Buybacks Aren't Hurting Innovation

by Greg Satell
March 31, 2015

Companies are spending more money buying back their own stock than they ever have. These stock buybacks have come under criticism as a bad investment – the argument being that companies sitting on record amounts of cash ought to invest in innovation, salaries, or at least dividends, rather than pumping up their own stock price through buybacks.

But before we vilify stock buybacks, let's take a closer look at the charges against them.

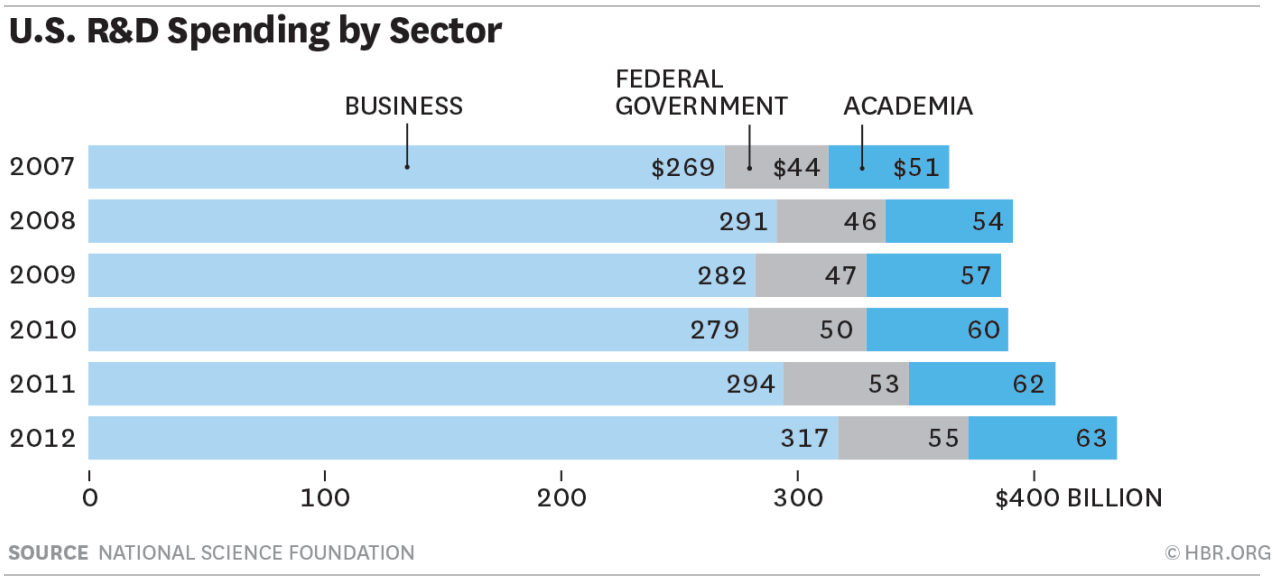
Critics have pointed out that companies who spend money on stock buybacks a) are wasting money they could be plowing into R&D and innovation, and b) also hypocritically lobby for federal investment in research benefits them. Intel, for one, urged for greater public funding for nanotechnology research. Other top executives at the American Energy Innovation Council are pushing for more funding for alternative energy research. The list goes on. Shouldn't these companies be using the money they're spending on stock buybacks to fund that research themselves?

Not so fast. For one thing, it's not clear that the stock buyback trend is actually limiting corporate innovation spending. US business already are spending heavily on research and development – data from the National Science Foundation (NSF) even shows an uptick in US business investment in R&D.

Not only has business investment in R&D been outpacing economic growth in recent years (2012 is the most recent year available), but it's also outpacing longer term trends.

While R&D spending is an imperfect proxy for innovation investment, this data should give us pause when we hear claims that American innovation is in crisis because corporate investors are unwilling to invest in the future, or because activist investors demand short-term results.

The case of Apple is an instructive, if extreme, example. Last year, the company spent $56 billion on share repurchases. That exceeds its operating income of $52.5 billion by more than 7%. Surely, it seems that Apple is rewarding investors at the expense of its future.



But a closer look reveals that Apple has also been expanding investment on R&D at a compound rate of 28%, while simultaneously increasing its ratio of R&D to sales. What's more, the company still holds more than $170 billion in cash that it has very little idea what to do with.

We should also question the assumption that investor preference for quick returns limits managers' ability to invest in the future. In fact, private capital investment, an even larger ticket item than R&D, has also been increasing and is at historically high levels of GDP.

And it's not just short-term investors that like buybacks and dividends. Mark Mulholland, whose Matthew 25 Fund holds investments for an average of five years, argues that returning excess capital to investors is healthy, not just for share prices, but for the economy. He says, "a company shouldn't sit on cash, they should put money to work. If not in their own business then back to their investors so that it can be deployed elsewhere."

So it appears that the current surge in share buybacks may be a reasonable course of action: faced with a superabundance of capital, firms are both increasing investments and returning the excess to shareholders so that it can be invested elsewhere.

Moreover, we can't assume that these firms are lobbying for the federal government to invest in research that they could just as easily perform themselves. Firms are in business to make money and should therefore willing to make investments to make more of it. However, not all investments are equal. Some, like the development of specific technology for a new product, largely benefit one firm. Others, such as the discovery of DNA, the human genome project and clean energy, benefit society more broadly. The former tends to be conducted by corporations to develop products they expect will be profitable, and the latter tends to be more exploratory.

Even if corporations were willing to take on exploratory research, it's not clear the public should want them to. Because private research is proprietary, its fruits become the property of the organization. Public research, on the other hand, is published and shared widely. If we replace public sources of funding with private ones, we run two risks: first, that exploratory research would be effectively defunded, and second,

that any important discoveries made will not become public property, but will remain in private, corporate hands.

The two different types of research are complementary. As Ed Lazowska, who co-chaired President Bush's Information Technology Advisory Committee, says, "In it's essence, innovation is combination. A private company is unlikely to come up with more than a few pieces of the puzzle. If the government doesn't invest, there will be nothing for these companies to engineer into products."

Let's return to the example of Intel, one of the companies that's used its cash to buy back it's own stock, even as it's lobbied for more federal funding for research that would benefit them. In a recent HBR article by William Lazonick, he writes that "Intel executives have long lobbied the U.S. government to increase spending on nanotechnology research" and then points out that Intel's share repurchases are four times the federal nanotechnology budget.

Fair enough, but Lazonick fails to mention that according to Intel's most recent 10-K filing, the company's annual research budget of $11.5 billion is *more than six times* that of the National Nanotechnology Initiative (NNI) budget of $1.5 billion. So clearly Intel's advocacy of broad based nanotechnology should not be considered a reticence to invest in the future.

I'm not arguing that hypocrisy and rent seeking in corporate lobbying doesn't exist and, in fact, Lazonick cites some other examples where it does seem to be taking place.

My point is that there is a fundamental difference between public and private investment. We don't advocate for corporate investments in all the public goods corporations rely on—the roads their trucks drive, the schools that educate their future employees, and so on. (Although we do expect corporations to pay their taxes, which of course help to fund those things.)

The fact that private firms benefit from public investment in research is not a bug, but a feature. Vannevar Bush, who was the chief architect of today's federal research programs, wrote that "there must be a stream of new scientific knowledge to turn the wheels of private and public enterprise."

He did not write these words offhand or as an aside, but in the founding document of our public research efforts, in which he argued strenuously that public support of basic research was essential to our national well-being and prosperity. He did so not to augment corporate programs, but to undertake efforts that they cannot.

And Bush's model clearly works. In fact, it is the envy of the world. It is not an accident that the iPhone was invented by a US company, virtually all of its basic technology has its roots in some federal program. Moreover, as Gary Pisano and Willy Shih point out in another HBR article, although data from the US funded Human Genome Project is available across the world, it is US companies that are reaping the benefits.

There is a lot to find fault with in corporate America today. Lobbying and rent seeking, elaborate tax dodging on a massive scale, outright fraud and other crimes are very real. However, insisting on private accountability is no excuse for shirking public duty.

The real problem isn't that corporations are unwilling to think long term, but the rest of us. It's easy to point our fingers at highly paid executives and greedy investors for short-term thinking, but when it comes to our collective future, we are failing to live up to our basic responsibilities.

The American Society of Civil Engineers gives US infrastructure a grade of D+ and we hardly take notice. A bill for an infrastructure bank, written in 2007, languishes in Congress due to lack of political support. Senators gain cheap political points by attacking scientific research and we cheer them on. We make drastic cuts to funding for an Ebola vaccine and then panic when there's an outbreak.That's the real capitalist's dilemma.

It's much easier to demand lower taxes than to fix our crumbling roads, bridges and airports. It feels good to laugh at egghead scientists and their goofy research, but much harder to understand the significance of their work. I shudder to think of what political hay today's leaders would make of Einstein's notion of the relativity of time and space.

The truth is that you can only win the future if you invest in it. It is, in fact, America's postwar commitment to infrastructure and science that we have to thank for our current prosperity. So if we really care about innovation, we not only need to be forward looking in our private decisions, but our public ones as well.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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The Real Effects of Share Repurchases

Posted by Mathias Kronlund, University of Illinois at Urbana-Champaign, on Monday, February 8, 2016

Editor's note: Mathias Kronlund is Assistant Professor of Finance at the University of Illinois at Urbana-Champaign. This post is based on an article authored by Professor Kronlund; Heitor Almeida, Professor of Finance at the University of Illinois at Urbana-Champaign; and Vyacheslav Fos, Assistant Professor of Finance at Boston College.

Companies face intense pressure from activist shareholders, institutional investors, the government, and the media to put their cash to good use. Existing evidence suggests that share repurchases are a good way for companies to return cash to investors, since cash-rich companies tend to generate large abnormal returns when announcing new repurchase programs. However, some observers argue that the cash that is spent on repurchase programs should instead be used to increase research and employment, and that the recent increase in share repurchases is undermining the recovery from the recent recession and hurting the economy's long-term prospects. Repurchases have also been cited as an explanation for why the increase in corporate profitability in the years after the recession has not resulted in higher growth in employment, and overall economic prosperity.

Is there any ground for these claims? Do share repurchases have real effects on other corporate policies such as employment and research and development (R&D)? Previous studies show a negative correlation between share repurchases and investment, but the standard interpretation for this correlation is that it is driven by variation in growth opportunities. That is, firms with poor growth opportunities reduce investment and direct resources towards share repurchases. If this standard interpretation is correct, then claims that repurchases reduce economic growth are incorrect: the reductions in investment would have occurred irrespective of the amount of repurchases. To test whether repurchases have causal effects on firm outcomes, we need to measure variation in repurchases that is not related to unobservable variation in growth opportunities.

In our paper, The Real Effects of Share Repurchases, recently featured in the *Journal of Financial Economics*, we propose such a test. The test exploits a discontinuity in the likelihood of share repurchases that is caused by earnings management considerations. There is a strong discontinuity in the probability of accretive share repurchases around the threshold at which the firm would narrowly miss the analyst earnings consensus, without conducting share repurchases. Thus, companies that would just miss their earnings per share (EPS) forecasts by a few cents absent executing a repurchase are significantly more likely to repurchase shares than companies that beat their EPS forecasts by a few cents.

We find that an increase in share repurchases made by firms that would have a small negative EPS surprise is associated with significant changes in other corporate policies. These companies

tend to decrease employment, Capex, and R&D in the four quarters following increases in EPS-induced repurchases, relative to companies that just meet analyst EPS forecasts. The effects correspond to approximately 10% of the mean capital expenditures, 3% of the mean R&D expenses, and 5% of the average number of employees in our sample. The results support anecdotal and survey evidence that companies are willing to trade off employment and investment for stock repurchases.

We further exploit cross-sectional heterogeneity in the magnitude of the discontinuity in share repurchases around the zero surprise threshold. We show that the discontinuity in repurchases is much weaker or absent among firms that are financially constrained, and among firms that do not mention “EPS” or “Earnings Per Share” in their proxy statements. Financially constrained firms are less able to engage in large share repurchases to manage EPS, and firms that do not mention EPS in their proxy statement arguably care less about managing EPS. We find that among these firms that don’t respond as much by doing repurchases, there is little or no relationship between having a negative pre-repurchase EPS surprise and future employment/investment.

Finally, we study the consequences of EPS-induced repurchases for firm valuation and performance. We find that when firms change the sign of EPS surprise from negative to positive using repurchases, they experience a positive and significant cumulative abnormal return (CAR) around their earnings announcement. This abnormal return is virtually identical to that for firms that report positive EPS surprises without repurchasing shares. We find similar results for operating performance (measured by return on assets (ROA)). Further analysis uncovers interesting cross-sectional variation in stock price reactions and operating performance. Firms that cut some type of real investment (either Capex, employment, or R&D) in the same quarter as they achieve a repurchase-induced EPS surprise show a stock price reaction that is on average 0.23% lower than that of firms that change the sign of the EPS surprise without cutting any real investments (e.g., these firms could be using internal cash to finance the repurchase). Consistent with the valuation results, firms that cut investments in the same quarter as the earnings surprise have lower subsequent operating performance than firms that finance the repurchase with cash or internal cash flow.

These results suggest that EPS-induced repurchases are on average not detrimental to shareholder value or subsequent performance. The interpretation of the cross-sectional evidence is a bit trickier because the choice of how to finance a repurchase may be driven by factors that also influence performance. With this caveat in mind, the lower returns of firms that finance repurchases with real investments provide suggestive evidence that some firms are willing to sacrifice valuable investments to finance share repurchases.

The full paper is available for download here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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The New Paradigm for Corporate Governance

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Wednesday, February 3, 2016

Editor's note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here), and The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here). Critiques of the Bebchuk-Brav-Jiang study by Wachtell Lipton, and responses to these critiques by the authors, are available on the Forum here.

Since I first identified a nascent new paradigm for corporate governance with leading major institutional investors supporting long-term investment and value creation and reducing or eliminating outsourcing to ISS and activist hedge funds, there has been a steady stream of statements by major investors outlining the new paradigm. In addition, a number of these investors are significantly expanding their governance departments so that they have in-house capability to evaluate governance and strategy and there is no need to outsource to ISS and activist hedge funds. The following is a summary consolidation of what these investors are saying in various forums.

Clearly articulated plans are necessary to gain and keep the support of these investors. A company should not leave an opening for an activist with a more attractive long-term plan.

Board participation in the development and approval of strategy should be effectively communicated in letters to these investors, annual reports and proxy statements. The description should include the major issues debated by the board and how they were resolved.

A company should recognize that **ESG and CSR issues and how they are managed are important**to these investors.

A company should develop and communicate its procedures for **engagement by management and directors** with these investors. In addition, a company should **facilitate direct engagement** with directors by these investors who request it.

A company should **support national policies that are designed to achieve long-term value creation**. A company should support major investment by government in infrastructure, a rational tax policy that encourages long-term strategies and other policies that encourage and support long-term growth on both a company and a macro basis.

These investors **do not favor stock repurchases** at the expense of long-term investment.

These investors recognize that there is **no need for quarterly earnings guidance**, if a company has a clearly articulated long-term strategy. These investors also recognize that quarterly guidance is inconsistent with the long-term investment strategies that they are encouraging.

In addition to the statements by, and actions of, these leading institutional investors, similar views are being expressed by The Conference Board, The Brookings Institution, The Aspen Institute, Focusing Capital on the Long Term (an organization formed to promote long-term investment), the chief economist of the Bank of England and numerous others. In addition, recent academic research has revealed the methodological fallacies in the so-called “empirical evidence” used by the academics who have argued that unrestrained attacks by activist hedge funds create long-term value for the targets of their attacks, thereby strengthening the ability of these institutions to refuse to support activist attacks on portfolio companies. A recent article by Professor John Coffee of the Columbia Law School and the February 1, 2016 Letter from Larry Fink of BlackRock to the CEOs of the S&P 500 are must reads.