Harvard Roundtable on Shareholder Engagement

June 14–15, 2017

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Tab I: Choice Act 2.0 and other Regulatory Reforms

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]

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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
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This paper is also a discussion paper of the
Harvard Law School Program on Corporate Governance

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

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

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.").

CHOICE Act 2.0

Affecting Shareholder Rights

Dodd-Frank.com, [excerpt, p.460-462]

April 2017

(A) by striking ''effective—'' and all that follows through ''(1) with respect to'' and inserting ''effective with respect to'';

(B) in paragraph (1), by striking ''; and'' and inserting a period; and

(C) by striking paragraph (2).

(b) CONFORMING AMENDMENT.—Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act is amended by striking subsection (c).''.

SEC. 843. FREQUENCY OF SHAREHOLDER APPROVAL OF EXECUTIVE COMPENSATION.

Section 14A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78n–1(a)) is amended—

(1) in paragraph (1), by striking ''Not less frequently than once every 3 years'' and inserting ''Each year in which there has been a material change to the compensation of executives of an issuer from the previous year''; and

(2) by striking paragraph (2) and redesignating paragraph (3) as paragraph (2).

SEC. 844. SHAREHOLDER PROPOSALS.

(a) RESUBMISSION THRESHOLDS.—The Securities and Exchange Commission shall revise section 240.14a–8(i)(12) of title 17, Code of Federal Regulations to—

(1) in paragraph (i), adjust the 3 percent threshold to 6 percent;

(2) in paragraph (ii), adjust the 6 percent threshold to 15 percent; and

(3) in paragraph (iii), adjust the 10 percent threshold to 30 percent.

(b) HOLDING REQUIREMENT.—The Securities and Exchange Commission shall revise the holding requirement for a shareholder to be eligible to submit a shareholder proposal to an issuer in section 240.14a–8(b)(1) of title 17, Code of Federal Regulations, to—

(1) eliminate the option to satisfy the holding requirement by holding a certain dollar amount;

(2) require the shareholder to hold 1 percent of the issuer's securities entitled to be voted on the proposal, or such greater percentage as determined by the Commission; and

(3) adjust the 1 year holding period to 3 years.

(c) SHAREHOLDER PROPOSALS ISSUED BY PROXIES.—Section 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) is amended by adding at the end the following:

"(j) SHAREHOLDER PROPOSALS BY PROXIES NOT PERMITTED.—An issuer may not include in its proxy materials a shareholder proposal submitted by a person in such person's capacity as a proxy, representative, agent, or person otherwise acting on behalf of a shareholder.''.

SEC. 845. PROHIBITION ON REQUIRING A SINGLE BALLOT.

Section 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) is amended by adding at the end the following:

''(k) PROHIBITION ON REQUIRING A SINGLE BALLOT.—The Commission may not require that a solicitation of a proxy, consent, or authorization to vote a security of an issuer in an election of members of the board of directors of the issuer be made using a single ballot or card that lists both individuals nominated by (or on behalf of) the issuer and individuals nominated by (or on behalf of) other proponents and permits the person granting the proxy, consent, or authorization to select from among individuals in both groups.''.

SEC. 846. REQUIREMENT FOR MUNICIPAL ADVISOR FOR ISSUERS OF MUNICIPAL SECURITIES.

Section 15B(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–4(d)) is amended by adding at the end the following:

''(3) An issuer of municipal securities shall not be required to retain a municipal advisor prior to issuing any such securities.''.

APRIL 20, 2017 · 12:06 PM

Shareholder proposal process in the crosshairs

by Cydney Posner

According to this report in *Bloomberg BNA*, the plans for changing the shareholder proposal process in the Financial CHOICE Act 2.0 are quite dramatic and could effectively curtail the process, if that is, the current version of the provision ever makes it into law.

In February, we saw a memo from Jeb Hensarling, Chair of the House Financial Services Committee, to the Committee's Leadership Team outlining the proposed changes from the original Financial CHOICE Act, introduced last year (see this PubCo post), to be included in the Financial CHOICE Act 2.0. The memo indicated that one of the provisions of CHOICE 2.0 would seek to modernize the shareholder proposal and resubmission thresholds for inflation, but no details were provided. (See this PubCo post.)

SideBar: Currently, to be eligible to submit a shareholder proposal, the shareholder must have continuously held, for at least one year, company shares with a market value of at least $2,000 or 1% of the voting securities. With regard to resubmission, shareholder proposals that deal with substantially the same subject matter as proposals that have been included in the company's proxy materials within the past five years may be excluded from proxy materials for an upcoming meeting (within three years of the last submission to a vote of the shareholders) if they did not achieve certain voting thresholds, which vary depending on the number of times previously submitted: if proposed once in the last five years, the proposal may be excluded if the vote in favor was less than 3%; if proposed twice and the vote in favor on the last submission was less than 6%; and if proposed three times or more and the vote in favor on the last submission was less than 10%.

Now, as *BNA* reports, draft CHOICE Act 2.0 would require the SEC to revise the eligibility requirements for shareholder proposals to eliminate the dollar threshold *entirely* and provide eligibility only where the shareholder holds 1% of company's voting shares (or a higher threshold if the SEC so determines). The draft would also increase the required eligibility holding period for shares from one year to three years. In addition, CHOICE 2.0 would require the SEC to raise the resubmission thresholds (see the *SideBar* above) as follows: if proposed once in the last five years, the proposal could be excluded if the vote in favor was less than 6%; if proposed twice and the vote in favor on the last submission was less than 15%; and if proposed three times or more and the vote in favor on the last submission was less than 30%. And, in a provision that seems expressly tailored to limit (or at least restructure) the activity of that most frequent submitter of shareholder proposals, John Chevedden, CHOICE 2.0 would prohibit an issuer "from including in its proxy materials a shareholder proposal submitted by a person in such person's capacity as a proxy, representative, agent, or person otherwise acting on behalf of a shareholder.'' Mr. Chevedden often handles shareholder proposals and interacts with Corp Fin as a representative for his associates.

SideBar: Reportedly, the group associated with John Chevedden and James McRitchie accounted for approximately 70% of all proposals sponsored by individuals among Fortune 250 companies in 2014. According to the *NYT*, Mr. Chevedden's focus on shareholder proposals "started after being laid off," with his first target being the parent of his employer to which he submitted a proposal asking the parent to disclose more information about the employment practices of Chevedden's former employer. His current activism, he believes, "'gives shareholders more of a say' and potentially puts management on its toes and prevents it from lapsing into complacency." (See this PubCo post.)

In a 2014 interview with The Corporate Crime Reporter, Chevedden affirmed that he was a believer in corporate democracy and that, notwithstanding the absence of financial incentive to submit these proposals, one reason for his actions was simply to improve governance: "'These proposals have been adopted by many companies. Some of the ones that get big votes — like declassify [the board] and simple majority voting — when I go back to companies that have adopted these, they will point out that they have improved their governance by adopting these proposals, as if they did it without my suggesting it, and therefore they don't need any more improvement. They are so good they don't need to get any better.'" Interestingly, many of the proposals that were submitted many years ago—and considered highly controversial at the time—have now become commonplace proposals and, in some cases, routine corporate governance practices, such as shareholder ratification of the selection of corporate auditors.

The draft provision is clearly intended to staunch the flow of shareholder proposals, which have certainly been the bane of many a CEO and board. The article observes that the "higher threshold would block 'corporate gadflies,' faith- and values-based investors and even the nation's biggest public pension funds" from submitting shareholder proposals, especially at larger companies "where 1 percent of stock would be billions of dollars. Only the likes of Vanguard, BlackRock and State Street would be able to propose ideas for a shareholder vote at the largest companies. Asset managers have shown little interest in wielding their voting power on proposals, much less submitting their own."

SideBar: Although the shareholder proposal process has been defended as essential to shareholder democracy, there are nonetheless critics who contend that individual shareholder activism is a nuisance and a waste of corporate time and money. According to this *NYT* DealBook column, the U.S. Chamber of Commerce estimates companies' costs at $87,000 for each proposal, presumably reflecting costs of submitting no-action requests to the SEC, preparing statements in opposition for proxy statements, engaging with shareholders and sometimes even battling the proposals in court. As a result, it should come as no surprise that some of these critics are likely to be fully on board with this draft provision tightening the criteria to submit shareholder proposals. In support of their contentions that the process is wasteful, these critics also point to the poor showing of most of these proposals. According to a recent paper from the Rock Center for Corporate Governance at Stanford University, most of these proposals receive only minimal shareholder support — an average of only 29% of the vote over the 10-year period, with "only a handful of subject matters garner[ing] meaningful support, including the elimination of supermajority requirements, the elimination of staggered boards, and the removal of bylaw provisions that limit shareholder influence." We might add proxy access to the list. "By contrast," the paper observes, "voting support for most board, compensation, and social policy matters remains exceptionally low; over half of all categories of issues brought before individual shareholders *never* received majority support in any corporate meeting during the entire 10-year measurement period…."

However, public pension funds appear to be up in arms over the possibility. A representative of CalSTRS commented in the article that "'[i]t would shut down the shareholder proposal process completely.'" And the New York State Comptroller, who manages the state's retirement fund, contended that "the legislative proposal would 'diminish corporate accountability' and 'put investors and corporations at risk.'" A representative of CalPERS observed that the proposed legislation would turn the shareholder proposal process "into the billion dollar club."

A House hearing on CHOICE 2.0 is scheduled for next week and, while passage in the House seems likely, it would be surprising for the Act to survive the Senate unscathed — raising the question perhaps of whether Chair Hensarling might possibly be staking out a tough position for expected future negotiation. But, even if adopted, according to one academic commentator cited in *BNA*, the idea could very well "backfire," as "many shareholders who might otherwise have filed proposals 'will find other ways to confront management,' by voting against directors, for example."

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Financial CHOICE Act Imposes Sweeping Shareholder Proposal Reforms

Posted by Ning Chiu, Davis Polk & Wardwell LLP, on Thursday, April 27, 2017

Editor's note: Ning Chiu is counsel at Davis Polk & Wardwell LLP. This post is based on a Davis Polk publication by Ms. Chiu.

The modified version of the legislation, CHOICE Act 2.0, released by House Financial Services Committee Chairman Jeb Hensarling (R-TX), is mostly known for proposing major financial regulatory reforms. Tucked into the lengthy bill, however, are several significant changes that would completely overhaul the shareholder proposal process. Some are similar to proposals by the Business Roundtable, which we previously discussed here.

Ownership Threshold. Currently, Rule 14a-8 allows any shareholder who owns at least $2,000, or 1%, of a company's stock to offer a proposal for inclusion in the company's proxy statement for the annual meeting. The CHOICE Act changes that ownership and holding requirement to permit submission of proposals by only a shareholder owning 1% of the company's securities entitled to vote on the proposal, or such greater percentage as determined by the SEC, so long as the shareholder has held the stock for a minimum of three years. This change eliminates the dollar threshold entirely.

Since 1% of a large-cap company could be billions of dollars of stock ownership, the amendment would render ineligible almost all of the shareholder proponents who submit proposals today, particularly several prolific retail shareholders, but even some of the major pension funds and social activists.

Resubmission Threshold. The CHOICE Act revives a 1997 SEC rule proposal, never adopted, for when shareholders may resubmit a similar proposal in the following year after it was voted on in a proxy statement. The statute excludes proposals that, in the past five years, received less than 6% of favorable support once, 15% if proposed twice and 30% if proposed three times. The current rule allows resubmission if a proposal received more than 3%, 6% and 10%, respectively, which means a proposal that receives more than 10% can be sent to a company indefinitely.

The statute is silent on the length of time that a proposal can be excluded on this basis, but the current rule would exclude a proposal without the requisite vote thresholds for any meeting held within the last three years of the last time the proposal was in the proxy statement. This change would permit more social-based proposals to be excluded.

Proposal by Proxy. Companies have complained for years that only a shareholder who actually owns stock should be allowed to submit proposals, rather than a proponent who acts as a designee for one proposal while submitting another one on his or her own behalf, or entities that have sprung up largely to develop and advocate for proposals without owning any company shares. Various no-action letters arguing that forms of "proposal by proxy" should be banned have failed to convince the SEC staff.

The CHOICE Act prevents these practices, and states that companies can block a proposal submitted by a person in that person's capacity as a "proxy, representative, agent, or person otherwise acting on behalf of a shareholder."

A hearing is scheduled for [April 26], and a markup of the bill is expected next month.

CHOICE Act 2.0

Frequency of Shareholder

Approval of Executive Compensation

Dodd-Frank.com, [excerpt, p.460]

April 2017

(A) by striking "effective—" and all that follows through "(1) with respect to" and inserting "effective with respect to";

(B) in paragraph (1), by striking "; and" and inserting a period; and

(C) by striking paragraph (2).

(b) CONFORMING AMENDMENT.—Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act is amended by striking subsection (c).".

SEC. 843. FREQUENCY OF SHAREHOLDER APPROVAL OF EXECUTIVE COMPENSATION.

Section 14A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78n–1(a)) is amended—

(1) in paragraph (1), by striking "Not less frequently than once every 3 years" and inserting "Each year in which there has been a material change to the compensation of executives of an issuer from the previous year"; and

(2) by striking paragraph (2) and redesignating paragraph (3) as paragraph (2).

SEC. 844. SHAREHOLDER PROPOSALS.

(a) RESUBMISSION THRESHOLDS.—The Securities and Exchange Commission shall revise section 240.14a–8(i)(12) of title 17, Code of Federal Regulations to—

Did Say-on-Pay Reduce or "Compress" CEO Pay?

Posted by Ira Kay, Pay Governance LLC, on Monday, March 27, 2017

Editor's note: Ira Kay is a Managing Partner at Pay Governance LLC. This post is based on a Pay Governance publication by Mr. Kay, Blaine Martin, and Clement Ma.

In the Dodd-Frank Act legislation after the 2008 Financial Crisis, the inclusion of shareholder SOP voting was driven by bipartisan Congressional support to "control executive compensation…" at corporations. In 2009, a former SEC chief accountant said, "Executive compensation at this point in time has gotten woefully out of hand… The time to adopt 'say on pay' type legislation is certainly past due."[1] **Politicians, regulators, and some institutional shareholders clearly thought that, "The impetus for passage of Dodd-Frank's say-on-pay requirement in 2011 focused on remedying 'excessive' CEO pay**."[2]

Some of the original economic, governance, and social objectives of this legislation are certainly debatable. **However, the proponents clearly intended to reduce CEO pay levels.**

After 5 years of SOP votes, it is now possible to review the pre- and post-SOP statistical impact on CEO compensation. With sufficient historical data post-SOP, we answer 2 fundamental questions regarding this legislation's consequences:

Key Takeaways

- SOP was implemented to reduce or freeze CEO pay. Pay Governance reviewed broad trends in S&P 500 CEO pay levels pre- and post-SOP to test the impact of this legislation.
- Median S&P 500 CEO pay increased 27% for the 4 years after SOP implementation relative to the 3 years preceding SOP.
- The continued upward trend in median CEO pay post-SOP, combined with shareholder support for SOP averaging >90%, suggest that SOP may have bolstered the executive pay model by documenting broad, transparent shareholder support.
- However, the rate of CEO pay increases at the median of our sample slowed to low single digits post-SOP. While SOP may have influenced this lower increase rate, CEO pay rate increases or decreases have traditionally tracked broader economic factors (eg, CEO pay declined during the pre-SOP financial crisis).
- *While CEO pay increased at the median, the overall distribution of CEO pay compressed. This was indicated by a narrowing ratio between the sample's 90th and 10th percentiles after SOP implementation.

[1] Lynn Turner. As cited in: Lisa Zagaroli. "Will financial crisis give shareholders a say in exec pay?" McClatchy. January 8, 2009. http://www.mcclatchydc.com/news/article24522490.html.

[2] Michael Bauch. "Executive Pay: How Much Do Shareholders Really Care?" Investopedia.http://www.investopedia.com/articles/personal-finance/112013/executive-pay-how-much-do-shareholders-really-care.asp.

- Our analysis of year-over-year trends at the top and bottom of the CEO pay distribution indicates that CEO pay at the 90th percentile was generally flat in the post-SOP years, while CEO pay generally increased 2%-13% annually in the rest of the distribution.
- We believe that proxy advisors' and shareholders' focus on the highest-paying S&P 500 companies, and the diminished benchmarking of CEO pay to the 75th percentile, may have slowed CEO pay growth at many companies.
- We conclude that SOP did not reduce overall S&P 500 CEO pay levels, but it may have slowed the rate of growth in median CEO pay and has possibly sustained a flat amount of CEO pay at the 90th percentile of the sample.
- For all companies—particularly those with CEO pay at the 90th percentile of the S&P 500—it is important to use executive compensation strategically and creatively to recruit, retain, and motivate executive talent while maintaining strong corporate governance standards.

1) Did the amount of S&P 500 CEO pay decline since SOP (2011)? 2) Does the CEO labor market structure have a more compressed compensation range post-SOP?[3]

SOP implementation increased proxy advisors' governance impact. These quasi-regulatory bodies have influenced qualitative changes to executive compensation program design over the past 6 years: an increased weight of performance-based stock awards, the use of TSR as a performance metric, the virtual elimination of excise-tax gross-ups on CIC severance, and the increased prevalence of stock ownership guidelines, among others.

However, this viewpoint addresses the most quantifiable potential impact: SOP's effect on CEO pay opportunity structure and amounts. Our research found that median CEO pay has continued to rise post-SOP. While this continued increase was disappointing to the architect and other advocates of SOP,[4] this was not surprising to corporate directors, executives, and most institutional investors. It is arguably another example of the CEO labor market's relative competitiveness. Shareholders at a clear majority of companies endorse the labor market: of the >14,000 SOP votes Pay Governance has tracked for major US companies (the Russell 3000) over the past 6 years, only 2.1% failed.

Background

In order to answer the questions above, we assessed CEO pay level trends before and after SOP. Pay Governance assembled a multi-year database of 222 S&P 500 companies for the fiscal years 2008-2015 (3 years of data pre-SOP [first vote in 2011] and 4 years of data post-SOP).[5] We focus our analysis on CEO target total direct compensation because total CEO pay (as disclosed in the proxy) has been—and remains—the primary emphasis of SOP, proxy advisory firms, shareholders, and the media. Our analysis of this large, multi-year data set (summarized below) provides factual data on the recent CEO pay level history, from which we draw conclusions about SOP's role and influence on the CEO pay market.

[3] We define CEO pay compression as the convergence of CEO pay distribution. In this post, we measure compression by comparing ratio changes between research sample's 90th and 10th percentiles.

[4] Ross Kerber. "Dodd-Frank co-author disappointed on pay votes, cites fund managers." Reuters. March 27, 2015. http://in.reuters.com/article/ceo-pay-barneyfrank-idINL2N0WR16B20150327.

[5] Our sample was limited to 222 companies to ensure data continuity for all sample companies across several consolidated databases. Data were provided using Equilar.

Amidst the economic/stock market recovery and many other concurrent governance changes, SOP represented a single—but potentially dominant—corporate governance impact on CEO pay levels. While our findings provide insight into the broad pre- and post-SOP CEO pay market, they cannot isolate the specific impact of SOP. Thus, our summary findings represent a broad historical perspective on CEO pay from 2008-2015, split by the dominant corporate governance shift in 2011: SOP. We then interpret the impact and role that SOP may have had on these findings.

Question 1: Did the amount of S&P 500 CEO pay decline since SOP (2011)?

We examined median S&P 500 CEO pay for the 3 years before SOP (2008-2010) and the 4 years after SOP (2012-2015). Table 1 below indicates that median CEO pay for 2008-2010 was $8M, compared to $10.2M for the 4-year post-SOP period (2012-2015). **Thus, total CEO pay post-SOP was 27% above pre-SOP levels.**

Table 1: S&P 500 CEO Target Total Direct Compensation (TDC) Pre- and Post-SOP (2011)

S&P 500 CEO TDC Summary Statistics (n=222)	S&P 500 CEO Pay Target Total Direct Compensation ($000's)		Growth Rate Pre-SOP to Post-SOP
	4-Year Average 2012-2015	3-Year Average 2008-2010	
90th Percentile	$17,577	$17,589	0%
75th Percentile	$13,890	$11,593	20%
Median	$10,222	$8,021	27%
25th Percentile	$7,756	$5,845	33%
10th Percentile	$5,920	$3,938	50%

While some commentators may have expected SOP to decrease or flatten median CEO pay among S&P 500 companies, this was not the case. It is not possible to prove that SOP caused the continued increase over the reviewed period or that CEO pay would have increased further had SOP not been in place. However, the continued upward trend in median CEO pay post-SOP occurred simultaneously with high levels of shareholder support for executive pay programs (average SOP support: >90%). The combination of these 2 phenomena suggests **that SOP may have bolstered the executive pay model by documenting broad, transparent shareholder endorsement**.

For most companies, TSR post-SOP is significantly above TSR pre-SOP, with a median of 15.3% versus 1.2% on an annualized basis. This higher overall median TSR post-SOP may have provided support for Compensation Committees' increasing CEO pay levels at most companies based on proxy advisor and institutional investor comparisons of CEO pay and TSR. Nevertheless, it appears that TSR was not a significant factor in the size of *individual* company CEO pay increases post-SOP. For example, we found that companies in the 90th percentile (which effectively had flat CEO pay post-SOP) had approximately the same TSR as companies in the 10th percentile (which experienced major increases in pay post-SOP). This, as well as the observation that company size measured using revenue scope and market cap were the most significant differentiators of CEO pay levels both pre- and post-SOP, are shown in Appendix 2.

Based on the time period reviewed (2008-2015 in Table 2 below), low single-digit pay increases at the median appear to be lower post-SOP than pre-SOP. However, CEO pay decreased in 2008-2009 during the financial crisis[6] and was reduced dramatically in 2001 when the Tech Bubble burst. These decreases indicate that companies did adjust CEO pay—both up and down—based on company, stock market, CEO labor market, and overall economic events before the regulatory pressure of SOP. We will continue to monitor this issue.

Table 2: Year-Over-Year Change in CEO Pay Summary Statistics

Year-Over-Year Change in Summary Statistics:	2014-2015	2013-2014	2012-2013	2011-2012	2010-2011	2009-2010	2008-2009
Change in 90th Percentile	1%	-1%	3%	0%	-5%	18%	-16%
Change in 75th Percentile	-2%	6%	6%	-1%	0%	18%	-5%
Change in Median	-1%	5%	4%	2%	5%	19%	-2%
Change in 25th Percentile	2%	6%	10%	9%	-1%	26%	-4%
Change in 10th Percentile	9%	3%	7%	13%	4%	23%	14%

Question 2: Does the CEO labor market structure have a more compressed compensation range post-SOP?[7]

While the trend in median S&P 500 CEO pay levels is clearly up, how did SOP affect the range of CEO pay within the S&P 500? To answer this question, we looked at the compression of CEO pay, measured by comparing the ratio between the 90th and 10th percentiles of the sample for the years pre- and post-SOP. Table 3 below demonstrates that CEO pay was more concentrated in the years after SOP: the ratio between the 90th and 10th percentiles decreased from 447% pre-SOP to 297% post-SOP. This indicates that the lowest-paid CEOs received large pay increases post-SOP and the highest-paid CEOs received effectively zero increases. **Thus, while CEO pay increased at the median post-SOP, the extremes of the sample moved closer together after SOP implementation.** This is consistent with our consulting experience with very large and often very successful companies. While some advocates may attribute this finding as a SOP success, it may also indicate restricted executive motivation and corporate performance.

Table 3: Ratio of 90th Percentile to 10th Percentile CEO Pay Pre- and Post-SOP

Ratio of CEO Pay 90th to 10th Percentile (n=222)	
Post-SOP 2012-2015	Pre-SOP 2008-2010
297%	447%

We examined year-over-year CEO pay trends at various percentiles of the S&P 500 sample to provide further insight into the observed CEO pay squeeze. Table 2 above shows that, post-SOP, CEO pay generally increased at all levels of the distribution with the exception of the 90th percentile. At the 90th percentile of the S&P 500, CEO pay has generally been flat since 2010. Thus, the shrinking ratio between 90th and 10th percentile CEO pay—shown in Table 3—is being

[6] Equilar. "2009 and 2010 CEO Pay Strategies Reports." 2009 and 2010. www.equilar.com.

[7] We define CEO pay compression as convergence in CEO pay distribution. In this post, we measure compression by comparing ratio changes between the 90th and 10th percentiles of the research sample.

driven primarily by larger CEO pay increases at the lowest-paying S&P 500 companies (the 10th percentile) and stable CEO pay at the highest-paying companies (the 90th percentile).

Companies with 90th percentile CEO pay are generally among the largest public companies globally by revenue. Appendix 2 shows that CEO pay opportunity is significantly correlated with company revenue and market cap scope. However, CEO pay at the 90th percentile has remained relatively flat since 2010 despite above-median TSR, a 17% increase in 90th percentile revenue scope, and a 50% increase in 90th percentile market cap between 2010-2015 (see Appendices 3 and 4). Since CEO pay at the 90th percentile did not increase with the substantial increase in scope, SOP implementation and the associated corporate governance changes may have played a role in continuing relatively-flat CEO pay at the 90th percentile of S&P 500 companies.

Based on our consulting experience, there may be many reasons for this compression:

- Due to the rigid structure of the proxy advisors' P4P tests, higher-paying companies—even if larger than most economic peers—are more at risk of an "against" recommendation from proxy advisors and, thus, SOP challenges. This can occur, and has occurred, at long-term high-performing companies that have experienced a temporary dip in relative TSR performance and have been pressured to freeze CEO pay. To the extent that this occurs, the regulatory framework of SOP may restrict the use of incentive compensation and labor market efficiencies.
- Additionally, proxy advisors' ongoing criticisms of pay-benchmarking philosophies above an industry peer group's median have made this practice uncommon in the SOP environment. Thus, some of the largest and highest-paying companies in the S&P 500 now benchmark executive pay against the median of peer groups that may be different in scope, industry, and business model, potentially resulting in lower year-over-year increases in CEO pay.
    - However, companies below the median of the S&P 500 sample—especially the 10th percentile—experienced relatively large pay increases. This could be because they had a wider selection of industry peers and could benchmark CEO pay to the median of an appropriately-sized industry peer group, which may have been higher than their current CEO pay level.
- Recent memos by prominent institutional shareholders have indicated a focus on the absolute quantum of CEO pay when those investors cast their SOP votes. This heightened focus, they argue, is justified by the income inequality debate and the associated company reputational risk of "excessive" CEO pay. One memo clarified screening criteria, focusing on the absolute quantum of CEO pay for companies paying their CEOs significantly above the average for Dow 30 companies. In our sample, this level of pay would generally be included in the top 10% of highest-paid CEOs.[8]
- Alternatively, the recent relatively flat pay at the high end of the S&P 500 sample could indicate a steady-state for top talent among the largest public companies in the US and globally. If correct, this could be an advantage for private companies in the short-term.

Conclusions

[8] State Street Global Advisors Worldwide Entities. "Guidelines for Mitigating Reputational Risk in C-Suite Pay." June 1, 2016. https://www.ssga.com/investment-topics/general-investing/2016/Guidelines-for-Mitigating-Reputational-Risk-in-C-Suite-Pay.pdf.

The data reviewed in this viewpoint provide useful context for the post-SOP CEO pay environment. We found that CEO pay continued to increase after SOP—possibly at a slower rate than historical CEO pay increases—and that CEO pay distribution was narrower after SOP than it was before shareholder voting on executive compensation was implemented.

These findings are generally consistent with our intuitive understanding of the CEO pay market post-SOP. SOP implementation as well as the increased attention by shareholders and proxy advisors on the highest-paid S&P 500 CEOs may have continued a moderating effect on the 90th percentile of the S&P 500 CEO pay market. In contrast, the rest of the CEO pay distribution experienced ongoing pay increases as companies in the lower 3 quartiles increased pay to compete for top corporate management talent.

For all companies, but particularly those companies with CEO pay opportunity levels at the higher end of the S&P 500, continued monitoring of the pay market remains important. To the extent that SOP may have constrained the market for CEO talent of these highest-paying companies, the focus will continue to be on strategically and creatively using executive compensation in order to balance the tension: motivating executive talent while maintaining strong P4P linkage and corporate governance standards.

Appendix[9]

Appendix 1: S&P 500 Sample CEO Pay Pre- and Post- SOP Implementation[9]

S&P 500 CEO TDC	S&P 500 CEO Pay Target Total Direct Compensation ($000's)							
Summary Statistics (n=222)	2015	2014	2013	2012	2011	2010	2009	2008
90th Percentile	$18,251	$18,007	$18,263	$17,762	$17,724	$18,561	$15,689	$18,661
75th Percentile	$13,905	$14,135	$13,357	$12,638	$12,779	$12,760	$10,814	$11,413
Median	$10,259	$10,347	$9,810	$9,389	$9,197	$8,795	$7,393	$7,560
25th Percentile	$7,955	$7,829	$7,419	$6,726	$6,198	$6,243	$4,974	$5,202
10th Percentile	$6,107	$5,628	$5,456	$5,089	$4,518	$4,345	$3,528	$3,096

Appendix 2: Bifurcated Sample Comparison of TSR, Revenue, and Market Cap for High- and Low-paying S&P 500 Companies

	Median TSR		Median Revenues ($M)		Median Market Cap ($M)	
Bifurcated CEO Pay Sample	4-Year TSR (2012-2015 Annualized)	3-Year TSR (2008-2010 Annualized)	4-Year Average (2012-2015)	3-Year Average (2008-2010)	4-Year Average (2012-2015)	3-Year Average (2008-2010)
Above-Median CEO Pay	16.2%	0.4%	$19,065	$15,363	$34,506	$21,427
Below-Median CEO Pay	14.4%	3.2%	$6,158	$4,607	$11,483	$6,862
Total Sample	15.3%	1.2%	$10,134	$7,885	$19,353	$10,198

[9] The sample used for this analysis is different than the S&P 500 CEO sample used for Pay Governance's recent viewpoint, "S&P 500 CEO Compensation Increase Trends," which excludes CEOs that were not in their roles for at least 3 years. We note that both samples indicate similar median CEO pay levels and year-over-year changes.

Appendix 3: Revenue Scopes for S&P 500 Companies 2008-2015

Summary Statistics (n=222):	S&P 500 Annual Revenues ($M)							
	FY2015	FY2014	FY2013	FY2012	FY2011	FY2010	FY2009	FY2008
90th Percentile	$53,745	$55,144	$50,198	$53,735	$48,738	$45,886	$40,659	$36,274
75th Percentile	$20,293	$19,835	$19,556	$18,989	$19,763	$17,844	$15,718	$17,120
Median	$10,343	$10,431	$9,691	$9,436	$8,812	$8,282	$7,452	$8,060
25th Percentile	$5,098	$4,935	$4,591	$4,249	$4,151	$3,795	$3,413	$3,897
10th Percentile	$3,052	$3,097	$2,778	$2,590	$2,307	$1,960	$1,710	$2,032

Appendix 4: Market Capitalization Scopes for S&P 500 Companies 2008-2015

Summary Statistics (n=222):	S&P 500 Market Cap ($M)							
	12/31/2015	12/31/2014	12/31/2013	12/31/2012	12/31/2011	12/31/2010	12/31/2009	12/31/2008
90th Percentile	$92,751	$97,381	$86,553	$64,246	$57,280	$61,692	$56,957	$46,026
75th Percentile	$42,529	$41,431	$37,745	$30,549	$28,817	$29,141	$26,464	$18,093
Median	$19,291	$22,111	$18,595	$15,481	$12,937	$12,576	$10,502	$8,300
25th Percentile	$10,489	$10,571	$10,301	$8,045	$7,673	$7,681	$6,054	$4,217
10th Percentile	$6,597	$7,782	$6,916	$5,622	$4,526	$4,695	$3,974	$2,756


MAKING SENSE OF
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The Dodd-Frank Act has broad and deep implications that will touch every corner of financial services and multiple other industries. This site, developed and maintained by attorneys at Stinson Leonard Street, is dedicated to making sense of this complex legislation and helping businesses understand how it will affect them specifically. **Our Bloggers »**

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Draft Financial Choice Act 2.0 Prohibits Universal Proxy and Restricts Shareholder Proposals

by Steve Quinlivan | April 20, 2017

The House Financial Services Committee has released a discussion draft of a revised Financial Choice Act. The Committee will hold a hearing on the Act on April 26, 2017.

Section 845 of the Act would prohibit the SEC from requiring the use of a universal proxy. It states "The Commission may not require that a solicitation of a proxy, consent, or authorization to vote a security of an issuer in an election of members of the board of directors of the issuer be made using a single ballot or card that lists both individuals nominated by (or on behalf of) the issuer and individuals nominated by (or on behalf of) other proponents."

Section 844 of the Act would drastically alter the shareholder proposal rules. The Act would require the SEC to eliminate the option to satisfy the holding requirement by holding a certain dollar amount, require the shareholder proponent to hold one percent of the issuer's voting securities and increase the holding period from one year to three years. It would also increase thresholds for resubmission of proposals.

Interestingly, the Act would prohibit the common practice of having a proxy submit a proposal on behalf of a shareholder. One would hope, if passed, coaching from the sidelines by those frequently granted proxies today would be interpreted as the unauthorized practice of law.

You can find an extract of the two provisions discussed above here. The full 593 pages of the discussion draft can be found here. It's worth a look.

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Dodd-Frank.com, [excerpt, p.462]

April 2017

such person's capacity as a proxy, representative, agent, or person otherwise acting on behalf of a shareholder.''.

SEC. 845. PROHIBITION ON REQUIRING A SINGLE BALLOT.

Section 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) is amended by adding at the end the following:

''(k) PROHIBITION ON REQUIRING A SINGLE BALLOT.—The Commission may not require that a solicitation of a proxy, consent, or authorization to vote a security of an issuer in an election of members of the board of directors of the issuer be made using a single ballot or card that lists both individuals nominated by (or on behalf of) the issuer and individuals nominated by (or on behalf of) other proponents and permits the person granting the proxy, consent, or authorization to select from among individuals in both groups.''.

SEC. 846. REQUIREMENT FOR MUNICIPAL ADVISOR FOR ISSUERS OF MUNICIPAL SECURITIES.

Section 15B(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–4(d)) is amended by adding at the end the following:

''(3) An issuer of municipal securities shall not be required to retain a municipal advisor prior to issuing any such securities.''.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Universal Proxy Unlikely to be Adopted (and Would Have Little Effect Anyway)

Posted by Gail Weinstein and Philip Richter, Fried, Frank, Harris, Shriver & Jacobson LLP, on Wednesday, December 21, 2016

Editor's note: Gail Weinstein is Senior Counsel and Philip Richter is a Partner at Fried, Frank, Harris, Shriver & Jacobson LLP. This post is based on a Fried Frank publication by Ms. Weinstein; Mr. Richter; Robert C. Schwenkel; David J. Greenwald; Steven Epstein; and Warren S. de Wied. Related research from the Program on Corporate Governance includes Universal Proxies by Scott Hirst (discussed on the Forum here).

In late October, as expected, the SEC proposed proxy rule changes that would require that "universal proxy cards" be used in contested elections of directors, giving shareholders the ability to pick and choose among all of the nominees put forth by the company's board and by a dissident shareholder when deciding how to vote. Observers have commented that, if adopted, the proposed rule changes, by making it easier for shareholders to elect director candidates nominated by dissident shareholders, would alter the dynamics of contested director elections—increasing the prevalence of proxy contests and the leverage of activist investors. In our view, adoption of the universal proxy card mandate now appears improbable. In any event, we believe that adoption of the mandate probably would not have a significant effect on contested proxy elections or activist situations. Below, we:

- Describe the proposed universal proxy card mandate and explain our view that it probably will not be adopted;
- Clarify how a universal proxy card differs from "proxy access" (which continues apace);
- Note the concerns that observers have expressed about a universal proxy card mandate;
- Discuss our view that a universal proxy card mandate, if adopted, likely would not significantly affect contested director elections and activist situations; and
- Note some possible effects of the universal proxy card mandate not being adopted.

The comment period for the proposed rule changes ends January 9, 2017. Thus, even if adopted, the rules would not be in effect for the 2017 proxy season.

A universal proxy card permits shareholders who vote *by proxy* to split their vote between the board's nominees and a dissident's nominees

Currently, shareholders who vote *by proxy* in a contested election must choose to vote either for the board's nominees (on the company's proxy card) *or* for the dissident's nominees (on the dissident's proxy card). Under the new proposed rules, both the company and the dissident shareholder would distribute a "universal proxy card" to shareholders, listing both the board's nominees and the dissident's nominees, and each shareholder voting by proxy could choose to vote for any combination of the nominees on the two lists. Current rules effectively preclude shareholders who vote by proxy from splitting their vote between the board's nominees and a dissident's nominees, although a split vote is permitted for shareholders who vote in person at a meeting or otherwise properly instruct the company regarding their vote. The impetus for the universal proxy card mandate has been to redress the artificial difference in voting flexibility for shareholders who vote by proxy as compared to those who vote in person or instruct the company. We note that, currently, institutional and other large shareholders have the knowledge and resources to vote at a meeting or to instruct the company when they wish to split their vote, while retail shareholders typically do not have the knowledge or resources to do.

In our view, adoption of the universal proxy card mandate now appears improbable

Of the three current SEC Commissioners, only SEC Chair White has been a strong proponent of the universal proxy card approach. Chair White has announced that she will be resigning by the end of President Obama's term. SEC Commissioner Piwowar, who is reportedly being considered for the position of interim SEC Chair pending selection of a successor SEC Chair by President-Elect Trump, has been against a universal proxy card mandate, arguing that it would increase the likelihood of proxy fights and thereby distract managements from their core mission of operating companies. Further, the universal proxy card concept has been strongly disfavored by Republicans in the House of Representatives, who passed a bill this summer prohibiting the SEC from using any funds to propose or enforce a universal proxy card requirement. Particularly given the likelihood of new or different priorities at the SEC under the incoming Presidential administration, in our view, it is now unlikely that the universal proxy card mandate will be adopted.

The universal proxy card mandate is different from "proxy access"

Following the SEC's failed effort to enact rules requiring "proxy access," approximately 40% of S&P 500 companies now have adopted "proxy access" bylaws (up from 1% in 2014 and 5% in 2015). Like a universal proxy card, "proxy access" allows a shareholder to have its director nominees listed on the company's proxy card and allows shareholders voting by proxy to split their vote between the board's and the dissident's nominees. However, proxy access does not have the same objective or effect as a "universal proxy card" would. "Proxy access" has been intended as a vehicle to facilitate the nomination of director candidates by major, long-term shareholders in non-control contests—not intended to facilitate nominations by activists or other short-term shareholders who seek to influence or change control of the company.

Unlike the proposed universal proxy card mandate, proxy access bylaws:

- Do not apply to contested control elections—that is, in most cases, the bylaws do not permit proxy access if the shareholder has, or has had, an intention to change or influence control at the company (as in the case, for example, of an activist investor who has approached the company to propose changes);

- Almost invariably apply only to shareholders who have held at least 3% of the company's shares for at least three years and who are not nominating more than 20% of the board; and
- Permit a shareholder making nominations to avoid the expense of proxy materials and a proxy solicitation (by providing that the company will include in its own proxy statement information about the shareholder and its nominees, as well as a statement by the shareholder in support of its nominees).

Proxy access is not designed to have a significant impact on proxy contests or activist situations

As noted, proxy access is focused on allowing a *long-term major investor* of a company to piggyback on the company's proxy materials in a *non-control* election. By contrast, the universal proxy card approach is focused on making it easier for shareholders to split their vote, in either a *control or non-control* election, and, as a practical matter, making it just as possible for a *retail investor* (who does not necessarily have the knowledge or resources to vote in person or to properly instruct the company with respect to the vote) to split his or her vote as it is for an institutional investor (who typically does have the resources to vote in person or to properly instruct the company).

So far, proxy access has been used to nominate directors only one time. In November 2016, GAMCO Asset Management Inc., which is affiliated with activist investor Mario Gabelli, nominated director candidates for election at the 2017 annual meeting of National Fuel Gas Company, using National Fuel Gas's proxy access bylaws. Like most proxy access bylaws, GAMCO's bylaws included a requirement that the nominating shareholder must have acquired its shares in the ordinary course of business and not with the intent to change or influence control of the company, and that the shareholder must not presently have such an intent. According to National Fuel Gas, GAMCO had expressed an intention to change or influence control of the company and therefore was ineligible to use proxy access. GAMCO withdrew its nominations (without challenging or conceding the company's contention).

We believe that proxy access is likely to continue to be utilized only infrequently. Activists in most cases will not be eligible to use proxy access because, typically, they will not meet the 3%-ownership-for-at- least-three-years requirement or the "passive investment"-type restriction. Moreover, both activists and large shareholders in most cases want to engage in a more typical election contest process in which they produce their own materials and conduct their own solicitation. For these shareholders, generally, the potential cost-saving benefits of piggy-backing on the company's proxy statement would be outweighed by the disadvantages of not conducting one's own proxy solicitation.

Opposition to a universal proxy card mandate has centered on concerns that it will lead to more proxy contests and increased leverage for activists

Opposition to a universal proxy card mandate has been based primarily on concerns that:

- Dissident nominees would garner more votes if shareholders can vote for one or more of them while also voting for one or more of the board's nominees—and that this will lead to more proxy contests, more pressure on companies to settle with dissidents to avoid the risk of loss of proxy contests, more replacement of existing directors with dissident directors, and more “short- termism” by companies to appease shareholders;

- The election process could become based not on the fundamental shareholder-oriented judgment about support-for-the-board versus need-for-change, but, instead, on a more personal kind of judgment about each individual director candidate’s qualifications for office;
- Greater proxy costs would be imposed on companies (which, for smaller companies, could be significant);
- Greater confusion could result for retail investors as to which nominees are being supported by the board and which by a dissident shareholder; and
- A universal proxy card mandate could come to be viewed as a substitute for, and therefore limit further adoption of bylaws providing for, proxy access.

In our view, the universal proxy card mandate, if adopted, would not significantly affect the outcome of proxy contests or activist situations

As noted, the prevailing view has been that a universal proxy card mandate would increase the leverage of dissident shareholders in achieving election of their director candidates and thus would increase the prevalence of proxy contests and/or settlements to avoid proxy fights. In our view, in most cases, the universal proxy card mandate, if adopted, likely would *not* have a significant impact on the outcome in control elections or activist situations because:

- **Strategic considerations override considerations relating to mechanics.** The strategic decision for an activist whether to commence a proxy contest, and, if so, whether to seek to seat a few nominees or to replace the entire board, will be based primarily on the fundamental strategic considerations involved, not whether the available mechanics do or do not to some extent facilitate shareholders’ ability to split their vote.
- **Institutional and other large shareholders already have meaningful incentive, and the ability, to split their vote when they wish to do so.** By providing a ready-made, easy mechanism (merely checking a box on the single proxy card received) for splitting a vote between a board’s and a dissident’s nominees, shareholders may be encouraged to some extent to split their vote more often than currently (as the current mechanism for doing so is more difficult, involving either attending the meeting in person or properly instructing the company with respect to the shareholder’s vote). However, making it easier to split-vote by proxy should not significantly affect an institutional or large shareholder’s incentive as to whether or not to split its vote, and that decision is likely going to be made, as it is now, primarily based on the shareholder’s view of the substantive merits, not on the ease with which a split vote can be accomplished. While the universal card mandate *would* have a significant effect on *retail* shareholders’ ability to split their vote (as they typically do not have the knowledge or resources to appear in person or instruct the company, even in a contested election in which they would want to split their vote), the retail vote in the aggregate is typically a relatively small percentage of the overall vote and in most cases does not have a meaningful impact on the outcome of a proxy contest.
- **Most contested situations are settled before a vote.** Currently, the vast majority of cases involving a potential proxy contest or activist situation end in a settlement, without a proxy contest. Settlements occur because both sides usually prefer to avoid the

expense, distraction, and, especially, the uncertainty of result, of a proxy fight. At the same time, both sides usually have a good sense of the likely support (or lack of support) from the large shareholders, leading to settlement. Availability of a universal proxy card and split voting would not likely affect these fundamental facts-on-the-ground in a significant way.

- **Dissidents rarely propose full slates.** With a universal proxy card, when a dissident shareholder proposes a full slate of director candidates (*i.e.,* a wholesale replacement of a board, or at least directors who represent control of the board), shareholders would no longer have to choose between the dissident's full slate and the board's full slate. Thus, a universal proxy card could make it less likely that, when a dissident puts forth a *full* slate, the full slate (as opposed to just some of the nominees) would be elected. However, most dissident campaigns already are focused on the election of a small number of nominees rather than wholesale replacement of the board.

We note that there may be circumstances where a universal proxy card mandate could encourage activity that would not otherwise have occurred. These situations could involve "second tier," less well-funded activist investors; activists with smaller than usual equity positions or positions in smaller companies; specific dissident or board nominees that attract an unusual amount of attention (whether positive or negative); and/or mid-tier companies not primarily institutionally owned or other situations where the vote of the retail investors is likely to be particularly important.

Possible effect of universal proxy card mandate not being adopted

If, as we expect, the universal proxy card mandate is not adopted, companies may face increased pressure from shareholders to:

- **Expand proxy access.** Shareholders may increase the pressure on companies that have not adopted proxy access to do so. Further, shareholders may seek to revise proxy access bylaws in order to make proxy access available to shareholders owning a smaller percentage of shares and/or that were held for a shorter period of time than is the case currently; and/or to make proxy access available in contested elections.
- **Agree to use of a universal proxy card.** Institutional or other shareholders may more often *request* that a company allow shareholders to use a universal proxy card in a proxy situation. With the consent of the company and the dissident shareholder, as well as the board's and the dissident's respective nominees, use of universal proxy card would permit a split vote without any change to the SEC proxy rules. A company may decide to agree to use of a universal proxy card when the board believes that there is a reasonable likelihood that, without a universal card, the *entire* dissident slate would be elected—and, therefore, the company would be willing to *increase* the chance that only *part* of the dissident's slate would be elected, while reducing the change that the full slate would be elected. A dissident shareholder might request, or agree to a company's request, to use of a universal card when it doubts that its entire slate would be elected—and, therefore, the dissident would want to reduce the risk that *none* of its candidates would be elected. (In the 2015 Trian-DuPont proxy contest, activist investor Trian, which had nominated a short slate, requested that DuPont allow use of a universal proxy card, contending that it would "reflect best-in-class corporate governance." DuPont, with a shareholder base comprised of a relatively large percentage of retail shareholders, rejected the request.

None of Trian's nominees were elected. In recent years, Tessera Technologies, Shutterfly, and GrafTech International have proposed use of a universal card where they viewed the chance of defeating *all* of a shareholder's nominees as remote and wanted to increase the likelihood that only some of those nominees would be elected rather than the full slate.)

- **Adopt bylaws requiring a universal proxy card.** Shareholders may seek to pressure companies into adopting bylaws that require use of a universal proxy card when a dissident shareholder makes director nominations. No change to current SEC rules would be required for a company to use a universal proxy card if a company's bylaws provided that a nomination would not be valid unless the nominee consented in advance to his or her name being included on a universal proxy card.

We note, also, that, if the universal proxy card mandate is not adopted, shareholders of companies that have adopted proxy access bylaws may be more incentivized to preserve their ability to utilize proxy access. In this regard, shareholders should be mindful that their 13D filing disclosures may foreclose use of proxy access if an intention to change or influence control of the company has been indicated, including in a 13D filing. Shareholders that file 13Ds as a routine matter on companies in which they invest, in order to avoid any possible 13D issues in the future, should reconsider that approach to the extent that they may wish to preserve the option of utilizing proxy access.

Tread Lightly When Tweaking Sarbanes-Oxley

Posted by Michael W. Peregrine, McDermott Will & Emery LLP, on Wednesday, April 12, 2017

Editor's note: Michael W. Peregrine is a partner at McDermott Will & Emery LLP. This post is based on an article by Mr. Peregrine; his views do not necessarily reflect the views of McDermott Will & Emery or its clients. Thomas J. Murphy assisted in the preparation of this post.

Nascent discussions about repealing discrete sections of the Sarbanes Oxley Act should be monitored closely by proponents of effective corporate governance. As the federal regulatory pendulum swings hard to an extreme, even the most limited proposals to amend the Act could conceivably invite unintended consequences. This is particularly the case if caught in the tailwind of efforts to amend or repeal Dodd-Frank and other financial regulations. If unchecked, such actions could severely undermine the culture of corporate responsibility that has been a crucial legacy of Sarbanes.

These discussions have arisen in the context of the Trump Administration's overarching interest in making the public markets more accessible to private companies, in part through reducing related regulatory barriers. Indeed, by Executive Order dated February 3, 2017, President Trump set forth the "Core Principles for Regulating the United States Financial System", which Principles include the goal of making financial regulation efficient, effective, and appropriately tailored. Numerous articles over the last three months have spoken to legislative and other interest in scaling back provisions of Dodd Frank, and those portions of Sarbanes Oxley deemed particularly burdensome.

The "big picture" criticism of Sarbanes has historically been the extent to which its provisions prompt growing companies to shift away from public offerings. More specific criticism has long been focused on the controversial Section 404, addressing internal controls. In essence, Section 404(a) requires all public companies to include in their annual reports on Form 10-K a report from management that speaks to the effectiveness of the company's internal control over financial reporting. Section 404(b) requires a public company's independent auditor to attest to, and report on, management's assessment of the effectiveness of those internal controls.

To its supporters, Section 404 has resulted in improved financial reporting and greater transparency for public companies. To its detractors, the financial expense (e.g., increased audit fees) and administrative costs associated with Section 404 are so excessive as to outweigh any benefit to investors. Rather, the detractors argue, the costs of Section 404 compliance could be put to better use by companies in creating jobs or satisfying demand for their products and services.

Dodd-Frank amended Sarbanes by adding a new Section 404(c) providing relief from the auditor attestation requirement of Section 404(b) to issuers who are neither accelerated filers nor large accelerated filers. Although non-accelerated filers will continue to provide the report from management in their annual reports, the permanent exemption from 404(b) for smaller issuers was expected to significantly reduce the ongoing costs of being a public company. In a subsequent study directed by Dodd Frank, the SEC declined to recommend any further amendment to Section 404. The 2012 JOBS Act included a provision exempting "emerging growth companies" from 404(b) attestation. Nevertheless, the criticism of Section 404 has continued among many in the business community.

This Executive Order has been generally interpreted as initiating the process for a rollback of Dodd-Frank, which the President has repeatedly denigrated as burdensome and needlessly complex. This has prompted many companies and commercial interest groups to advocate for expanding the exemption under Section 404(c), if not the actual repeal of the entire provision. Indeed, media reports speculate that the Republicans' proposed replacement for Dodd Frank would contain such an additional exemption.

On its own, further amendment of Section 404—or even its complete repeal—by a Dodd Frank replacement legislation would appear to have little implications for corporate governance. Section 404 was perceived as an important means for assuring investor protection and reducing the risk of corporate fraud. It is independent of the primary corporate governance provisions of the Sarbanes statute and has no direct governance implications except for the related oversight responsibilities of the audit committee. (Other provisions of Dodd Frank do, of course, address governance matters but those pale in comparison to the extent included within Sarbanes).

But when viewed in a larger context, placing **any** provision of Sarbanes "in the mix" carries some risk for collateral damage to the corporate responsibility principles grounded in that Act. This has nothing to do with the merits of revising or replacing Section 404, and everything to do with the current anti-regulatory climate in Washington, D.C.—especially as it relates to financial regulation. The legislative momentum sparked by the Executive Order, and inflamed by the proposed repeal/replacement of Dodd Frank, could conceivably undermine Sarbanes. After all, Section 404 is not the only controversial provision of the Act.

Fair arguments can be made for the amendment or repeal of a number of other, long-controversial provisions of Sarbanes; e.g., audit partner rotation (Section 301); financial report certification (Section 302); restrictions on the provision of non-audit services (Section 201) and obstruction of justice (Section 802). Also "in play" could be several provisions tied to related sections of Dodd Frank; e.g., the executive compensation claw-back provisions of Section 304 and the "whistleblower" provisions of Sections 301 and 1107.

The status of these and other controversial provisions is made potentially tenuous by the broad scope of the February 3 Executive Order and by the political and business orientation of many new Trump Administration appointees with oversight over financial laws and regulations. This is particularly the case with respect to a law that some observers believe (perhaps unfairly) has served to "federalize" certain principles of corporate law and fiduciary duty, or otherwise forces boards to concentrate too much on matters of compliance and law, instead of guidance to management.

The concern is that once Sarbanes is opened to piecemeal revision (e.g., Section 404), the entire statutory framework could be open to repeal in pursuit of the Core Principles (e.g., job creation, and reducing administrative burdens for business). It's like the popular analogy about the olive jar; it's very hard to get the first olive out of the jar, but once you do, the rest of them come out very easily. And the more that "come out of the jar" (i.e., sections of Sarbanes rolled back), the more potential for Sarbanes to be undermined.

From a governance perspective, the impact could be catastrophic. That's because Sarbanes is so much more than an anti-corporate fraud statute; it has become the keystone of modern corporate governance; the spark to the corporate responsibility environment that remains in force to this day. In a very large sense, it is "where it all began"; i.e., the seismic recalibration of corporate direction from the executive suite back to the board. It achieved this in two major ways. First, by means of its express provisions addressing corporate governance. And second, the extent to which it prompted or otherwise influenced related regulatory requirements (e.g., SEC rules); industry guidance (e.g., stock exchange listing requirements); best practices compilations (e.g., the ABA's "Cheek Report"); professional standards (e.g., AICPA, state rules of professional responsibility) and state corporate law of multiple stripes.

The need for caution is underscored as the fifteenth anniversary of Sarbanes approaches. A new generation of corporate leaders has entered the boardroom since July 30, 2002. Their related memories are likely to be dim; many may lack familiarity with the Act and the circumstances that led to its enactment. To the under-informed fiduciary, measures to amend or repeal portions of Sarbanes could send the unfortunate message that the governance laws, principles and practices it prompted are redundant, excessive or a burden to broader principles of jobs growth and economic development.

And that would be a terrible blow to responsible fiduciary conduct—and to those who advise fiduciaries on such conduct. For, as the daily headlines suggest, the failures of corporate governance that led to the enactment of Sarbanes could certainly happen again in today's boardrooms. It would be so ironic if the Core Principles of the Executive Order, and the resulting efforts to "rationalize the Federal financial regulatory framework", had the unintended consequence of undermining longstanding principles of governance accountability.

But let's be clear: the sky is not falling. As of this writing there is no notable movement to amend any provision of Sarbanes-Oxley, much less Dodd Frank. Administration officials are not directly targeting Sarbanes as a focal point in their efforts to reform financial regulation. Neither has the Administration expressed any specific concern with corporate responsibility tenets. Yet there is a clear interest within some groups in Congress, and their constituents, for reform of certain financial regulations. Should Dodd Frank reform efforts move forward, the possibility of Sarbanes revisions would logically follow in the legislative queue.

Proponents of corporate responsibility should thus remain watchful as efforts for financial regulatory reform take shape. There is much to be said for the Core Principles, and for the economic and other benefits that might arise from selective legislative amendment. Yet there is value, even at this early stage, in offering a "tread carefully" message to those who, for no doubt good and proper reasons, would consider implementing the Executive Order through "tweaking" controversial provisions of Sarbanes.

The more that interested observers are alert to the potential for financial regulation reform, the less likely it is that any such reform will work to undermine the vitality of Sarbanes' governance provisions, and its broader legacy of corporate responsibility.

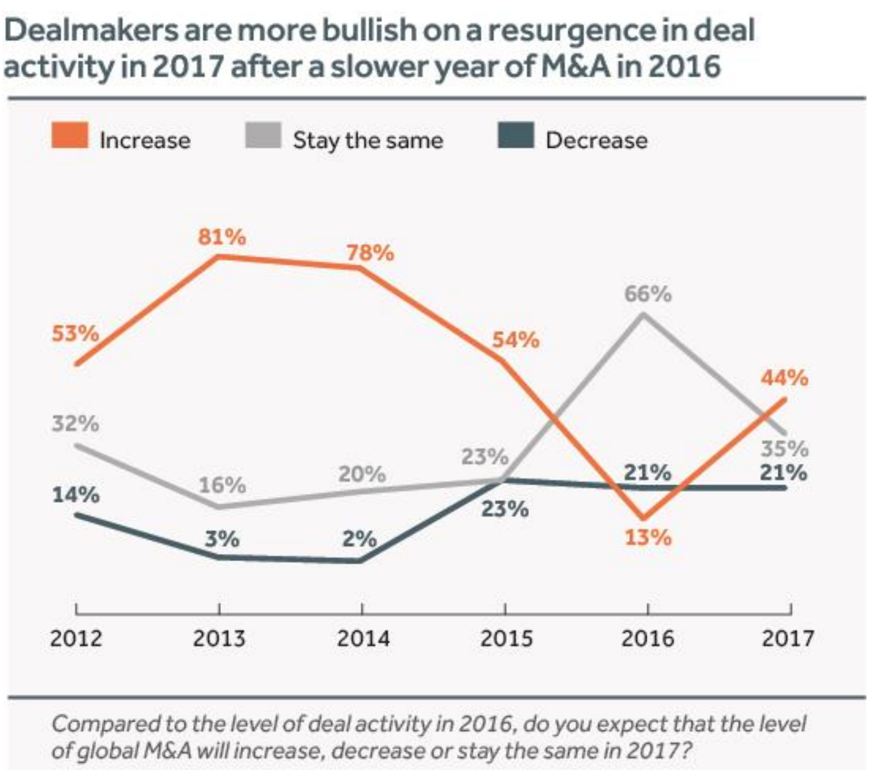
Dealmakers Expect a "Trump Bump" on M&A

Posted by Steven Lipin, Brunswick Group LLP, on Monday, April 10, 2017

Editor's note: Steven Lipin is a Senior Partner at the Brunswick Group LLP. This post is based on a Brunswick publication by Mr. Lipin. Additional posts addressing legal and financial implications of the Trump administration are available here.

After an unpredictable political cycle and an equally unpredictable M&A environment in 2016, dealmakers have refreshed their outlook for M&A activity under the Trump administration—and they like what they see. According to Brunswick Group's 10th Annual Global M&A Survey, about 44% of respondents expect M&A activity to increase in 2017, a significant surge since last year, when only 13% of respondents were optimistic about M&A levels growing in the wake of record-breaking levels in 2015. At the same time, practitioners expect more scrutiny of cross-border deals, particularly from China, and a lighter touch with regard to antitrust obstacles. And the impact on jobs will be front and center.

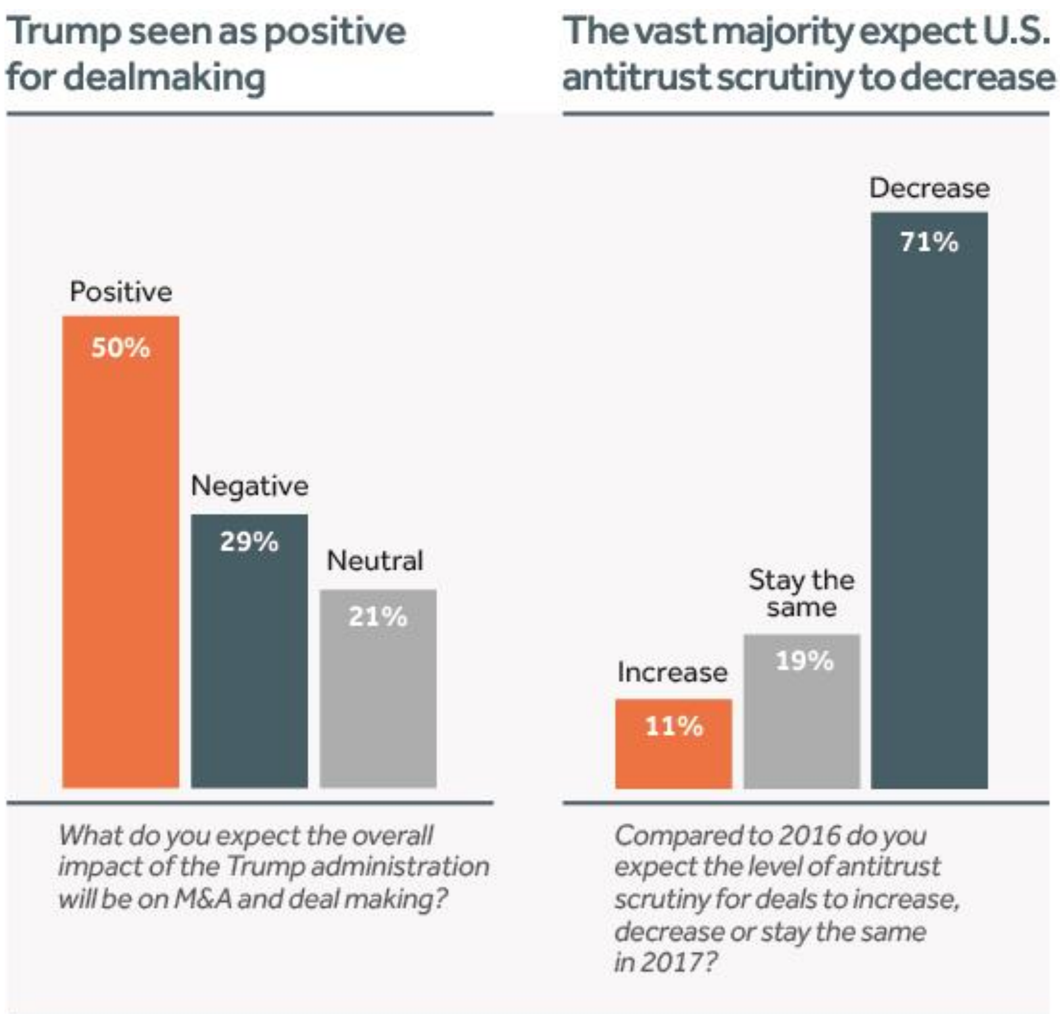
This proprietary survey of 120 top M&A practitioners and observers around the world, including lawyers, bankers, advisors and financial reporters, suggests how the M&A landscape is expected to change in 2017 and offers insight into how companies may navigate the new terrain.



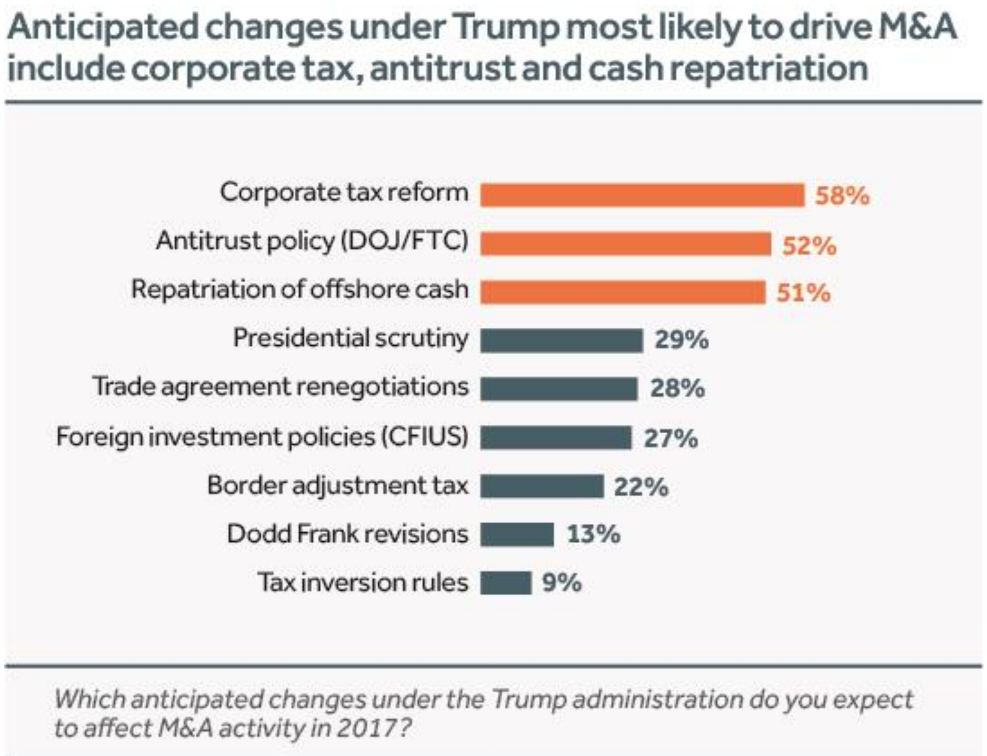
A Trump Bump?

Last year, when the survey was conducted at the start of the U.S. presidential primary elections, dealmakers selected Donald J. Trump as the candidate most beneficial to deal-making and corporate interests. This optimism regarding M&A persists despite Trump's populist campaign, during which he rallied his supporters against big business and large M&A deals.

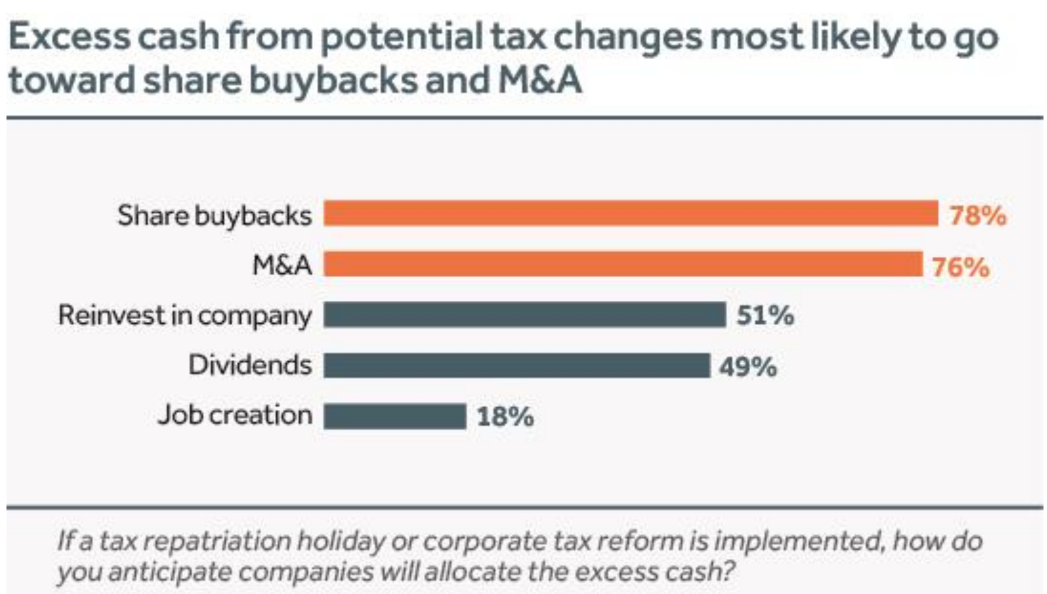
Under the new administration, this year's survey respondents view President Trump as a boon for M&A in 2017, betting that the president's oft-cited transactional worldview is fundamentally friendly to deals. Half of dealmakers believe the overall impact of the Trump administration will be positive for M&A, and an overwhelming 71% expect that antitrust scrutiny will decrease. Less than a third of respondents (29%) see the Trump administration as a setback for M&A.



Dealmakers are excited by vows to implement corporate tax reform, a hallmark of the Trump presidential campaign, as well as potential new guidelines on cash repatriation, as these measures would free up balance sheets and empower companies to pursue more M&A. Among the anticipated changes under the new administration, over half of respondents see corporate tax reform (58%), antitrust policies (52%) and repatriation of offshore cash (51%) as the top three drivers of deal activity in 2017.



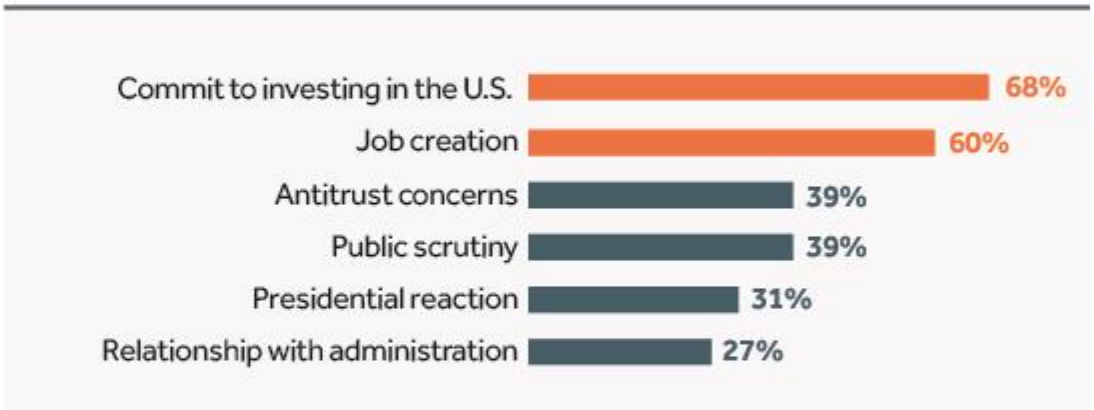
However, the view is that not all excess cash derived from Trump's anticipated changes will be used by companies to pursue M&A opportunities or reinvest in growth. Dealmakers expect companies to return capital to shareholders by applying about as much of the potential excess cash toward share buybacks (78%) as to M&A (76%), with nearly half of respondents expecting greater dividends.



Sealing the Deal

Despite optimism, the Trump administration does not represent free reign for dealmakers. The president's willingness to criticize companies from his Twitter account for offshoring jobs is a signal that he plans to hold fast to his "America First" credo. Trump's presidency places new emphasis on the impact of M&A on local communities and job creation, and companies must be prepared to address these concerns as they seek to successfully close M&A transactions with regulatory and public approval. For example, 68% of respondents believed commitments to investing in the U.S. would need to be considered when making an M&A decision. Similarly, 60% of respondents felt job creation would be a factor.

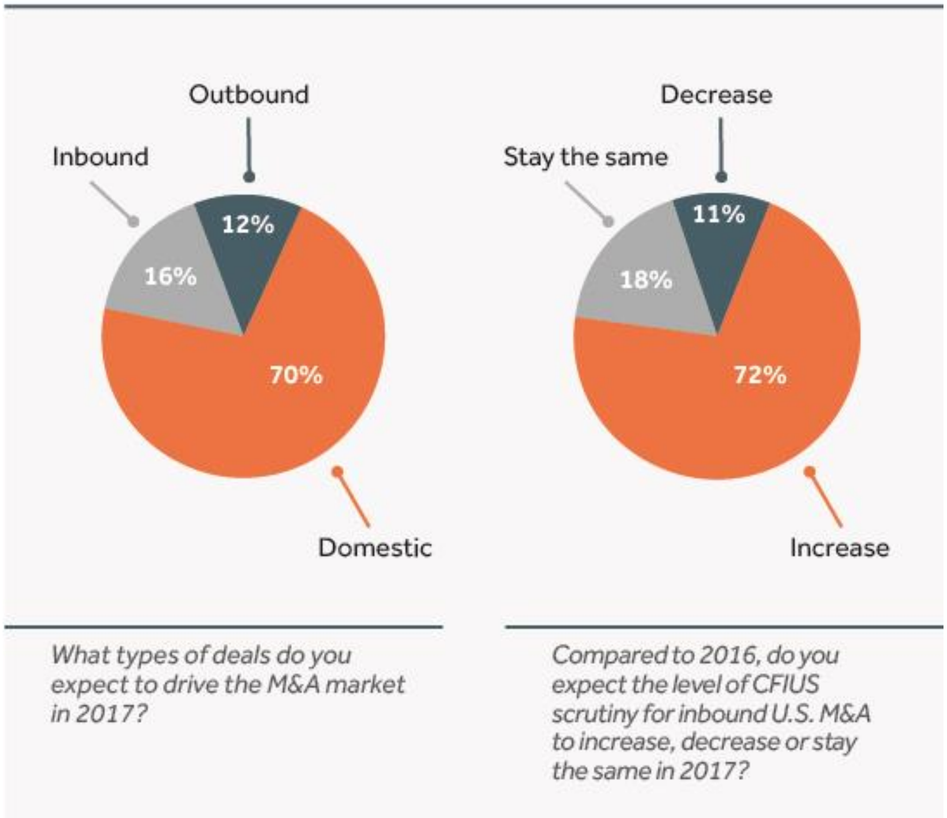
Commitment to U.S. investment and job creation seen as most important considerations when making an M&A decision



Under the Trump administration, what are the top considerations companies should have when making an M&A decision?

With this in mind, the vast majority of survey respondents (70%) predict that domestic deals will drive M&A in 2017. International deals are likely to face more roadblocks under the Trump administration, with 72% of dealmakers predicting that foreign inbound deals will face greater scrutiny from the Committee on Foreign Investment in the U.S. (CFIUS). But even domestic deals may come with more strings attached—56% of respondents believe that the administration would require domestic investment in exchange for overseas cash repatriation.

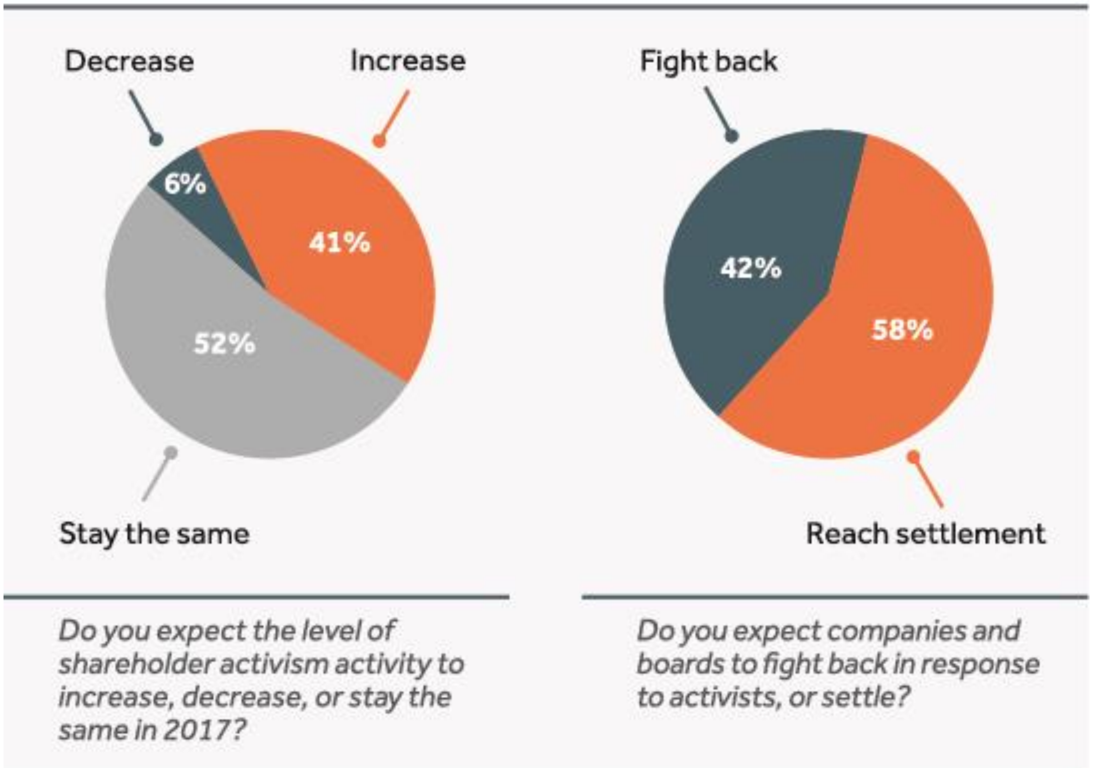
Dealmakers see a friendlier domestic U.S. M&A market, but greater CFIUS scrutiny for foreign buyers



The Role of Activists

According to this year's survey, shareholder activists will maintain their influence, and their presence may be felt beyond corporate boardrooms. With high-profile activist investor Carl Icahn serving as a special advisor to President Trump, the activist perspective may gain greater influence over policy and regulation. Just over half of survey respondents (52%) predict that the level of shareholder activism activity will remain steady in 2017, a large amount (41%) predict an increase and few (6%) expect a decrease from 2016. At the same time, the majority of respondents (58%) predict that companies are more likely to settle with activists than engage in proxy fights, extending 2016's trend toward settlements.

Activists are here to stay – companies are expected to settle rather than fight



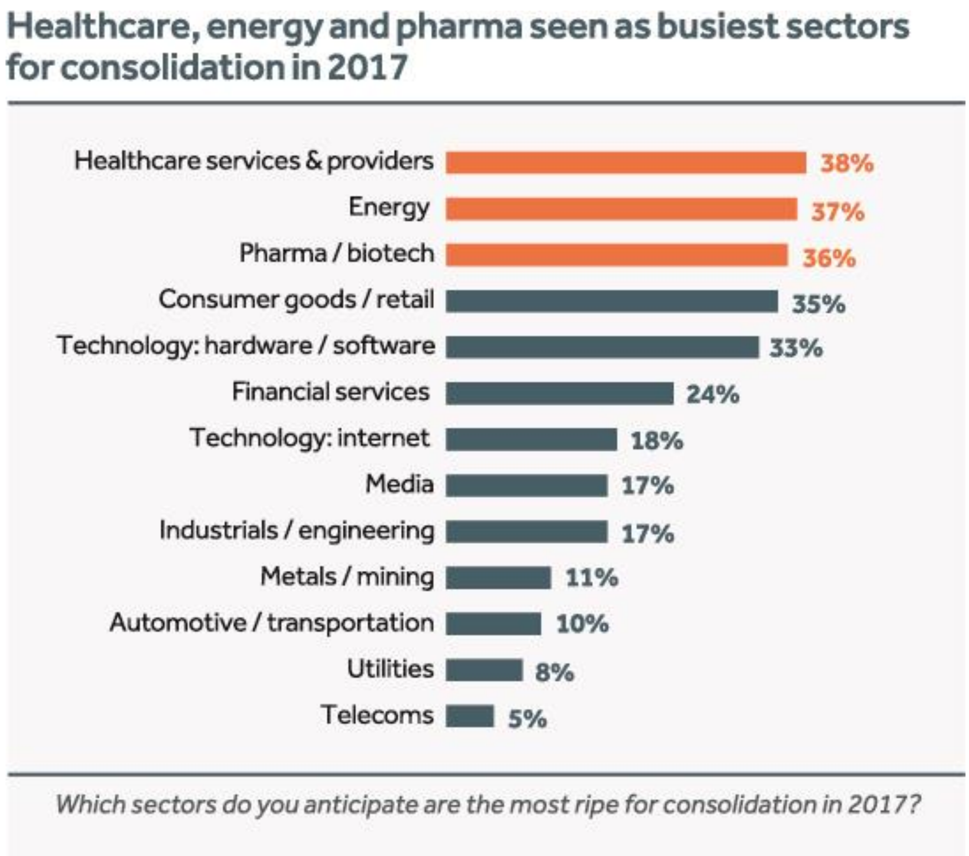
The survey respondents continue to expect activists to make a wide array of demands, predicting that M&A (20%) and spinoffs/divestitures (20%) will be nearly as prevalent as recurring demands for operational and performance improvements (27%) and returning capital to shareholders (21%).

Activists expected to seek M&A and spinoffs/divestitures in addition to performance and returns

Sectors to Watch

Respondents identified a wide range of sectors as likely to see the most deal activity in 2017. Most respondents (38%) predict that healthcare services and providers will undergo the most consolidation, even in the face of healthcare reform. The Republican Party's effort to repeal the Affordable Care Act (ACA) generated significant uncertainty, but the party's failure to gather the necessary votes means the ACA will likely remain the law of the land for the foreseeable future, providing greater bandwidth for long-term planning in the health industry.

Other industries identified as likely to see the most deal activity were energy (37%), pharmaceuticals/biotechnology (36%), consumer goods/retail (35%), and technology hardware/software (33%). Respondents predicted that automotive/transportation, utilities and telecoms would be among the least active sectors.



The Overall Outlook

With a more optimistic outlook on deal-making and a softening regulatory environment, the M&A community is gearing up for greater activity in 2017. Though the Trump administration promises to deliver an array of policy changes that would encourage M&A, unpredictability remains the rule in 2017. In fact, most dealmakers (61%) don't expect meaningful corporate tax reform to be implemented until 2018, and it remains to be seen if the bet by dealmakers that Trump will align himself with financial and corporate interests will deliver another global M&A boom.

The Promise of Market Reform: Reigniting America's Economic Engine

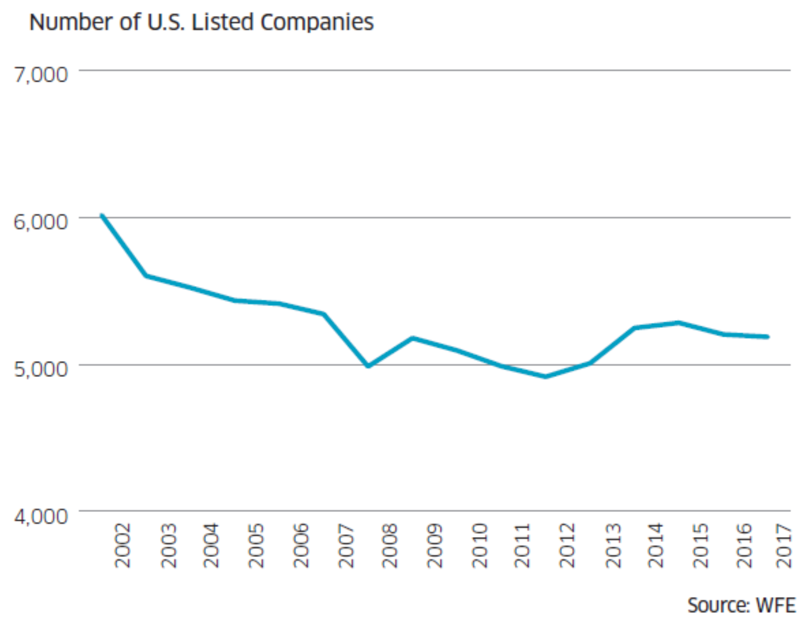
Posted by Adena Friedman, Nasdaq, Inc., on Thursday, May 18, 2017

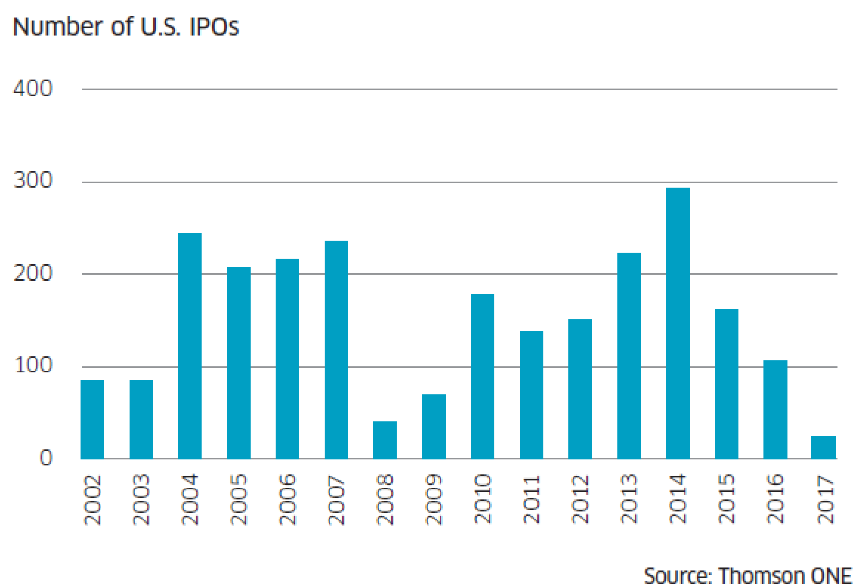
Editor's note: Adena Friedman is President and CEO of Nasdaq, Inc. This post is based on a Nasdaq publication by Ms. Friedman.

Robust public markets are the fuel that ignites America's economic engine and wealth creation. Companies list on U.S. exchanges to access a steady, dependable stream of capital to grow and create jobs, and investors choose our markets because they are the world's most trusted venues for long-term wealth creation.

Built on the shoulders of entrepreneurs with great ideas, public companies drive innovation, job creation, growth and opportunity across the global economy. A central reason for the success of U.S. capital markets is that American public companies are among the most innovative and transparent in the world. Additionally, the mechanisms that govern our markets ensure opportunity through fair and equal access—providing a solid foundation for the diversity of investing perspectives, participants and strategies represented in our capital markets.

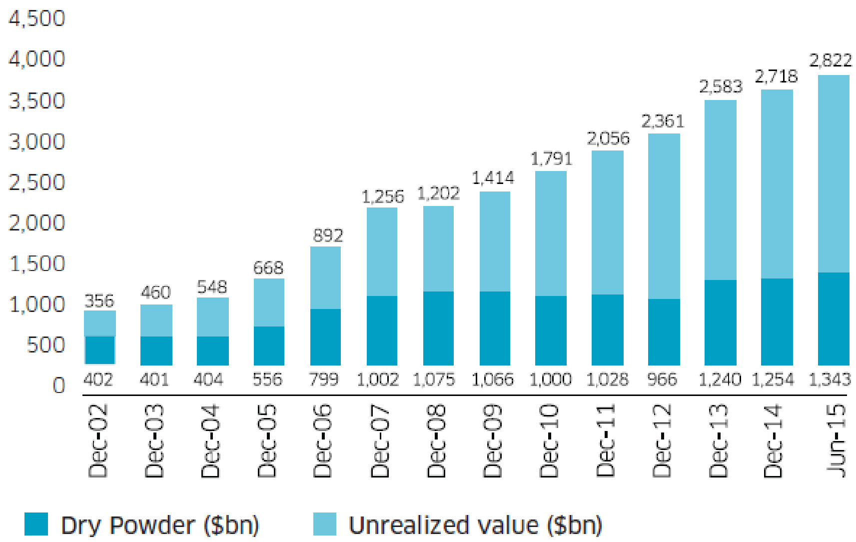
There is no question that companies that choose to participate in equities markets and make their shares available to the public take on a greater obligation for transparency and responsible corporate practices. Regulations are needed to maintain these "rules of the road." But as the U.S. has continued to add layer after layer of obligation, we have reached a point where companies increasingly question whether the benefits of public ownership are worth the burdens. If not addressed, this could ultimately represent an existential threat to our markets. In fact, in recent years, a growing number of companies have been choosing to remain private—and some public companies are reversing course and going private.





The dynamics catalyzing the turn away from public markets are complex. They range from concerns about: a) activists, b) frivolous shareholder litigation, c) pressure to prioritize short term returns over long-term strategic growth, d) burdensome costs and headaches of the proxy process as well as irrelevant but required disclosures, to name a few. Once public, particularly smaller issuers sometimes find that the cost of accessing equity capital to fund growth can be expensive given the distributed nature of trading across markets and trading venues today. Therefore, they seek private sources of capital, and in today's environment, many dynamic companies are finding an abundant supply of that capital available.

Private Capital Assets Under Management 2002-2015**

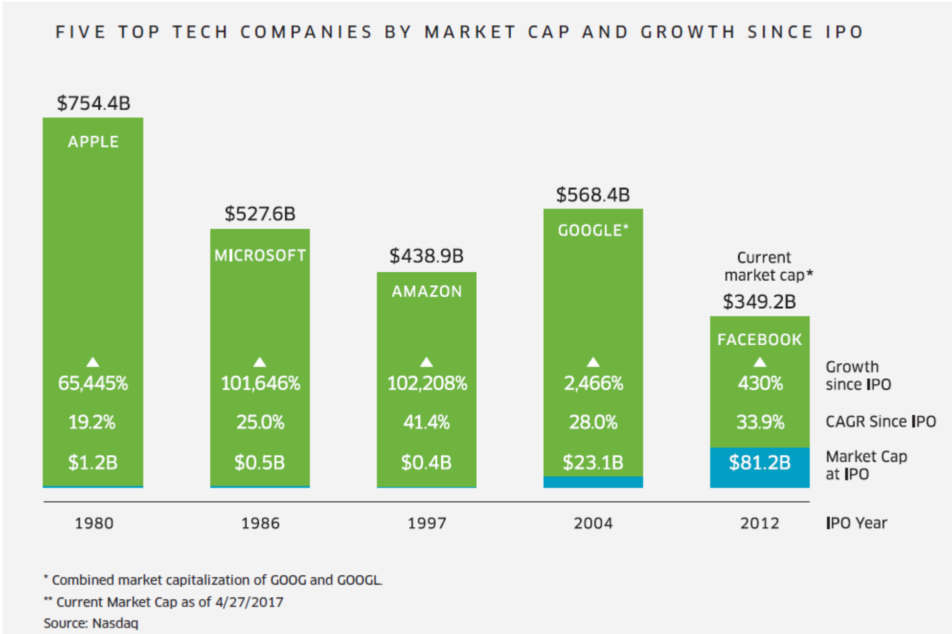


"**Direct lending is excluded prior to 2006

Source: Preqin: 2016 Preqin Global Private Equity & Venture Capital Report

While the risk of a diminishing public capital market may not yet be fully realized, it is not difficult to anticipate what may lie ahead: since not everyone has the opportunity to invest in private companies, main street investors may lose the chance to share in wealth creation, which could foster a greater divide between the wealthiest and everyone else. Additionally, American companies could increasingly consider foreign public markets; and top international companies might opt not to list in the United States.

The case for strong public markets is overwhelming. Since 1970, 92% of job creation has occurred after IPO. The vast majority of Americans are invested in and count on public markets, either directly through stock ownership or through pension funds, mutual funds, and retirement accounts.



Additionally, with more investors choosing index strategies to meet their investment needs, funds and ETP providers are relying upon a deep and healthy selection of public companies across industries and at various stages of maturity and growth to provide investors a wide range of index strategies with strong return profiles. Investor access to vibrant and growing public capital markets is a critical driver of wealth creation and financial security for the American people.

Private investment firms (a.k.a. alternative asset managers) state that they represent average investors indirectly by serving pension funds that exist on behalf of American workers, and that is indeed true. However, today, pension funds are slowly shrinking and being replaced with defined contribution retirement plans as the core savings vehicles for average American workers. Additionally pension plans allocate only a small percentage of their overall portfolios to private alternative funds because the underlying investments are very illiquid and difficult to value. Defined contribution plans are even more limited in their ability to invest in private securities and private equity funds today due to the lack of liquidity and valuation transparency. Therefore, for the foreseeable future, pension funds and most mutual funds that serve average investors will continue to rely heavily on the public markets to supply investment opportunities that will help them reach their return thresholds. That will get harder and harder if there are fewer growth-oriented companies coming into the public markets.

Nasdaq believes that private markets do serve an important role in our economy. Our goal is to apply the best aspects of private markets—including the ability for companies to manage themselves to the longer-term—to the public markets. At the same time, we are advocates for private markets that also adapt to feature the best aspects of public markets—including the opportunity for more frequent liquidity events with price discovery—to open up the private markets to a broader client base, most notably defined contribution plans.

Our concerns over the state of our public markets fall into three categories:

First, a complex patchwork of regulation that disincentivizes market participation.

Second, a one-size-fits-all market structure that deprives companies of the benefits they need to participate and succeed in public markets, particularly for small and medium growth companies;

And third, a culture in the investment community and in the mainstream media that increasingly values short-term returns at the cost of long-term growth. We focus on concrete solutions across three topic areas:

1. Reconstructing the Regulatory Framework

Nasdaq strongly believes that safe markets need guardrails. The regulations enacted during and immediately after the credit crisis accomplished some important goals in key areas of systemic risk. However, for issuers much-needed improvements to the capital markets have been largely ignored while regulators shoulder the burden of shoring up the most critical components of the financial system. Therefore, during this period of relative market calm, now is the time to address those burdens on public companies that create an unwelcome capital market environment.

One crucial area of regulatory reform is in the proxy process. While proxy voting can be an important tool to raise legitimate concerns, it is far too often used for unhelpful purposes that cause a nuisance and significant financial strain on companies, particularly smaller ones. A number of simple, common-sense reforms can protect the shareholder voice while filtering out needless and costly headaches.

Nasdaq believes it is long past time to move away from a one-size-fits-all approach to corporate disclosure. Transparency is critical to healthy markets, but technology and markets have evolved to a point where a reasonable degree of flexibility can allow for disclosure requirements that are shareholder-friendly while reducing the burden on companies. For example, if companies report all key financial and business details in quarterly press releases, we should consider eliminating the archaic 10-Q form, which is duplicative and bureaucratic. We should also study options that allow for greater flexibility in reporting schedules, so that as long as companies are transparent with shareholders, they have the flexibility to report on a less-rigid structure. This would also promote our third goal of promoting long-termism.

We also believe that companies of all sizes will benefit from comprehensive litigation and tax reform, two topics that are debated endlessly but have yet to see comprehensive action.

We are seeing a record rate of securities class action lawsuits and a record number of dismissals. In fact, filing these cases has become its own cottage industry. But companies and shareholders are paying a steep price for these frivolous cases, which also discourage private companies from going public.

Nasdaq supports the current administration’s efforts to lower tax rates for U.S. companies, as well as a territorial taxation system for foreign corporate earnings. We also advocate for lower taxes for individuals, specifically related to their investments in public securities. Appropriate tax reform will encourage companies and investors to put more of their dollars to work to grow and/or gain financial security. We are particularly intrigued by the concept of creating a tax structure for individual investors that ties a low-level of taxes on investments to the overall value of the account, rather than a higher dividends and capital gains tax on earnings within the account. This could result in a dramatic rise in the number of individual investors and more of the dollars staying with the investors to shore up their longer-term financial security.

2. Modernizing Market Structure

The last ten years have seen extraordinary technological advances and regulatory changes to the way markets function. As a result, just as bridges built for pedestrians required rebuilding for the age of automobiles, the regulatory infrastructure upon which yesterday's markets were built must be modernized to support the complex markets of today.

One of the unintended consequences of current market structure is that small and medium growth companies (and investors in them) are not receiving a proportional share of the benefits. The relatively high volatility and low transaction volume of smaller issues is exacerbated by an inflexible one-size-fits-all construct that spreads already-thin trading across too many venues. In fact, thoughtful market reforms will broadly benefit companies of all sizes. Modern markets can and must be flexible markets. We need to move past the rigid, one-size-fits-all thinking of the past and leverage technology to solve emerging problems and benefit all market participants.

3. Promoting Long-Termism

A variety of factors in recent years have made it more difficult for companies to focus on the long-term goals of innovation, expansion and job creation, which are critical to healthy markets and a strong U.S. economy. In addition to harming companies, the trend away from long-termism also harms the vast majority of investors.

While the term "activist investing" is complex and some forms of activism achieve worthy goals, the trend toward exerting pressure for short-term gains at the expense of long-term health is concerning. Nasdaq especially believes that the goals, tactics and financial arrangements of activist investors should be examined by policy makers and made transparent to the companies and their other shareholders.

We also support dual class structures in appropriate situations. America is a breeding ground and magnet for entrepreneurship and innovation, and in order to maintain this strength, we must offer entrepreneurs multiple paths to participate in public markets. Dual class structures allow investors to invest side-by-side with innovators and high-growth companies, enjoying the financial benefits of these companies' success.

In this post, we offer a broad range of policy recommendations that we believe will accomplish these critical goals. Some of these proposals are straightforward and ready to be implemented today. Others are more conceptual and require further study. Some have long been debated, while others are newer. For these reasons, we consider this post a blueprint to engage stakeholders and move the conversation toward concrete action.

If investors, industry groups and policymakers come together, we can construct healthier U.S. equities markets and a durable economy that works for all Americans.

Section One: Reconstructing the Regulatory Framework

The flurry of regulation following the financial crisis accomplished some important goals, but we have also seen many unintended consequences and corners of the market that are still desperately in need of modernization. The result is an inconsistent regulatory patchwork that under-regulates some areas and overregulates others. Public companies—and those contemplating an entrance into public markets—are increasingly hamstrung by the complexity and cost of navigating this regulatory maze, and investors are harmed both by the impact of these costs on companies that do go public and the shrinking investment options as more companies avoid going public. Establishing a modern framework that can adapt to different industries and types of companies will unleash economic productivity across our economy by reducing costs and complexity and allowing companies to focus on growing and innovating, to the benefit of both issuers and investors.

Reform the proxy proposal process.

Nasdaq supports shareholder-friendly regulations that provide healthy interactions between public companies and shareholders. However, current regulations governing the way shareholders access a company's proxy statement can poison the company-shareholder relationship by amplifying the voice of a tiny minority over the best interests of the vast majority. The cost to public companies in legal expense, let alone the time and attention of management and boards, is real and significant. Therefore, the following reforms are crucial:

Raise the minimum ownership amount and holding period to ensure proposals have meaningful shareholder backing. SEC rules allow any shareholder holding $2,000 or more of company stock for one year or longer the ability to include an issue on the company proxy for a shareholder vote, even if the issue is not material or relevant to the company's business. A study sponsored by the Manhattan Institute reported that one-third of shareholder-led proxy proposals in 2016 were driven by six small investors and their families. The current process is costly, time-consuming and frustrating for companies, which in aggregate must address thousands of such proposals each year. Deleting this meaningless dollar threshold and instead requiring that a proposing shareholder hold at least 1% of the issuer's securities entitled to vote and increasing the holding period to three years, would ensure that shareholder proposals representing the views of a meaningful percentage of the companies' long-term owners are considered at shareholder meetings.

Update the SEC process for removing repetitive, unsuccessful proposals from proxies. Congress should adopt the Choice Act proposal to significantly increase the shareholder support that a proxy proposal must receive before the same proposal can be reintroduced at future meetings. The SEC should study the categories of topics suitable for shareholder proxies and modify its rules accordingly to ensure that proposals considered at annual meetings are properly placed before shareholders, are meaningful to the business of the company, and are not related to ordinary business matters.

Create transparency and fairness in the proxy advisory industry. Due to the large number of proposals they must consider within a concentrated time period, institutional investors have come to rely on proxy advisory firms to analyze corporate proxy votes and provide insight into how to vote. While this service is valuable in theory, in practice the industry is a largely unregulated black box, rife with opacity, lack of accountability and conflicts of interest. Absent requirements to explain their criteria or to provide companies a means to question analysis or even correct factual errors, the outcome of critical decisions is often at the whim of unpredictable and impenetrable advisory firms. Additionally, these firms are not even required to disclose whether they have a financial relationship or ownership stake in the companies on which they report. The SEC took preliminary steps to address these concerns with the proxy advisory industry several years ago, but these efforts are far from sufficient. Proxy advisors must have a line of communication with the companies they analyze and clear transparency around ownership of, or short interest in, covered companies.

Reduce the burden of corporate disclosure.

Investors demand and deserve clear, consistent reporting of key company information on a regular basis. Nasdaq fully supports the transparent and robust disclosure, which is one of the reasons why U.S. markets are the world's most trusted. However, this necessary disclosure must be re-evaluated to reduce the cost and burden for smaller companies while maintaining the level of access and detail that investors need

Offer flexibility on quarterly reporting. For many large companies, quarterly reporting remains the ideal vehicle for regular disclosure. However, some companies looking to encourage long-termism and reduce costs would benefit from the flexibility to provide full reports semiannually, as has been done in the United Kingdom. Companies would be able to update key metrics for any material changes between mandated reports using the tools readily available to communicate directly with shareholders.

Streamline quarterly reporting obligations for small and medium growth companies. In today's market, between detailed, annual Form 10K disclosures, companies provide key data via an earnings press release each quarter. For virtually all investors, the press release is the quarterly report. Yet companies are then required to file a formal Form 10-Q document with the SEC, which is complex, time-consuming, and provides little additional actionable information that cannot be found in the press release. By establishing simple guidelines, the press release can replace the 10-Q entirely for issuers that prefer to report information quarterly, aligning regulatory and shareholder interests and significantly decreasing corporate reporting red tape without reducing the key disclosure that investors rely upon. Detailed disclosures would continue to be available through the annual Form 10-K process.

Along the same lines, advancing technology has created new alternatives that many feel reduce the usefulness of eXtensible Business Reporting Language (XBRL), the XML standard language that public companies are required to use in order to tag data in their financial statements and related footnote disclosures. With many analysts deploying their own sophisticated research tools, XBRL should be reconsidered to ensure that the benefit to investors outweighs the complexity and burden of implementation.

Expand classifications for disclosure relief. Current regulations permit certain types of companies, including small growth companies, to submit disclosure reports that are robust and transparent but far less burdensome than those required for more mature companies. This important exemption makes being public far more appealing for private companies contemplating the regulatory requirements of going public, and significantly decreases the resources necessary to file until the company has become mature. However, the definitions of classes like “smaller reporting company,” “emerging growth company” and “non-accelerated filer” are narrow, sometimes limited in duration, and difficult to navigate; as a result, fewer companies benefit from the spirit of these carve-outs. They should be expanded and simplified by:

- Expanding the JOBS Act’s “test-the-waters” provisions, allowing emerging growth companies to communicate with certain potential investors, and file their registration statement confidentially to all companies and all capital raising transactions.
- Raising the revenue cap to qualify as emerging growth company from the current $1 billion (subject to inflation adjustment every five years) to $1.5 billion and deleting the current phase-out five years after the IPO.
- Harmonizing the definitions for smaller reporting company and non-accelerated filer with those of emerging growth company to avoid a patch work of inconsistent and illogical exemptions.

On a broader level, the SEC should complete its 2016 “Disclosure Effectiveness Initiative” to strip out unnecessary and duplicative requirements to simplify requirements so that disclosure is less onerous for companies and more meaningful to investors. In a similar vein, the Commission should consider ways to streamline the offering process by giving all public companies the opportunity to raise capital using simplified and faster “shelf registrations” and reducing the requirements for supplemental forms and other bureaucracy associated with capital raising that serve no meaningful purpose.

Roll back politically-motivated disclosure requirements.

We can and should make a clearer distinction between disclosure of material information that investors require to evaluate a company’s financial performance and economic prospects and those that are motivated by social and political causes or otherwise aren’t relevant to a company’s bottom line. For example, we support the elimination of the currently-required reporting of conflicts minerals and executive pay ratio, along with a comprehensive review of all disclosure requirements and the elimination of those that do not have a clear connection with a company’s financial performance, practices and outlook. These disclosures impose costs and burdens on public companies that their private competitors do not face, without a concomitant benefit to their investors.

Litigation reform

Defending meritless class action lawsuits is more than a “cost of doing business” for public companies. 2016 saw a record number of securities class actions—and a record number of dismissals.

Class actions target public companies more than private ones; the broader public disclosures and the greater number of shareholders offer class action mills greater leverage to extract settlements and legal fees. Class action settlements also tend to benefit one set of stockholders (investors at the time of the alleged fraud) at the expense of another set (more recent investors).

Nuisance cases that result in dismissal are not costless. The mere filing of a securities class action has been estimated to wipe out an average of 3.5% of the equity value of a company, and companies must bear the cost of defense, estimated to exceed $1 billion per year in aggregate. As the rate of these cases rises, it has become a major reason cited by private companies for staying out of the public markets. Given the trend of third-party investors financing these cases. there is every reason to expect that the number of cases filed will only increase—along with the burden placed on public companies—unless litigation reform is prioritized.

Nasdaq supports reforms that reduce the burden of meritless class actions, recognizing that it can be difficult to distinguish legitimate from frivolous cases. Litigation rules can raise the bar for filing class actions by, for example, making it easier to impose sanctions for frivolous suits. Steps to promote conclusive resolution of cases at an earlier stage would reduce the amount and duration of leverage enjoyed by class action profiteers.

Support Congressional action. Nasdaq supports the enactment of legislation currently before Congress that addresses litigation reform. The legislation would, among other things:

- Ease the standard for imposing sanctions on lawyers bringing frivolous lawsuits.
- Tighten the requirements for granting class certification.
- Facilitate interlocutory appeal of decisions to grant class certification.
- Require disclosure of third-party financing of litigation.
- Limit plaintiff legal fees.

Expand scope of provisions under Congressional consideration. Congress should also consider enhancing this legislation with additional similar provisions that would:

- Allow interlocutory appeals from the denial of a motion to dismiss.
- Allow a plaintiff to amend its complaint only once.
- Further codify the standards for pleading with respect to scienter and loss causation, and clarify the exclusive nature of federal jurisdiction over securities claims.
- Require proof of actual knowledge of material misstatements or omissions (as opposed to mere recklessness).
- Make SEC findings in enforcement consent decrees inadmissible in private litigation.

Study longer-term comprehensive reform. Given the significant costs of the current system and questions about whom the system actually benefits, long-term consideration should also be given to more comprehensive changes. These might include:

- For securities class action suits, adopt the English system of requiring the loser to pay legal fees of the winner, and ensure that plaintiffs have adequate resources to cover such fees by requiring them to post a bond or demonstrate financing.
- Allow companies to adopt charter/by-law provisions that require stockholders to pursue claims against the company, directors, and officers through arbitration.

Tax reform

The federal government has repeatedly failed to enact meaningful tax reform for more than thirty years. As a result, public companies and investors are left with a tax system that is complex, burdensome, inefficient, and does not properly incentivize longterm investing. It is long past time to reform U.S. tax policies to promote, rather than discourage, saving and investment in the U.S. economy. The personal savings rate in the U.S. is half what it was in the 1950s and 1960s, and in 2015 the U.S. savings rate was near the bottom of the OECD member countries. Nasdaq supports strong consideration of modern, forward-looking solutions.

Offer “investment savings accounts” for investors. In 2012, Sweden introduced a compelling new structure that ties taxes on investment to the value of a Swedish investment savings account (or “ISK account”), rather than earnings (known as capital gains) within the account. The ISK account is available to individual investors and there is no maximum amount which an investor may contribute to an ISK account. The individual investor manages the ISK account and can freely move funds within the account. Funds in the ISK account may be invested in cash (including foreign currency), financial instruments which are traded on a regulated market, or financial instruments traded on a multilateral trading facility. The investments may be made in either the Swedish or global marketplace.

In a relatively short time, this investor-friendly concept has attracted approximately 1.6 million Swedish individual investors (approximately 16% of the total Swedish population) to the ISK accounts as of 2015, and the number of ISK accounts held by Swedish citizens has more than doubled in 2014- 2015. Based on other information made available by the Swedish Tax Agency (or “STA”), the value in such accounts increased 68% in 2014-2015, as compared to a decrease in the OMX Stockholm 30 Index of 1% over the same period. We can also ascertain from the information published by the STA that the value of the ISK accounts have been taxed at a rate of approximately 0.3% to 0.6% for the years 2012-2015. Using the S&P 500 index as a benchmark to track the value of an U.S. equity investment account, if the ISK account model had been adopted in the U.S. over the past ten years, investors would have benefited from considerably lower taxes on their investments, allowing for increased longer-term savings.

Over the same period of time, from 2014-16, the number of IPOs in Sweden has almost doubled, with two-thirds of the new companies listing on the First North market, a market dedicated to smaller growth companies. It is early days for statistical gathering of ISK’s impact on the market. That said, after four years, the data indicates a correlation between ISK and the Swedish IPO Market.

Nasdaq supports the creation of this optional type of investment account in which U.S. investors may invest in the global markets. Alternatively, investments solely in the U.S. markets are also acceptable.

Expand tax exemption on sale of small business stock to the secondary market. The tax code currently includes an exemption from tax on the sale of the stock of small startup businesses; however, the exemption is narrowly defined. Because in practice it will be difficult to apply this exemption to shares of public companies, the benefits accrue only to venture capitalists and high net worth individuals—not to the potential broader class of smaller shareholders of companies seeking public funding. Furthermore, due to the complexity of these rules, this provision of the tax code is rarely used by taxpayers. This exemption should be expanded to include all qualified domestic corporations. We also recommend considering shortening the ownership tenure requirement from five years to three years, and increasing the maximum asset threshold from $50 million to $100 million. This shareholder-friendly move would enable these smaller companies to access the public markets.

Enact 100% dividends received deduction for holders of corporate stock. One of the most irrational elements of our current tax code is the double taxation of corporate profits. The company pays taxes on profits, and then the shareholder is taxed on distributions derived from those profits. For individuals, the rate of taxation on dividends can be as high as the tax rate applied to ordinary income. Nasdaq strongly supports complete elimination of the double taxation of corporate profits through a 100% dividends received deduction for holders of qualified domestic corporate stock.

Eliminate net investment income tax. Enacted in 2013, individual investors currently pay a surcharge tax—above and beyond the tax applied to dividends and capital gains—of 3.8%. This tax increases the over-taxation of corporate profits and penalizes individuals from participating in markets. It should be repealed.

Exclude dividends and capital gains from income for purposes of determining the phase-out of itemized deductions. Enacted in 1991, individual taxpayers' itemized deductions are limited if their gross income exceeds certain levels. Nasdaq supports continuation of the phase-out of itemized deductions for higher earners, however investment income should be excluded in determining this phase-out as a means to encourage greater investment.

Section Two: Modernizing Market Structure

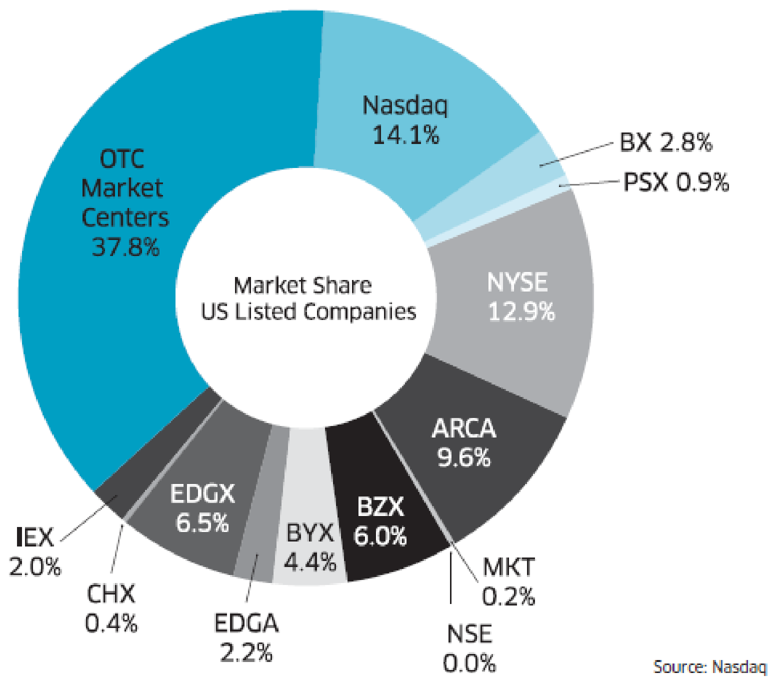
In many ways, today's markets bear little resemblance to those of just a decade ago. The old images of brokers fielding telephone calls and floor traders hollering orders has long since given way to a profoundly interconnected, technology-driven marketplace that transacts across an astonishing array of exchanges and trading venues. As the founder of electronic trading, Nasdaq views market innovation as a tremendous force for good, unlocking competition and unleashing the flow of capital to catalyze economic activity. Yet, as markets have advanced, the fundamental structure that underpins them has not evolved to benefit all market segments equally. While efficient markets benefit both issuers and investors, inefficient markets can choke the flow of capital, become a drain on growth, and block companies—particularly small and medium growth companies—from reaching their fullest potential. We sit in a unique position to observe both the areas of excellence and of challenge in our markets, and to recommend solutions that improve conditions for Issuers, Investors, and our economy.

Many of the regulations that form the foundation of today's markets—including Reg NMS and Reg ATS—were developed and implemented more than a decade ago. Now is the time to write new rules of the road that ensure U.S. equities markets continue to enable efficient capital flow and formation to support the U.S. economic engine. We can accomplish this with new and improved market constructs that account for the different needs amongst market participants and the fluid nature of our markets. It's time to address the one-size-fits-all regulatory regime.

Strengthen markets for smaller companies.

Despite incremental improvements to markets in recent years, liquidity and the trading experience for small and medium growth companies and investors in these companies still lag far behind that of larger issuers. For small and medium growth companies—those with a market capitalization below $1 billion, particularly when the lower market cap is accompanied by low daily trading volume—relatively small orders can create dramatic price movements. This increases costs for both the companies and their investors. For example, regardless of the listing market that a company may choose, small and medium growth companies have shown a worsening incidence of high-volatility days, which increases investor confusion and undermines confidence in our markets.

This liquidity dilemma stems from a long-term trend towards fragmentation, where liquidity has spread across an increasing number of trading venues. As recently as 15 years ago, more than 90% of liquidity was often concentrated in a single exchange with the small remainder spread over an additional eight to ten other exchanges and electronic communications networks. Today, liquidity is spread thinly across fifty or more venues (there are 12 exchanges alone), and no single market controls even 25% of trading.



As a result, every venue has a very thin crust of liquidity for small and medium growth companies, a crust that can be broken by a single large order. When the liquidity crust is broken, the order can quickly impact the market's ability to efficiently absorb it, resulting in a poor experience for the investor who placed the order.

Compounding that trend, liquidity has also moved off exchanges and onto alternative trading venues, making it more difficult to find latent liquidity. Nearly half of U.S. publicly traded small and medium growth companies have more than 50% of their trading occurring off-exchange, away from the benefits of price formation and transparency of U.S. exchanges.

Nasdaq believes concentrating that disaggregated liquidity onto a single exchange, with limited exceptions, will allow investors to better source liquidity. In addition, investors will enjoy a higher level of transparency because exchanges are required to display their best quotes to the public, and most exchanges choose also to publish full supply and demand information (i.e. order book depth information) within their markets.

The introduction of Unlisted Trading Privileges (UTP) gave rise to fragmentation, combined with a proliferation of alternative trading systems. In 1975, Congress determined that investors would benefit from greater competition if securities listed on one exchange were available for trading on all other exchanges and in over-the-counter trading venues. In 1998, determining that further steps were necessary to foster competition, the Securities and Exchange Commission enacted Regulation ATS, which lowered the bar for the launch of alternative trading systems. Advances in technology and further regulatory changes, most notably Regulation NMS, enacted in 2006, then led to an explosion of ATSs and exchanges, culminating in the current environment in which we have 40-plus active trading venues. While these changes have spurred competition that has brought benefits to larger Issuers, they have proven extremely challenging for less liquid companies. When it comes to UTP, the law of diminishing marginal returns applies—and we have far exceeded the point at which the benefit outweighs the costs.

With creativity and flexibility, this liquidity challenge can be solved, making capital markets far more cost-effective and attractive for small and medium growth companies:

Give issuers choice to consolidate liquidity and improve trading quality.

Nasdaq recommends permitting issuers to choose to trade in an environment with consolidated liquidity. By creating a market for smaller issuers that is voluntary for issuers to join and that is largely exempt from the UTP obligations—subject to key exemptions—we can concentrate liquidity to reduce volatility and improve the trading experience. Eliminating UTP for small and medium growth companies would reduce the number of exchanges authorized to trade them; most importantly, it would allow liquidity to develop, and for supply and demand to find one another. Without the rigidity of Regulation NMS which was enacted to cater to a UTP market model, the new markets would also create natural opportunities for other market structures to develop and thrive—for example, intraday auctions to bring together supply and demand for the benefit of all. Further requirements for off-exchange trading, described below, would likely further concentrate liquidity and limit fragmentation. The net effect would be a substantial “thickening” of the liquidity crust on the exchange that lists the security.

Off exchange trading represents 38.4% of small and medium growth company trading volume today. While there are great benefits to consolidating on-exchange trading, there is also important value provided by off-exchange trading that merit consideration, especially block trades and price-improved trades. The network of off-exchange brokers also supports systemic resiliency for the trading of these securities. We want to work with the industry towards constructive solutions that balance on- and off-exchange activities.

Nasdaq has learned from experience that for small and medium sized issuers, consolidation offers significant benefits to investors. Nasdaq operates the First North market in Sweden, containing small and medium low liquidity stocks in an even less liquid Swedish market. Unlike in the U.S., the limited liquidity is concentrated on a single market rather than distributed over many markets. When comparing the trading characteristics of the securities on the unfragmented First North market with the corresponding stocks in the fragmented U.S. markets, spreads are 37% better and volatility is also better on First North, even though the stocks listed are smaller than those listed in the U.S.

Some may wonder—separate from the impact to specific issuers and their investors—whether consolidation creates more systemic risk than we have today. Consolidation for this segment of the market will reduce the level of unnecessary complexity related to the many interconnections of exchanges. Furthermore, order types designed specifically to accommodate market fragmentation can be removed also increasing simplicity and decreasing risk. Reducing fragmentation does not have to come at the cost of reduced resilience. The listing exchange should ensure that a robust “hot-hot” backup system is in place—as well as a named backup exchange—to ensure resiliency for the trading of these securities. For example, Nasdaq has a proud history of maintaining resiliency in markets, including robust testing, geographically diverse systems, primary/backup systems operating simultaneously which could be replicated here. In sum, these changes would work to bring additional benefits to small and medium growth companies and their investors.

- **Deploy intelligent tick sizes for small and medium growth companies.** Every company listed on U.S. markets trades with the same standard tick sizes, but technology makes this standardization unnecessary. Nasdaq’s experience and research demonstrates that a one-size-fits-all approach to tick size is suboptimal for many, particularly small and medium growth companies, which should trade in a suitable tick regime determined by their listing exchange. Nasdaq believes that these companies should have the ability to trade on sub-penny, penny, nickel, or dime increments. Transparent and standardized methodologies can and should be used to accurately determine the optimal tick size to increase liquidity and reduce trading costs.
- **Cultivate innovative market-level solutions that improve the trading of small and medium growth companies.** Much of the trading and routing functionality in use today was designed in response to UTP and Regulation NMS. For issuers that choose to list in a non-UTP structure, much of that complex functionality will no longer be necessary to trade these companies. In addition, with the consolidation of liquidity, the listing exchange is appropriately incented to develop innovative solutions designed to cultivate liquidity and improve the trading experience for investors in small and medium growth companies. In a world where liquidity is more effectively nurtured, we will be able to address the unique needs of small and medium growth companies. We recognize the cost of adopting new technology across the industry in considering such innovations and believe that any such cost would be outweighed by the benefit to the market. We have several key ideas we’ve been working on and look forward to discussing in further detail with the industry.
- **Implement an intelligent rebate/fee structure that promotes liquidity and avoids market distortions.** Nasdaq is committed to balancing the privileges and obligations for market makers in small and medium growth securities to help incentivize tight spreads and a high-quality trading environment for all participants in these less liquid stocks. The opportunity for market making reforms and the impact of these changes would be magnified in a world where liquidity is concentrated as Nasdaq proposes. We do need to be very careful about policies that would eliminate or significantly reduce rebates in the context of less liquid stocks where incentivization of market making is most impactful.
- **Ensure fair and reasonable pricing for participants in the context of limiting exchange competition.** If UTP were to be revoked for small and medium growth companies, flexible tick sizes and liquidity incentivization must occur within a construct that preserves competition amongst market participants and does not inappropriately advantage the market operator itself. The SEC plays an important role for efficient and well-operating markets, and to help establish appropriate pricing policies to address the

goals of stakeholders. We are committed to working with the industry to ensure that a consolidated ecosystem operates effectively for investors, Issuers and all other market participants.

Nasdaq is focused here on the elements of market structure and regulation that directly impact small and medium growth companies. While many of our targeted proposals would change Regulation NMS as it currently applies to these companies, we view our current analysis as separate from the broader, more comprehensive review of Regulation NMS that the SEC has undertaken through the Equity Market Structure Advisory Committee. Nasdaq will continue to engage energetically on the critical topics already being discussed, including protection of investors' orders, measures of market performance, market maker incentive structures (including rebate structures), availability and uses of market data, and systemic risk and resiliency. That broad review of Regulation NMS is important, but that review should not delay or defer changes that Nasdaq purposes that are vital to small and medium growth companies.

Section Three: Promoting Long-Termism

Nasdaq understands and respects that there are many investing strategies, and we believe that this mix of approaches help ensure vibrant markets. However, in recent years, a variety of market dynamics have started to disfavor long-term investors and longterm corporate strategies. Market participants and the investing community have become less patient with corporate management, boards of directors and their overarching strategies to deliver shareholder returns.

Against this backdrop, private companies are forced to weigh the capital raising benefits of public markets with the risks that they will be unable to pursue productive long-term strategies. The trend away from long-term thinking is also harmful to investors with long-term outlooks and to the broader American economy, because sustained job creation and economic output depends on a company's ability to measure performance not in quarters or fiscal years, but in decades. Nasdaq advocates for reforms that help public companies plan and execute for long-term growth, job creation and innovation, and ensure that long-term investors are able to participate in wealth creation on a level playing field with those who focus on speed and market timing.

Address concerns regarding activist investors

"Activist investing" is a complex term. Over the last five years, shareholder activism has become less taboo and has dramatically evolved into its own distinct investment style. Accordingly, this approach now includes a broad assortment of perspectives, motivations and strategies. Consequently, this swift development and unique classification has also placed a higher degree of complexity and confusion within the space. The investment community continues to think of activism on par with "value," "growth" or "GARP," however it has proven itself far harder to define. Regardless, while some activism has proven to be benign and beneficial, there exist some particular aspects of the style that ultimately act as an overall detriment to the public markets, especially with respect to long-termism. It is possible to begin to separate the first category of activist investing from the second with the following commonsense steps:

- **Call to action for industry dialogue**. There are many dimensions to this issue and Nasdaq is a strong believer in the capital markets ecosystem, exchanges, issuers, investors, coming together to develop a comprehensive solution to this topic. For instance, Nasdaq strongly supports, and has built into its rule book, the need for greater transparency around arrangements by which activist investors tie director compensation to share price, which creates the potential for conflicts between the activist's and the company's best interest. This dialogue can and should focus on several key issues that promote transparency so that investors and activists are on a level playing field when engaging with the company.

- **Equalize short interest transparency**. Equalize short interest transparency. Currently, securities laws require certain investors to disclose their long positions 45 days after the end of each quarter and require institutions to make disclosure within ten days after their position reaches or exceeds 5% of a company's outstanding shares. There are no corresponding disclosure requirements applicable to short positions. Legitimate short selling contributes to efficient price formation, enhances liquidity, and facilitates risk management, and short sellers may benefit the market and investors in other important ways, including by identifying and ferreting out instances of fraud and other misconduct at public companies.
- However, the asymmetry of information between long investors and those with short positions deprives companies of insights into trading activity and limits their ability to engage with investors and it deprives investors of information necessary to make meaningful investment decisions.
- Several European countries require disclosure of short positions. Within the U.S., the policies that underlie the Section 13 disclosure requirements applicable to investors with long positions—transparency, fairness and efficiency —apply equally to investors with significant short positions. Moreover, investors with short positions can pursue strategies designed to invisibly drive down share prices or rely on regulatory processes to inexpensively challenge key intellectual property of a company, intending to profit from the uncertainty created. To provide transparency to other investors and the affected companies, we therefore support extending existing disclosure requirements for long investors, such as on Form 13F, Schedule 13D and Schedule 13G, to persons with short positions, including any agreements and understandings that allow an investor to profit from a loss in value of the subject security.
- **Continue to support dual class structure.** One of America's greatest strengths is that we are a magnet for entrepreneurship and innovation. Central to cultivating this strength is establishing multiple paths entrepreneurs can take to public markets. Each publicly-traded company should have flexibility to determine a class structure that is most appropriate and beneficial for them, so long as this structure is transparent and disclosed up front so that investors have complete visibility into the company. Dual class structures allow investors to invest side-by-side with innovators and high growth companies, enjoying the financial benefits of these companies' success.
- **Encourage, rather than mandate, ESG disclosure.** According to CSRHub research, as much as 84% of all Nasdaq-listed companies make some Environmental, Social and Governance disclosures. They do this not just because they believe in responsible business practices and because they understand that investors are increasingly expecting to analyze ESG metrics in their decision-making process. Many ESG disclosures and policies are intrinsically long-term in their focus. By being proactive in ESG disclosure, companies can set the tone in their long-term focus. Further, many companies find that the lack of ESG disclosure gives rise to activist concerns. As a result, companies end up needing to deploy an immediate, short term response to their challenge. By addressing ESG proactively, and on their terms, companies can keep their

focus on more orderly long term business planning and execution. In keeping with our support of custom solutions for complex markets, we generally support the principle that ESG reporting shouldn't become so prescriptive that it loses its value. Many companies are already doing a great job identifying the proper and appropriate ways to report material ESG metrics for their business practices and industry. This should be encouraged, rather than mandated.

Immediate Action and Further Study

Comprehensive market reform is extraordinarily complex. Nasdaq recognizes that it would be unrealistic and imprudent to enact all the reforms we recommend at once. Some are "shovel-ready" and could be implemented immediately with great benefits and little to no disruptions, while other reforms we support require additional study and fine-tuning.

Because this report is meant to be a blueprint that catalyzes dialogue and action, the summary below clarifies our view on which reforms are ready for immediate action and which are part of a longer-term strategy.

Reconstructing the Regulatory Framework

Immediate Action:

- Reform the proxy process
  - Raise minimum ownership amount and holding period
  - Streamline the SEC process for removing nuisance proxy proposals from the docket
  - Create transparency and fairness in the proxy advisory industry
- Reduce the burden of corporate disclosure
  - Offer flexibility on quarterly reporting
  - Eliminate 10-Qs and reconsider XBRL tagging requirement while keeping annual 10-Ks.
  - Expand and harmonize classifications for disclosure relief
  - Roll back politically-motivated disclosure requirements
- Litigation reform
  - Reduce the burden of litigation
  - Support Congressional action
  - Expand scope of provisions under Congressional consideration
- Tax Reform
  - Enact 100% dividends received deduction
  - Eliminate net investment income tax
  - Exclude dividends and capital gains from income for purposes of determining the phase-out of itemized deductions

Further Study:

- Investment Accounts
- Expand tax exemption on sale of small business stock
- Study longer-term comprehensive litigation reform (loser pays)

- Mandatory arbitration

Modernizing Market Structure

Immediate Action:

- Allow issuer choice to revoke UTP for small and medium companies with select exemptions
- Deploy intelligent tick sizes for small and medium growth companies
- Cultivate innovative market level solutions that improve the trading of small and medium growth
- Incentivize quality market making

Further Study:

- Broader market structure review

Promoting Long-Termism:

Immediate Action:

- Continue to provide choice on share class structure
- Equalize short interest transparency

Further Study:

- Address concerns regarding activist investors specific to tactics that coerce companies into short-term actions to the detriment of long-term planning and actions

The complete publication, including footnotes, is available here.

Tab II: Engagements between Issuers and Activists

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

The Activist Investing Annual Review 2017

Posted by Josh Black, Activist Insight, on Tuesday, February 21, 2017

Editor's note: Josh Black is Editor-in-Chief at Activist Insight. This post is based on excerpts from *The Activist Investing Annual Review 2017*, published by Activist Insight in association with Schulte Roth & Zabel, and authored by Mr. Black, Paolo Frediani, Ben Shapiro, and Claire Stovall. 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 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.

The juggernaut of shareholder engagement kept rolling in 2016 as a surge of one-off campaigns, governance-related proposals and remuneration crackdowns made for a busy year. 758 companies worldwide received public demands—a 13% increase on 2015's total of 673—including 104 S&P 500 issuers and eight of the FTSE 100.

Yet for dedicated activist investors, it was a more muted affair. Investors deemed by Activist Insight to have a primary or partial focus on activism targeted fewer and smaller companies, accounting for just 40% of the total which faced public demands, and 10% fewer companies in North America. Turbulent markets, redemptions and competition all played a part in reducing the volume of activist investing. By contrast, shareholder engagement flourished.

With hangovers from poorly timed investments in energy markets, the near-demise of Valeant Pharmaceuticals International and antitrust concerns breaking up deals on which activists had bet substantially, dedicated activists enjoyed a particularly poor start to the year in the U.S. Jason Ader, the CEO of SpringOwl Asset Management, told Activist Insight for this report that 2016 might be "the year that activists were humbled."

However, the number of newly engaged investors suggests the feeling is not widespread. According to Activist Insight, 51 primary, partial or occasional focus U.S. investors founded since 2009 launched their first U.S. campaign in 2016, up from 38 the year before. Although the data include recently founded activist firms, the universe of activists is expanding rapidly.

Indeed, engagement activists, typically institutions or individuals that push for governance changes, targeted 155 companies worldwide in 2016—up 24% after three years in which activity had remained flat. But it was "occasional" activists—which do not include activism as part of their regular investment strategy but which make infrequent public criticisms of portfolio companies—that account for the highest volume, making demands at 311 companies.

Not all of these demands trouble management equally. Only 58% of resolved demands initiated in 2016 were at least partially successful, with the rate of achievement rising with the focus level of the activist. That rate may yet fall as campaigns are resolved, with 2014 and 2015 both posting around 53% at least partially successful.

Downsizing

One of the most notable trends of the year was the strengthening of small cap activism, at the expense of the large targets activists have increasingly pursued. While the number of targeted companies valued at more than $10 billion rose marginally overall, among primary and partial focus activists it fell from 44 in 2015 to 30 last year. Indeed, in 2016, the sub-$2 billion market cap arena accounted for 78% of all targets, up from 72% in 2015 and 70% in 2014. After mixed results, Ader says he is unlikely to repeat his PR-heavy campaigns at Viacom or Yahoo, where SpringOwl published lengthy presentations in 2016.

That may continue to be a trend this year, unless activist fundraising picks up substantially. Assets under management of primary focus funds globally fell from $194 billion in 2015 to $176 billion—still higher than in 2014, but their first drop in five years.

Despite the tough climate, activists are still raising funds—SpringOwl and long/short specialist Spruce Point launched new ones, while Hudson Executive Capital and Marcato Capital have had some success with prior launches. Co-investment, meanwhile, remains a favored strategy for both new and old activists.

Major activists were undoubtedly preoccupied—Icahn by bearishness, Trian Partners by several new positions taken a year previously, and Pershing Square Capital Management by turning around Valeant, although Ackman's fund did participate in overhauling the board of Chipotle Mexican Grill late in the year. If all three become more prolific in 2017, large caps could yet face renewed scrutiny.

Towards financials

Activism in the technology sector was proportionately flat for the third straight year, this despite activity that ensured it remained one of the most publicized areas, including Starboard Value's brief threat of a full board contest at Yahoo before a settlement was reached. M&A continued to provide activists with an exit strategy in the sector, including for Elliott Management targets EMC, Infoblox and Qlik and other companies such as Epiq Systems (Villere & Co) and Outerwall (Engaged Capital).

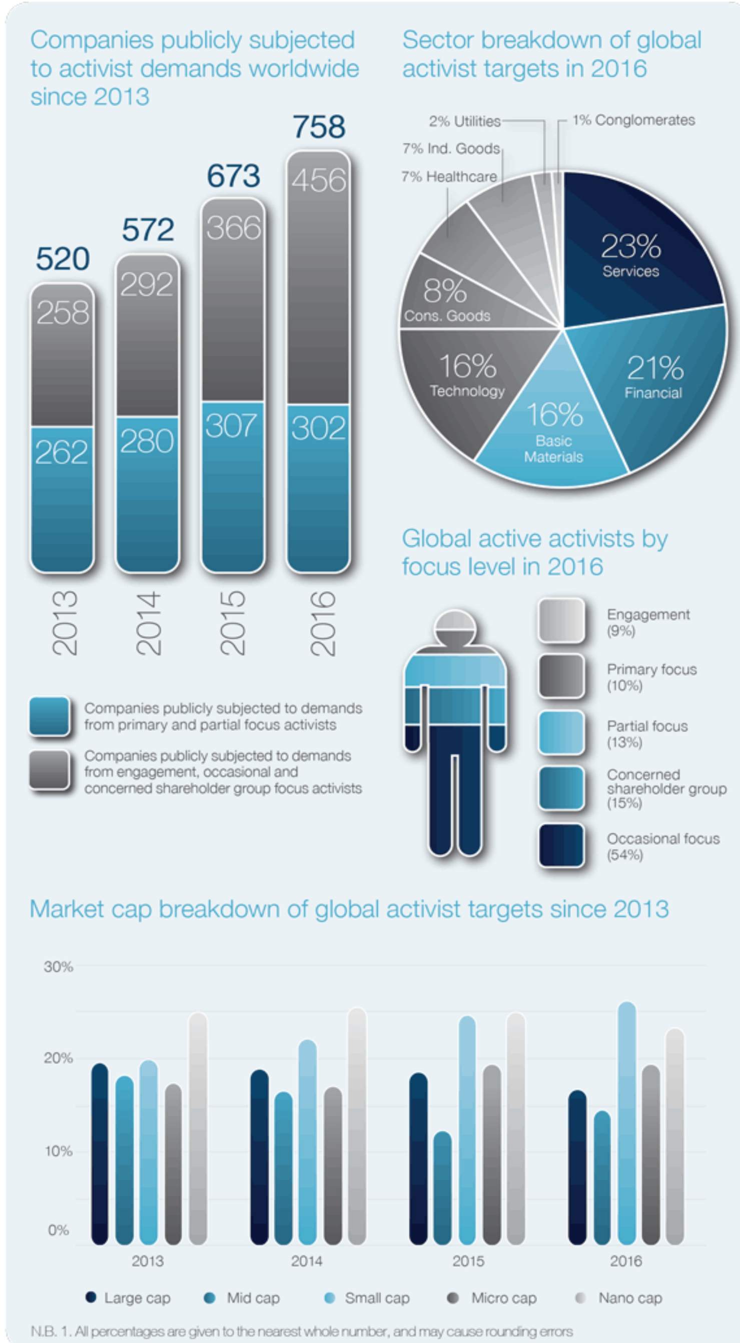
Moreover, a post-election rally notwithstanding, activists that have made their living focusing on buyouts in the sector—Elliott and Viex Capital among them—are unlikely to suffer a drought, according to Evercore's Bill Anderson.

Financial stocks have also been facing the heat, with volume up 28% in the U.S. and 15% globally. Proxy contests at FBR & Co and Banc of California stand out, while a rally in such stocks after the November election of Donald Trump to the presidency of the U.S. may portend more M&A among small banks and property and casualty insurers, Anderson added in an interview for the complete publication (available here).

The next frontier

Bullish M&A markets have allowed activists to play “bumpitrage” by seeking higher offers from previously announced deals. After Britain voted to leave the European Union, a host of such mergers were exposed to calls for re-evaluations by disgruntled shareholders, as at SABMiller and Poundland in the U.K. In Europe, Elliott Management took up holdout stakes in XPO Europe and Ansaldo, while Paris-based Charity Investment Asset Management has also specialized in defending minority investors in controlled companies.

Getting a hearing became easier in Europe in 2016, with Rolls-Royce Holdings becoming the first FTSE 100 company to cede a board seat to an activist (ValueAct Capital Partners) and Active Ownership Capital winning a seat at Stada in a rare German proxy contest. Whether similar trends emerge in regions where the culture of shareholder activism remains underdeveloped, such as Asia and Australasia, remains to be seen. Back in the U.S., if securing a hearing becomes more of a challenge again, it will be due to the spread of activism, not the lack of it.



N.B. 1. All percentages are given to the nearest whole number, and may cause rounding errors

Activism booms outside the US

Activism outside the U.S. exceeded expectations in many regions in 2016, with the number of public targets surging despite the preference for privacy in European and Asian countries, where investment communities are averse to public spats, shareholders do not have stringent disclosure requirements for their plans, and most activism takes the form of behind-the-scenes negotiations.

The number of European companies publicly facing activist demands in 2016 reached 97, up from 72 in 2015, and in Asia it rose to 77, up from 52 in 2015. The growth in these regions compensate for stable activity in Australia and a slowdown in Canada. In percentage terms, the number of companies in the crosshairs of activists outside the U.S. reached 40% of the total in 2016, up from 38% in 2015 and 35% in 2014.

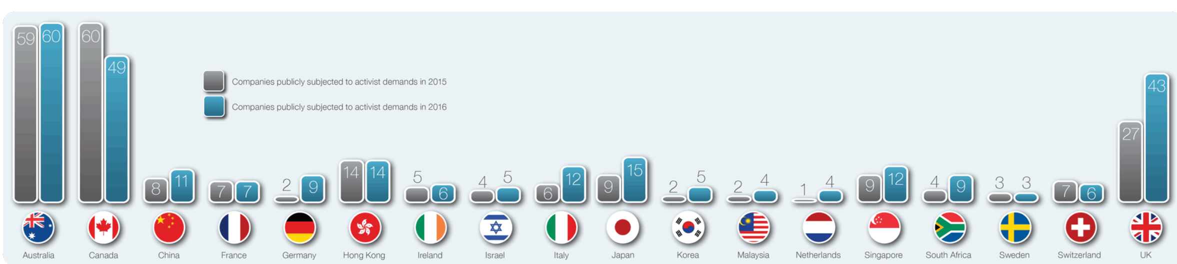
Event-driven Europe

The U.K. has always been at the forefront of European activism, and 43 companies publicly targeted in 2016 had their headquarters in the country—up from 27 in 2015.

The outcome of the Brexit referendum in June did not scare activists away. Instead, London-based RWC Partners and U.S. activist Livermore Partners said in interviews with Activist Insight that Brexit made potential targets cheaper. Livermore's David Neuhauser added that the increased uncertainty will force British companies to seek ways to unlock shareholder value, creating opportunities for activists.

In Germany, where the number of companies targeted rose from a six-year nadir of two in 2015 to nine in 2016, and in Italy, where it rose from six to 12, the surge was partially correlated with the increasing presence of foreign institutional investors in the two countries. In the second half of 2016, governance adviser CamberView Partners boosted its European office, and the firm's new managing partner for the region, Jean-Nicolas Caprasse, told Activist Insight that Continental Europe has seen an increased presence of institutional investors from the U.S. and the U.K.—ideal interlocutors for activists.

Along with established activists Elliott Management and Amber Capital—both extremely busy in Europe in 2016—Swiss investment firm Teleios Capital Partners disclosed a series of activist positions in the U.K., Active Ownership Capital and The Children's Investment Fund Management waged historic campaigns in Germany, and British institutional investors such as Standard Life Investments, Royal London Asset Management and Hermes Investment Management were often vocal with their portfolio companies.



The Asian boom

In Japan, the number of companies targeted by activists increased from nine in 2015 to 15 in 2016. The Japanese surge was expected by many, as favoring shareholder activism was part of Prime Minister Shinzo Abe's plan to revive the country's economy. In Singapore, it increased from nine to 12, in China from eight to 11 and in South Korea from two to five—with Elliott Management once again waging a high profile campaign at the Samsung group.

David Hurwitz of SC Fundamental—which operates in South Korea in tandem with local activist Petra Capital Management—told Activist Insight that dissident investors in the country had been helped by increasingly loud calls from market participants, including the government and the

State pension fund National Pension Services, for better capital allocation at listed companies—which tend to hold huge piles of cash.

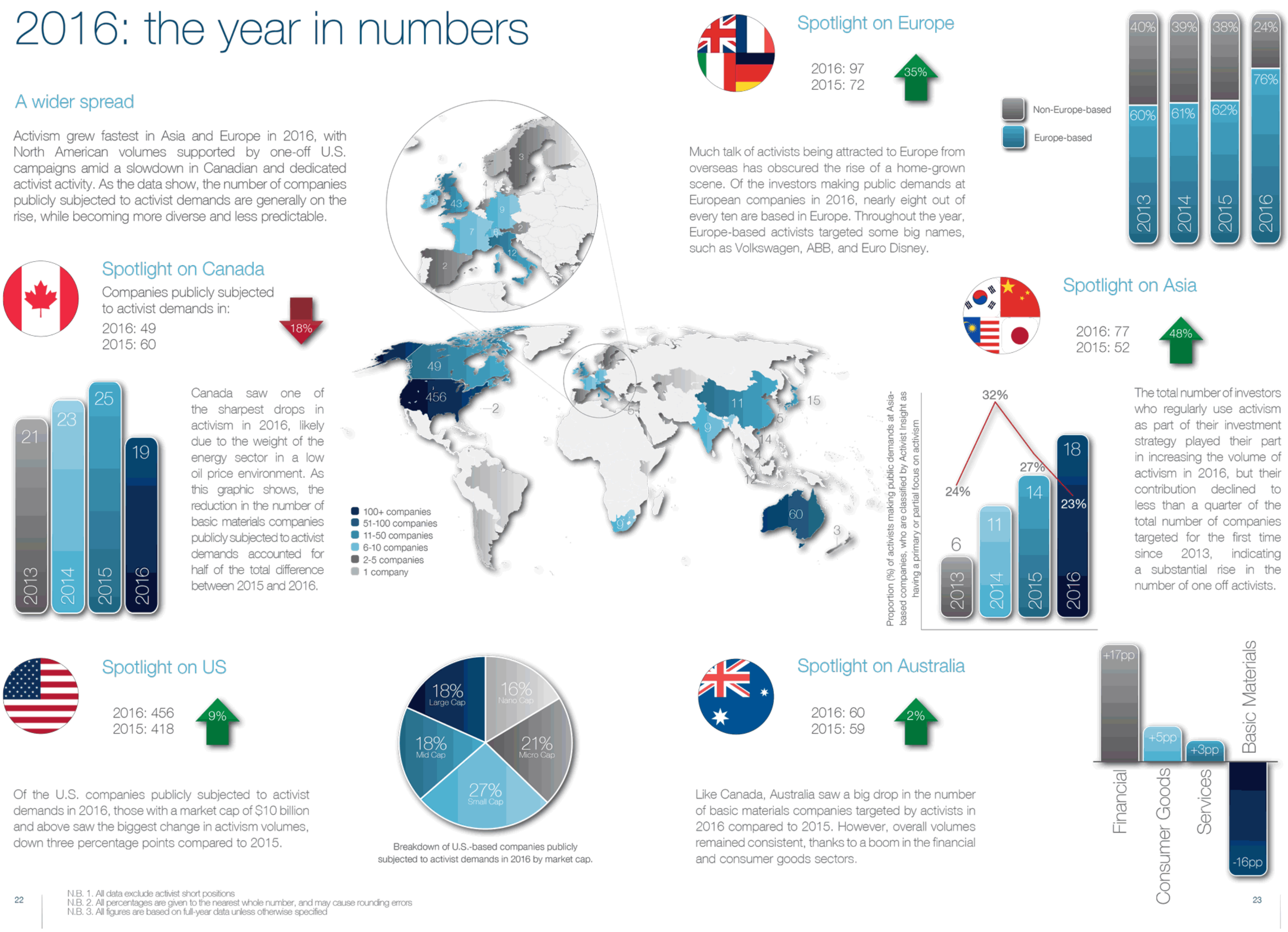
Dektos Investment's Roland Jude Thng and Quarz Capital Management's Jan Mörmann, two activists operating in Singapore, said in interviews with Activist Insight that excess cash is often an issue in Singapore too, and that the poor performance of the stock market, the undervaluation of several companies, and cultural changes are making shareholders more demanding.

As for China, most of the companies targeted by activists are listed in the U.S. or Hong Kong, due to a larger mass of institutional investors outside the mainland, according to activist Peter Halesworth, the head of Heng Ren Investments. However, in an interview with Activist Insight he said, "Some of the most energetic and clever activists that we have met are Chinese and living in China. They are very sensitized to their rights, and know a bad deal when they see one."

In India, a battle between Tata Group's patriarch Ratan Tata and Cyrus Mistry, the chairman of several of the conglomerate's portfolio companies, brought U.S.-style governance battles to the attention of the financial press for months.

Australia, and Canada's slowdown

The global surge in activism in 2016 was not driven by the basic material sector, where the number of companies targeted rose by just one, to 119, from 2015's total. Difficulties faced by natural resources companies made activists less willing to engage in campaigns in Canada and Australia, where miners and oil and gas firms have traditionally been their favorite targets. In Canada, only 49 companies faced public activist demands in 2016, down from 60 in 2015. In Australia, there were 60 targets, up from 59 a year before, and only 48% in the basic material sector, against 64% in 2015. That said, Australia has almost twice as many targeted companies per inhabitant than the U.S., while Canada does not lag far behind its neighbor.



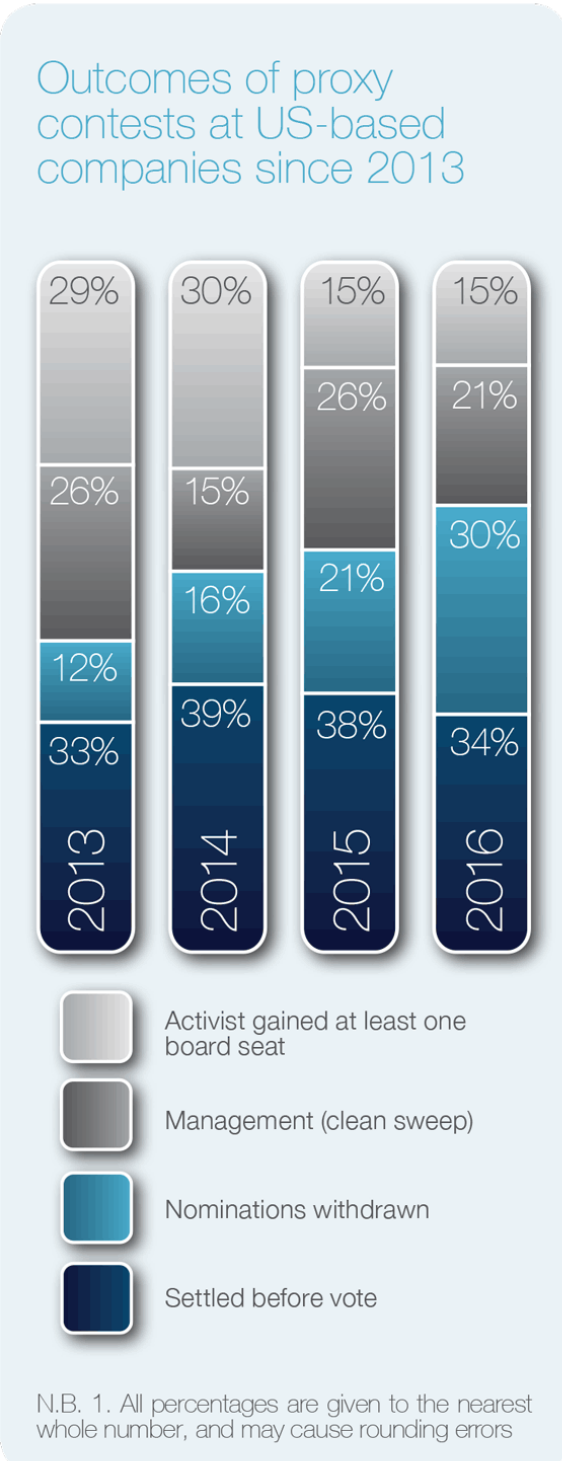
Diminishing returns

As the number of activist situations has risen over the past half-decade, the prominence of the strategy has enabled both issuers and investors to understand its capabilities and limitations, to the point that the two sides have generally avoided its most costly byproduct, proxy contests.

After two years in which more than half of demands for board seats settled before a contest, 2016 saw 63% settle early. That percentage has been on the rise since 2012, and represented a major jump from 2015, when activists and companies settled without a public spat 54% of the time.

“Management teams and boards are becoming more sophisticated and actually appreciate the value that shareholders that have a long term view can add,” said Chris Teets, partner at Red Mountain Capital Partners. “There is certainly a heightened willingness to settle between shareholders and management teams, and it tends to be the most egregious cases when you tend to see the fights.”

At the 212 U.S. companies where activists sought board seats in 2016, only 65 companies opposed nominations, and of those nearly one-third settled later in the process. Yet, while 2012 and 2013 saw the outcomes of shareholder votes go mostly to the activists, the advantage reversed in 2015 and 2016—last year dissidents won at least one board seat in nine contests, to 13 clear sweeps for management, including one for Roomba maker iRobot over Red Mountain.



While the total number of settlements has risen in recent years, investors are gaining fewer board seats overall. Where at least partially successful, activists gained 1.5 seats per company in 2016, on average, compared to 1.7 the year before and over two in each of 2013 and 2014. The trend may be attributable to a higher frequency of withdrawals, as investors make optimistic demands and then walk away from a fight after a company calls their bluff. Some 30% of contests saw activists withdraw their nominations in 2016, compared to 21% in 2015 and just 12% in 2013.

The combined effect of increased withdrawals and issuers becoming more adept at shutting out investors can be seen in the declining number of board seats gained by activists each year. After activists gained a record 276 board seats in 2014 at just 154 companies, they were only able to accrue 215 director positions in 2016 despite launching 212 campaigns aimed at board representation.

It may only get worse, according to Luma Asset Management Founder Greg Taxin, who is confident the universal ballot, which would force companies to issue a single proxy card containing both its director candidates along with the dissidents', will be approved in late 2017. The hedge fund manager admitted the rule will not be implemented until next proxy season, but unlike most investment managers, he believes it will be detrimental to activists.

"Under today's system, investors are put to a hard choice, fully support status quo, or vote on any, or some amount of change," said Taxin. "Because most companies that go to fight are well chosen by dissidents, investors vote on the dissident card, and in doing so starve management of votes, because they can't mix and match."

Taxin went on to say that under the universal ballot, investors will naturally give votes to management in addition to voting for one or two members of the dissident slate. The change would be beneficial to issuers, which would more often avoid comprehensive defeats at the hands of activists.

"I ran three proxy fights for a majority of the board and won all three times. Part of the reason I won is because they wanted some amount of change and voted on my card, and management got no votes," said Taxin said Taxin, who serves as an adviser on a number of activist situations. "They all voted for mine, because no one voted on management cards, and that wouldn't happen on the universal ballot."

Taxin's victories were not indicative of his peers' success in 2016, and perhaps the pendulum will swing back in their favor in the 2017 proxy season. Four activists have already gained board representation in 2017 and several have threatened to go all the way to a vote as annual meeting season begins.

Spread betting

Over the past couple of years, we've watched activist short calls grow from a relatively unknown phenomenon to target 112 companies in 2013 and a whopping 205 in 2015, according to Activist Insight data. The question on all of our minds was whether activist short sellers' momentum would continue at an equally fast trajectory. In fact, 2016 saw 193 companies targeted, slightly lower than the year prior. And, instead of adding to their campaigns at home, several prominent short sellers this year turned to new markets and began a year of laying the foundations for short campaigns to come.

Eyes on Asia

Most notably in 2016, activist short sellers flung open the doors to Japan, beginning with Well Investments Research's campaign at Marubeni in December 2015. Well Investments went on to launch campaigns at three more Japanese companies in 2016.

It wasn't long until prominent short sellers Muddy Waters Research and Glaucus Research took notice, each announcing an activist short campaign of their own; Horseman Capital Management and Oasis Capital Management also unveiled Japanese shorts in 2016, bringing the campaign from zero in late 2015 to a remarkable 11 by the end of 2016.

Discussing his turn to Japan, Well Investments' Yuki Arai credited the country's new focus on corporate governance as an opportunity to take a fresh look at mispriced assets. This attitude may have spilled over into the rest of the region; South Korea saw its first activist short less than three months after Arai first published in Japan, with the launch of Ghost Raven Research's campaign at $10 billion biologics company Celltrion. The next month, we followed the first activist short campaign in Taiwan when The Street Sweeper discussed Himax Technologies.

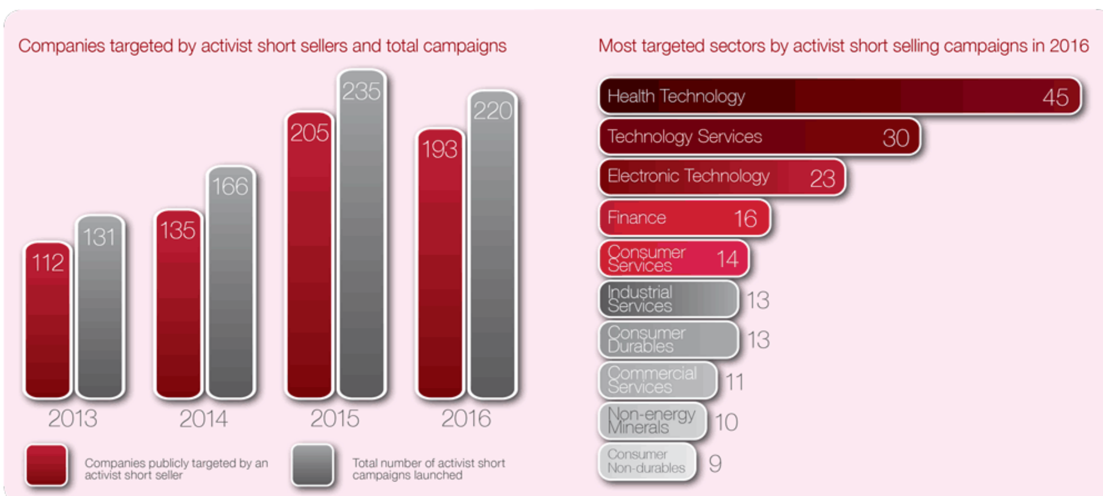
Beginning a long road

Citron Research's Andrew Left is a big exponent of short selling in Asia. When questioned on where he and his kind will look for opportunities in 2017, Left was decisive: "There is a lot of fraud in Japan," he notes. Yet for Citron, Hong Kong, the favored domain of activist short sellers for several years, "is pretty closed," after 2016 saw Left found guilty of using "sensationalist language" and making false claims—a verdict he says sanctioned him "for telling the truth." Hong Kong is "still a different kind of market," he argues.

Other prominent activist shorts seem to disagree. Anonymous Analytics wrote in a July report for Activist Shorts Research, before its acquisition by Activist Insight, that the road ahead for Hong Kong to clean up "remains long and will be littered with the corpses of more fraudulent companies to come." Muddy Waters' Carson Block is on the same page, having promised in December to seek out more Hong Kong targets on concerns of stock manipulation.

GeoInvesting, which has launched campaigns at over 30 companies in China and Hong Kong according to Activist Insight data, also pledged in March to continue cleaning up China based fraud—most recently combining with long activist Heng Ren Investments to air allegations against Sinovac Biotech.

But Left hopes Japan will be different. "With Abenomics, we're closer and closer to cracking Japan," he said. "Japan has been a very closed system for years. The shorts haven't really worked it out to where they should, but once Japan learns that activist shorts actually add value, there is going to be a lot of opportunity there for shorts. But in the long run, that's going to be very good for their markets." Left added, "It's a cleansing process."



Shorts go global

Companies outside of Eastern Asia haven't escaped scrutiny. The year also saw the first campaign at a Bahamas-headquartered company, with Richard Pearson targeting Nymox Pharmaceutical.

Further, Muddy Waters' Block came through on his Fall 2015 promise to target the "ticking time bombs" of Western Europe, following a theme for 2016 of shorting heavily financially engineered companies. After the activist's October 2015 short of $24 billion Swedish telecom company TeliaSonera, as well as its December 2015 short of French grocer Casino and Casino's parent company Rallye, Muddy Waters delivered our second German short of 2016 with a campaign at media company Ströer in April.

However, beating Muddy Waters to the punch in Germany, which had not seen activist short activity since 2013, was a new, anonymous short seller called Zatarra Research & Investigations. The activist launched a relentless campaign in February against $6 billion payments company Wirecard, which saw a regulatory inquiry, the rise of an anonymous whistleblower and comments from noted short seller Bronte Capital, as well as reported legal action against both the short seller and the company.

Where to next?

At the same time, other activist shorts continued pursuing some of their most reliable targets. For the fourth year in a row, health technology companies were the most popular sector for shorting. Following Valeant Pharmaceuticals in 2015, activists such as Citron Research kept the conversation in 2016 focused on pharmaceutical and biotechnology companies, including targets such as Express Scripts and AveXis.

Speaking with Activist Insight on shorts' interest in health technology companies, Andrew Left of Citron Research noted that "the mega trend is 'banks are the new pharma, and pharma is the new banks.'" He added that "any pharma company that has built its business on raising prices is gone."

Behind the calls

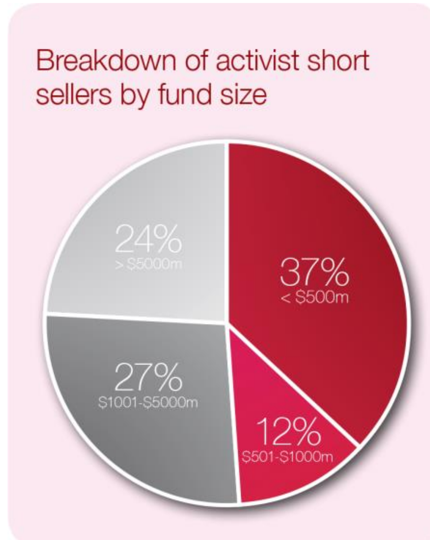
Types of activist short sellers

According to Activist Insight data, activist short sellers are more often than not anonymous entities and funds. Much less often, activist short sellers are classified as single individuals launching a short campaign.

2014 was a banner year for the debut of new, anonymous shorts, which have since decreased slightly. The number of new funds unveiling an activist short strategy peaked in 2015, meanwhile, at 18. With fewer new activist short sellers of all types in 2016, the balance between fund manager and anonymous was more balanced than ever.

Size of funds

Short calls come from funds of all sizes, where total assets under management (AUM) figures are known. Perhaps surprisingly, the average activist short seller classified as a fund has a median AUM of $1.1 billion. But that hasn't stopped smaller funds, particularly the 15 activist short funds with less than $500 million in known AUM. Funds in that category, including prominent short sellers like Bronte Capital and Kerrisdale Capital, have launched 70 campaigns so far since January 2013, which represents 10% of all campaigns and a remarkable 40% of campaigns launched by funds.



Location, location, location

More often than not, activist short sellers are based in the U.S., regardless of whether they are a fund, an individual or an anonymous entity. But as short sellers extend their global reach into new markets, so do the locations of the activists themselves. This year saw the debuts of short sellers located in Singapore, Canada, Hong Kong and the U.K.. Notably, the count of known U.K. activist short sellers doubled from two to four in 2016, and we saw the first known activist short seller based in Singapore.

The complete publication is available here.

Proxy Fights: Don't Underestimate the Risk

Posted by Kai Haakon E. Liekefett, Vinson & Elkins LLP, on Thursday, February 16, 2017

Editor's note: Kai Haakon Liekefett is partner and head of the Shareholder Activism Response Team at Vinson & Elkins LLP. This post is based on a Vinson & Elkins publication.

"We are no target for shareholder activists." I hear this every other day. From small- and mid-cap companies (and sometimes even large caps) all across the U.S. and abroad, from executive officers, board members and others. Occasionally this assessment is correct. More often than not, however, it is not. It only reflects common misconceptions.

For example, many companies believe that shareholder activism is on the decline because they do not read about it in the news all the time any more. In fact, shareholder activism is as prevalent as ever. There were 233 *publicly reported* activism campaigns in the U.S. in 2016. Since many activism situations are resolved outside the public eye, we estimate that the number of *actual* activism campaigns is at least 400 annually. There are around 4,200 public companies in the U.S., which means that activists will target approximately 10% of Corporate America—each year.

Many small- and mid-cap companies seem to believe that shareholder activism affects only larger companies. After all, the national media outlets report only about proxy contests against the likes of *Yahoo!* and *DuPont*. Nothing could be further from the truth. Last year, 52% of all publicly-reported activism campaigns and 83% of all proxy contests targeted companies with a market capitalization of under $1 billion. In other words: it is really high noon for small- and mid-cap companies. And yet many of them don't realize this and don't even own a gun—let alone the right types of bullets—for their highly likely showdown with an activist. This post describes five of the most egregious mistakes these woefully unprepared companies are making.

Mistake #1: Inadequate Charter and Bylaws

Do you know what your charter and bylaws provide for contested director elections? Most public companies, in particular smaller ones, have hopelessly inadequate organizational documents for proxy fights. The problem is that they all have bylaws that were put in place many years ago at the IPO stage. Often times these bylaws were drafted by a mid-level capital markets associate who pulled a form and filled in the blanks—but who has never seen a proxy fight. In an activism situation, every word in your bylaws matters and may take on new significance. In our practice, we find at least 10 to 15 mistakes and vulnerabilities in every set of bylaws that we review.

The reality, however, is that the bylaws of most companies have actually never been reviewed someone who fights proxy contests for a living. It is critical to retain a proxy fight specialist to review a company's charter and bylaws—and not regular outside counsel who most likely has never been involved in a proxy contest and thus does not know what to look for.

Mistake #2: "Shelf" Poison Pill is Not Operational

Most companies do not have an active shareholder rights plan (aka "poison pill") to limit stock accumulations to a certain threshold (e.g., 10%). In the absence of a specific threat, companies are generally advised not to adopt a poison pill because proxy advisory firms (ISS and Glass Lewis) and institutional investors generally oppose poison pills.

The alternative to outright adoption is placing a poison pill "on the shelf." This means that the poison pill documentation is fully drafted and ready for adoption. This enables the board to react quickly in the event an activist rapidly accumulates a stake. Many small- and mid-cap companies do not have a "shelf" poison pill at all—or they have a poison pill that is actually not fully operational. The problem is that most law firms who provide their clients with a "shelf" poison pill have no experience with adopting them. Therefore, these law firms—let alone their clients—do not even realize that their "shelf" poison pill actually does not work as drafted and do not understand the practical steps required to adopt it. It takes them often days to adopt a poison pill.

A shelf poison pill that cannot be adopted overnight is a tool than cannot serve its intended purpose when it's needed most. If it takes a few days, the activist can continue adding shares to its already sizable stake and gain further tactical leverage over the company.

Mistake #3: No Adequate Stock Surveillance

Even if a company has a fully operational poison pill on the shelf, its effectiveness as a defense measure is severally impaired without proper stock surveillance.

Most activists quietly amass a significant stake under the radar, called a "beachhead." Most regulatory reporting regimes contain enough loopholes to enable a dawn raid of an activist. Most notably, in the U.S., an activist has ten days after crossing the 5% threshold before filing of a Schedule 13D with the SEC. Shrewd activists use this ten-day window to buy as many shares as possible. For example, recently a company woke up to an initial Schedule 13D filing with a new 25% activist shareholder—and the company had never even heard of the activist before the filing was made.

In an era of shareholder activism, it is therefore important to watch the trading in a company's stock. Most small- and mid-cap companies do not use a stock watch firm or they use a service that is not paying close enough attention. In fact, most stock watch firms only monitor basic trading metrics which will do very little to help a company identify an activist lying in wait. Stock watch is more art than science. Only a handful of stock surveillance firms have their ear to the ground, read the tea leaves when reviewing a company's DTC transfer sheets and can give a company a heads-up in a case of rapid and furtive stock accumulation by an activist.

Mistake #4: Unprepared Meetings with Activists

“I don’t need anyone to babysit me. If I can’t handle a one-one-one with a shareholder, I have no business being the CEO of this company,” the CEO of a billion dollar market cap company told me when explaining why he did not need to hire activism advisors. Six months later, he was “retired.”

Many executives are eager to meet activists face to face—and they underestimate their adversary. The first meeting with an activist often comes as a shock: many activists are testing executives by intentionally pushing their buttons. And most activists are quite adept at this since they do this all the time (some are even trained by former CIA or FBI interrogators). Most executives are successful businessmen who are used to people admiring and courting them. They are not used to open criticism, let alone an aggressive confrontation. The result is often disastrous. Some executives become first defensive, then aggressive and then say things they later regret—which is exactly what the activist was looking for. The activist will use these sound bites against the company in the “court of public opinion” during a live campaign.

So how do you prevent this from happening? Preparation, preparation, preparation. We firmly believe that the proper groundwork for a meeting with an activist is like deposition prep in litigation. It is critical to take clients through a simulated meeting with an aggressive activist and equip them with responses to the most likely tough questions and statements.

The problem is that in at least half of the situations we become involved in, the company has already been talking to the activist for weeks or even months—without prior preparation. Investor relations officers often times do not even recognize investors as activists. Of course everyone knows Carl Icahn, Pershing Square and Starboard, but there are over 200 other activists operating in the U.S. alone and many investor relations officer do not know them. We have seen companies set up meetings even with the likes of ValueAct, Elliot and Raging Capital without knowing they are well-known activists. Uninformed investor relations officers also allow activist investors to ask questions on earnings calls, facilitating a public take-down of management in front of all the company’s major investors and analysts. The same happens at industry conferences: often the conference organizers are arranging for one-on-one meetings between activists and unwary companies—often with unfortunate consequences.

The take-away is that your company’s investor relations officer should run every inbound inquiry from new investors by activism specialists in order to identify activists in a timely manner and schedule a prep session before speaking with an activist by phone or in person.

Mistake #5: No “Break the Glass” Response Plan

Activist attacks rarely come out of the blue, but either way it is important to have a “break the glass in an emergency” response plan.

Every company should retain a response team that includes an investment banker, special proxy fight counsel, regular outside counsel, PR firm and proxy solicitor—and designated personnel at the company. This response team should prepare a detailed response plan and standby press release for the most likely contingencies (e.g., plain or aggressive Schedule 13D filing, nasty public letter, or an unsolicited takeover bid).

The team should get together on a call once a quarter to update the company on any threats or trends and to review the company's shelf poison pill, bylaws and corporate governance practices to make sure they are state-of-the-art from proxy fight perspective. Moreover, companies should take their board of directors through a "shareholder activism boot camp," including a mock proxy contest.

In our experience, companies with a response plan in place are, in fact, less likely to ever have to "break the glass"—these companies are one step ahead of the activists, making an attack much less likely.

Conclusion

We hear from many small- and mid-cap companies that they are reluctant to invest time and effort into shareholder activism preparation. This never ceases to amaze me. In an era of shareholder activism, chances of an activist attack on your company are high, and increasing. If your company was not the target of an activism campaign in 2016, chances are higher you will confront one in the next year or so. It borders on malpractice not to prepare for this contingency. After all, everyone is buying homeowner's insurance even though likelihood of a fire is low. So why would you not insure your company against shareholder activism when the odds of being confronted by an aggressive activist are so much higher?

Dancing with Activists

Posted by Lucian A. Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch, on Tuesday, May 30, 2017

Editor's note: Lucian Bebchuk is Professor of Law, Economics, and Finance, and Director of the Program on Corporate Governance, at Harvard Law School; Alon Brav is Professor of Finance at Duke University; Wei Jiang is Professor of Finance at Columbia Business School; and Thomas Keusch is Assistant Professor of Accounting and Control at INSEAD. This post is based on their study, Dancing with Activists, available here. This study is part of the research undertaken by the Project on Hedge Fund Activism of the Program on Corporate Governance. Related Program research includes The Long-Term Effects of Hedge Fund Activism by Bebchuk, Brav and Jiang (discussed on the Forum here); and The Law and Economics of Blockholder Disclosure by Lucian Bebchuk and Robert J. Jackson Jr. (discussed on the Forum here).

We recently released a study, entitled Dancing with Activists, that focuses on "settlement" agreements between activist hedge funds and target companies. Using a comprehensive hand-collected data set, we provide the first systematic analysis of the drivers, nature, and consequences of such settlement agreements.

Our study identifies the determinants of settlements, showing that settlements are more likely when the activist has a credible threat to win board seats in a proxy fight. We argue that, due to incomplete contracting, settlements can be expected to contract not directly on the operational or leadership changes that activists seek but rather on board composition changes that can facilitate operational and leadership changes down the road. Consistent with the incomplete contracting hypothesis, we document that settlements focus on boardroom changes and that such changes are subsequently followed by increases in CEO turnover, increased payout to shareholders, and higher likelihood of a sale or a going-private transaction.

We find no evidence to support concerns that settlements enable activists to extract significant rents at the expense of other investors by introducing directors not supported by other investors or by facilitating "greenmail." Finally, we document that stock price reactions to settlement agreements are positive and that the positive reaction is higher for "high-impact" settlements. Our analysis provides a look into the "black box" of activist engagements and contributes to understanding how activism brings about changes in its targets.

Below is a more detailed account of the analysis and findings of our study.

In August 2013, Third Point, the hedge fund led by Daniel Loeb, disclosed a significant stake in the auction house Sotheby's, criticized the company for its poor governance and its failure to take advantage of a booming market for luxury goods, and called for the ouster of the company's CEO. Third Point launched a proxy fight for board representation and both sides prepared for a contested election at the company's upcoming annual meeting. However, the day before the scheduled annual shareholder meeting, the company's board of directors and the activist fund entered into a settlement agreement in which Sotheby's agreed to appoint three of the Third Point director candidates and Third Point agreed to discontinue the proxy fight. The settlement terms did not require the company to make any of the operational and executive changes that Third Point was seeking. However, ten months later, Sotheby's announced the hiring of a new CEO, the appointment of a new board chairman, and a plan to return capital to its investors.

While such settlements used to be rare, they now occur with significant frequency, and they have been attracting a great deal of media and practitioner attention. Understanding settlement agreements is important for obtaining a complete picture of the corporate governance landscape and the role of activism within it. Using a comprehensive, hand-collected dataset of settlement agreements, we provide in this study the first systematic empirical investigation of activist settlements. We study the drivers of settlements, their growth over time, their impact on board composition, their consequences for the operational and personnel choices that targets make, and the stock market reaction accompanying them. We further study the aftermath of settlements in terms of CEO turnover, payouts to shareholders, M&A activity, and operating performance.

With the growing recognition of the importance of hedge fund activism, a large empirical literature on the subject has emerged (see Brav et al. (2015b) for a recent survey). This literature has studied the initiation of activist interventions—the time at which activists announce their presence, usually by filing Schedule 13(d) with the SEC after passing the 5% ownership threshold, and the stock market reactions accompanying such announcements. This literature has also studied extensively the changes in the value, performance and behavior of firms that take place during the years following activist interventions; among other things, researchers have studied the changes in Tobin's Q, return on assets (ROA), payouts to shareholders, capital structure, likelihood of an acquisition, and accounting practices that ultimately follow activist interventions. But there has been limited empirical work on the "black box" in between—the channels through which activists' influence is transmitted and gets reflected in targets' economic outcomes. In particular, the determinants, nature and role of settlement agreements—and the cooperation between activists and targets that they introduce—have not been subject to a systematic empirical examination. We attempt to help fill this gap.

We begin by investigating the factors that determine the likelihood that an activist will be able to obtain a settlement agreement. Building on insights from the economics of settlements, we hypothesize that an activist will need to have a credible threat to win seats in a proxy fight to be able to extract a settlement agreement. Consistent with this hypothesis, we find that the likelihood of a settlement agreement in general, and a "high-impact" settlement agreement involving a substantial change in company leadership, covaries with several factors that are associated with improved odds for the activist in winning board seats in a proxy fight.

We quantify the upward trend in activist settlements. In particular, we show that the unconditional likelihood of a settlement increased threefold from the time period 2000-2002 (3%) to the period 2003-2005 (9%), increased by another 56% during 2006-2008 (14%) and by 29% during 2009-2011 (18%). These results hold when controlling for target and activist characteristics. Consistent with the view that settlements require activists having a credible threat to win board seats in a proxy fight, we argue that the increase in the settlement rate was driven by the growing willingness of institutional investors and proxy advisors to support activists, which in turns strengthened the credibility of the activist's threat to win seats in a contest.

Turning to the terms of settlements, we explain the cost and difficulty of entering into contractual agreements that specify ultimate outcomes—the types of changes in operations, strategy, payouts or executive personnel that activists often seek. We document that settlements indeed rarely stipulate directly such outcomes. Rather, activists commonly settle on changes in board composition. We demonstrate that settlements are a key channel through which activists bring about board changes and we investigate the nature of these changes, showing that they bring about an increase in the number of activist-affiliated and activist-desired directors, well-connected directors and decrease the number of old and long-tenured directors.

Why do activists settle on changes in board composition if their ultimate goal is in bringing about operational or personnel changes? We argue that introducing individuals into the boardroom who are sympathetic, or at least open to the changes sought by the activist, is an intermediary step that can facilitate and bring about such changes. Consistent with this view, we show that, while settlements generally do not specify an ouster of the CEO, settlements are followed by a considerable increase in CEO turnover and in the performance-sensitivity of CEO turnover in the years following the settlement. Thus, settlements often plant the seeds for a subsequent CEO removal that is more face-saving to the CEO and the incumbent directors than an immediate ouster would be. Similarly, while settlement agreements generally do not specify operational changes, we document that such changes do follow in subsequent years. Settlements are followed by increased payouts to shareholders, a higher likelihood of target firms being acquired, and improvements in ROA.

We also investigate concerns raised by practitioners and the media that settlements between activists and targets enable activists to extract rents at the expense of other shareholders who are not "at the table" when the settlement is negotiated. We examine two suggested channels for such rent extraction and find little evidence that settlements provide activists with significant rents at other shareholders' expense. First, we find no evidence that settlements enable activists to put directors on the board who are not supported by other shareholders. Directors who enter the board through settlements do not receive less voting support at the following annual general meeting than incumbent directors or those activist directors who get on the board without a settlement. Second, we find little evidence that settlements produce a significant incidence of "greenmail" by getting the target to purchase shares from the activist at a premium to the market price; buybacks of activist shares occur in a very small fraction of settlement agreements and, when they do occur, they are typically executed at the market price.

Finally, we analyze the stock market reactions accompanying the announcement of a settlement agreement. Settlements are accompanied by positive abnormal stock returns. Furthermore, we find that the positive abnormal returns are especially large when the settlement is "high impact" in terms of introducing two or more new directors or providing for an immediate CEO turnover. This pattern is consistent with the view that the market welcomes the boardroom and leadership changes that activist settlements produce and inconsistent with the view that such changes can be expected to be disruptive and detrimental to other shareholders.

Our study is available for download here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Balancing Concessions to Activists Against Responsiveness to the Broader Shareholder Base

Posted by Ethan A. Klingsberg and Arthur H. Kohn, Cleary Gottlieb Steen & Hamilton LLP, on Tuesday, April 4, 2017

Editor's note: Ethan A. Klingsberg and Arthur H. Kohn are partners at Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb publication by Mr. Kohn, Mr. Klingsberg, Elizabeth Bieber, and Rolin Bissell. 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 Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

Quick settlements with activist hedge funds to recompose boards and adjust strategic plans have resulted in hundreds of new directors and changes to stand-alone plans in the S&P 500 over the last two years. The arguably outsized influence of these activists, which often own less than 5% of their targets' public floats, led one of the leading hosts of index funds, State Street, to issue publicly a position paper earlier this year in opposition to this "quick settlement" trend.[1] Underlying State Street's concern is the view that incumbent directors frequently settle to avoid the painful scrutiny and distraction of proxy contests while failing to take into account the sentiments of their companies' broader shareholder bases. The views of State Street and the other major index funds matter not only because these "passive"-strategy funds regularly control up to 40% of the public floats of listed companies, but also because that figure is likely to continue to rise steeply, along with similar increases in the interest of these funds in (as well as the number of personnel at these funds scrutinizing) governance, board composition and processes, and strategic shifts at publicly traded companies. As a result, targets of activist campaigns are increasingly struggling with balancing the benefits of a quick and comprehensive settlement with activist hedge funds against the desirability of assuring that there is broad shareholder support, especially among long-term institutional holders, for making concessions to the activists.

CSX's quick settlement earlier this month with relative-newcomer activist hedge fund Mantle Ridge fits within this mold of quick and significant concessions to less than 5% holders, but includes some novel characteristics indicative of the target company's concerns about responsiveness to its broader shareholder base. In a mere 47 days, Mantle Ridge's campaign netted four new non-management board seats, a promise that the board would not be expanded until the 2018 annual meeting, and the installation of a new CEO, E. Hunter Harrison, who came on board from competitor Canadian Pacific with a new stand-alone strategic plan for CSX. The scope of these concessions was on the high end of the spectrum for a settlement with an activist hedge fund. Four seats exceeds the typical activist settlement of one to three seats. Moreover,

[1] http://newsroom.statestreet.com/press-release/corporate/state-street-global-advisors-calls-corporations-protect-long-term-shareholde

while the commencement of an activist campaign significantly increases the likelihood that there will be CEO turnover within the next one-to-two years,[2] the installation of a new CEO and operating plan does not typically happen with the speed seen at CSX.

Against this backdrop, the incumbent board of CSX took some novel steps to assure that it was acting with the support of the broader shareholder base. First, 27 days into the discussions between the activist and the company, the board announced that it had reached an impasse with the activist and would be calling a special meeting of the shareholders "to seek guidance from shareholders on whether CSX should agree to Mr. Harrison's and Mantle Ridge's proposals" and that the board would not be issuing any recommendations to shareholders in connection with this vote. Then, when the board reached a settlement agreement with Harrison and the activist fund 20 days later, the company abandoned the special meeting idea, but the settlement announcement provided that:

- Portions of the new CEO's pay package would be put to an advisory vote at the company's next annual meeting of shareholders (on which vote the board again indicated that it would not provide any recommendation)
- The decision of the board whether to have the company assume these portions of the package would be deferred until after this advisory vote, and
- The new CEO intended to resign if the board elected not to have the company assume these portions of his package.

Harrison's aggregate package was reported to be valued at about $300 million over four year—high relative to peers, but low relative to the approximately $10 billion surge in CSX's market capitalization in response to the initial news that Harrison was considering the job. The portion subject to a vote is a requested reimbursement for the $84 million of compensation and benefits forfeited by Harrison as a result of his separation from Canadian Pacific, and the provision of a related tax indemnity. If Harrison resigns because the company does not agree to be responsible for the $84 million payment and related tax indemnity, it appears that he will be entitled to a severance payment of approximately $5 million and that Mantle Ridge will in turn cover the $84 million reimbursement and related tax indemnity.

Putting this, or any, portion of a CEO's pay package to an advisory vote of shareholders is highly unusual and categorically different than the usual say-on-pay vote about pay policies generally. Through this additional say on CEO pay vote, shareholders are being given the gift of a unique opportunity to register their opinions on a controversial topic and arguably the strategic direction of the company which is tied to the new CEO's presence. This aspect can be seen as a positive development for shareholder rights generally, and more specifically can be seen as responsive to State Street's open letter criticizing companies for settling with activists too quickly and without long-term shareholder input. However, a reasonable argument could be made that the shareholder vote is less a move toward shareholder rights and involvement, than a veneer to shield the board from a tough call. Do shareholders or the board really have a choice?[3] If the

[2] A 2016 study by FTI Consulting stated that CEO turnover when an activist gained board seats was 34.1% and 55.1% over a one and two year period, respectively, compared to 16.6% and 30.9% over the same respective periods without an activist in the boardroom.

[3] See, e.g., "CSX CEO Hunter Harrison's Pay Is No Great Train Robbery", Fortune Magazine (March 24, 2017), at http://fortune.com/2017/03/24/csx-hunter-harrison-pay/ (the "Fortune Article") ("Earlier this month, when Harrison took the job of CEO of the nation's No. 3 railroad CSX some critics said the exec, who has proven adept at turnarounds, was essentially holding up his new shareholders by demanding they make good on the $84 million payday he walked away from when he exited his old job. It seemed to be another example of CEO pay going off the rails.")

compensation is not approved, CSX will suffer from the disruption of having to undergo another transition at the helm as well as interference with the implementation of the company's strategic plan.

Where does this leave the board? Although the board has publicly indicated that it is uncomfortable with certain aspects of the CEO's compensation, the board is unwilling to make a recommendation to shareholders on the matter. While there is established precedent that informed and uncoerced shareholder votes insulate director liability, the CSX board's approach in the instant situation may raise as many issues as it solves. In particular, the board's decision not to make a recommendation raises the question of whether the directors are abdicating their duty to manage the affairs of the corporation.

CSX is incorporated in Virginia, where the applicable standard of review of compliance by directors with their duties is arguably more favorable to the directors than the standard applicable to directors of a Delaware corporation. The board of directors of a Delaware corporation has not only the statutory authority to manage the corporation under 8 Del C, §141(a), but also the fiduciary duty to carry out that statutory authority with due care.[4] Under Delaware law, the failure of the board to disclose to the shareholders its informed view on the advisability of approving a matter on which the shareholders are being asked to vote will expose such board to the charge that it has failed to carry out its duties to manage the affairs of the corporation in good faith and to disclose all information material to the shareholders' decision.[5] In short, the board of a Delaware corporation could not submit for a shareholder vote this matter of the CEO's pay package without disclosing the reasons why the board's informed deliberations led to a determination that approval of the pay package was either advisable or inadvisable. Furthermore, although federal securities laws do not impose the same duty on directors as state corporate law to arrive at an informed view, a similar disclosure issue would exist under the Securities Exchange Act of 1934 to the extent the directors have informed views but are holding them back while asking the shareholders to vote without guidance.[6]

Moreover, under Delaware law it is even doubtful that, as a matter of statutory mechanics, a corporation may submit a matter to a shareholder vote without the board's having first resolved to approve the matter in question. 8 Del C. § 146 permits a corporation to agree to submit a matter to a shareholder vote "whether or not the board of directors determines at any time *subsequent to approving* such matter that such matter is no longer advisable and recommends that the stockholders reject or vote against the matter." (emphasis added) This language contemplates that a board must approve a matter before agreeing to submit it to shareholders. Although a board may later change its recommendation, there is no procedure under Delaware law for putting a matter to a shareholder vote without the board's having at least initially determined to approve the matter in question.

Finally, the efficacy of a stockholder vote and any insulation from liability the board may wish to gain from it is premised on the assumptions that the vote is un-coerced and the voting

[4] See e.g., *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227,240 (Del. 2008)(determining that a proposed shareholder adopted bylaw mandating election expense reimbursement was invalid because the bylaw contained no language or provision that would reserve to CA's directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all); and *Smith v. Van Gorkum*, 488 A.2d 858, 873 (Del. 1985) (in connection with a shareholder vote on a merger, directors not permitted to abdicate their duty to "act in an informed and deliberate manner" by simply leaving the decision up to the stockholders).

[5] *Malone v. Brincat*, 722 A.2d 5, 12 (Del. 1998).

[6] See e.g., Rules 14a-9 and 12b-20 under the Exchange Act.

shareholders are fully informed. As discussed above, these assumptions may not hold up to close scrutiny in this instance.[7]

Nonetheless, the advisory shareholder vote concept is a novel mechanic for attempting to address the tricky balance between responsiveness to the broader shareholder base and the benefits of settling with activists. The pressure on companies to strike this balance will continue as the fount of “good ideas” from activists with minority equity positions continues at full force while the nature of public company shareholder profiles continues to increasingly skew toward huge positions by index funds. These “passive”-strategy fund shareholders in turn can be expected to become more focused in the coming years on assuring that they have a say.

[7] See the *Fortune* article (“Nixing the $84 million would send Harrison packing and the share price tumbling. Chances are excellent he’ll get the cash.”).

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The Rise of Settled Proxy Fights

Posted by Jay Frankl and Steve Balet, FTI Consulting, on Wednesday, March 22, 2017

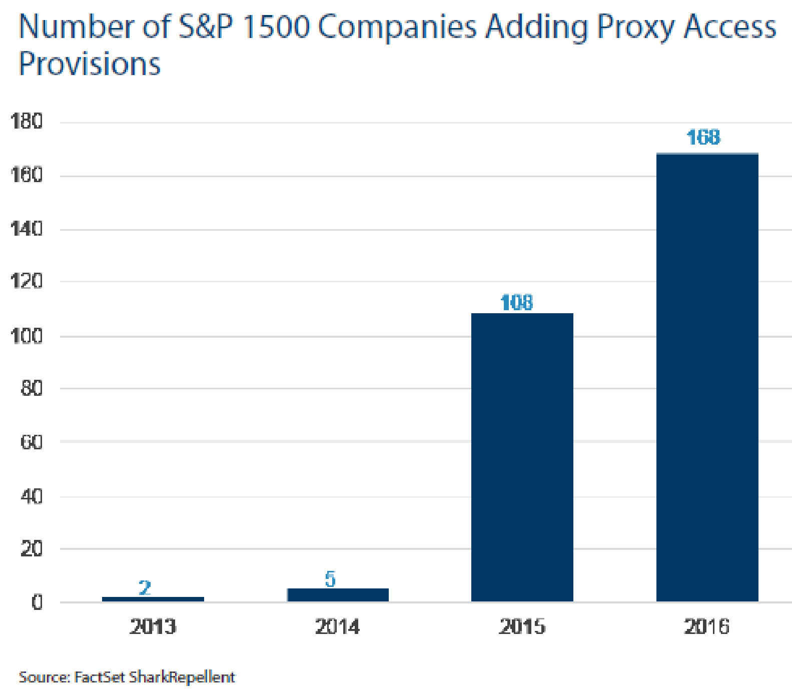
Editor's note: Jason Frankl is Senior Managing Director and Steven Balet is Managing Director at FTI Consulting. This post is based on an FTI publication by Mr. Frankl, Mr. Balet, and Merritt Moran.

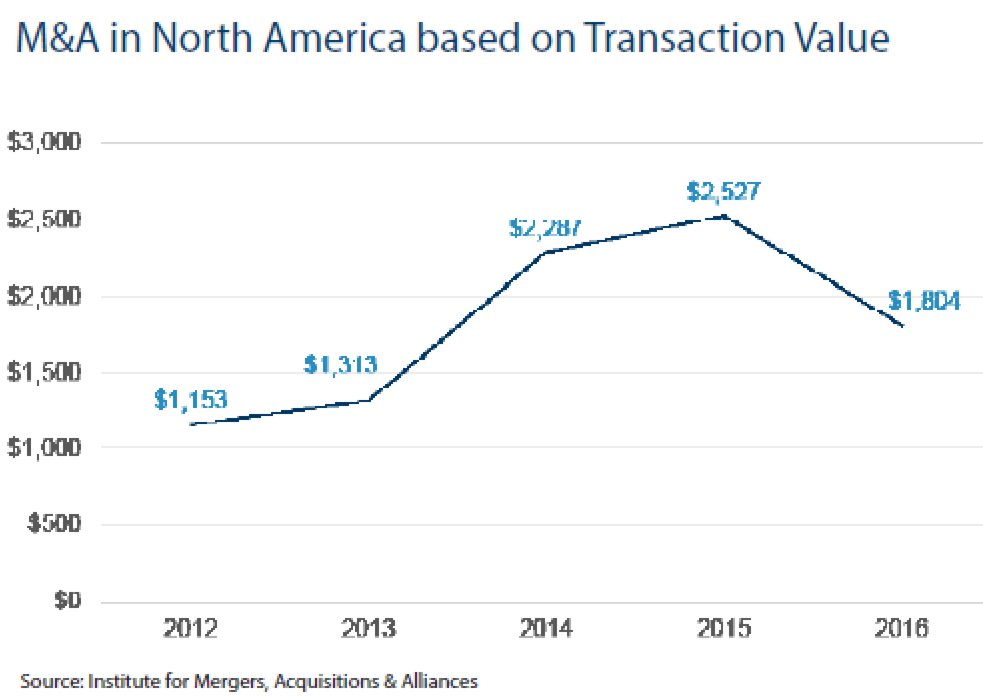
Shareholder activists showed no signs of slowing down in 2016. These investors continue to instill fear in corporate board rooms across America and bring their concerns to the public as illustrated by the growing number of proxy fights; 110 in 2016 alone, a 43% surge over 2012.[1] In that time, companies have more frequently succumbed to these investors and at times, accepted unfavorable settlement terms instead of pushing forward and fighting through a proxy contest.

In 2016, activists' objectives shifted from primarily business strategy and balance sheet activism to board-related governance. In 2013, board-related governance was one of the less common objectives, but it outpaced M&A actions this past year, which has been a dominant objective of activism since the corporate raider era of the 1980s. The surge of proxy access campaigns was a primary driver for the prevalence of board related activism. This bylaw provides certain shareholders the ability to nominate board candidates, and was voted on and adopted by over 75% of S&P 100 companies.[2] This fact alone demonstrates the strength of demand from shareholders for companies to refresh their boards and in some cases take on a "shareholder representative," also known as a dissident board candidate. One of the most prolific activists, Starboard Value, obtained eight board seats at its targets in 2016 and five board seats in 2015.[3]

[1] FactSet SharkRepellent.
[2] FactSet SharkRepellent.
[3] FactSet SharkRepellent.

Furthermore, M&A volume was down in 2016, likely due to uncertainty surrounding the administration change in the U.S., possible changes in U.S. corporate tax policy and anticipation of continued rate hikes. The combination of an uncertain investing environment and continued aggression from activists has certainly affected management decision making when engaging with activists as well. Perhaps that broadly explains why companies were much more willing to concede to activist demands to avoid public proxy fights. Perhaps it does not.

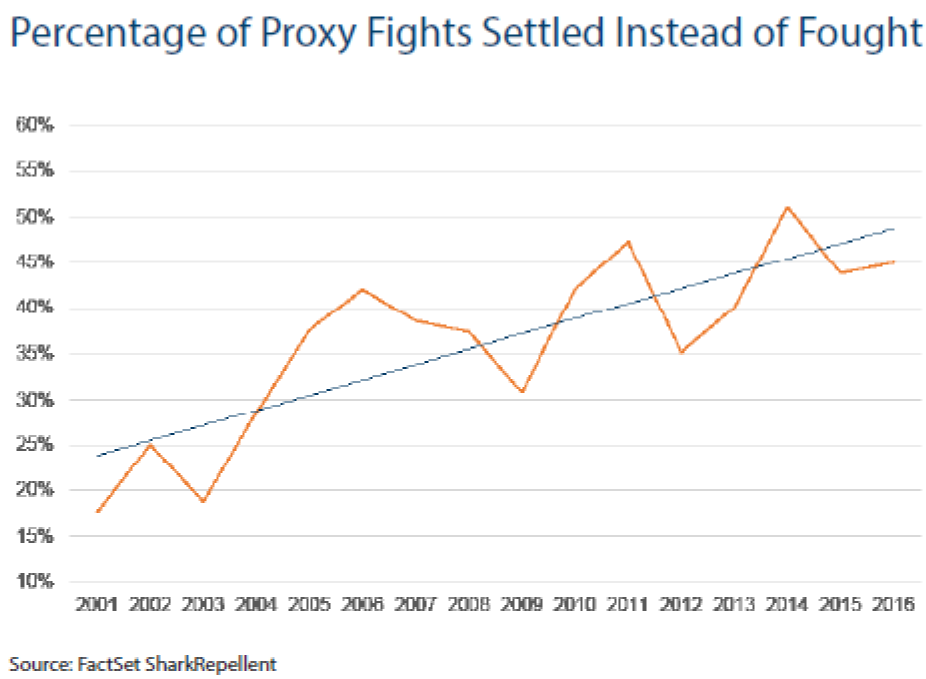




Of the 110 proxy fights in 2016, 50 ended in settlement, the most we have ever seen in a given year. Only 36 companies were willing to take the dispute to a vote in 2016, and agreed to settle in 45% of fights. The remainder of contests from 2016 are either pending or were withdrawn. This marks a significant increase over 15 years ago, when only 17.5% of fights were settled prior to a vote.[4] Additionally, these statistics only take into account the fights that reached proxy contest

[4] FactSet SharkRepellent.

phase, which suggests that even more settlements occurred in private negotiations, well before shareholder meetings.



However, of the 37 proxy fights that did make it to a vote this year, 27 were won by management; seemingly pretty good for the incumbents. Yet when examined deeper, this statistic further illustrated how willing companies have been to settle with activists. Maybe this statistic shows that companies only held their ground when a win was a near certainty. The average time to settlement, from the first campaign announcement to reaching a settlement, decreased to 56 days. In 2013, that same statistic was 146 days.[5] Together, these trends indicate the strength investors have been able to exert on target companies. An example from this year was when QLik Technologies, a $2.9 billion market cap technology company, held out for only eight days prior to settling with Elliott Management.

[5] FactSet SharkRepellent.

A Majority of the Board Seats Won by Activists in Proxy Fights are Attained Via Settlement

Proxy Fights	2014	2015	2016
Board Seats Sought by Dissidents	308	329	346
Board Seats Won by Dissidents	148	101	89
Portion of Dissident Seats Won in Proxy Fights where Settlements/Concessions Made Occurred	81	74	58
	55%	*73%*	*65%*

Source: FactSet SharkRepellent

Reasons Companies Settle

It is not surprising that companies fear public proxy fights these days as institutional investors and the media are increasingly siding with activists. At a minimum, companies take on heavy uncertainty and risk by engaging with activists. The perception change of activist investors has given the strategy a boost in popularity and media following, causing many moves companies make in proxy fights to hit front-page news. These fights can be damaging to long-term company credibility, especially those with difficult facts to defend. For example, in Starboard's fight against Yahoo!, Jeff Smith's team secured four board seats and pushed to remove CEO Marissa Mayer upon completion of the Verizon merger. Other activists have followed a similar playbook with accompanying public disclosures that highlight operational weakness and threaten credibility of existing management and boards of directors.

Beyond avoidance of public scrutiny from activist funds, some companies may settle in order to avoid the distraction and costs associated with a proxy campaign. Many companies targeted by shareholder activists are underperforming, and therefore, it can be alluring to quietly accept one or more activist nominated board members in order to quickly initiate a standstill agreement and force the activist to be silent while management executes existing strategies. This position leaves companies in a vulnerable position.

Risks of Premature Settlement

Disproportionate voting rights

In many settlement scenarios, activists gain outsized influence for the amount of investment put into company stock. Consider a company with 10 board seats. Until a shareholder owns 10% of outstanding shares, it is unreasonable to expect that shareholder should receive one board seat and receive the influence of 1/10th of the board. When a board of directors has even fewer total directors, and an activist owns less than the corresponding percentage of outstanding shares, it is effectively gaining outsized influence to the long-held corporate governance principle of one share, one vote, which continues to be embraced by Nasdaq and NYSE listing standards. For example, in Carl Icahn's insurgency at Hertz, he helped name the new CEO and three of the seven directors. Icahn reportedly held 9% of Hertz at the time and simultaneously, three non-dissident directors stepped down.

By accepting dissident board nominees, management teams are handing over a disproportionate amount of control—contrary to the one share, one vote principle, at least until the next shareholder meeting. This could introduce a harsh new reality for management teams. At the beginning of Icahn's activist engagement, he negotiated three board seats in exchange for not running a proxy contest. Two years later, Hertz's then-CEO, John Tague, was replaced by Kathryn Marinello. Activist engagement preceded CEO departures many other times in 2016.

CEO Turnover Rate after Activist Engagement—A History Lesson

FTI Consulting's Activism and M&A Solutions group looked at more than 300 activist campaigns between 2012 and 2015 and found that CEOs were three times as likely to be replaced within 12 months after an activist received a board seat compared to our baseline. Even when activists engaged a company and did not receive a board seat, CEOs were twice as likely to be replaced within the same period. Once an activist gains a board seat, his or her influence to find a new shareholder-friendly CEO increases. Our baseline includes a broad array of companies both underperforming and outperforming; therefore, these turnover statistics cannot be credited to activist investors in every case. Regardless, the jump in CEO turnover rate after an activist joins a company's board should be cause for concern for management teams.

Furthermore, of the 50 companies that negotiated settlement agreements in 2016, 11 had a management change later on in the year. These 11 situations were not all classic activist investor campaigns, however, many of the settlement agreements that CEOs accepted last year preceded their job loss. It is well understood that most management changes at that level are complicated and take time to execute. Private negotiations within the company, and between the activists and companies, may provide more insight into whether the CEO departure was planned even prior to activist engagement.

Short-termism

In the current environment, it is not always clear whether it is institutional investors or activist funds seeking change. The highest profile activist investors often seek out institutional support prior to launching their campaigns. In the 1980s, this type of partnership was unheard of (or at least unspoken).

Today, activist investors depend upon institutional support in campaigns and have been successful in attaining it. However, when it comes to settling with activists, institutional funds have recently held a more pro-management stance. Funds like State Street Global have voiced concern that the shortened period from campaign launch to settlement is causing companies to accept too harsh of settlement terms that do not take into account the prerogative of other shareholders.[6]

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[6] See State Street Press Release Dated 10/10/16: http://newsroom.statestreet.com/press-release/corporate/state-street-global-advisors-calls-corporations-protect-long-term-shareholder

Examples of settlements that preceded CEO changes this year include:

Company/Dissident	Proxy Fight Announce Date	Price At Proxy Fight Announce Date	Price EOY	% Change	Dissident Board Seats Won
Neurotrope, Inc. / Iroquois Capital Management LLC	07/07/2016	$13.44	$7.52	-44.0%	1
Team Health Holdings, Inc. / JANA Partners, LLC	02/25/2016	$44.52	$43.45	-2.4%	3
MYR Group Inc. / Engine Capital Management LLC	01/07/2016	$19.84	$37.68	89.9%	2
Cardica, Inc. / Broadfin Capital LLC	09/04/2015	$3.40	$0.96	-71.8%	5
Arotech Corporation / Ephraim Fields	12/10/2015	$1.81	$3.50	93.4%	1
PICO Holdings, Inc. / Leder Holdings LLC	01/27/2016	$8.50	$15.15	78.2%	0
LRAD Corporation / Iroquois Capital Management LLC	01/14/2016	$1.77	$1.71	-3.4%	2

Source: FactSet SharkRepellent

Institutional funds like BlackRock and Vanguard have additionally pointed out that the short-term focus of activist investors directly contradicts the best interest of institutional funds whose focus is longer-term.[7] The holding period of hedge funds is often much shorter than that of institutional funds, creating the possibility that the activist influence will negatively impair the institutional fund's interest in the long-term.

Investors in hedge funds almost always demand relatively rapid returns whereas shareholders of a public company, especially pension funds and institutional investors are more interested in building long-term, sustainable value. This conflict may not immediately materialize, especially during initial negotiations, however, the short-term perspective of the activist might manifest. Often, the demands cited are immediate in nature, such as a sale of assets or subsidiaries, share buybacks or changes in management and/or the board. Activists seldom demand investment in plants, property, and equipment over share buybacks.

Suggestions for Companies

The best defense against activist investors will always be preparedness. Our report on the basic steps companies can take to prepare and defend against activist investors dives deeper into this subject. However, aggressive activist campaigns do not always afford companies enough time to make proper preparations. When a company is in this position, management should remain reluctant to welcome dissident directors onto the board. The increased likelihood of management ouster should stand as encouragement to remove board seats as a bargaining chip in discussions with activists and seek a pro-management outcome.

[7] Letters from Blackrock and Vanguard: http://www.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2 and https://about.vanguard.com/vanguard-proxy-voting/CEO_Letter_03_02_ext.pdf

Activist suggestions are not always negative, so it is in the company's best interest to listen to activists' suggestions and, in some cases, adopt recommendations, but not give away board seats as easily as companies have this past year. Companies need to have more confidence in their ability to negotiate with activists in ways that support long-term shareholder value.

Think Twice Before Settling With An Activist

Posted by Kai Haakon E. Liekefett, Vinson & Elkins LLP, on Thursday, December 22, 2016

Editor's note: Kai Haakon Liekefett is partner and head of the Shareholder Activism Response Team at Vinson & Elkins LLP. This post is based on a publication authored by Mr. Liekefett andLawrence Elbaum. The opinions expressed in this article are solely those of the authors and not necessarily those of Vinson & Elkins or its clients. 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 Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

The vast majority of activist situations result in a negotiated settlement between the activist and the target company. The problem is that—more often than not—settlements fail to secure long-lasting peace between the parties. This post examines why many companies have "buyer's remorse" post-settlement and why a proxy fight is not the only alternative to settling with an activist.

The tide of shareholder activism keeps rising in the U.S. and elsewhere around the world. At the beginning of this era of shareholder activism, target companies fought back. For example, 15 years ago in 2001, more than 60% of the proxy contests in the U.S. went to a shareholder vote and only 20% settled prior to the shareholder meeting. Times have changed dramatically. In 2016 to date, only approximately 30% of the proxy fights in corporate America went the distance while 47% of them ended in settlements. And these numbers understate the prevalence of settlements because the vast majority of activist situations never reach the proxy contest phase. Many activist situations settle in private, confidential negotiations before any public agitation by the activist begins and long before the shareholder meeting.

Moreover, not only do parties settle more often than they did 15 years ago, they also settle much faster. The time period between the beginning of an activist campaign and a settlement has contracted significantly—from 146 days in 2013 to 60 days in 2016. Corporate America is capitulating. At times, it appears that corporate boards cannot wait to hoist the white flag and invite activists into the boardroom.

Needless to say, there are often good reasons for boards to settle. Frequently, boards and activists find sufficient common ground during private negotiations. Proxy contests are time-consuming, distracting and costly, which motivates many boards to avoid them. However, in recent years, it has become clear that many settlements did not yield the desired results. This post examines why boards should think twice before they rush into a settlement with an activist.

A Changing Investor Sentiment on Settlements

In the past, institutional investors favored settlements with activists due to the cost and distraction of proxy contests, but this sentiment has started to change. The rush to settlement in recent years has "unsettled" many institutional investors. They are now troubled that companies may settle with activists without seeking the input of other shareholders. Long-term focused institutional investors have come to realize that the short-term strategies of many activists are frequently at odds with their own investment horizon. The problem is that most activist hedge funds have relatively short lock-up periods, which is why these funds focus on short-term, event-driven strategies.

In response, several institutional investors have privately and publicly called on companies to engage with long-term investors prior to entering into a settlement agreement with an activist. For example, State Street issued a press release in October 2016 in which it called on companies to better protect long-term shareholder interests in settlements with activists. Over the past two years, other large institutional investors such as BlackRock and Vanguard have been pushing back against short-termism and hasty settlements with activists that could jeopardize long-term strategy.

Many institutional investors object to settlements that are reached outside the public eye. They would like companies to delay settlement and instead initially proceed toward a proxy fight to provide long-term investors with an opportunity to express their views. They criticize the fact that many companies treat the director nomination deadline as a "point of no return" that forces the parties into a rushed, private settlement. Many institutional investors would like companies to force activists to publicly disclose their opposing director slate and strategy. A private settlement without input from institutional investors may create more new issues than it solves.

The Inherent Conflicts of Activist Directors

Most activists demand a "shareholder representative" on the board and thus settlement agreements typically give activists the right to designate board members. At first sight, it makes perfect sense to give a significant shareholder a seat on the board. Upon deeper reflection, however, the concept of activist representatives as board members is fraught with potential for conflict. Like every other board member, activist directors owe fiduciary duties to the company on whose board they sit. Simultaneously, these individuals also most often owe a duty of loyalty to their funds and their own investors. Frequently, conflicts arise for these representatives in their role as dual fiduciaries as a result of different investment time horizons. As explained, activist hedge funds are frequently *short-term* investors by design. By contrast, Delaware law requires that directors maximize the value of the corporation over the *long-term* for the benefit of all shareholders. Under Delaware law, a director's fiduciary duties require that the director act in the best interest of *all* the corporation's shareholders as a collective. This "single owner standard" creates a dilemma for board members who are also principals or employees of the activist hedge fund that designated them to the board. A common retort of activist directors is that if they were placed on the board by a particular constituency, they must represent the interests of that constituency. However, Delaware courts have consistently rejected the concept of "constituency directors." Therefore, activist directors are breaching their fiduciary duty of loyalty if they act to benefit their fund to the exclusion or detriment of the corporation and its shareholders.

Consequently, in theory, activist directors are required by law to put the interest of the company above the interests of the activist hedge fund.

Unfortunately, the reality in corporate America does not always meet this legal standard. While there are instances of activist directors who act in the best long-term interest of all shareholders, there are countless examples of activists who solely promote their own short-term interests in the boardroom. Common examples are activist directors who advocate for an immediate sale of the company even if there is reason to believe that a higher price could be obtained a few years later. Activists also frequently push for an immediate "return of capital" to shareholders in the form of share buybacks or special dividends, and it is almost unheard of for activist directors to promote a long-term investment in a plant or R&D. That should not surprise anyone, especially because there are not always legal repercussions when activist directors promote their short-term agendas. For a variety of reasons, boards are extraordinarily reluctant to sue fellow activist directors for breach of fiduciary duty. Activist directors face potential liability mostly as a result shareholder lawsuits in connection with the sale of a company. For example, last year, a Delaware court found an *entire* board potentially liable for breach of fiduciary duty after the incumbent directors allegedly acquiesced after being badgered into a sale by activist directors.

In sum, there are myriad complexities that arise when appointing an activist director to the board. These issues are at least mitigated, however, if the activist fund designates an *independent* director as board member. In this context, it is important to unearth any "golden leash" arrangements, pursuant to which activists provide additional, special compensation to their directors designees. In several proxy fights, companies successfully argued that "golden leashes" create incentives for activist directors to put the interests of the activist above their fiduciary duties as directors of the company. As a consequence, nowadays activists are exceedingly reluctant to employ golden leashes.

Failed Settlements and Subsequent Proxy Fights

In light of the aforementioned divergence of interests, it should not come as a surprise that many settlements fail to secure lasting peace. Numerous activist situations that were resolved with a rushed settlement subsequently escalated into a full blown public fight after the standstill period expired. In other words, many settlements ultimately fail to achieve the board's primary objective: avoiding a fight.

The problem is that many boards agree to settlements even though they disagree with the core strategies advocated by the activist. Boards often hope to convince activists of the wisdom of their vision for the company once the activists are inside the boardroom. The reality, however, is that activists often will *not* come around to the board's views, in part due to different investment horizons. In these cases, settlements only "kick the can down the road." In other cases, in particular where the activist's goal is a sale of the company, activist directors intentionally make the board dysfunctional in order to incentivize the other directors to sell.

Another factor is that standstill periods in most settlement agreements are relatively short. In recent years, most settlements provided for a one-year standstill, where the activist sits out only one proxy season and reserves the right to launch another proxy contest the following year. Depending on the nomination deadline for the next annual meeting, some standstills last even only six to nine months. This is not a lot of time for a board to implement changes with lasting effects and makes it difficult for the board to focus on long-term strategies. In practice, the looming specter of a proxy fight in the near future often stands in the way of constructive cooperation between an activist and a board.

Fighting a proxy contest against activists becomes harder after they have been inside the boardroom. Delaware courts have indicated that, when a director serves on the board as the designee of a shareholder, the director is permitted to share confidential board information with the designating shareholder. Many practitioners believe that the courts established only a default rule that can be contracted away by virtue of a bylaw, a confidentiality agreement or a board policy. Generally, however, activist directors are free to share confidential company information with their fund, provided that the fund does not trade on the information or misuse it in other ways. Activists often expressly negotiate for this right in a settlement agreement.

This issue becomes even more problematic if the settlement agreement permits activist directors to serve out their terms after the standstill expires. In that framework, the activist is free to launch a proxy contest against the board from within the boardroom, which creates complicated legal issues. Under Delaware law, a director has generally "unfettered access" to all company information. However, this situation may make it desirable or even necessary to shield the deliberations of the remaining directors from the activist representatives on the board. Delaware courts have allowed boards to form special committees and withhold privileged information once sufficient adversity exists between the company and the activist directors. Still, numerous practical issues persist.

Alternatives to Settlements: Looking for the "Third Way"

The risks and issues described above should make it plain that settlements are often not the right answer. Boards should be reluctant to enter into settlement agreements if there is not sufficient common ground with the activist. Still, even boards that realize this point are often hesitant to show the courage of their conviction because of a desire to steer clear of proxy contests.

In practice, the fear of proxy fights is largely overblown because these contests are not remotely as sordid as political campaigns. Institutional investors and proxy advisory firms such as ISS and Glass Lewis insist on civilized, merit-based campaigns. The Securities and Exchange Commission (SEC) is closely watching proxy contests and expressly prohibits activists to impugn the character, integrity or personal reputation of a company's directors without factual foundation. And, while the media is fascinated with activist campaigns against mega cap companies, proxy contests at smaller companies are rarely picked up by *The Wall Street Journal*, *Bloomberg* or *CNBC*. Lastly, unlike in previous years, this year boards have fared pretty well in proxy contests that went all the way to a shareholder vote. In 2016 to date, boards prevailed in almost 70% of the proxy contests. This shows that directors who have the courage of their conviction do not need to be afraid of a proxy contest.

That said, the better approach is to not view activism as a binary decision between settlement and proxy fight. Rather, boards should work with their activism advisors to look for a "third way" to resolve an activist situation. For instance, in practice, it is uncommon for activists to be wrong on all counts. Sometimes it makes sense to implement a few of the activist's suggestions unilaterally. There are also many other creative tactics that can be used to take the wind out of an activist's sails. Typically activists have numerous companies in their portfolio; however, they do not have the bandwidth to pursue more than two or three full-blown campaigns simultaneously. If a board is nimble early in the engagement, many activists can be convinced to move on to another, easier target without a settlement.

Settlement Agreements with Activist Investors—the Latest Entrenchment Device?

Posted by Derek D. Bork, Thompson Hine LLP, on Thursday, July 7, 2016

Editor's note: Derek D. Bork is a partner at Thompson Hine LLP and the Chair of its Takeovers and Shareholder Activism Group. This post is based on a Thompson Hine publication by Mr. Bork. 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).

An increase in settlements between public companies and activist investors that have targeted a campaign against a company has been widely reported. An increase in the speed with which these settlements occur—meaning the number of days a settlement is reached after an activist initiates a campaign—has also been widely reported. Some commentators attribute increased settlements to boards being motivated to avoid the costs, distractions and negative publicity that usually come with an extended proxy contest. Other commentators suggest that increased settlements are an indication that boards have begun to recognize the value that activists and other shareholder representatives can bring to a board. The driving force behind increased settlements, however, may be altogether different. Companies may be more frequently seeking settlements with activists, not in the name of good corporate governance, but for a less noble reason—as a defensive measure.

As shareholder activism has grown, boards have increased their efforts to be prepared for and more effectively respond to activist campaigns. Some of these actions are arguably positive—boards are implementing more effective shareholder outreach programs, reexamining their governance structures and strategic plans, and sometimes even preemptively adopting the proposals made by activists. In many cases, however, boards are deciding to challenge activists and are fighting back more aggressively. In each of these cases, the board's ultimate goal is not to constructively engage with activists, but to keep them out of the boardroom and minimize their influence.

Boards are pursuing settlements with increased frequency not only because this path is now more commonly presented to boards as an option, but often because they view a settlement as a means to restrict the activist, or a group of activists, and avoid more drastic changes at the board level. Although a settlement agreement usually provides an activist with one or more board seats, the restrictions that companies attach to the board seats often reveal an entrenchment motive. In more extreme cases, the settlement approach may be motivated by an even more questionable objective—to hand-cuff the activist while the board seeks to effect a sale of the company or other extraordinary corporate transaction.

If a company agrees to provide an activist with one or more board seats to resolve a proxy contest, it naturally follows that the activist should agree to forego running a proxy contest at the shareholder meeting in question. It also arguably makes sense that the activist should agree not to run a proxy contest during the period of the time that the board seats are provided (usually until the next annual meeting). However, companies often push for a "standstill" provision that extends for periods of time longer than this—but why should the board be insulated from a proxy contest from a shareholder during a period of time when the shareholder is not being provided board representation? Why should an activist get a 12-month (or shorter) board seat and give an 18-month (or longer) standstill? Why should an activist agree not to run a proxy contest for two annual meetings when its board designee will be nominated at only one?

A typical "standstill" provision is aimed at preventing the activist from continuing a public campaign against the company; the activist may not, for example, run a proxy contest, call a special meeting of shareholders, raise proposals directly for a vote of shareholders, or engage in a public "fight" campaign against the company or its board. These provisions make sense—the parties are seeking to resolve the proxy contest and avoid a continuing public battle. Other provisions that are designed to cause the activist to work through the board arguably make sense and also reflect good corporate governance—if an activist has board representation, then the activist should generally seek to effect change and advance proposals through the board.

Yet, companies often push for a long litany of additional restrictions to be placed on the activist while it has a representative on the board, including preventing the activist from having any contact with other shareholders, merely suggesting changes in the composition of the board or to the company's anti-takeover provisions, making any public statements regarding the company, or even expressing its views on extraordinary corporate events, such as a proposed sale of the company. Companies often seek to bind the activist to vote its shares in favor of every board proposal made while it has a representative on the board, regardless of whether the activist agrees with the proposal as a shareholder. Companies often seek provisions that would prevent an activist from taking any steps that might be aimed at preparing for a future proxy contest or other campaign in support of change at the company. Companies often seek to prevent the activist from making an offer to acquire the company, privately or publicly, which certainly does not seem motivated to advance shareholder interests.

Companies also often seek to place limits on the amount of shares that an activist can acquire, or the amount of shares that the activist can transfer to another shareholder. If a company has not elected to adopt a share limit applicable to all of the company's shareholders, such as through a poison pill, why should such a limit be imposed on the activist? Boards often decide not to adopt anti-takeover measures such a poison pill to avoid adverse voting recommendations from proxy advisory firms like ISS, which has a policy that disfavors the adoption of a poison pill without shareholder approval. If a company cannot have a poison pill due to the impact of ISS or the views of its shareholders, then why should a company be able to implement the equivalent of a poison pill in a settlement agreement with an activist? It is inconsistent with the corporate governance structure that the board has elected or been forced to implement for all of its other shareholders.

Worse yet, some companies have required board representatives of activists to sign and pre-deliver director resignations that are automatically triggered when the board decides that the representative has breached the settlement agreement, which often includes a long litany of provisions and board policies with which the representative must comply. Board policies are important, and all directors should be required to comply with them, but having a director subject to the threat of being automatically removed from the board for what might be an immaterial breach of an insignificant board policy is an appalling affront to good corporate governance. It creates the appearance that the company is attempting to keep the new director on a short leash—making sure the director is fearful of being too vocal and independent in the boardroom. This problem is even more egregious when the company seeks to require the new director to promote collegiality or some other standard of board decorum to avoid the threat of removal. Pre-delivered resignations also create a potential risk of uncertainty as to who is actually on the board at a given time, in the event that there is a dispute as to whether a resignation has been triggered, which could cause tremendous disruption to the effective functioning of the board.

Boards may be more willing than ever to consider a settlement to avoid a proxy contest, and they may be considering settlements earlier in the process. Nevertheless, this may not actually signify the positive development of boards being more receptive to outside influence; it may be a sign of boards using a settlement as an opportunity to implement defensive measures. When boards propose and push for settlement agreements that go beyond well-known and customary terms, and when they seek restrictions that do not apply to other significant shareholders or their own hand-picked directors, they more likely are advancing entrenchment motives.

Overreaching by boards in this area could lead to courts striking down some of these provisions as unlawful anti-takeover measures or infringements on the ability of directors to carry out their fundamental duties as fiduciaries. It could also lead to proxy advisory firms like ISS implementing formal voting policies, or taking action in specific cases, that result in adverse voting recommendations against directors who implement egregious settlement agreements. In the meantime, activists should be careful to avoid the traps often set by boards in settlement agreements, and they should take their case directly to shareholders when boards go too far.

Tab III: Engagements between Issuers and Institutional Investors

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Letter from Larry Fink to CEOs
Regarding Investor Engagement

BlackRock, Inc., [from Larry Fink's annual letter to CEOs]
January 2017

ANNUAL LETTER TO CEOS

I write on behalf of our clients…

January 24th, 2017 / by Larry Fink

Each year, I write to the CEOs of leading companies in which our clients are shareholders. These clients, the vast majority of whom are investing for long-term goals like retirement or a child's education, are the true owners of these companies. As a fiduciary, I write on their behalf to advocate governance practices that BlackRock believes will maximize long-term value creation for their investments.

Last year, we asked CEOs to communicate to shareholders their annual strategic frameworks for long-term value creation and explicitly affirm that their boards have reviewed those plans. Many companies responded by publicly disclosing detailed plans, including robust processes for board involvement. These plans provided shareholders with an opportunity to evaluate a company's long-term strategy and the progress made in executing on it.

Over the past 12 months, many of the assumptions on which those plans were based –including sustained low inflation and an expectation for continued globalization – have been upended. Brexit is reshaping Europe; upheaval in the Middle East is having global consequences; the U.S. is anticipating reflation, rising rates, and renewed growth; and President Trump's fiscal, tax and trade policies will further impact the economic landscape.

At the root of many of these changes is a growing backlash against the impact globalization and technological change are having on many workers and communities. I remain a firm believer that the overall benefits of globalization have been significant, and that global companies play a leading role in driving growth and prosperity for all. However, there is little doubt that globalization's benefits have been shared unequally, disproportionately benefitting more highly skilled workers, especially those in urban areas.

On top of uneven wage growth, technology is transforming the labor market, eliminating millions of jobs for lower-skilled workers even as it creates new opportunities for highly educated ones. Workers whose roles are being lost to technological change are typically facing retirement with inadequate savings, in part because the burden for retirement savings increasingly has shifted from employers to employees.

These dynamics have far-reaching political and economic ramifications, which impact virtually every global company. We believe that it is imperative that companies understand these changes and adapt their strategies as necessary – not just following a year like 2016, but as part of a constant process of understanding the landscape in which you operate.

As BlackRock engages with your company this year, we will be looking to see how your strategic framework reflects and recognizes the impact of the past year's changes in the global environment. How have these changes impacted your strategy and how do you plan to pivot, if necessary, in light of the new world in which you are operating?

BlackRock engages with companies from the perspective of a long-term shareholder. Since many of our clients' holdings result from index-linked investments – which we cannot sell as long as those securities remain in an index – our clients are the definitive long-term investors. As a fiduciary acting on behalf of these clients, BlackRock takes corporate governance particularly seriously and engages with our voice, and with our vote, on matters that can influence the long-term value of firms. With the continued growth of index investing, including the use of ETFs by active managers, advocacy and engagement have become even more important for protecting the long-term interests of investors.

As we seek to build long-term value for our clients through engagement, our aim is not to micromanage a company's operations. Instead, our primary focus is to ensure board accountability for creating long-term value. However, a long-term approach should not be confused with an infinitely patient one. When BlackRock does not see progress despite ongoing engagement, or companies are insufficiently responsive to our efforts to protect our clients' long-term economic interests, we do not hesitate to exercise our right to vote against incumbent directors or misaligned executive compensation.

Environmental, social, and governance (ESG) factors relevant to a company's business can provide essential insights into management effectiveness and thus a company's long-term prospects. We look to see that a company is attuned to the key factors that contribute to long-term growth: sustainability of the business model and its operations, attention to external and environmental factors that could impact the company, and recognition of the company's role as a member of the communities in which it operates. A global company needs to be local in every single one of its markets.

BlackRock also engages to understand a company's priorities for investing for long-term growth, such as research, technology and, critically, employee development and long-term financial well-being. The events of the past year have only reinforced how critical the well-being of a company's employees is to its long-term success.

Companies have begun to devote greater attention to these issues of long-term sustainability, but despite increased rhetorical commitment, they have continued to engage in buybacks at a furious pace. In fact, for the 12 months ending in the third quarter of 2016, the value of dividends and buybacks by S&P 500 companies exceeded those companies' operating profit. While we certainly support returning excess capital to shareholders, we believe companies must balance those practices with investment in future growth. Companies should engage in buybacks only when they are confident that the return on those buybacks will ultimately exceed the cost of capital and the long-term returns of investing in future growth.

Of course, the private sector alone is not capable of shifting the tide of short-termism afflicting our society. We need government policy that supports these goals – including tax reform, infrastructure investment and strengthening retirement systems.

As the U.S. begins to consider tax reform this year, it should seize the opportunity to build a capital gains regime that truly rewards long-term investments over short-term holdings. One year is far too short to be considered a long-term holding period. Instead, gains should receive long-term treatment only after three years, and we should adopt a decreasing tax rate for each year of ownership beyond that.

If tax reform also includes some form of reduced taxation for repatriation of cash trapped overseas, BlackRock will be looking to companies' strategic frameworks for an explanation of whether they will bring cash back to the U.S., and if so, how they plan to use it. Will it be used simply for more share buybacks? Or is it a part of a capital plan that appropriately balances returning capital to shareholders with prudently investing for future growth?

President Trump has indicated an interest in infrastructure investment, which has the dual benefits of improving overall productivity and creating jobs, especially for workers displaced by technology. However, while infrastructure investing can stem the flow of job losses due to automation, it is not a solution to that problem. America's largest companies, many of whom are struggling with a skills gap in filling technical positions, must improve their capacity for internal training and education to compete for talent in today's economy and fulfill their responsibilities to their employees. In order to fully reap the benefits of a changing economy – and sustain growth over the long-term – businesses will need to increase the earnings potential of the workers who drive returns, helping the employee who once operated a machine learn to program it.

Finally, as major participants in retirement programs in the U.S. and around the world, companies must lend their voice to developing a more secure retirement system for all workers, including the millions of workers at smaller companies who are not covered by employer-provided plans. The retirement crisis is not an intractable problem. We have a wealth of tools at our disposal: auto-enrollment and auto-escalation, pooled plans for small businesses, and potentially even a mandatory contribution model like Canada's or Australia's.

Another essential ingredient will be improving employees' understanding of how to prepare for retirement. As stewards of their employees' retirement plans, companies must embrace the responsibility to build financial literacy in their workforce, especially because employees have assumed greater responsibility through the shift from traditional pensions to defined-contribution plans. Asset managers also have an important role in building financial literacy, but as an industry we have done a poor job to date. Now is the time to empower savers with new technologies and the education they need to make smart financial decisions. If we are going to solve the retirement crisis – and help workers adjust to a globalized world – businesses need to hold themselves to a high standard and act with the conviction that retirement security is a matter of shared economic security.

That shared economic security can only be achieved through a long-term approach by investors, companies and policymakers. As you build your strategy, it is essential that you consider the underlying dynamics that drive change around the world. The success of your company and global growth depend on it.

Sincerely,

Larry Fink

Chairman and Chief Executive Officer
Laurence D. Fink is Founder, Chairman and Chief Executive Officer of BlackRock, Inc. He also leads the firm's Global Executive Committee.

BlackRock's 2017-2018 Engagement Priorities

Posted by Abe Friedman and Robert McCormick, CamberView Partners, on Friday, March 17, 2017

Editor's note: Abe M. Friedman is CEO and Robert McCormick is a partner at CamberView Partners, LLC. This post is based on a CamberView publication by Mr. Friedman, Mr. McCormick, Chad Spitler, and Rob Zvinuska.

On Monday, March 13th, BlackRock released its engagement priorities for 2017-2018 to help prepare directors and management teams to engage with its Investment Stewardship team over the coming year. BlackRock reiterated its preference to engage privately with companies in a constructive manner, but also reminded companies that it will vote counter to management recommendations when appropriate.

BlackRock's new engagement priorities address traditional areas of investor engagement such as governance, strategy and compensation alongside developing areas like climate risk and human capital management.

Highlights include:

- **Board Diversity & "Climate Competency"—**BlackRock emphasized that it will engage with companies regarding their processes for addressing director turnover, succession planning and diversity, with a specific focus on understanding how companies are improving gender balance in the boardroom. Similar to State Street Global Advisors' announcement earlier in March on how it plans to engage on issues around board gender diversity, BlackRock announced it may vote against nominating and/or governance committees for a lack of commitment to board diversity. In addition, BlackRock expects all directors of companies that are significantly exposed to climate risk to be "climate competent," which it defines as having demonstrable fluency in how climate risk affects the business and how management is adapting to and mitigating the risk. Where it has concerns that material risks around these issues are not being effectively dealt with, BlackRock may vote against certain directors.
- **Corporate Strategy for the Long-Term—**BlackRock continues to expect companies to succinctly explain their long-term strategic goals, as well as anticipated milestones and obstacles. This explanation should be refreshed and adapted to reflect the changing business environment and should take into account any new approach to capital allocation among capital investments, research and development, employee development and capital return to shareholders.
- **Compensation that Promotes Long-Termism—**BlackRock continues to be focused on how boards establish performance metrics and hurdles in the context of long-term strategic goals. In particular, the Investor Stewardship team will seek insight into how companies prioritize "inputs" within management's control with "output" metrics such as

earnings per share or total shareholder return. BlackRock also indicated it will focus on how internal pay equity and broader macroeconomic themes influence the structure of compensation programs.

- **Disclosure of Climate Risks –** BlackRock reiterated its belief that climate risk is a systemic issue and that disclosure standards should be developed that are both globally consistent and applicable across each market. BlackRock cites the recommendations of the 32 member, industry-led Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD), of which it is a member, as laying out a relevant roadmap for companies. BlackRock indicated that it will proactively engage companies that it believes are most exposed to climate risk to understand their view on the TCFD.
- **Human Capital Management—**BlackRock believes creating an engaged and stable workforce is a competitive advantage, particularly given the current talent-constrained environment. BlackRock views a company's approach to human capital management, employee development, diversity and commitment to equal employment opportunity, health and safety, labor relations and supply chain labor standards, among other topics, as a window into the company's culture, operational risk management practices and quality of its board oversight. In engagement, BlackRock will ask how boards oversee and work with management to improve performance in these areas.

How Companies Can Navigate Increased Investor Demands

CamberView expects the trend of increased investor focus on engagement to continue to grow in importance over the coming proxy season and beyond. BlackRock's guidelines reinforce the need for companies to sharpen their engagement approach to focus on key areas of investor concern across all investor constituencies. BlackRock's note, along with co-authored documents such as the Investor Stewardship Group (discussed on the Forum here), the SDX Protocol and the Commonsense Corporate Governance Principles (discussed on the Forum here), provides guidance for navigating engagement in this new, highly-engaged, investor environment.

Major institutional investors expect engagement to be substantive, sophisticated, targeted and relevant. However, BlackRock made clear in its note today that many engagements are triggered because companies "have not provided sufficient information in their disclosures to fully inform our assessment of the quality of governance, including the exposure to and management of environmental and social factors." This call for greater disclosure beyond areas traditionally covered in proxy statements continues to increase the importance of a holistic, investor-focused approach to discussions of governance, compensation, strategy and sustainability in company materials.

Companies can address investors' concerns by executing a responsive, substantive and multi-pronged effort which includes enhancing disclosures targeted by investors and engaging in regular, year-round dialogue with their investors.

Protecting the Interests of Long-Term Shareholders In Activist Engagements

Posted by Rakhi Kumar and Ron O'Hanley, State Street Global Advisors, on Monday, October 17, 2016

Editor's note: Rakhi Kumar is Head of Corporate Governance, and Ron O'Hanley is President and Chief Executive Officer of State Street Global Advisors (SSgA). This post is based on a SSgA publication. 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).

Key Takeaways

- State Street Global Advisors (SSgA) recognizes that activists can bring positive change to underperforming companies, especially when boards or management ignore investor concerns about poor corporate governance practices.
- As near permanent capital, SSgA's main goal is to ensure that activists are helping to promote long-term value creation in whatever way they choose to engage with companies.
- However, a recent rise in settlement agreements entered into rapidly between boards and activists and without the voice of long-term shareholders concerns us, as we see evidence of short-term priorities compromising longer-term interests.
- We believe boards should protect the interests of long-term shareholders in all activist situations, and carefully evaluate settlement agreements. In particular boards need to consider the interests of long-term shareholders as they assess: 1) duration of the agreements; 2) ownership thresholds and holding period requirements for continued board representation; and 3) risk to the company's share
- price posed by a lack of board oversight on significant pledging activities by activists serving on the board.
- To help inform and explain our voting decisions on the election of directors in activist situations, we will assess settlement agreements according to how they address the concerns highlighted in this paper.

Focusing on Long-Term Value Creation in Activist Situations

As a provider of long-term, near-permanent capital to listed companies through our index investing, SSgA is focused on maximizing the probability of long-term value creation on behalf of our clients. Our primary emphasis is on good corporate governance practices, which is a precondition for sustained, long-term performance. In the case of activist investors,[1] we acknowledge the positive changes these investors can often drive. In the past, we have supported activist investors in their objective to improve shareholder returns at companies in which boards had failed to address investor concerns around long-term underperformance and/or poor corporate governance. However, we are wary of activist models of engagement that favor short-term gains at the expense of long-term investor interests.

We acknowledge the inherent tension between short-term and long-term investors. Our view is that transparent debate around this tension is part of good shareholder democracy. We also recognize that each activist situation is different and that different ways exist for activists to engage with companies. While SSgA does not have a view on settlements versus other models of activist engagement, we do want boards to address issues in agreements that could affect the interests of long-term investors. Proxy contests, though often protracted and costly (and can pose reputational risk), give long-term investors and other market participants an opportunity to provide their views on long-term strategy, capital allocation and corporate governance issues such as board composition. By contrast, when companies quickly enter into settlement agreements with activist investors, long-term shareholders often do not have a voice.

For these reasons, we are concerned with the recent rise of settlement agreements entered into rapidly between boards and activist investors. Over the past three years, companies have conceded a steadily increasing number of board seats to activists through settlement agreements. Data on activist campaigns targeting companies with market capitalizations above $500M show that as of August 2016, 49 companies had conceded 104 board seats to activists, almost on par with the 106 seats conceded by 54 companies in all of 2015.[2] When reviewed in the context of total new director appointments at companies with similar market capitalizations, board seats conceded to activists account for approximately 13% of the 816 new board appointments[3] so far in 2016. Moreover, less than 10% of board seats that were conceded in 2015 and 2016 were through a proxy contest.[4] Most seats were conceded by companies in settlement agreements; by contrast, in 2014, 34% of seats were conceded through proxy contests.[5]

At SSgA, while we recognize that negotiated settlements between companies and activists might benefit boards and management by reducing time, expense and reputation risk, we are concerned that in some cases these settlements are being reached too quickly and without any input from other shareholders.

Activist Strategies Often Focused on the Short Term

We have researched the actions of 13 of the largest activist investors in 89 companies over the past 3 years and found that strategies pursued by activist investors differ by activist and from company to company. SSgA has identified certain actions as potential red flags for long-term investors as they raise questions about the motivations behind the actions and potential implications for sustainable value creation. These include:

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[1] An individual or group that purchases large numbers of a public company's shares and/or tries to obtain seats on the company's board with the goal of effecting a major change in the company, Investopedia.
[2] Data provided by Lazard's Board Preparedness Group as of August 19, 2016.
[3] Data provided by Institutional Shareholder Services as of August 31, 2016.
[4] Data provided by Lazard's Board Preparedness Group as of August 19, 2016.
[5] *Id*.

- Significantly increasing CEO pay without explanation
- Changing pay drivers in C-Suite compensation plans by incorporating earnings per share (EPS) as the primary determinant of CEO compensation, which we believe can overly focus management on short-term stock performance and often favors activities such as share buybacks over allocating capital for the long term
- Focusing on financial engineering such as share buybacks, leveraged dividends, spin-offs and M&A, which could add value in the short term but may also undermine long-term value

Each of these practices can have a lasting impact on a company's corporate governance and business strategy. Given that passive index investors will continue to hold the stock after many activist investors have exited, the interests of long-term shareholders must be considered by boards at the time of negotiating settlements with activists.

Protecting Long-Term Shareholders in Settlement Agreements

Recognizing that settlements are increasingly the outcome of engagements between companies and some activists, SSgA desires that boards identify and address issues in agreements that could affect the interests of long-term investors. We reviewed key settlement terms commonly included in agreements between companies and activists and found that while these agreements usually protect the board and management, they can fail to adequately consider the interests of long-term shareholders. In particular, we identified the following issues:

- **Duration of Settlement Agreements** Typical settlement agreements range from six to eighteen months and are designed to prevent activists from publicly airing their concerns in return for board seats.[6] If there is value for companies to concede board seats and change the profile of the board, we ask boards to consider whether the agreements should be entered into for longer periods. By simply lengthening the time horizon of the agreement, both companies and activists will be more sensitive to long-term factors and incorporate these into the settlement terms and strategic actions.
- **Time Period for Holding Shares** Few agreements explicitly require activist investors or their director nominees to continue owning shares for a stated period after receiving board seats. Instead, agreements are typically designed to prevent activists from increasing their stake in the company above a certain threshold during the agreement period.[7] Alternatively, if settlement agreements are designed to appropriately consider and align the interests of activist investors with those of long-term shareholders, boards would be less concerned about preventing activists from increasing ownership levels and would instead value the activist's investment and commitment to the company. SSgA believes that an activist firm should be required to hold its shares for long periods from the date of the settlement to align them with longer-termed shareholders.
- **Minimum Ownership Thresholds or Director Resignation Requirements for Board Representation** Typical agreements allow activists to reduce their stake to 1–2% below ownership levels at the time of settlement.[8] SSgA would like agreements to specify minimum ownership levels for longer periods in exchange for any board representation. Further, we believe that companies should require directors who are affiliated or not fully

[6] Source: SSgA Governance Team.
[7] *Id*.
[8] *Id*.

independent of the activists to tender their resignation if the activist investor's ownership in the company falls below a minimum threshold. Recognizing that effective directors are valuable, boards can nominate these same directors to stand for re-election after tendering their resignation. This will ensure that a clean break occurs between activist firms and independent directors identified by the activist.

- **Risk to Share Prices from the Pledging of Activist Shareholdings** SSgA found that activist investors who own a considerable stake in target companies often pledge a significant portion of their stake in margin accounts. While settlement agreements limit an activist's ability to engage in short sales, there are no restrictions on the pledging of shares. We believe this could create perverse incentives for the activist firm, which could result in their director nominees pursuing aggressive strategies to maintain share prices in the short term. SSgA believes that boards should evaluate carefully the pledging practices of activists and develop robust mechanisms to oversee and mitigate any potential risk from the pledge positions to the stock price.

Engagement and Proxy Voting Implications

Given the increasing prevalence of settlement agreements in activist situations, it is important for long-term shareholder interests to be considered in these agreements. Consequently, we believe companies and boards should require settlement terms that promote the interests of all shareholders and consider safeguards that protect long-term investors. We also believe that long-term owners, boards and activists should debate and together develop principles that protect the interests of long-term shareholders in settlement agreements.

Going forward, to help inform our voting decisions on the election of directors in activist situations, SSgA will assess settlement agreements according to how they address these issues. Further, we will engage with companies that pursue unplanned financial engineering strategies within a year of entering into a settlement with an activist to better understand the reasoning behind the strategic change. Finally, we call on boards to view passive investors as long-term partners and to communicate how the company's strategies, including their engagement with activists and board seat concessions, help create sustainable long-term value for all shareholders.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Shareholder Engagement: An Evolving Landscape

Posted by Tom Johnson, Abernathy MacGregor, on Thursday, March 9, 2017

Editor's note: Tom Johnson is Chief Executive Officer of Abernathy MacGregor. This post is based on an *Ethical Boardroom* publication by Mr. Johnson.

The significant rise of activism over the last decade has sharpened the focus on shareholder engagement in boardrooms and executive suites across the US.

Once considered a perfunctory exercise, designed to simply answer routine questions on performance or, occasionally, drum up support for a corporate initiative, shareholder engagement has become a strategic imperative for astute executives and board members who are no longer willing to wait until the annual meeting to learn that their shareholders may not support change of some sort, or their strategic direction overall.

When active shareholder engagement works, it leads to a productive dialogue with the voters—the governance departments established by the big institutional firms, which typically oversee proxy voting. It is important to remember the reality of public company ownership. The vast majority of public companies have shareholder bases dominated by a diverse set of large, institutional funds. Engagement with these voters not only helps head off potential problems and activists down the road, but it also gives management valuable insight into how patient and supportive their shareholder base is willing to be as they implement strategies designed to generate long-term growth. Indeed, the rising level of engagement is a positive trend that could, over time, help mitigate the threat of activism if properly managed.

This all sounds encouraging in theory and, in some cases, it works in practice as well. But the simple fact remains that this kind of dialogue is unobtainable for the vast majority of public companies, despite the best of intentions on both sides.

Struggles with Engagement

Even the largest institutional investors, many of whom are voting well in excess of 10,000 proxies a year, have at most 25-30 people in their governance departments able to engage directly with companies. Those teams do yeoman's work to meet demands, taking several hundred and in some cases well more than 1,000 meetings with company executives or board members a year. But with more issues on corporate ballots than ever before that need to be researched and analysed, companies are finding it increasingly hard to get an audience with proxy voters even when a determination is made to more proactively engage. This can be true for even large companies with market capitalisations in the billions.

Indeed, for small-cap companies, the idea is almost always a non-starter, though there are workarounds. Some institutional funds are willing to use roundtable discussions with several issuers at once to cover macro topics. Most mid-cap companies are out of luck as well, unless they are able to make a compelling case around a particular issue that catches a governance committee's eye (more on that in a minute). Large-cap companies certainly meet the size threshold, but even they need to be smart in making the request. The net result is a conundrum at companies that are willing to engage but find their institutional investors less willing to do so, or are stretched too thin to make it happen.

The problem is a difficult one to solve. In today's environment, companies cannot wait for a pressing issue to engage with their shareholders. By the time the issue becomes public because an activist has shown up or some other concern has emerged that affects the stock, it is often too late to have a productive conversation. Investors in those situations must decide what they know or can learn in a condensed period; they have little ability to become invested in the long-term thinking behind, for instance, a company's change to executive pay or corporate governance. At the same time, institutional investors, while very open to and, in many cases, strong advocates for meeting with executives, cannot always handle the number of requests they receive, particularly when the requests come in during a condensed period. This has led some investors to establish requirements around which companies 'qualify' for a meeting, leaving some executives that don't meet the thresholds frustrated that they can't get an audience. Both sides are striving to improve the process in this rapidly evolving dynamic. The fact is that both sides have a lot of room for improvement. Here are a few guidelines we advise companies to use when deciding how or even if they should more proactively engage with their largest investors.

> *In today's environment, companies cannot wait for a pressing issue to engage with their shareholders. By the time the issue becomes public because an activist has shown up or some other concern has emerged that affects the stock, it is often too late to have a productive conversation*

1. If a meeting is unlikely, make your case in other ways

Just because you can't get a meeting does not mean you can't effectively influence how your investors vote on an issue. Most companies today fall well short in communicating effectively with the megaphones they do control—namely, the financial reports that are distributed to all shareholders. When a governance committee sits down to review an issue, the first thing it does is pull out the proxy. Yet most companies bury the most compelling arguments under mountains of legalese or financial jargon that is off-message or confusing. In today's modern era, proxies need to tell an easily digestible story from start to finish. They need to be short, compelling and to the point.

Figure out the three to four things you need your investors to understand and put it right up front in the proxy in clear, compelling language. Be concise and to the point. Remove unnecessary background and encourage questions. Add clear graphic elements to illustrate the most important points. And be sure not to contradict yourself with a myriad of financial charts and footnotes, or provide inconsistent information with what you've said before. The proxy statement is the most powerful disclosure tool companies have, yet most are produced by disparate committees, piecing the behemoth filing together with little recognition of the overall document coming to life.

2. Know when to make contact

Most large, institutional shareholders and even some mid-sized ones, are open to meeting with management and/or board members under certain circumstances, but timing is key. Go see your investors on a “clear day”when a meaningful discussion on results and strategy can be had without the overhang of activist demands. For most companies, this means making contact during the summer and fall months after their annual meeting and when the filing window opens for the next year’s proxy.

Institutional investors do lots of meetings during proxy season as well, but those tend to focus on whatever issues have emerged in the proxy, or even worse, whatever demands an activist is making. If you believe you are vulnerable to an activist position, address that concern before it becomes an issue with the right combination of people who will ultimately vote the shares.

3. Know who to talk to

The hardest part of this equation for most companies is figuring out who the right person is at the funds for these conversations. Is it the portfolio manager (PM) who follows the company daily and typically has the most robust relationship with the company’s investor relations department? Is it the governance department that may have more sway over voting the shares? The answer is likely some combination of both. Each institution has its own process for making proxy voting decisions.

In many cases, it involves input from the portfolio manager, internal analyst and the governance department, as well as perhaps some influence from proxy advisory firms, such as ISS or Glass Lewis. But the ultimate decision-maker is always somewhere in that mix. The trick is to find out where. Start with the contacts you know best, but don’t settle for one relationship. If you don’t know your portfolio manager and governance analyst, then you are not going to get a complete picture on where you stand. In many cases, the PM can be a helpful advocate in having a governance analyst understand why certain results or decisions make sense. Once you find the right mix of people, selling the story will be much easier.

4. Don’t assume passive investors are passive

Today, many so-called passive investors are anything but. One passive investor told me his firm held more than 200 meetings with corporations last year.

A governance head at another institution said there is little difference today in how the firm evaluated proxy questions between its active and passive holdings. You may not always get an audience, but on important matters, treat your passive investors like anyone else. You may be surprised at how active they are. These firms also tend to be the busiest, so be assertive and creative in building a relationship. The front door may not be the only option.

5. Choose the best messenger

There is an interesting debate going on in the governance community right now about how involved CEOs and board members should be in shareholder discussions. As a rule, we view it this way: routine conversations around results and performance can be handled by investor relations (IR). More sophisticated financial questions get elevated to CFOs. Once the conversations delve into strategy and growth plans, CEOs should be involved, but usually only with the largest current or potential shareholders. And, finally, when it comes to matters of governance policy, consider having a board member involved.

Board engagement with shareholders is a relatively new trend, but an important one. Investors are often reassured when they see and hear from an engaged board and many will confess that those meetings can change their thinking. But having the right board member who can handle those conversations and be credible is key. A former CEO, who is used to shareholder interactions, or a savvy lead independent director can fit the bill.

But with investors increasingly asking for—and indeed many boards starting to offer—meetings with directors, every board should be evaluating who that representative will be if the opportunity comes along.

6. Be prepared and walk in with a clear set of goals

Too often, companies spend too much time just trying to determine what not to say in meetings with investors and not nearly enough time working on what they want to communicate. This mistake leads to frustration and missed opportunities, not to mention a reduced likelihood that it can get an audience again.

Every investor meeting is an opportunity to better refine or explain your corporate growth story. Walk into every meeting with clear goals in mind. Better yet, get the investor to articulate their own agenda as well. Know exactly what each of you wants to get out of the meeting and then get down to business. Be upfront and honest about why you are requesting the meeting. Governance investors are far more engaged when companies walk in with stated goals in mind. Surface potential problems and your solution to them, before they emerge.

Making the effort

Even with this level of planning, large companies can still find their requests for engagement on governance topics unheeded. Many of the large, institutional investors have installed various thresholds, generally predicated to a company’s size, that companies need to meet to receive an audience. But that does not mean companies should give up. Continue to work the contacts you do have within each institution. Tell your best story in routine discussions, such as earnings calls or conference presentations. Those are too often missed opportunities. Look for other opportunities to get in front of investors.

Conferences can be great forums, as can organisations, such as the Society of Corporate Governance, Council for Institutional Investors or National Association of Corporate Directors. Every time you communicate externally, it is a chance to tell your story and make the right disclosures. History is littered with companies that waited too long to do so, came under attack and lost control of their own destiny. Don’t waste any opportunity to make your best case to whomever is listening.

Harvard Law School Forum on Corporate Governance and Financial Regulation

Promoting Long-Term Value Creation—The Launch of the Investor Stewardship Group (ISG) and ISG's Framework for U.S. Stewardship and Governance

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Wednesday, February 1, 2017

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, Steven A. Rosenblum, Karessa L. Cain, Sabastian V. Niles, and Sara J. Lewis. Additional posts by Martin Lipton on short-termism and corporate governance are available here. Related research from the Program on Corporate Governance includes Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law, by Leo E. Strine (discussed on the Forum here) by Chief Justice Leo Strine; and The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here).

A long-running, two-year effort by the senior corporate governance heads of major U.S. investors to develop the first stewardship code for the U.S. market culminated today in the launch of the Investor Stewardship Group (ISG) and ISG's associated Framework for U.S. Stewardship and Governance. Investor co-founders and signatories include U.S. Asset Managers (BlackRock; MFS; State Street Global Advisors; TIAA Investments; T. Rowe Price; Vanguard; ValueAct Capital; Wellington Management); U.S. Asset Owners (CalSTRS; Florida State Board of Administration (SBA); Washington State Investment Board); and non-U.S. Asset Owners/Managers (GIC Private Limited (Singapore's Sovereign Wealth Fund); Legal and General Investment Management; MN Netherlands; PGGM; Royal Bank of Canada (Asset Management)).

Focused explicitly on combating short-termism, providing a "framework for promoting long-term value creation for U.S. companies and the broader U.S. economy" and promoting "responsible" engagement, the principles are designed to be independent of proxy advisory firm guidelines and may help disintermediate the proxy advisory firms, traditional activist hedge funds and short-term pressures from dictating corporate governance and corporate strategy.

Importantly, the ISG Framework would operate to hold investors, and not just public companies, to a higher standard, rejecting the scorched-earth activist pressure tactics to which public companies have often been subject, and instead requiring investors to "address and attempt to resolve differences with companies in a constructive and pragmatic manner." In addition, the ISG Framework emphasizes that asset managers and owners are responsible to their ultimate long-term beneficiaries, especially the millions of individual investors whose retirement and long-term savings are held by these funds, and that proxy voting and engagement guidelines of investors should be designed to protect the interests of these long-term clients and beneficiaries. The divergent needs and time horizons of these ultimate beneficiaries have long been emphasized by

Chief Justice Leo Strine (see, for example, Justice Strine's provocative article, *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law,* discussed on the Forum here), and implicates the new theory of corporate governance espoused by Professors Zohar Goshen and Richard Squire. While the ISG Framework is not intended to be prescriptive or comprehensive in nature, with companies and investors being free to apply it in a manner they deem appropriate, it is intended to provide guidance and clarity as to the expectations that an increasingly large number of investors will have not only of public companies, but also of each other.

Key highlights of the ISG Stewardship Framework for Institutional Investors and the ISG Corporate Governance Framework for U.S. Listed Companies are outlined below. The ISG has also supplemented each of these high-level principles with examples of illustrative implementation. Many of the principles in the ISG Frameworks will be familiar to those who have recognized the emergence of, and supported, The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth (discussed on the Forum here), sought to adapt their communication, engagement and governance practices to reflect the New Paradigm and tracked the heightened expectations and scrutiny placed on public company boards.

Stewardship Framework for Institutional Investors

- Principle A: Institutional investors are accountable to those whose money they invest.
- Principle B: Institutional investors should demonstrate how they evaluate corporate governance factors with respect to the companies in which they invest.
- Principle C: Institutional investors should disclose, in general terms, how they manage potential conflicts of interest that may arise in their proxy voting and engagement activities.
- Principle D: Institutional investors are responsible for proxy voting decisions and should monitor the relevant activities and policies of third parties that advise them on those decisions.
- Principle E: Institutional investors should address and attempt to resolve differences with companies in a constructive and pragmatic manner.
- Principle F: Institutional investors should work together, where appropriate, to encourage the adoption and implementation of the Corporate Governance and Stewardship principles.

Corporate Governance Framework for U.S. Listed Companies

- Principle 1: Boards are accountable to shareholders.
- Principle 2: Shareholders should be entitled to voting rights in proportion to their economic interest.
- Principle 3: Boards should be responsive to shareholders and be proactive in order to understand their perspectives.
- Principle 4: Boards should have a strong, independent leadership structure, which may be evidenced by an independent chair or a lead independent director.
- Principle 5: Boards should adopt structures and practices that enhance their effectiveness.

- Principle 6: Boards should develop management incentive structures that are aligned with the long-term strategy of the company.

ISG's goals are ambitious, seeking to have "every institutional investor and asset management firm investing in the U.S." sign the framework and incorporate the stewardship principles in their proxy voting, engagement guidelines and practices. It should be noted that while the ISG guidelines emphasize the need for a framework to promote long-term value creation, the current version does not specifically commit investors to support long-term investment but does express the view that it "is the fiduciary responsibility of all asset managers to conduct themselves in accordance with the preconditions for responsible engagement in a manner that accrues to the best interests of stakeholders and society in general, and that in so doing they'll help build a framework for promoting long-term value creation on behalf of U.S. companies and the broader U.S. economy."

The Framework is intended to be effective January 1, 2018 and apply to the 2018 proxy season; nevertheless, as companies conduct off-season and in-season shareholder engagement and finalize their 2017 proxy statement disclosures and associated annual letters to shareholders from the Board and/or management, they may wish to incorporate into their communications some of the themes highlighted in the ISG Framework and benchmark their disclosures and practices against the Framework.

Tab IV: The Short-Term/Long-Term Debate

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

Long-Term Value Begins at the Board

Posted by Ronald P. O'Hanley, State Street Global Advisors, on Monday, March 20, 2017

Editor's note: Ronald P. O'Hanley is President and CEO of State Street Global Advisors and Vice Chairman of State Street Corporation. This post is based on Mr. O'Hanley's recent remarks at the Weinberg Center 2017 Corporate Governance Symposium at the University of Delaware.

It's an honor to be here with you today [March 7, 2017], and I am grateful for the opportunity to share our perspectives on corporate governance.

First, I want to acknowledge the important work that Charles and his team do here at the Weinberg Center in promoting corporate governance.

The forum you provide for leaders in business, public policy and the legal community to discuss the governance issues that directly affect the ability of businesses to grow and prosper over the long run is absolutely critical.

These are existential issues not only for shareholders who want to invest in a vibrant future-but for our economy as a whole.

Today, I want to discuss our belief that "Long-Term Value Starts at the Board" and will review several key aspects:

1. The pressures of short-termism and the challenges and forces impacting long-term value creation today.
2. Why we believe asset managers like us have an important role to play in fostering good corporate governance.
3. The important role that effective, independent and diverse board leadership plays in focusing companies on the long term.
4. How we need to think of "Corporate Governance" much more broadly than we think of it today—and ensure it incorporates issues related to environmental and social sustainability.

And then I'll close by saying a few words about why partnership among shareholders, boards and institutional investors is essential to ensuring governance best practices for the long term.

Long-Term Value in a Short-Term World

But in order to understand the importance of long-term value and how we create it, it's critical that we first understand the factors working against it: what we call "short-termism"—that is, excessive focus on short-term results at the expense of long-term interests.

And certainly, financial markets aren't the only drivers of short-termism these days.

Everything from globalism to technology has created an "on-demand" expectation today that everything can and should be done quickly.

A few years ago, who would have thought that one day Amazon drones would be delivering our packages to our front doors hours after we've ordered them? Believe it or not, today that's right around the corner.[1]

That speed and efficiency are great in so many ways. But it's also created a mindset that the faster we can access and process information, the sooner we can move on to the next thing.

That's not always so great, and it's hard to look around without concluding that this kind of short-termism has manifested itself in a very profound way in today's businesses and financial markets.

Think about it. So many of the orientations, biases, and incentives in our capital markets and investment management systems today are implicitly or explicitly short term.

Public companies report earnings quarterly or, in some countries, semiannually.

Investment vehicles are increasingly valued daily or monthly. Indeed, an ETF gets revalued with every trade!

Perhaps the heaviest finger on the short-term side of the scale is management. From annual bonuses comprising a significant if not predominant portion of senior management compensation, to the average CEO tenure in the U.S. being a painfully short five years-hardly enough time to drive innovation and lasting change—to pressures on senior management.[2]

A recent study found that 80 percent of CFOs at 400 large U.S. companies said they would sacrifice economic value for the firm to meet that quarter's earnings expectations.[3]

As one *Harvard Business Review* piece put it, it was less surprising that 80% of CFOs would do such a thing than that they would actually admit it!

Now, boards are typically longer tenured than the CEO. But they are under tremendous pressure to "keep the stock price up."

Indeed, the topic du jour for many boards today is how to deal with the kind of activist that is short-term oriented and trying to maximize the stock price before they sell the company.

[1] CNN, "Amazon makes its first drone delivery in the U.K.," 12/14/16.
[2] Fortune, "CEO exit schedules: A season to stay, a season to go," 5/6/15.
[3] Harvard Business Review, "Yes, Short-Termism Really Is a Problem," 10/9/15.

But we can’t blame it all on activists, many of whom share our interest in improving a company’s governance and management.

Boards are responsible for overseeing a company’s long-term strategy, but many are comprised of directors who, frankly, lack expertise, scope and the diverse views and backgrounds necessary to effectively do that.

As important as who is on the board are the governance issues they are focused on.

Indeed, even as a host of environmental and social sustainability issues become more prominent-from climate change impacts and water and waste management, to supply chain management and safety issues-too often, companies are not focused on the risks these issues pose to their long-term viability and health, or the new opportunities they may offer.

ESG issues are long-term governance issues. But too often they aren’t treated as such.

Asset Stewardship and the Role of Permanent Capital

So why do we care about this at SSGA? Well, our mission is to invest responsibly to promote economic prosperity and social progress.

We do that by helping clients achieve investment goals, whether it is saving for retirement, funding research and innovation or building the infrastructure of tomorrow.

Most, if not all, of these desired outcomes are long-term in nature. Indeed, our fiduciary responsibility is to ensure that we are maximizing the probability of attractive, long-term returns on our clients’ behalf.

We do that primarily through building investment capabilities that help clients invest in companies that are likely to help them reach their long-term investment goals.

But creating those capabilities is only the beginning. After all, once clients invest in our strategies, they also own the underlying companies.

And we believe our responsibility to our clients extends to our stewardship of those assets. As passive managers, this is particularly important.

An index fund is essentially permanent capital. Unlike active managers, we can’t walk away from a company so long as it is in the index.

As Jack Bogle once said: If you’re an active manager and you don’t like what a company is doing, you sell it. If you’re an index manager, you try to fix it.[4]

You engage with companies in your portfolio.

[4] Bloomberg, “Q&A With Jack Bogle: We’re in the Middle of a Revolution,” 11/23/16.

You share your views on the risks and opportunities that you believe will affect returns over the long run.

Each year our team identifies specific areas that impact value over the long term and issues guidance to companies on how we think about addressing those areas.

Through this patient and consistent engagement, using both our voice and our vote, we seek to promote positive change.

That is asset stewardship—it goes hand-in-hand with good corporate governance. And the hallmark of our approach to it is not passive inaction or adversarial interaction-but active, transparent engagement.

Our goal is to create a two-way conversation that generates light, not heat, on different perspectives.

Effective, Independent and Diverse Board Leadership

So, what do we focus those engagements on? First and foremost, on board leadership.

Having served on a number of public, nonprofit, health care and mutual fund boards over the years, I believe effective, independent and diverse board leadership is a precondition for ensuring that companies are focusing on the long term, and increasing the probability of attractive long-term returns.

It is also possibly one of the most effective counterweights to the short-term pressures I described a moment ago.

By *effective,* we mean having the right skills. By *independent,* we mean a board that is not captured by management, that has the ability to exert its influence in oversight and decision-making. And by *diverse,* we mean with the skills, experience and diversity of thought necessary to provide a broad perspective.

The board is responsible for overseeing a company's long-term strategy. They are the ones assessing management's performance, ensuring board effectiveness and providing a voice independent from management that is accountable directly to investors.

They ask important questions, like, "Is the company meeting its milestones and exceeding its benchmarks?"

"What are emerging challenges and disruptions?" "From where will innovation emerge?"

And, "Is management executing as well as possible given the company's stated objectives for the next 5, 10 or 20 years?"

Now, the good news is that corporate boards have come a long way since the financial crisis. Today, they are more actively involved in setting strategy, mitigating risk and, thanks to partners like the Weinberg Center, they are getting better guidance on ethical and governance issues.

In fact, data shows that there has been a positive shift toward more independent leadership on corporate boards since 2008.[5]

Still, as of 2016 there were significant gaps: nearly a quarter of S&P 500 companies and more than a third of the Russell 3000 had no independent leadership structure.[6]

In Europe the situation was in some cases worse. Nearly 9 in lO of the CAC 40 in France, almost half of the DAX 30 in Germany, and a quarter of the FTSE 350 in the UK were led by boards without an independent chair.[7]

Notwithstanding their important role, we see a number of challenges at the board level preventing more companies from achieving their potential.

Perhaps the biggest is the frequency with which the "urgent triumphs over the important"-pressing business and regulatory needs come first, leaving long-term strategy and focus to fall to the bottom of the corporate board agenda.

Asset stewardship can go a long way toward reprioritizing a board that struggles with these issues.

That is why we made effective, independent board leadership the central element of our corporate governance engagement program- providing specific guidance on governance structures that enhance effectiveness, from the selection process, to the tenure of the position, to performance evaluation and succession.

Clearly with over 9,000 underlying companies in our investment portfolios, we do not engage with each. However, we have regular interaction with large companies as well as select sectors and companies with particular issues.

The goal of these efforts is to ensure that boards and individual board members of our portfolio companies are skilled and independent.

One of the big flashpoints in this debate has been whether to separate the CEO and board chairman roles.

We believe it's far more important that companies have policies, procedures and a board culture in place to empower independent board leadership—and leaders with good communication skills, the requisite time commitment, relevant industry expertise, and personal effectiveness.

We also expect boards to protect the interests of long-term shareholders when activist investors appear on the scene.

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[5] SSGA Letter to Directors and Guidelines on Effective Independent Board Leadership, 2016.
[6] Ibid.
[7] Ibid.

This has been an ongoing focus of our engagements with boards, as a growing number of companies have been reaching quick-fire settlement agreements with activists that change a company's long-term business, capital allocation strategies and corporate governance structures.

That's why we have told boards that they need to consider the interests of long-term shareholders as they assess everything from the duration of the agreements and ownership thresholds to holding period requirements for continued board representation.

They also need to consider any risk to the company's share price posed by a lack of board oversight on significant pledging activities by activists serving on the board.

Boards and Gender Diversity

Now, remedies such as board refreshment improve effectiveness and independence. What about diversity?

We think boards that embrace a broader range of perspectives are more likely to avoid groupthink and achieve better outcomes.

While we believe in and support board diversity on principle, we have been especially focused on gender diversity for a simple reason: Because of the compelling research connecting greater gender diversity with better performance.

A report by the Conference Board in January suggested that this outperformance is largely attributable to the new perspectives women bring.[8]

Notwithstanding this growing evidence, there are still far too few women serving on corporate boards.

A quarter of Russell 3000 companies still don't have a single woman on their boards- and for nearly 6-in-10 that do, less than 15% of their board members are women.[9]

It's not only at the board level where gender diversity matters. Evidence is also mounting that shows companies with higher levels of gender diversity in their senior leadership outperform companies with less diversity.

That research, and our collaboration with CalSTRS, was the basis for the proprietary gender diversity index we created last year along with the ETF that tracks it, with the appropriate ticker symbol: SHE.

The index is comprised of the largest US companies that have the highest levels of women in leadership positions relative to other firms in their sector.

[8] Darren Rosenblum, Daria Roithmayr "The Effect of Gender Diversity on Board Decision-making: Interviews with Board Members and Stakeholders," The Conference Board, January 2017.

[9] Equilar press release: "Boards Will Reach Gender Parity in 2055 at Current Pace," 2/1/17.

SHE was one of the most successful ETFs launched in 2016 in terms of assets under management.

Rather than wait for companies to take action themselves, SHE allows investors to use their capital to influence corporate behavior today, and the underlying index creates a standard that all companies can aspire to in their respective industries.

So today, on the eve of International Women's Day, and to mark the one-year anniversary of SHE, we are calling on the more than 3,500 companies we invest in in the US, UK and Australia to increase the number of women on their boards.

We are also issuing guidance to help them go about doing this. These principles are based on research showing the need for boards to expand the search for candidates beyond existing director networks and to address sources of unconscious bias that might inhibit the recruitment of women.

In addition, I have something else to share on the subject of gender diversity.

More than 25 years ago early one December morning the famous "Charging Bull" bronze sculpture was erected on Wall Street in front of the New York Stock Exchange.

The sculptor wanted the Bull to celebrate the "can-do spirit of America" and Americans' determination to work hard and be successful. The Bull was actually removed the same day it was installed.

Then there was a groundswell of support from New Yorkers, and then Mayor Koch and the Bowling Green Association found a permanent home for the Bull at the Bowling Green Park nearby where he stands today.

Today, we are giving him a new counterpart.

SHE is a daring and confident girl celebrating the "can-do spirit" of women-who are taking charge today and inspiring the next generation of leaders.

SHE stands as a reminder to corporations across the globe that having more women in leadership positions contributes to overall performance and strengthens our economy.

Now this is just a mock up because she was actually just placed there a couple hours ago.

But you can check out some real photos during the day today on our State Street Twitter handle and our website ssga.com.

SHE will be with the Charging Bull for at least the next week—go visit her!

Incorporating Sustainability into Corporate Governance

The broader point here is that a long-term horizon requires a focus on sustainability. Sustainability issues, both environmental and social in nature, are increasingly being seen as drivers of long-term value and better outcomes for companies.

And boards have a big role to play here, and are often better equipped than the day-to-day management to see these issues over longer time horizons.

As all of you know, environmental and social sustainability encompasses a broad range of issues, from climate change and water and waste management, to supply chain management and safety issues, and workplace diversity and talent development.

And we see the evidence that these issues are becoming more important all the time.

Corporate scandals of the last few years, such as those around automotive emissions, food safety or labor issues emphasize the need for companies to assess the impact of ESG risks.

Of the top 10 global risks the World Economic Forum has identified in terms of their likelihood and impact, 70% were associated with environmental and social risks.[10]

It is not surprising, perhaps, that climate impacts feature largely here, as we continue to set new high annual temperature records.[11]

All of which is to say, sustainability matters. Consumers value ESG.

Now, clearly we do not have the answers. That is the point. The range of outcomes that can happen is greater than what will actually happen. This is the definition of a risk and why we believe boards must incorporate ESG factors into the board's oversight of risk.

As ESG becomes a more mainstream risk factor, investing strategy and contributor to talent acquisition, it is changing how we think about governance.

Since 2013 we have had more than 2,000 engagements on ESG issues with over 1,200 companies in our global portfolio on a variety of issues.

For example, one sector project focused on oil and gas companies explored how businesses are navigating the challenges of falling crude oil prices, geopolitical risks, climate change, and emission reductions.

Talks with a Taiwanese packaged food company centered on monitoring food safety within its supply chain.

Meetings with a garment sector company raised ways that labor supply chains and fire safety standards can be improved.

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[10] World Economic Forum, "Part 1 – Global Risks 2017".
[11] New York Times, "How 2016 Became Earth's Hottest Year on Record," 1/18/17.

After a multiyear engagement with various companies on environmental standards, we saw significant improvements in the quality and transparency of reporting around hydraulic fracturing, water and waste management practices.

As we have engaged with companies on these issues over the years, we have seen the good, the bad, and the ugly of how companies are—or are not—considering ESG impacts.

This was especially true after our votes in 2016 supporting shareholder resolutions on climate change initiatives set us apart in the industry.

Now I want to be clear: making ESG a priority isn't about imposing morals or values.

It's about our belief that these issues have a long-term impact on the health of companies in our portfolio and, as such, are potential risks we think companies need to assess as they would any other.

We believe asset stewardship can help companies get out ahead of these issues.

As we have spoken out about these issues, boards have asked us for guidance on how to incorporate a sustainability lens into their long-term strategy.

That is one of the reasons we decided to make environmental and social sustainability the focus of our asset stewardship engagement in 2017.[12]

It is focused on six main areas.

1. First, has the company has identified material environmental and social sustainability issues relevant to its business?
2. Second, has the company done the work to assess these implications and, where necessary, incorporated them into their long-term strategy?
3. Third, does the company consider long-term sustainability trends in its capital allocation decisions? Are they spending money on it?
4. Fourth, do they have the right people with the right skill sets to evaluate and monitor these issues?
5. Fifth, are companies tracking and measuring performance in this area? Are they incorporating key sustainability drivers into performance evaluation and compensation programs with specific performance indicators?
6. And finally, has the company adequately communicated its approach to sustainability issues and its influence on strategy to shareholders and other key stakeholders?

We think getting more companies and boards to commit to focus on these areas will lead to a dramatic improvement in how ESG issues are considered from a business perspective.

Our preferred approach to all these issues-effective, independent board leadership, gender diversity and ESG-is through active dialogue with company and board leadership.

[12] SSGA.com ESG Guidelines, 1/26/17.

And in the event that companies fail to take action despite our best efforts to engage with them, we will use our proxy voting power to effect change.

Notwithstanding their important role, it shouldn't all be on the boards' shoulders. We all- investors, asset owners and other stakeholders—have a part to play in making corporate governance a priority.

That's why, in January, we helped launch a set of comprehensive stewardship and governance principles as part of the Investor Stewardship Group—a collective of large U.S.-based institutional investors and global asset managers.[13]

We took a leading role in the ISG, which is the first time that both asset managers and asset owners in the US have signed on to a common set of principles.

These principles, which you can find on the conference website, encourage all investors to become active owners and engage with the companies in their portfolios across all relevant ESG issues.

Already we have been inundated with requests from institutional investors to sign on to the principles.

Perhaps most importantly, ISG principles require us to work with other institutional investors to encourage their adoption.

Even though State Street manages $2.4 trillion in global assets, McKinsey reports that global assets under management total more than $68 trillion.[14]

That tells us that only as more and more of our fellow asset managers use their voices and votes alike can we make corporate governance the priority it needs to be.

Taking the Lead on Corporate Governance

But most of all, that tells us that to advance corporate governance, my industry needs to lead.

That as institutional investors, we can encourage businesses to be on the leading edge when it comes to long-term value creation, or behind the curve.

That we can either do the minimum for our clients, or act with a heightened fiduciary responsibility to the millions of individuals who entrust their financial futures with us through retirement plans, endowments and foundations, financial intermediaries, and sovereign institutions.

By being active stewards of the assets we hold-and by pushing boards at our portfolio companies to put a premium on diversity, sustainability and long-term value creation-we can enable economic prosperity, advance social progress and create the future investors want to invest in.

[13] Investor Stewardship Group Press Release, "Leading Investors Launch Historic Initiative Focused on U.S. Institutional Investor Stewardship and Corporate Governance," 1/31/17.

[14] Deloitte, "The new principles of brand leadership," 2017.

We look forward to working with the Weinberg Center to help make it possible.

Thank you.

Who Bleeds When the Wolves Bite?

Posted by Kobi Kastiel, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Thursday, February 23, 2017

Editor's note: Leo E. Strine, Jr. is Chief Justice of the Delaware Supreme Court, the Austin Wakeman Scott Lecturer on Law and a Senior Fellow of the Harvard Law School Program on Corporate Governance. This post is based on Chief Justice Strine's recent essay, Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System, forthcoming in the *Yale Law Journal*. Related research from the Program on Corporate Governance includes Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law (discussed on the Forum here) and Securing Our Nation's Economic Future (discussed on the Forum here), both by Chief Justice Strine, and The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here).

Leo E. Strine, Jr., Chief Justice of the Delaware Supreme Court, the Austin Wakeman Scott Lecturer on Law and a Senior Fellow of the Harvard Law School Program on Corporate Governance, recently issued an essay that is forthcoming in the *Yale Law Journal*, which is available here. The abstract of Chief Justice Strine's essay summarizes it as follows:

> This essay examines the effects of hedge fund activism and so-called wolf pack activity on the ordinary human beings—the human investors—who fund our capital markets but who, as indirect of owners of corporate equity, have only limited direct power to ensure that the capital they contribute is deployed to serve their welfare and in turn the broader social good.
>
> Most human investors in fact depend much more on their labor than on their equity for their wealth and therefore care deeply about whether our corporate governance system creates incentives for corporations to create and sustain jobs for them. And because human investors are, for the most part, saving for college and retirement, they do not gain from stock price bubbles or unsustainable risk taking. They only gain if the companies in which their capital is invested create durable value through the sale of useful products and services.
>
> But these human investors do not typically control the capital that is deployed on their behalf through investments in public companies. Instead, intermediaries such as actively traded mutual funds with much shorter-term perspectives and holding periods control the voting and buy and sell decisions. These are the intermediaries who referee the interplay between activist hedge funds and corporate managers, an interplay that involves a clash of various agents, each class of which has a shorter-term perspective than the human investors whose interests are ultimately in the balance.

> Because of this, ordinary Americans are exposed to a corporate republic increasingly built on the law of unintended consequences, where they depend on a debate among short-term interests to provide the optimal long-term growth they need. This essay humanizes our corporate governance lens and emphasizes the living, breathing investors who ultimately fuel our capital markets, the ways in which they are allowed to participate in the system, and the effect these realities have on what corporate governance system would be best for them. After describing human investors' attributes in detail—their dependence on wages and locked-in, long-term investment needs—this essay examines what people mean when they refer to "activist hedge funds" or "wolfpacks" and considers what risks these phenomena may pose to human investors. Finally, this essay proposes a series of reforms aimed not at clipping the wings of activist hedge funds, but at reorienting our corporate governance republic to truly serve the needs of those whose money it puts to work—human investors.

The full essay is available for download here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Engagement: The Missing Middle Approach in the Bebchuk–Strine Debate

Posted by Jasmin Sethi and Matthew Mallow, BlackRock, Inc., on Thursday, June 16, 2016

Editor's note: Jasmin Sethi is Vice President and Matthew Mallow is Senior Managing Director and Chief Legal Officer at BlackRock, Inc. This post is based on a recent article by Ms. Sethi and Mr. Mallow. This paper comments on two papers issued by the program, The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here), and Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law by Leo E. Strine (discussed on the Forum here). Additional related research issued by the program includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here), and Securing Our Nation's Economic Future by Leo E. Strine (discussed on the Forum here).

In our article entitled Engagement: The Missing Middle Approach in the Bebchuk–Strine Debate, recently published in the *NYU Journal of Law & Business*, we contend that in the debate over whether more director or shareholder control would maximize firm value, a critical approach for influencing firm management effectively is missing. This approach is shareholder engagement, and it is growing in importance for asset managers and institutional investors in influencing the actions of directors and firm management.

The board versus shareholder debate has long been about whether more director or shareholder control would maximize firm value. On one side are those who argue for giving shareholders as much power as possible to revamp firms and reorganize boards and the executive suite in ways to make firms more efficient. Under this view, firm executives are agents that need to be monitored and potentially sanctioned, generally through shareholder voting. Those advocating for this view contend that boards must not become entrenched because then they become close to executives and resistant to helpful change. Instead, executives need to be managed as effective agents through active principals. This view is compatible with advocating for corporate structures that incentivize better oversight of boards by shareholders. Recommendations consistent with this view include opposition to staggered boards, more frequent voting by shareholders, and more power for shareholders, including the ability to adopt provisions that would allow them to change the company's charter or state of incorporation.

On the other side are those who believe that firm management and boards are already incentivized to fulfill their fiduciary duties towards shareholders and that boards need to be insulated from shareholder activism. Under this view, boards can be trusted to act consistently with shareholder interests without shareholder intervention. Advocates of this view contend that activist shareholders influencing boards can harm longer-term firm value by trying to make short-term gains that simply increase risk at the expense of long term benefits. Hence, boards should be more closely aligned with executive management. Protection of boards leads to long-term considerations, and incentives should be designed to keep activist shareholders from undermining the efforts of the expert fiduciaries. Recommendations in this area include having staggered boards, less frequent voting by shareholders, and maintaining a corporate republic that defers to the elected directors.

By contrast, engagement is a middle approach that has been described by a number of market participants, and even regulators. Engagement has been defined as "direct communication between investors and companies,"[1] and "direct contact between a shareowner and an issuer (including a board member)."[2] Other commentators have provided more nuanced definitions of engagement. Investors can view engagement in differing ways depending on factors influencing their investment. For example, investors may define engagement as any communication with a company that enhances mutual understanding, or as a process intended to bring about a change of approach or behavior at a company, or even as a continuum covering all this and more, including full-blown activism.

Engagement should be of interest to shareholders because it has been effective in certain situations and has the potential to be even more effective going forward. This is because engagement builds relationships over time that engender trust and facilitate effective communication through "informed dialogue … rather than public confrontation, [which is more likely to build trust] and lead to a mutually productive outcome."[3] Regardless of the definition being utilized, engagement is a more collaborative approach to effecting change than the view of activism assumed by Professor Bebchuk and Justice Strine. Engagement also allows for a more dynamic relationship between management and those entities, often asset managers, representing shareholders than the relationship between firm management and shareholders that has typically been assumed in the academic commentary. The academic literature tends to focus on whether shareholder votes are for or against management, and it often uses shareholder proposals as a signal of shareholders being active and responsible. Indeed, by many commentators, voting is seen as synonymous with shareholder engagement. Conversely, engagement, by our definition, is more effective for accountability and influencing change in companies that are responsive to shareholders, particularly on issues that are nuanced—as many business-relevant governance (including environmental and social) factors are.

In our article, we draw from work conducted on and by institutional investors and asset managers to describe the use and significance of engagement and to advocate for its greater use. Although not specifically about engagement, other recent work is beginning to examine the influence of asset managers on the corporate governance of firms. Some preliminary studies discussed in our article, though not systematic in their nature, indicate that examining the efficacy of engagement would be worthwhile. Understanding the efficacy of engagement is important because certain trends point towards its increased relevance. Many investors are long-term, buy-and-hold investors via retirement savings and through the use of index funds, which require long-term relationships between investors and the companies in which they invest. Furthermore, companies themselves have been recognizing the need for engagement and are voluntarily choosing to

[1] Michelle Edkins, The Significance of ESG Engagement, in 21st Century Engagement: Investor Strategies for Incorporating ESG Considerations into Corporate Interactions, 4 (2015), https://www.blackrock.com/corporate/en-us/literature/publication/blk-ceres-engagementguide2015.pdf.

[2] Marc Goldstein, Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors and Executives, 7 (2014), http://irrcinstitute.org/wp-content/uploads/2015/09/engagement-between-corporations-and-investors-at-all-time-high1.pdf.

[3] Teachers Ins. & Annuity Ass'n–Coll. Retirement Equities Fund, Policy Statement on Corporate Governance, 3 (6th ed. 2011), https://www.tiaa.org/public/pdf/pubs/pdf/governance_policy.pdf.

commit to it as an approach through actions such as becoming signatories to the Principles for Responsible Investment and utilizing the Shareholder–Director Exchange Protocol.

We believe that shareholders need not face a choice between activism that involves aggressive tactics and power through adversarial voting versus deference towards long-term management. A third, middle-of-the-road approach exists. This approach involves ongoing communication and discussions on a long-term basis; its efficacy is more difficult to quantify and measure. These limitations, however, do not make it less worthy of study. Rather, academics and policy makers should look for more ways to understand and promote engagement in order to fully reap its benefits.

The full article is available here.

Tab V: Buybacks and Repurchases

Short-Termism and Shareholder Payouts: Getting Corporate Capital Flows Right

Posted by Jesse Fried, Harvard Law School and Charles C.Y. Wang, Harvard Business School, on Thursday, January 12, 2017

Editor's note: Jesse Fried is the Dane Professor of Law at Harvard Law School and Charles C.Y. Wang is an Assistant Professor of Business Administration at Harvard Business School. This post is based on a recent paper authored by Professor Fried and Professor Wang. Related research from the Program on Corporate Governance includes: Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang; and The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here).

A fierce debate has been raging over whether shareholder-driven "short-termism" (or "quarterly capitalism") is a critical problem for U.S. public firms, their investors, and the nation's economy. Certain academics (Bratton and Wachter, 2010; Coffee and Palia, 2015), corporate lawyers (Lipton, 2015), Delaware judges (Strine, 2010), and think tanks (Aspen Institute, 2009) contend that quarterly capitalism, exacerbated by the growing power of hedge funds, is substantially impairing firms' ability to invest and innovate for the long term. Pushing back against this view, a number of academics have forcefully argued that hedge funds play a useful role in the market ecosystem (Bebchuk and Jackson, 2012; Gilson and Gordon, 2013; Kahan and Rock, 2007) and that concerns over short-termism are greatly exaggerated (Bebchuk, 2013; Roe, 2013).

The empirical evidence on shareholder activism and short-termism is, in fact, mixed. Market pressures can lead executives to act in ways that boost the short-term stock price at the expense of long-term value (Bushee, 1998; Dichev et al., 2013; Graham et al., 2006) and may undesirably reduce investment at public firms (Asker et al., 2015). But these costs must be weighed against the potential reduction in agency costs created by greater director accountability to shareholders. One prominent study finds evidence of such benefits, reporting that shareholder activism increases the stock price at targeted firms in both the short term and the long term (Bebchuk et al., 2015). Subsequent work, however, seeks to challenge these findings (Cremers et al., 2016).

As the search for more and better evidence about short-termism continues, academics, market participants and policymakers have increasingly pointed to the large volume of dividends and repurchases as convincing evidence of activism-induced short-termism. Much of the focus on shareholder payouts is due to the work of economist William Lazonick, who has repeatedly and forcefully argued that these shareholder payouts impair firms' ability to invest, innovate, and provide good wages. In the introduction to his most well-known work, an influential 2014 *Harvard Business Review* article entitled "Profits Without Prosperity," Lazonick set out his main claim:

Corporate profitability is not translating into widespread economic prosperity. The allocation of corporate profits to stock buy-backs deserves much of the blame. Consider the 449 companies in the S&P 500 index that were publicly listed from 2003 through 2012. During that period those companies used 54% of their net income—a total of $2.4 trillion—to buy back their own stock, almost all through purchases on the open market. Dividends absorbed an additional 37% of their net income. That left very little for investments in productive capabilities or higher incomes for employees. (Lazonick, 2014)

Since the publication of "Profits Without Prosperity," Lazonick's findings and similar shareholder-payout figures have been cited by economists at the Brookings Institution (Galston and Kamarck, 2015), prominent asset managers (Fink, 2015), leading corporate lawyers (Lipton, 2015), and senior politicians and policymakers as evidence that short-term pressures generated by activist shareholders are depriving firms of the capital they need to invest for the long term and pay adequate wages. Financial economists (Kahle and Stulz, 2016) have also pointed to the magnitude of shareholder payouts as a percentage of net income as evidence for concern about US public firms' opportunities (or incentives) to invest.

In a paper recently posted on SSRN, Short-Termism and Shareholder Payouts: Getting Corporate Capital Flows Right, we explain that these shareholder-payout figures fail to provide convincing evidence—or indeed *any* evidence of harmful short-termism—because they are an incomplete and misleading measure of public-firm capital flows.

First, shareholder payouts tell only half the story of capital movements between firms and their shareholders. In particular, they fail to account for direct and indirect equity capital inflows through share issuances. U.S. firms issue considerable amounts of common stock to raise cash, pay employees, and acquire assets. We put forward and implement a methodology for estimating net shareholder payouts (shareholder payouts less equity issuances) in S&P 500 firms. Using this measurement method, we find that there is a massive wedge between shareholder-payout figures (that are cited as evidence of short- termism) and net shareholder payouts (that measure net capital movement between firms and shareholders). For example, during the period 2005-2014, S&P 500 firms distributed to shareholders more than $3.95 trillion through stock buybacks and $2.45 trillion through dividends. These cash outflows, which totaled $6.4 trillion, represented 93% of these firms' net income during this period. But during this same period, S&P 500 firms absorbed, directly or indirectly, $3.4 trillion of equity capital from shareholders through share issuances. After taking into account equity issuances, our estimates indicate that net shareholder payouts from S&P 500 firms during the years 2005-2014 were only about $3 trillion, or 44% of these firms' net income over this period.

Second, a focus on S&P 500 firms—which generally have fewer growth opportunities than smaller and younger firms—creates a misleading picture of net shareholder payouts in the public markets as a whole. We show that while S&P 500 firms are net *exporters* of equity capital, public firms outside of the S&P 500 are net *importers* of equity capital, absorbing $520 billion of equity capital, or about 16% of the net shareholder payouts of S&P 500 companies, during the period 2005-2014. Across *all* public firms, net shareholder payouts from 2005 to 2014 were only $2.50 trillion, about 33% of the net income of public firms over this period.

Third, during the period 2005-2014 public firms engaged in approximately $800 billion of net debt issuances, equaling 32% of the $2.50 trillion in net shareholder payouts. When a firm borrows $X and issues a dividend of $X, there is no reduction in the firm's assets. Rather, such a transaction merely rebalances the firm's capital structure, substituting $X of debt for $X of equity. Thus, $800 billion of the $2.50 trillion in net shareholder payouts by public firms in this period are effectively debt-for-equity recapitalizations, rather than downsizing distributions. Across the entire market, only $1.7 trillion of net shareholder payouts, about 22% of aggregate net income, are not offset by net debt issuances.

Our analyses of net shareholder payouts, along with our findings on the extent to which net shareholder payouts are offset by net debt issuances, have important implications for the debate over short-termism. They indicate that capital flows from public firms to shareholders—which have been described as convincing evidence of short-termism—are (a) substantially smaller than they appear and (b) because of offsetting debt transactions, likely to have an even smaller impact on public-firm financial capacities.

To be sure, we cannot rule out the possibility that short-termist pressures are causing some firms to distribute too much cash to shareholders (or are generating other costs unrelated to capital flows). However, a close look at the data reveals that there is little reason to believe that short-termism is, as is commonly believed, systematically stripping firms of the capital needed to invest, innovate, and pay higher wages.

In our paper, we also offer three additional reasons why concerns about shareholder payouts from public companies are likely to be overblown. First, the focus on shareholder payouts as a percentage of net income is highly misleading; it wrongly implies that "net income" reflects the totality of a firm's resources that are generated from its business operations and are available for investment. In fact, net income is calculated by subtracting the many costs associated with future-oriented activities that can be expensed (such as R&D). These amounts are substantial. On average, firms spend approximately 25-30% of their net income on R&D alone. In other words, much of the resources generated by a firm's business operations have already been used for long-term investment before net income is calculated.

Second, even net shareholder payouts (adjusted for net debt issuances) tell us little about the effect of such capital flows on public firms' financial capacities–because firms can always choose to issue more stock. The amount of equity issued by any given public firm in any given year does not represent a cap; the firm could have chosen to issue even more stock to raise cash, acquire assets, or pay employees. Thus, if that firm has a valuable investment opportunity, but little cash, the firm should generally be able to use equity financing to exploit the opportunity.

Third, the concern about the volume of shareholder payouts appears to be based, in part, on an implicit assumption that there is no economic benefit to putting cash in the hands of public shareholders. But net shareholder payouts from public companies do not disappear down the economic drain. Just as much of the net shareholder payouts from S&P 500 firms flow to smaller public firms outside the S&P 500, much of the net shareholder payouts from public companies in the aggregate are likely to be invested in firms raising capital through an IPO, or in non-public businesses backed by private equity or venture capital. Historically, these firms have been generators of tremendous innovation and job growth in the U.S. economy. Thus, even if net shareholder payouts were to reduce public firms' ability to invest, innovate, and provide higher wages, some of these funds will find their way to private firms and enable *these* firms to invest, innovate, and provide higher wages. In short, any economic costs borne by stakeholders of public firms as a result of net shareholder payouts must be weighed against the economic benefits generated by the investment of at least some of these funds in private firms.

Our analysis thus suggests that the volume of share repurchases and dividends by the largest public firms is highly unlikely to indicate that short-termism, or some other factor, is causing public firms to distribute too much cash to shareholders. Those arguing that short-termism is harming the economy will need to look elsewhere to find support for their claim.

The full paper is available for download here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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How the Influx of Dividend-Minded Shareholders Will Impact Shareholder Activism

Posted by Leonard Chazen, Covington & Burling LLP, on Monday, November 21, 2016

Editor's note: Leonard Chazen is Senior Counsel of Covington & Burling LLP. This post is based on a Covington & Burling publication.

2016 has been the year of the dividend. Fixed income investors seeking higher yields have moved into dividend-paying common stocks, and dividends have replaced earnings as the primary factor determining the movement of stock prices.[1] As a result public corporations have acquired a sizeable body of new shareholders for whom increased dividends are more important than earnings growth.

This post considers how the influx of dividend-minded shareholders will impact board decision-making and shareholder activism. These dividend-minded shareholders are a potential third force in the contest for influence between institutional investors who want the corporation to be managed to enhance long-term profitability, and shareholder activists who want the board to maximize the current price of the stock. As supporters of higher dividends these new shareholders are natural allies of the activists, but unlike the typical shareholder activist, they have a long term stake in the corporation and an interest in limiting stock buy backs and dividends to a level that does not impair the ability of the corporation to continue paying dividends in the future.

The influence of dividend-minded investors may already be seen in a trend in 2016 for companies to reduce stock buy backs at the same time that they are increasing dividends.[2] While buy backs are desirable for investors seeking a profitable exit from a company's stock, dividends are preferable for investors who want a good yield over an extended period of time.

In the future dividend-minded investors may prove to be a moderating influence on shareholder activists or they may emerge as an independent force, pressing corporations to increase dividends to the extent that they are sustainable. However, it is also possible that dividend-minded investors will fail to have a major influence on corporate policy either because they do not choose to "go-activist" or because a rise in interest rates sends them out of common stocks into other investments.

[1] Ben Eisen, "Dividends Are What Matter," *The Wall Street Journal*, August 25, 2016.

[2] Mike Bird, Vipal Mongaand and Aaron Kuriloff, "Dividends Eat Up a Bigger Slice of Company Profits," *The Wall Street Journal Online*, August 19, 2016.

Why Have Dividends Come to the Fore in 2016?

Two reasons can be identified for the increased importance of dividends in 2016:

1. Dividends have remained stable, while interest rates have declined, making high-yielding common stocks an attractive investment for some fixed-income investors,[3] and
2. Earnings have declined,[4] thereby increasing the relative contribution of dividends to shareholder returns.

The dominance of dividends could end if the economy goes into high gear, bringing back robust earnings growth and higher interest rates, but as long as earnings growth and interest rates remain low, public companies are likely to have a large constituency of investors who make dividends their top priority. These investors presumably understand that corporations must continue to make capital investments to generate the earnings and cash flow that support dividends, but some may be interested in earnings growth primarily as a basis for dividend increases rather than as an end in itself, and others may make a sustainable dividend stream their top priority, while placing some independent value on earnings growth.

Dividends versus Investment for Long Term Growth

Over the years, shareholder activists have done well at gaining investor support for campaigns to get companies to return more money to shareholders,[5] but their success at winning proxy contests has not won them comparable respect in the corporate governance literature. One reason for their "bad boy" image is the fact that they are short term investors, who run their campaigns for the very purpose of providing themselves with an exit from the stock. If the company scrimps on investment in order to fund the activist's program, and the business suffers in the long run, it is not the activist who suffers but subsequent owners of the company's stock. In the words of Chief Justice (then Vice Chancellor) Strine, writing in his capacity as corporate governance commentator, the activists don't have to "eat their own cooking."[6] For similar reasons long term investors who criticize boards for underinvesting in the company's business are often

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[3] The dividend yield on the S&P 500 Index was 2.08% on October 13, 2016, compared to 2.11% on December 31, 2015. The dividend yield has generally been stable over the past few years. The yield was 1.92% on December 31, 2013. Chart Showing S&P 500 Dividend Yield, available on the Internet. The 10 year treasury rate declined steeply in the first half of 2016, and by mid-October was still down for the year, despite a modest recovery since the beginning of July. The ten year treasury rate stood at 1.77% on October 11, compared to 2.31% on December 30, 2015 and 1.38% on July 6. Ten year treasury rates have declined over the past several years. The rate was 3.01% on January 8, 2014. Y Charts, Ten Year Treasury Rate.

[4] In the quarter ended June 30, S&P 500 earnings declined for the fifth consecutive quarter. *Factset Insight*, August 26, 2016.

[5] See, Vipal Monga, David Benoit, and Teo Francis "As Activism Rises, U.S. Firms Spend More on Buy Backs Than Factories," *The Wall Street Journal*, May 26, 2015.

[6] Leo B. Strine, Jr. "One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates also Act and Think Long Term," 60 *Business Lawyer* (2010), 4.

treated as enlightened business statesmen, rather than as mere spokesmen for one of several contending points of view about what companies should do with their money.[7]

Negative comments about short termism generally do not go as far as to claim that directors have a legal obligation to elevate long term valuation creation over a current return to investors.[8] However, critics of short termism are clearly of the view that it would be preferable for corporations to place greater emphasis on investment for the long term.[9]

The pejorative description "short-term" does not fit the investors who have moved into dividend-paying common stocks in search of higher yields. While they may sell a stock position at any time for the normal reasons, there is nothing inherently short-term about their investment strategy. In fact, a common stock that provides a strong yield over an extended period of time is an investment position they are likely to hold since it has the investment characteristics they are looking for. To the extent that these investors get involved in in disputes about dividend policy on the side of the activists, the description of these controversies as a battle between short term and long term thinking will no longer apply.

Sustainability

One issue on which dividend-minded stockholders may be allied with other long-term investors rather than the typical short-term activist is sustainability: that is, the capacity of the corporation to continue paying dividends at the current level in the future.

An activist who promotes share buy backs and dividend increases to cause a short term increase in the price of the stock is concerned about sustainability of the dividend increases only to the extent that evidence of sustainability is necessary to translate dividend increases into a higher stock price. If the market ignores the sustainability issue, the activist can happily take advantage of the price increase generated by the stock buy backs and higher dividends, and exit the stock before the dividends are subjected to the test of time. A dividend minded investor, on the other hand, is likely to worry about sustainability whether or not the market sees an issue because this investor is buying the stock to hold it and receive dividends for an extended period.

The sustainability of dividends is an issue that has received a lot of attention in 2016. As dividends have risen while earnings have fallen, concern has grown about the sustainability of corporate dividends. The press has focused on companies, such as Exxon Mobil, that have raised dividends in the face of falling earnings and as a result have been paying dividends in excess of earnings per share.[10] A discrepancy between earnings and dividends does not necessarily mean that the dividend is unsustainable. If a company has ample cash reserves, and

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[7] See Adi Ignatius, "I'm Not Talking About This to Win a Popularity Contest,": An Interview with Larry Fink, *Harvard Business Review*, November 2015. For a balanced presentation of competing views on these questions, see "As Activism Rises, U.S. Firms Spend More on Buy Backs Than Factories," Footnote 5.
[8] See footnote 13, and related text.
[9] See e.g., Letter dated February 1, 2016 from Laurence D. Fink, Chairman and Chief Executive Officer of BlackRock to corporate CEOs urging resistance to "the powerful forces of short-termism" and "working instead to invest in long-term growth"; Succeeding in the New Paradigm for Corporate Governance posted by Martin Lipton, Wachtell Lipton, Rosen & Katz on March 15, 2016 in the *Harvard Law School Forum on Corporate Governance and Financial Regulation*.
[10] Dividends Are What Matter, Footnote 1.

its earnings are temporarily depressed by a cyclical factor such as the decline in commodity prices, the board may reasonably conclude that it will be able to maintain its dividend rate in the future even if the dividend currently exceeds earnings. However, the discrepancy between earnings and dividends should flag sustainability as an issue for the board to consider in setting dividend policy.

When a company with depressed earnings pays a dividend in excess of earnings, there is little danger that investors and market commentators will miss the sustainability issue. That is not true of corporations that have sufficient current earnings to cover their dividends, but are reducing capital investment to such an extent that the current dividend rate may not be sustainable in the future. The market may fail to detect this issue because the level of capital investment needed to sustain earnings is a question of judgment, which requires information that may not be available to the public. At a time when companies are under pressure from investors to raise dividends there is a particular danger of wishful thinking about how much companies need to reinvest in order to maintain earnings and sustain current dividends.

While this may be a real problem, it would be a mistake to impose a duty on directors to limit dividends to a level that they believe is sustainable. There are numerous legitimate reasons why corporations may choose to pay unsustainably high dividends, including the belief that a temporary high dividend rate is the best use of excess cash, and the board's dissatisfaction with the returns available on investments in the company's business. But as part of their fiduciary duty to be informed and act with care, directors should consider whether the company will be able to pay dividends at the current level in the future and, if they perceive a material risk that dividends are not sustainable, they should also make sure that the market is adequately informed of those risks.

Higher Dividends versus Long Term Growth

Assuming that a corporation has excess cash after investing enough to sustain its current dividend rate, the board may face a choice between investing the excess cash in the company's businesses or distributing it to shareholders. This is an issue on which advocates of long term growth and dividend-hungry investors, who are allies on sustainability, may part company, and the growing influence of dividend-hungry investors may lead corporations to cut back on investment even when the corporation could earn an adequate return on these investments.[11]

Some corporate governance commentators might urge boards of directors not to follow the preferences of dividend-minded stockholders because the economy will suffer if corporations fail

[11] Satisfying demands from investors for higher dividends would not necessarily require a corporation to reduce investment. In one survey directors of companies that bought back their stock said that the share repurchases did not jeopardize growth, because the alternatives to buy backs were uneconomic investments which they would not have wished to pursue anyway. Richard Fields, Tapestry Networks, "Buybacks and the Board: Director Perspective on the Share Repurchase Revolution," Harvard Law School Forum on Forum on Corporate Governance and Financial Regulation, September 20, 2016 posting. A company that wants to maintain capital investment and raise dividends also has the alternative of adding leverage and doing both. Nevertheless, it seems likely that over time, a policy of increasing dividends to the extent feasible will result in a reduction of capital investment, and investors who support this policy may come into conflict with those who put a priority on investing in the company's business to foster long term growth.

to invest for long term growth. This may be a correct statement about the impact of corporate dividend policy on the overall economy, but at least in Delaware the board does not have the right to subordinate shareholder interests to the interests of other constituencies or public policy goals.[12] Furthermore, in a system in which shareholders, and only shareholders, elect the board of directors, a board that defied shareholder will over a sustained period of time would be turned out of office. Therefore, if corporate investment should be encouraged for the good of society rather than shareholder welfare, the way to do it is through economic and social legislation, not corporate governance.

The law appears to give boards discretion to divide the corporation's excess cash between dividends and capital investment, as part of the directors' broader authority to determine the time frame over which to maximize shareholder value.[13] In a corporation with a divided shareholder base—some emphasizing long-term value creation, others wanting a high dividend rate, and a third group looking for an exit from the stock at the highest possible price—there is no all-purpose guiding principle for directors to follow in setting dividend policy. Dividend sustainability can play this role in some circumstances because it is an issue that is germane to the financial health of the corporation and should concern all long-term investors. But if sustainability is not an issue, there is no obvious touchstone for the board to use in setting dividend policy. In these circumstances the board may be inclined to follow a middling course, dividing the company's excess cash flow between increased dividends and capital investment. This has been described as setting "corporate goals and behavior to generate a balance of short term returns and long term returns to respond to conflicting shareholder demands and manage the corporation to increase corporate profitability within these limits."[14]

The rise of dividend-hungry investors may cause corporations to change the mix, replacing share buy-backs with dividends and paying out more to shareholders and investing less than they would have in the past, but it remains to be seen how much influence dividend-minded investors actually exercise over corporate policy. There have been no proxy contests by dividend-minded investors this year, although the trend toward paying out more in dividends and less in share buy backs in 2016 may reflect their indirect influence.[15] If dividend-minded investors are unwilling to "go activist", their role may be limited to serving as a swing vote in proxy contests waged by

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[12] Leo E. Strine, Jr., "The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law," University of Pennsylvania Law School Institute for Law and Economics, Research Paper 15-08. See footnote 7 of this article for the views of corporate governance commentators who deny that directors of public corporations are required to act in the interest of shareholders.

[13] *Smith v. Van Gorkom, 488 A.2d 858, 873 (1985), Paramount Communications Inc. v. Time Inc.,*571 A. 2d, 1140, 1154 (Del 1989). Vice Chancellor J. Travis Laster of the Delaware Chancery Court has been the outstanding proponent of the view that directors have a fiduciary duty to maximize stockholder value over the long term, a position that might limit the board's discretion to raise dividends and reduce capital investment. See *In re Trados Incorporated Shareholder Litigation,*Consol. C.A. No. 1512-VCL (2013); Jack Bodner, Leonard Chazen and Donald Ross, "Vice Chancellor Laster and the Long-Term Rule," March 11, 2015 posting in The Harvard Law School Forum on Corporate Governance and Financial Regulation.

[14] Donald Ross, Responding to Shareholder Directives to Directors, *Harvard Law School Forum on Corporate Governance and Financial Regulation*, May 10, 2016. The share repurchase program initiated by Apple in response to Carl Icahn's activist campaign is sometimes mentioned as an example of this kind of behavior, although the Apple repurchases came very close to the $50 billion advocated by Icahn. William Lazonick, Matt Hopkins, and Ken Jacobson, "Opinion: Carl Icahn's $2 billion Apple stake was a prime example of investment inequality," *Market Watch*, June 7, 2016.

[15] See text at footnote 2

activists seeking to generate an immediate increase in the price of the stock. It is also possible that common stock ownership by dividend-minded investors will decline as interest rates rise and fixed income investors move out of common stocks. In that case the prospect for dividend-minded investors to exercise influence over corporate governance will decline correspondingly.

One complicating factor is the tendency of dividend-minded investors to do their investing through funds that specialize in high-yield stocks or stocks that offer a combination of substantial yield with the prospect of income growth as well. These funds have been flooded with cash in 2016. For example, the Vanguard dividend growth fund, which had doubled in size over the past three years, closed to new investments to assure that it could continue to produce strong returns for investors.[16] Given the support that giant managers like Vanguard and BlackRock have shown for long-term growth as a corporate goal, it is hard to imagine them leading or even supporting an activist campaign to get to reduce investment and increase dividends. On the other hand, these firms can be expected to respond to the preferences of their investor base, and if the people who invest with BlackRock and Vanguard want more current yield in their investment returns, this preference is likely to have some effect on the views that their corporate governance teams express in their meetings with portfolio companies.

In particular cases dividend-minded investors may succeed in electing board majorities devoted to maximizing sustainable dividends. This result might be less than ideal for the economy, but it would not be a failure of corporate governance. Higher dividends and growth in earnings are both legitimate investor objectives, and shareholders are entitled to exercise their voting rights to **[16]**

[16] Coumarianos, "The Problem with Dividend Stocks," *The Wall Street Journal*, September 6, 2016.

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Buybacks and the Board: Director Perspectives on the Share Repurchase Revolution

Posted by Richard Fields, Tapestry Networks, on Tuesday, September 20, 2016

Editor's note: Richard Fields is a Principal at Tapestry Networks. This post is based on the executive summary of a publication by Tapestry Networks and the IRRC Institute authored by Mr. Fields.

To learn how companies make decisions about share repurchases, Tapestry Networks interviewed 44 directors serving on the boards of 95 publicly traded US companies with an aggregate market capitalization of $2.7 trillion. The complete publication (available here) synthesizes these directors' views and broader research on repurchase programs.

Report highlights include:

Companies are buying back shares at historically significant levels

In recent years, Standard and Poor's 500 companies have repurchased their shares at a remarkable rate. S&P 500 companies acquired $166.3 billion of their own shares in the first quarter of 2016, more than in any other quarter since the financial crisis. In each of the last nine quarters, at least 370 S&P 500 companies repurchased shares, and over the last three years, S&P 500 companies spent over $1.5 trillion on buybacks.

Macroeconomic factors make share buybacks unusually attractive

Monetary and fiscal policies and macroeconomic forces have pushed companies to consider repurchase programs. Many directors said that they would be unlikely to find enough good opportunities to invest all their companies' capital in today's low-growth, low-interest-rate environment, and that it was often better to return capital to shareholders. They tend to prefer buybacks to dividends, primarily because they believe a buyback program offers greater flexibility over time.

US tax policies that discourage companies from repatriating foreign cash have also spurred buyback activity. Because creditors know that borrowers can repatriate foreign earnings at any time, some corporations are able to engage in almost costless borrowing to fund buyback programs.

Directors say that companies repurchase shares for one or more of four reasons:

- To return capital to shareholders
- To invest in the company's shares
- To offset dilution from using equity as currency
- To alter the company's capital structure

Success depends on the purpose of the buyback. Buybacks can only be evaluated effectively if a company is explicit about the reason or reasons for the repurchase program.

Most directors do not agree with popular criticisms of buyback programs

The two most common criticisms of buyback programs are that they jeopardize corporate growth and that they lead to large, unjust pay packages for senior managers. Some directors saw merit in these criticisms; most did not. In general:

Directors believe that buybacks do not jeopardize growth

Some research suggests that companies regularly turn down projects with positive net present value because of irrational risk aversion or excessive discounting of future cash flows. Other research correlates higher buyback activity with lower capital expenditure and revenue growth. Nonetheless, most directors think that their executives do everything they can to grow their businesses. Indeed, some embrace buybacks out of fear that companies would otherwise squander capital by chasing uneconomic growth.

Directors believe that buybacks do not unjustly enrich senior executives

Pay for top executives at major companies is almost always linked, directly or indirectly, to company share prices. Buybacks may increase executive compensation by improving the company's performance on metrics such as earnings per share (EPS), or by causing the share price to rise, affecting total shareholder return calculations or the value of stock executives own or expect.

However, most directors said that their companies are aware of the relationship between buyback programs and compensation and that they make deliberate, informed choices to ensure that they reward executives for desired behavior rather than for financial manipulation of share prices. Anticipated buyback effects on EPS are usually factored into EPS targets, they say, and unanticipated effects can be adjusted out.

Investor and public concerns about high rewards for near-term share price growth are primarily about the risk that these incentives pose to long-term value creation. Most directors think that their companies are focused on long-term growth and that their incentive programs reward executives accordingly.

There is room to improve corporate disclosures about share repurchase programs

Few companies publicly disclose details about buyback decision-making and very few state which of the four reasons are driving any particular buyback program. Although a number of directors mentioned that their companies project how buyback activity will affect EPS and adjust targets accordingly, only 20 S&P 500 companies disclosed that they did so. Most companies and boards with robust buyback processes do not currently disclose enough to receive credit for their work.

* * *

The complete publication is available for download here.

Tab VI: Horizontal Shareholding

Economic Downsides and Antitrust Liability Risks from Horizontal Shareholding

Posted by Einer Elhauge, Harvard Law School, on Tuesday, January 12, 2016

Editor's note: Einer Elhauge is the Petrie Professor of Law at Harvard Law School. This post is based on Professor Elhauge's recent article, forthcoming in the *Harvard Law Review*.

In recent decades, institutional investors have grown and become more active in influencing corporate management. While this development has often been viewed as salutary from a corporate governance perspective, the implications for product market competition have become deeply troubling. As I show in a new article called Horizontal Shareholding (forthcoming in the *Harvard Law Review*), this growth in institutional investors means that a small group of institutions has acquired large shareholdings in horizontal competitors throughout our economy, causing them to compete less vigorously with each other.

For example, seven shareholders who controlled 60% of United Airlines also controlled big chunks of United's major rivals, including 27.5% of Delta Airlines, 22.3% of Southwest Airlines, and 20.7% of JetBlue Airlines. More generally, institutional investors held 77% of the stock of all airlines operating in the average route. A new econometric study shows that this sort of horizontal shareholding has made average airline prices 3-10% higher than they otherwise would have been.

The airline industry is not the only industry plagued by such horizontal shareholdings. In the banking industry, the top four shareholders of JP Morgan Chase (BlackRock, Vanguard, Fidelity, and State Street) were also the top four shareholders of Bank of America and four of the top six shareholders of Citigroup, collectively holding 19.2% of JP Morgan Chase, 16.9% of Bank of America, and 21.9% of Citigroup. Another new econometric study finds that such horizontal shareholdings have significantly increased the fees that banks charge and decreased the deposit rates that banks pay.

Likewise, these institutional investors had leading horizontal shareholdings at Apple and Microsoft and at CVS and Walgreens. Indeed, there is every reason to think that the problem of horizontal shareholding is pervasive across our economy because institutional investors like BlackRock, Vanguard, Fidelity, and State Street now own around 80% of all stock in S&P 500 corporations.

Economic theory has long shown that horizontal shareholdings like these reduce the incentives of horizontal competitors to compete with each other. This is easiest to see when the owners of a firm are identical to the owners of that firm's rival. In that case, a firm has no incentive to undercut its rival's price to take away a sale because the movement of the sale to the firm from the rival simply moves money from one of their owners' pockets to another. The net effect for those owners of cutting prices would be that the prices charged by both firms are lower, thus lowering those owners' profits across both firms.

This anticompetitive incentive is similar, though somewhat attenuated, when the shareholders of two firms are only partially overlapping. Suppose one firm's shareholders also own 50% of that firm's rival. Now, the firm's shareholders will gain some profits by moving a sale from the rival to the firm, but less profits than if their shareholders were entirely different. Instead, a firm acting on behalf of its shareholders will realize that each sale gained by the firm costs the firm's owners not only the usual marginal cost of making the product, but also 50% of the profits those shareholders lose from having the sale taken away from the rival. The effect on firm pricing incentives is the same as if its marginal cost for expanding output were increased by an amount equal to half the profits the rival loses by losing a sale. Like any increase in a firm's marginal costs, this effect reduces the incentives of each firm to price products lower even if their respective managers never communicate or coordinate with each other.

Evidence indicates that institutional investors usually communicate with and actively seek to influence the corporations in which they own shares, which exacerbates the anticompetitive effects of horizontal shareholdings. However, investor-manager communications are not necessary for horizontal shareholdings to have anticompetitive effects. Without any active communication, corporate managers know the identity of their shareholders and the fact that their shareholders also own shares in their rivals. Managers also have incentives to take those shareholder interests into account for a variety of reasons, including: out of a sense of fiduciary duty or gratitude, to gain support in future elections, to enhance future job prospects, because executive compensation methods align with shareholder interests, or so their shareholders will help fend off takeover threats. None of those reasons requires any management- shareholder communication.

Such horizontal shareholdings can help explain some fundamental economic puzzles. Of particular interest to those interested in corporate governance, I show that horizontal shareholdings help explain the puzzle of why large, sophisticated corporate shareholders support executive compensation methods that reward executives for the success of their industry rather than the relative success of their firm alone. My colleagues Professors Lucian Bebchuk and Jesse Fried have persuasively shown that the prevailing method of executive compensation does not maximize profits for the individual firm. But given horizontal shareholdings, institutional investors do not want to maximize profits at the individual firm. They instead want to maximize profits across all the firms in that market in which they are invested. Rewarding managers for industry performance thus serves well the financial interest of horizontal shareholders.

Horizontal shareholdings also help explain why, in the recovery from the recent Great Recession, firms that made record-high profits because of enormous fiscal and monetary stimuli have proven so reluctant to invest those high profits on increasing output and employment. Finally, the rise of horizontal shareholdings in recent decades helps explain why, as Thomas Piketty has famously observed, income inequality has risen in those recent decades.

Contrary to the assertion by some that new legislation is required to deal with this new anticompetitive problem, current antitrust law provides ample authority for antitrust agencies and private litigants to attack stock acquisitions that create anticompetitive horizontal shareholdings in concentrated markets. The so-called passive-investor exception is not a bar. That exception requires complete passivity in influencing corporate management or governance, not a passive investment strategy like indexing to pick investments. Nor is it really an exception because, when established, all the doctrine really does is heighten the burden of proof. Because the empirical evidence suggests this heightened burden can be met, even truly passive horizontal shareholdings could be subject to antitrust challenge.

Institutional investors should thus consider seriously the fact that their horizontal shareholdings in concentrated product markets make them vulnerable to a risk of antitrust liability and damages whenever it can be shown that those horizontal shareholdings likely produced an increase in product prices. This risk may be hardest to address for index funds and ETFs that are growing fast and are currently committed to invest across all majors firms in an industry. But to avoid antitrust problems, index funds and ETFs must at some point either stop growing, give up any voting influence, or become indexed across industries rather than indexed across all competitors in each industry.

The full article is available for download here.

Harvard Law School Forum on Corporate Governance and Financial Regulation

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Cross-Ownership by Institutional Investors

Posted by Barry A. Nigro, Jr., Fried, Frank, Harris, Shriver & Jacobson LLP, on Thursday, March 31, 2016

Editor's note: Barry A. Nigro Jr., is a partner in the Antitrust and Competition and Corporate Practices and chair of the Antitrust Department at Fried, Frank, Harris, Shriver & Jacobson LLP. This post is based on a Fried Frank publication by Mr. Nigro, Nathaniel L. Asker, and Matthew E. Joseph.

On Capitol Hill last week, the Assistant Attorney General for the Antitrust Division of the Department of Justice, William J. Baer, confirmed that the DOJ is investigating potential antitrust issues arising from investors' "cross-ownership," or minority shareholdings, in firms that compete against each other in concentrated industries. Baer's statement follows two recent academic papers suggesting that institutional investors' minority interests in major U.S. airlines may reduce competition among the carriers. Baer told a Senate subcommittee that the DOJ is investigating cross-ownership "in more than one industry," and press reports indicate that the airlines industry is one of these.[1] Notably, Baer acknowledged that it was unclear whether cross-ownership alone would violate the existing antitrust laws, absent evidence of collusion.[2]

Cross-Ownership Theory

A recent working paper by economists, including a professor at the University of Michigan, examines whether cross-ownership of airlines' stocks by diversified institutional investors has led to higher air fares.[3] The study found that increased cross-ownership of the major airlines by institutional investors correlated with higher airfares for consumers.[4] Building on that work, a Harvard Law School professor recently published a law review article (discussed on the Forum here) advocating aggressive antitrust enforcement against cross-ownership in airlines and other industries.[5]

According to these authors, businesses have less incentive to compete when they have significant minority shareholders in common with their rivals. Under the theory, because the

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[1] See Oversight of the Enforcement of the Antitrust Laws: Hearing Before the Subcomm. On Antitrust, Competition Policy and Consumer Rights, 114th Cong. (March 9, 2016) (unpublished); *see also* David McLaughlin & Mary Schlangenstein, *U.S. Looks at Airline Investors for Evidence of Fare Collusion*, Bloomberg Business (Sept. 22, 2015), *available at* http://www.bloomberg.com/news/articles/2015-09-22/do-airfares-rise-when-carriers-have-same-investors-u-s-asks.

[2] Oversight of the Enforcement of the Antitrust Laws: Hearing Before the Subcomm. On Antitrust, Competition Policy and Consumer Rights ("[Cross-ownership] is new. It is not clear to me that the antitrust laws existing today do fully reach it.")

[3] José Azar, Martin C. Schmalz & Isabel Tecu, *Anti-Competitive Effects of Common Ownership*, 14 (Ross School of Business, Working Paper No. 1235, Apr. 21, 2015).

[4] *Id.* at 37.

[5] Einer Elhauge, *Horizontal Shareholding*, 129 Harv. L. Rev. 1267 (2016) (discussed on the Forum here).

institutional shareholder benefits when all of its investments in an industry succeed, the investor would prefer that its portfolio investments avoid competing with one another to boost industry-wide profits. Portfolio firms, in turn, have knowledge of these common investments and, the authors argue, refrain from competing in order to please their largest shareholders. In addition, the authors suggest that institutional investors offering passively managed index funds often seek to influence management of public companies.[6] The cross-ownership theory is novel and raises numerous questions, including why the airlines or other issuers would favor one set of investors over shareholders as a whole and risk exposing themselves to fiduciary duty claims.

Airlines Investigation

According to press accounts, the DOJ is probing cross-ownership in connection with its ongoing investigation into whether the airlines colluded on capacity or price. Press reports indicate that the DOJ asked for information, via a civil investigative demand, related to the airlines' meetings with shareholders whose stakes exceed two percent in which capacity was discussed.[7] Reports suggest that the DOJ is investigating what role, if any, these meetings may have had in the airlines' decisions relating to capacity and pricing.

Up in the Air

Cross-ownership as a theory of antitrust harm is likely to encounter skepticism in the courts.[8] Section 1 of the Sherman Act would require evidence that a shareholder facilitated an agreement among competing firms; cross-ownership alone would not be sufficient to establish a violation. Section 7 of the Clayton Act, which prohibits stock acquisitions that may substantially lessen competition, contains an exemption for acquisitions solely for investment, meaning that a plaintiff would need to show that the institutional investor actively sought to influence management of the company to lessen competition.[9] In addition, institutional investors' individual ownership stakes in public companies are generally small in percentage terms, often five percent or less.[10] Precedents challenging acquisitions of minority interests generally involve larger percentage interests, contractual control rights, and/or board seats in a competitor.[11]

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[6] *See* Azar, at 4 ("For example, it was recently shown that institutional asset managers—previously presumed to be 'passive' shareholder—in fact actively and regularly 'engage' with their portfolio companies 'behind the scenes.'") (citations omitted); Elhauge, at 1306–07 ("A passive investment strategy differs from *passive ownership* because institutional investors with a passive investment strategy usually do actively seek to influence corporate management, including by direct communication, having investor executives serve on corporate boards, and voting their shares to favor positions and management that best advance their investor interests.") (emphasis in original) (citations omitted).

[7] McLaughlin, *supra* note 1.

[8] *See, e.g.*, *Vantico Holdings S.A. v. Apollo Mgmt., L.P.*, 247 F. Supp. 2d 437 (S.D.N.Y. 2003) (rejecting motion to preliminarily enjoin a private equity investment firm's acquisition of debt and contractual control rights in a competitor of a portfolio company).

[9] 15 U.S.C. § 18 ("This section shall not apply to persons purchasing stock solely for investment and not using the same by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition.")

[10] *See* Azar, at Table 1; *see also* Azar, Online Appendix, at Table A.1 (listing institutional shareholders' ownership interests in Delta, United, Southwest, and JetBlue ranging from 1.6% to 14%).

[11] *See, e.g.*, *United States v. Dairy Farmers of America*, 426 F.3d 850 (6th Cir. 2005) (challenging an acquisition of 50 percent interest in a competitor of a 50 percent held firm); Complaint at ¶22, *United States v. AT&T Inc. and Dobson Commc'ns Corp.*, No. 1:07-CV-01952 (D.D.C. Oct. 30, 2007),*available at* https://www.justice.gov/atr/case-document/complaint-34 (challenging acquisition of a 10 percent stake in

Takeaways

Going forward, investment firms should be aware of emerging antitrust scrutiny of cross-ownership and consider reviewing their portfolios to identify cross-ownership investments in concentrated industries. Investors should be particularly sensitive to antitrust considerations regarding such ownership, including potential filing obligations under the Hart-Scott-Rodino Act, if they intend to seek to influence management decisions of an issuer. Most importantly, investors should be mindful of any actions that could be construed as facilitating coordination between competing companies in which they hold minority positions.

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a competitor, which included rights to control "core business decisions" of the firm); Complaint at ¶¶34–35, *In the Matter of TC Group, L.L.C. et al.*, Dkt. No. C-4183 (F.T.C. Jan. 25, 2007) (challenging private equity firms' acquisition of 22.6 percent interest and board seat in competitor of existing portfolio company).

Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance

Posted by Edward B. Rock, New York University School of Law, and Daniel L. Rubinfeld, NYU School of Law, on Monday, March 13, 2017

Editor's note: Edward B. Rock is Professor of Law at New York University School of Law; andDaniel L. Rubinfeld is Professor of Law at NYU School of Law and Robert L. Bridges Professor of Law Emeritus and Professor of Economics Emeritus at the University of California, Berkeley. This post is based on recent paper by Professor Rock and Professor Rubinfeld.

For the past thirty years, regulatory reform efforts have focused on encouraging diversified institutional investor involvement in corporate governance. Now, some recent economic research threatens to chill these developments. In Azar, Schmalz and Tecu (working paper 2015) and Azar, Raina and Schmalz (working paper 2016), the authors argue that concentration among shareholdings by institutional investors has led to higher prices in two relatively concentrated industries: airlines and banking. Based on this research, Einer Elhauge (2016) has argued that current ownership patterns by diversified institutional investors violate Section 7 of the Clayton Act. Following on Elhauge's piece, Posner, Scott Morton and Weyl (working paper 2016) propose a "solution" in which diversified investors would be limited to acquiring one firm in any oligopolistic industry.

In this paper, we critique the economic evidence, focusing on the airline industry. We then challenge Elhauge's legal analysis and critically examine the proposals of Posner et al. Although we are unconvinced by the provocative claims of this new literature, we agree that an open discussion of the antitrust implications of common ownership by large institutional investors is appropriate and timely. We meet this challenge by sketching out and defending proposed "Antitrust Guidelines," including a safe harbor, in an effort to prevent possible anticompetitive effects, while continuing to encourage institutional investor involvement in corporate governance.

The economic analyses are implausible theoretically and unconvincing empirically. The core claim is that managers of airlines, in choosing their business strategies, take into account the effect of those strategies on the value of the stock portfolios held by their investors. Because, as we show, the airlines' shareholders have very different portfolios—some own all the major airlines, others only some, and some only one—we do not see how managers could do this. Other than maximizing the value of their own company, no other strategy could command the approval of investors with heterogeneous and often changing portfolios. Although "soft competition" might be in the economic interests of some of their shareholders, it will be against the economic interest of others. We also find implausible the claim that shareholders would be able to influence managers to "soften" competition so as to maximize portfolio value. How would they do so when directors do not run on a "competition" platform, and when shareholders vote on few other issues of importance?

Turning to the empirical analysis, we raise a variety of questions, focusing primarily on the claim that the modified Herfindahl-Hirschman index or HHI (the MHHI) is commensurate with the familiar HHI. Moreover, we are unconvinced by the efforts of Azar et al to control for the endogeneity of *both* the HHI and the MHHI. With regard to the claimed channel of influence—executive compensation—we are likewise unconvinced. Azar et al rely on a related paper that argues that the channel of influence is the (relative) absence of "Relative Performance Evaluation" in management compensation in concentrated industries. The idea is that without RPE, managers will care more about the profits of other firms in the same industry. Examining airlines, we show that contrary to the Azar et al assumption, RPE is pervasive in the airline industry, as one would expect given the pressure from leading shareholders and Institutional Shareholder Services ("ISS") to utilize relative performance measures in structuring compensation.

We then provide a comprehensive analysis of the legal framework, starting with Clayton Act Section 7 and the 1957 Supreme Court case *of U.S. v. DuPont (GM).* The key legal issues are (a) whether there is evidence that the holdings are anti-competitive and (b) the scope of the "solely for investment" exemption. Contra Elhauge's analysis, we conclude that existing ownership patterns do not violate Section 7, a position that is consistent with decades of DOJ/FTC enforcement policy.

Turning to Posner et al, we reject their proposal that index funds should be forced to abandon their highly successful business model and limit themselves to buying one firm in any concentrated industry. A much more likely response to antitrust risk, we argue, would be for funds to become entirely passive in governance matters, essentially "putting their shares in a drawer." Although this strategy would satisfy the "solely for investment" exemption, the cost to corporate governance would be high, and any theory of antitrust liability that would induce this conduct should be viewed skeptically.

The final section takes seriously the core issue raised by this provocative line of research raises, namely, the intersection between the increased concentration of shareholdings and antitrust. Although we reject the claims that existing ownership patterns have anti-competitive effects, we agree that common ownership can be anti-competitive. We sketch out and defend proposed "Antitrust Guidelines," including a safe harbor for investment below 15%, with no board representation and only "normal" corporate governance activities. This, we argue, complies with current law and will preserve institutional investors' involvement in corporate governance. We also explore scenarios that *would* raise serious issues under Clayton Act Section 7 and Sherman Act Section 1, including the acquisition of large (30%+) holdings in competing airlines, and portfolio managers who act as "Cartel Ringmasters."

The key takeaway is clear: although the current structure of institutional investor ownership does not violate the antitrust laws, institutional investors, like industrial companies, must be conscious of antitrust risk and should train their professionals accordingly.

The complete paper is available for download here.

Product Market Competition in a World of Cross-Ownership: Evidence from Institutional Blockholdings

Posted by Jie He, University of Georgia & Jiekun Huang, University of Illinois, on Tuesday, April 4, 2017

Editor's note: Jie (Jack) He is Associate Professor at the University of Georgia Terry College of Business and Jiekun Huang is an Assistant Professor of Finance at the College of Business at the University of Illinois Urbana-Champaign. This post is based on a recent article by Professor He and Professor Huang, forthcoming in the *Review of Financial Studies*.

Over the past few decades, publicly traded firms have become increasingly interconnected through common stock ownership. For example, the fraction of U.S. public firms held by institutional blockholders that simultaneously hold at least 5% of the common equity of other same-industry firms has increased from below 10% in 1980 to about 60% in 2014. This increasing trend of institutional cross-ownership of same-industry firms suggests that treating firms as independent decision-makers in the product market may no longer adequately capture real strategic interactions among them. In fact, ample anecdotal evidence suggests that large common blockholders can exert influence on the corporate decisions and product market strategies taken by their cross-held firms. Given the tremendous growth in same-industry institutional cross-ownership and the fact that such ownership is still largely unregulated (as opposed to the heavy regulations on direct same-industry ownership such as horizontal mergers), understanding the economic consequences of same-industry institutional cross-ownership, especially its implications for product market dynamics, is important for both academics and policy makers.

In our article, Product Market Competition in a World of Cross-Ownership: Evidence from Institutional Blockholdings, forthcoming in the *Review of Financial Studies*, we address the above research question by empirically examining the effect of institutional cross-ownership of same-industry firms on product market performance and behavior. We hypothesize that cross-ownership can offer product market benefits by fostering coordination among firms that are cross-held by the same blockholder.

A cross-holder's objective is to maximize risk-adjusted portfolio returns. However, intense competition among its portfolio firms, especially those operating in the same industry and thus offering similar products and services, can impose negative externalities (e.g., interfirm lawsuits, advertising wars, and R&D races) on one another and reduce combined portfolio returns for the cross-holder. Consequently, the cross-holder has an incentive to make portfolio firms reduce rivalry against each other and foster implicit or explicit coordination (such as joint ventures, strategic alliances, or acquisitions) among the firms in the product market. This hypothesis predicts that firms cross-held by the same institutional blockholder should gain a competitive advantage in the product market relative to otherwise similar non-cross-held firms.

There are at least two fundamental reasons for why cross-ownership may improve the level and efficiency of collaboration between same-industry firms beyond what these firms can achieve on their own. First, due to incomplete contracting, firms considering collaboration with rivals in the same industry may be concerned about the risk of being expropriated by their counterparties. Because cross-holders' objectives are to maximize the combined value of their portfolio holdings, they may help align the incentives of the contracting parties and mitigate frictions associated with incomplete contracting. Second, cross-holders can reduce information asymmetry among same-industry firms and facilitate the exploration of profitable collaboration opportunities. Firms in the same industry have a natural tendency to conceal proprietary information from competitors, which may lead to suboptimal levels of collaborations. Cross-holders can facilitate coordination by enhancing information sharing among competing firms, thereby improving their product market performance.

Using a comprehensive sample of U.S. public firms from 1980 through 2014, we examine the impact of institutional cross-holdings of same-industry firms on product market performance. Our multivariate OLS analysis shows that cross-held firms experience significantly higher market share growth than non-cross-held firms. This result is robust to alternative empirical specifications and is driven primarily by activist institutions. We also find that the gains in market share associated with cross-ownership translate into higher stock valuation and improved operating profits.

To address potential endogeneity concerns, we exploit a quasi-natural experiment of financial institution mergers using a difference-in-differences (DiD) approach. When two institutions merge, a firm block-held by one merging institution is likely to experience an increase in cross-ownership when one of its same-industry rivals is block-held by the other merging institution before the merger. Thus, the treatment sample consists of firms whose ownership linkages with same-industry firms are likely to increase just because of the merger. The control sample, on the other hand, consists of other block-held firms in the same institution's portfolio that are unlikely to experience such changes. We find evidence that treatment firms, relative to control firms, experience an approximately 0.8 percentage points larger increase in annual market share growth (about 16% of its standard deviation) surrounding the institution mergers, which suggests a causal impact of cross-ownership on product market performance.

Moreover, we find that treatment firms affected by the same institution merger are significantly more likely to engage in explicit coordination (joint ventures, strategic alliances, or within-industry acquisitions) with each other than control firms do, indicating a bridge-building role played by cross-holding institutions. We also find that treatment firms experience an increase in their innovation productivity and operating profit margin relative to control firms, suggesting that cross-held firms may collaborate on their innovation activities (e.g., by sharing technological know-how and other R&D resources) and may coordinate their product market strategies implicitly by cutting production and distribution costs (e.g., via collective bargaining against major suppliers and/or reducing marketing campaigns directly against each other). Overall, these results suggest that cross-ownership by institutional blockholders facilitates product market coordination.

Our paper is the first firm-level study that examines the implications of institutional cross-ownership for firms' product market behavior and performance. Our findings that cross-ownership facilitates collaboration and improves product market performance carry important policy implications. While regulators are rightly concerned about potential anticompetitive effects in some industries, the regulatory framework should be designed so as not to discourage efficiency-improving collaborations in other industries.

The complete article is available for download here.

Tab VII: Company Defenses and Legal Arrangements

Anti-Activist Poison Pills

Posted by Marcel Kahan and Edward Rock, NYU School of Law, on Wednesday, March 22, 2017

Editor's note: Marcel Kahan is George T. Lowy Professor of Law at NYU School of Law and Edward B. Rock is Professor of Law at NYU School of Law. This post is based on a recent paper by Professor Kahan and Professor Rock. 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 includes 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.

Hedge funds have become active in corporate governance. They push for changes in strategy, including making very specific proposals, and sometimes seek (and secure) board representation. They do this by buying shares, conducting public campaigns, lobbying managers and other shareholders, and sometimes running a proxy contest. In response, boards of directors have adopted a variety of "defensive measures" including deploying the "poison pill" shareholder rights plan against activists.

We provide a comprehensive policy and doctrinal analysis of the use of poison pills again activists in corporate governance contests. Although pills have been in common use as anti-takeover devices since the 1980s, it is only now—in the context of anti-activist pills—that many design features of pills start to matter. The reason lies in the different sources of gains derived by the raiders of yore and today's activists. In takeovers, the bidder's primary gains are expected to come from acquiring the company and improving it. As a result, bidders neither need to nor, it turns out, in fact buy substantial blocks of shares before they offer to buy a company. Hence, pill features such as the trigger threshold, the types of ownership interests that count towards the threshold, and the rules on aggregation of shares held by other investors turned out to be largely irrelevant. By contrast, many of today's most prominent activists expect to profit from an increase in the stock price of the target generated by their activism and a corresponding increase in the value of their stakes. For activists, therefore, the ability to acquire a stake in the target—and the limitations on that ability created by a pill—is of great significance.

Under Delaware law, the validity of a pill hinges on whether the pill is a reasonable response to a cognizable threat. In the activist context, we identify two threats that may justify a pill: a threat that the activist is trying to obtain control ("creeping control"); and a threat to a fair election process caused by a contestant having an excessive voting stake. By contrast, we argue that the possibility that shareholders will support an activist in the mistaken belief that its proposals are in the best interest of the company or the possibility that the activist intends to focus on short-term profits are not cognizable threats from a doctrinal and policy perspective. The possibility that the activist may cause disruption by activism or obtain disproportionate influence, while possibly cognizable under existing doctrine, do not justify a pill as a reasonable response.

Importantly, the nature of the threat must justify the design features of the pill. Thus, for example, the threat of creeping control will generally not justify pills with a trigger threshold below 20%; and the threat posed to a fair election process requires a response that is evenhanded and does not favor one of the contestants. On our analysis, synthetic equity—which confers on an activist an economic interest but not voting rights—generally poses no cognizable threat and thus should not count towards the pill trigger because the cognizable threat posed by an activist derives from its power to vote its shares, and not from a pure economic stake. On the other hand, permitting an activist to accumulate an economic stake through synthetic equity is desirable as it enables the activist to benefit if the activism results in an increase in the value of the company and lends credibility to the claim that the activist is motivated to generate such an increase.

Similarly, it is generally not justified for pills to "grandfather" an existing shareholder friendly to management at a higher stake than an emerging activist. In the presence of existing large shareholders allied with management, it is unclear why permitting an activist to accumulate an equivalent stake would present a threat of creeping control; and permitting an activist to accumulate such a stake may enhance, rather than undermine, a fair election process. Different pill thresholds for active and passive shareholders, however, may be justified on the grounds that large stakes by passive shareholders do not pose threats to the fair election process or to control equivalent to large stakes by active shareholders.

One of the most difficult problems with respect to the terms of anti-activist pills is whether and how a company may consider "wolf-packs" (several hedge funds taking sizeable positions in a target and acting in what critics claim is a parallel manner, but without having any explicit or implicit agreements with each other). One approach is to aggregate the holdings of the entire pack to determine whether the pill threshold is exceeded. Thus, some pills aggregate the holdings of all shareholders who "act in concert" to change or influence the control of the target company if there is an "additional plus factor", such as an exchange of information and attendance of the same meeting, that supports a determination that they intended to act in concert.

In our view, such wolf-pack provisions suffer from two fatal flaws. First, because triggering a pill would have severe adverse consequences, vague and potentially overbroad standards of aggregation are likely to have a chilling effect on an activist's ability to communicate with other shareholders. Second, wolf-pack provisions would impede normal interactions among shareholders—such as meetings in which shareholders exchange and discuss their views about the company and management—that sound corporate governance depends upon and that decades of reform have sought to encourage.

On the other hand, it may be more legitimate for a company to take account the presence of a wolf pack in setting the pill threshold. Even if there is no formal or informal agreement between members of the wolf-pack at the time, all members of a wolf-pack may share a self-interested goal. If one accepts our view that preserving a fair election process may be a legitimate board goal, the detail of what this means will have to be worked out in the factual context of actual contests. While our thoughts on this issue are still preliminary, we can envision circumstances where there is a substantial likelihood that a member of a wolf pack will vote their shares not based on the "merits"—their assessment of the best interest of the company—but based on a self-interest that is aligned with the interest of the activist. In such circumstances, the goal of preserving a fair election process may be served by adjusting the pill threshold—and thereby limiting the voting stake of an activist—to take account of the presence of other shareholders whose votes are not up for grabs.

The complete paper is available for download here.

Texas Bill Targets Activist Investors, Advisors

Posted by Dimitri Zagoroff, Glass, Lewis & Co., on Monday, May 15, 2017

Editor's note: Dimitri Zagoroff is a Senior Proxy Research Analyst at Glass, Lewis & Co. This post is based on a Glass Lewis publication by Mr. Zagoroff. 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 Law and Economics of Blockholder Disclosure by Lucian Bebchuk and Robert J. Jackson Jr. (discussed on the Forumhere); and Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

Regulations proposed by the Texas State Legislature would mark a blow to shareholder rights, subjecting investors, proxy advisors and other shareholder support firms to unprecedented disclosure requirements, and potentially serving to reverse the recent expansion of proxy access.

Texas House Bill 2382 would require "activist investors" in Texas-based public companies to register with the state's Securities Commissioner, and provide both the state and the company in question with exhaustive disclosure (including "all plans, intentions, motives, strategies, and objectives" along with any related "notes, e-mails, memoranda, letters, communications, proposals, analyses, spreadsheets, presentations, instruments, and any other documents", and associated costs) within 10 days of becoming a beneficial owner and activist investor. Moreover, the same extensive disclosure requirements apply to all beneficial owners of the activist investor "until the last person named is a natural person," creating a massive headache for any fiduciary and privacy issues for savers. Failure to comply would constitute a Class C Misdemeanor, equivalent to simple assault or criminal trespassing.

The bill defines activist investors as anyone directly or indirectly seeking to propose a shareholder resolution or nominate a director to the board, or simply acting "broadly in concert with" a proponent. As such, the onerous disclosure requirements could apply not just to investors actively pushing for nominees or agenda items, but also to unrelated shareholders who believe that disclosing their voting intention on AGM business forms part of their stewardship responsibility.

The bill also uses a very broad definition of a Texas-based headquarters, which would include "any location at which the president or other chief executive officer of the entity, a general partner of the entity, or any other senior member of the entity's management team routinely performs duties." As such, the scope of the legislation appears to go beyond issuers that are actually based in Texas, such as AT&T, Exxon Mobil and Southwest Airlines, to include companies based across the U.S. with a valid Texas presence.

With respect to proxy advisors, HB 2382 would require disclosure of a firm's beneficial owners, five years of financial statements, and any documents "relating to the discussions and deliberations that resulted in the proxy advisory firm's analysis or recommendation regarding the activist investor's … nominee or shareholder proposal."

Much like with "activist investors," the bill includes an extremely broad definition of proxy advisors, including any firm "that provides corporate governance ratings, proxy research, analyses, shareholder services, or other similar services to shareholders of publicly traded entity." This could include a wide variety of firms, from traditional ratings agencies, such as Moody's and S&P, to ESG ratings such as Sustainalytics and MSCI, proxy solicitation firms or engagement services providers.

In an alert to clients, attorneys from the law firm Olshan describe the scope of the legislation as "unduly burdensome, excessive and inequitable," and warn that "it could have a chilling effect on shareholder activism and proxy advisory work that have a specified presence in Texas, which, in turn, would help entrench management and the Boards of underperforming Texas-based companies."

Following submission of HB 2382, a similar bill was proposed in the Texas Senate. While SB 2206 does not cover proxy advisors, and would not treat an activist investor's failure to comply as a misdemeanor, it would nonetheless implement the same burdensome disclosure regime on investors.

The potential stifling of shareholder rights is particularly concerning in the context of the growing trend of active stewardship across the U.S. market. Shareholder resolutions have seen rising support on key issues ranging from governance practices to climate change to pay equity, and the recent expansion of proxy access provides long-term investors with an opportunity to shape the board itself. In addition, more and more investors are publicizing their voting intentions and working together where appropriate. However, these key rights are less likely to be utilized if they come attached to an onerous regulatory regime.

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Special Meeting Proposals

Posted by Yafit Cohn, Simpson Thacher & Bartlett LLP, on Friday, September 2, 2016

Editor's note: Yafit Cohn is an associate at Simpson Thacher & Bartlett LLP. The following post is based on a Simpson Thacher publication authored by Ms. Cohn, Karen Hsu Kelley, and Avrohom J. Kess.

Shareholders petitioning the board for the special meeting right propose either to create the right or, in circumstances where the right already exists, lower the minimum share ownership threshold required to exercise the right. As of June 30, 2016, 295 companies in the S&P 500 already provided their shareholders with the right to call a special meeting outside of the usual annual meeting, as compared with 286 companies at this time last year. Among companies in the Russell 3000, approximately 1,300 provide their shareholders with the right to call special meetings. During the 2016 proxy season, 19 special meeting shareholder proposals went to a vote at Russell 3000 companies. Of these, five proposals sought to create the right, one of which received majority shareholder support to create the right for holders of 15% of the company's outstanding common stock. The other 14 proposals sought to lower the ownership threshold with respect to an existing right, two of which received majority support; these proposals requested to lower the threshold of an existing right to 10% from either 25% or 50%. Overall, shareholder proposals relating to special meetings received average shareholder support of 41.5% this proxy season.

I. Positions of the Proxy Advisory Firms

A. Institutional Shareholder Services Inc. ("ISS")

With respect to proposals related to special meetings, consistent with its position in 2015, ISS generally recommends:

- voting against proposals that restrict or prohibit a shareholder's right to call a special meeting; and
- voting for proposals that provide shareholders with the ability to call a special meeting.

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 2016, even those that proposed a threshold greater than 10%. Likewise, ISS recommended a vote "for" 11 of the 12 management proposals submitted to a vote in 2016, even though none of them proposed a threshold of 10% and one was submitted together with a competing shareholder proposal.

ISS's recommendations suggest that its view is that some right to call a special meeting 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. If, however, the company's shareholder outreach efforts reveal that a different threshold is acceptable to the company's shareholders, "and the company disclosed these results in its proxy statement, along with the board's rationale for the threshold chosen," ISS has indicated that it will take this into account on a case-by-case basis. ISS will similarly consider the ownership structure of the company. With regard to limitations on the right to call a special meeting, ISS finds "reasonable limitations on the timing and number per year of special meetings" to be "generally acceptable."

ISS considers the right of shareholders to call special meetings beyond just the context of shareholder proposals. For instance, 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."

Additionally, 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 to be an action that "materially reduces shareholder rights," which could negatively impact 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.

B. Glass Lewis

Consistent with its position in 2015, 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 provisions 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.

II. 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. For instance, State Street Global Advisors votes for proposals that set the threshold at 25% or less but not less than 10%, and BlackRock supports proposals that set the threshold at 25% or less but not less than 15%. Conversely, other investors, like Fidelity Management & Research Co., recommend voting for a proposal if the threshold is 25% or more. Still others, such as Vanguard, support shareholders' right to call special meetings (for good cause and with ample representation) and will generally vote for proposals to grant the right, irrespective of the minimum ownership threshold, and against those that seek to abridge the right. 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.

III. SEC No-Action Letters

The 2016 proxy season was marked by a meaningful decrease of no-action requests with regard to special meeting shareholder proposals, with only two requests made on procedural grounds (both of which were granted) and no requests made pursuant to Rule 14a-8's substantive exclusions. This is a significant decrease from 2015, during which there were a total of 17 no-action requests seeking the exclusion of special meeting shareholder proposals, 14 of which were based on substantive grounds.

This decrease is, at least in large part, due to the issuance by the Securities and Exchange Commission ("SEC") of Staff Legal Bulletin 14H ("SLB 14H") on October 22, 2015, which clarified the SEC's view of Rule 14a-8(i)(9)—the provision that permits the exclusion of a shareholder proposal that "directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting." Alleviating the uncertainty created by the Division of Corporation Finance's announcement in early 2015 that it would not consider no-action requests based on Rule 14a-8(i)(9) during the 2015 proxy season, SLB 14H indicated that, in considering no-action requests under Rule 14a-8(i)(9), the SEC would now focus on "whether there is a direct conflict between the management and shareholder proposals," explaining that "a direct conflict would exist if a reasonable shareholder could not logically vote in favor of both proposals." In essence, under the SEC's new approach, if the proposals are "in essence, mutually exclusive," then the shareholder proposal would be excludable; otherwise the proposal may not be excluded on the basis of Rule 14a-8(i)(9). SLB 14H further suggested that a pair of proposals on the same general subject matter but containing different eligibility thresholds would not be deemed "directly conflicting" for purposes of Rule 14a-8(i)(9).

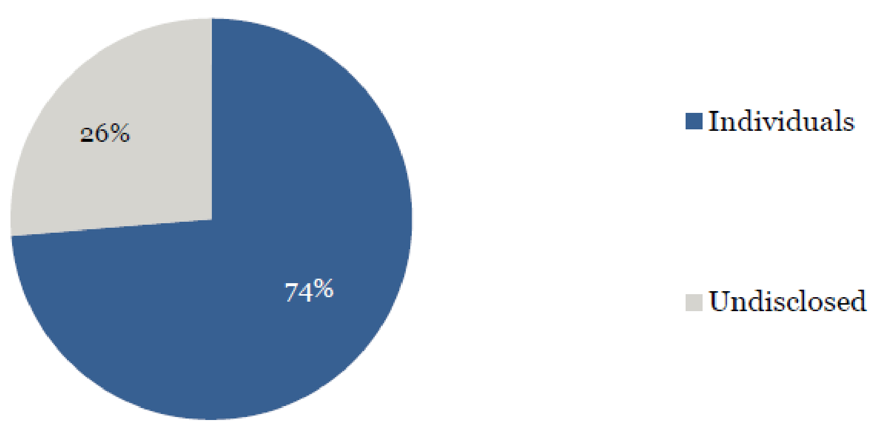
Accordingly, unlike last year, in which 12 no-action requests pertaining to special meeting shareholder proposals were predicated on Rule 14a-8(i)(9), no company submitted a request for no-action relief to exclude a special meeting proposal on the ground that it was submitting a competing management-sponsored proposal on the issue. In fact, 2016 was the first year since 2008 that no companies submitted no-action requests to the SEC on the basis of Rule 14a-8(i)(9) with respect to special meeting shareholder proposals. More broadly, 2016 marked the first year in which there were zero no-action requests regarding special meeting proposals submitted to the SEC on substantive grounds since the SEC's Division of Corporate Finance began publishing no-action letters on its website on October 1, 2007.

IV. Special Meeting Proposal Trends

A. Overall Trends

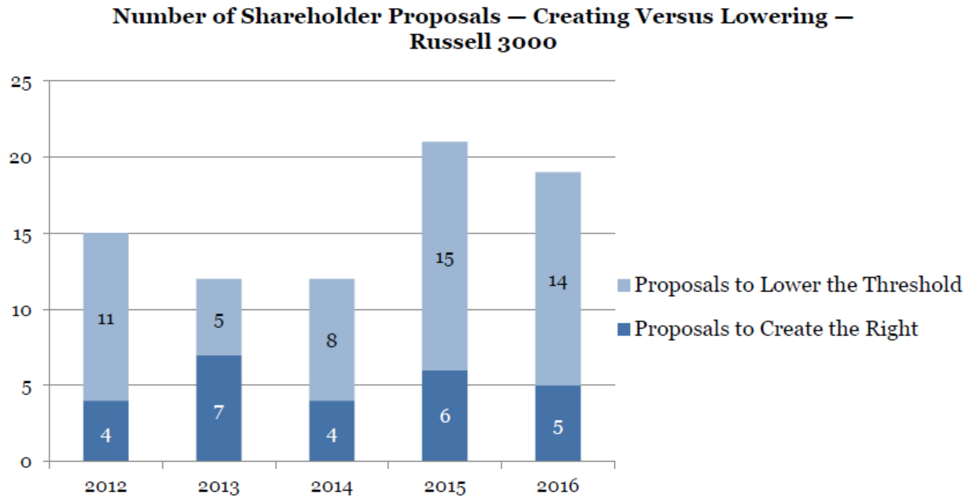
- **This proxy season saw a similar number of special meeting proposals to last year.** The number of proposals submitted by shareholders seeking either to create the right to call special meetings or to lower the threshold requirement for share ownership held steady during 2016, with 19 proposals going to a vote at Russell 3000 companies, compared with 21 such proposals going to a vote in 2015. With the exception of last year, a higher number of special meeting shareholder proposals has not been submitted since 2011, when there were at total of 27 such proposals. The high water mark for special meeting shareholder proposals came in 2009, in which a total of 52 such proposals were submitted to a vote.
- **As in 2015, the majority of proposals were submitted by individual activist shareholders.** Three proponents—John Chevedden, James McRitchie and Shawn McCreight—submitted 100% of the shareholder proposals submitted by individuals.

2016 — Sponsors of Special Meeting Shareholder Proposals — Russell 3000



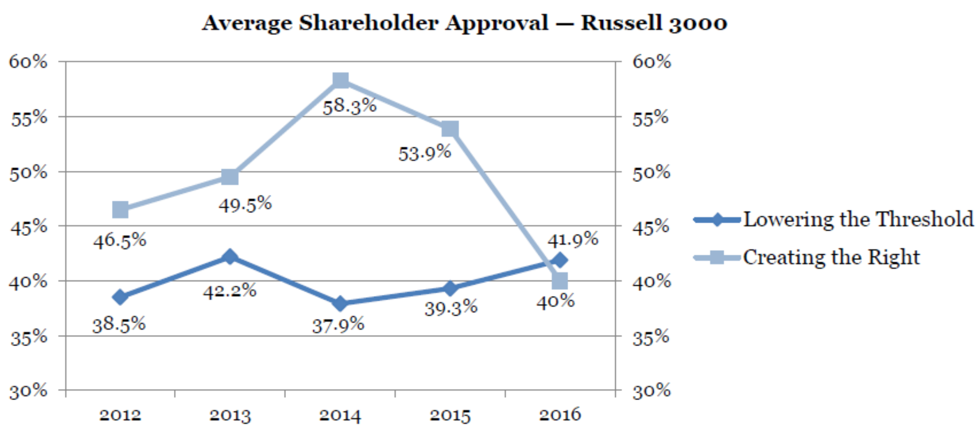
B. Creating the Right Versus Lowering the Threshold

The increase in special meeting shareholder proposals over the past two years has resulted from a greater increase in the number of shareholder proposals to lower the threshold for an existing right than to create the right.



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, 53.6% of proposals (or 15 of 28) to create the right have passed, whereas 13.5% of all proposals (or seven of 52) to lower the threshold of an existing right have passed.

Additionally, in previous years, shareholder proposals to create the right received meaningfully higher average shareholder support than proposals seeking to lower the threshold of an existing right. This year, average shareholder support for shareholder proposals seeking to create the right to call a special meeting dropped significantly, though this seems to be the result of unusually low support at one company. When this company is removed from the calculation, average shareholder support for these proposals increased to 51.3%, which is more in line with average shareholder support observed in previous years.

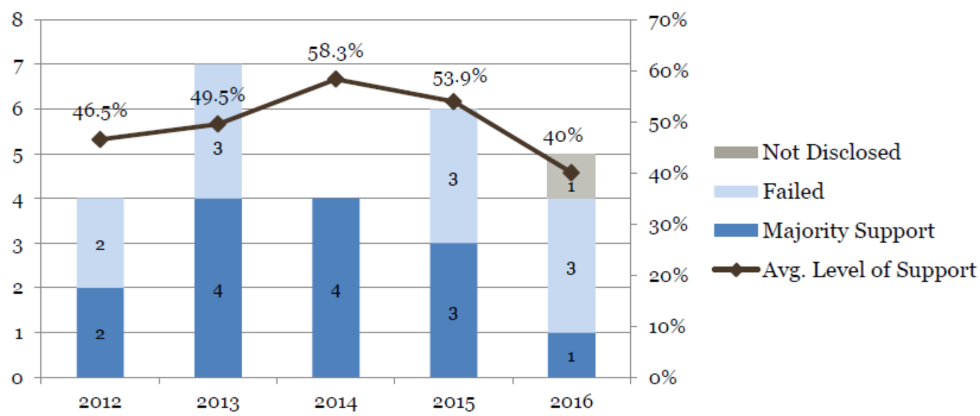


1. Creating the Right

Of the 19 proposals that went to a vote in 2016, five sought to create the special meeting right for the first time. Only one out of these five proposals received majority support this proxy season, representing a considerably lower success rate than observed in previous years.

This year, the average level of shareholder support for proposals seeking to create the right fell to 40% but, when corrected for one outlier, was 51.3%.

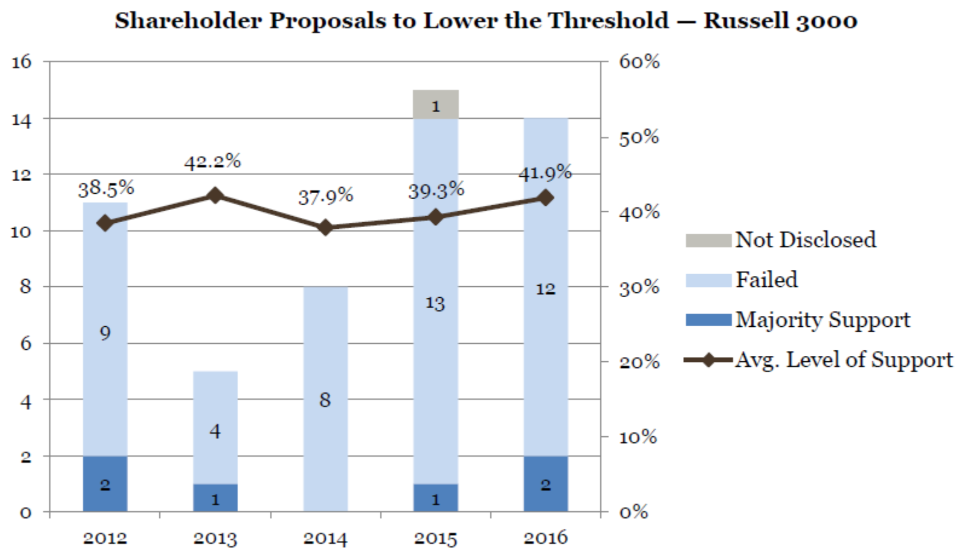
Shareholder Proposals to Create the Right — Russell 3000



2. Lowering the Threshold

Of the 19 special meeting shareholder proposals that reached a vote in 2016, 14 proposed to lower the ownership threshold of an existing right. This number is consistent with 2015 but reflects a significant increase from previous years. Notwithstanding this increased number of proposals seeking to lower the threshold, only two of these proposals (submitted to CBRE Group, Inc. and Staples, Inc.) garnered majority support this year, which is generally consistent with the low success rate of these proposals in previous years.

The average level of shareholder support in 2016 for proposals seeking to lower the threshold was 41.9%, generally comparable to the shareholder support these proposals received over the past five years, which ranged from 37.9% to 42.2%.



C. Management Responses to Special Meeting Shareholder Proposals

Following the SEC's issuance of SLB 14H, which clarified the application of Rule 14a-8(i)(9) to exclude "directly conflicting" proposals and suggested that a special meeting shareholder proposal could not be excluded by submitting a management-sponsored proposal with a different eligibility threshold, issuers that received special meeting shareholder proposals were faced 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 (15 companies)	• 3M Company; • Alexion Pharmaceuticals, Inc.; • American Tower Corporation; • Bristol-Meyers Squibb Company; • Celgene Corporation; • Chevron Corporation; • Colgate-Palmolive Company; • Danaher Corporation; • Ford Motor	Three of the 15 proposals sought to create the right; one received majority support (Average Support = 40.0%) 13 of the 15 proposals sought to lower the threshold; two received majority support (Average Support = 41.1%)

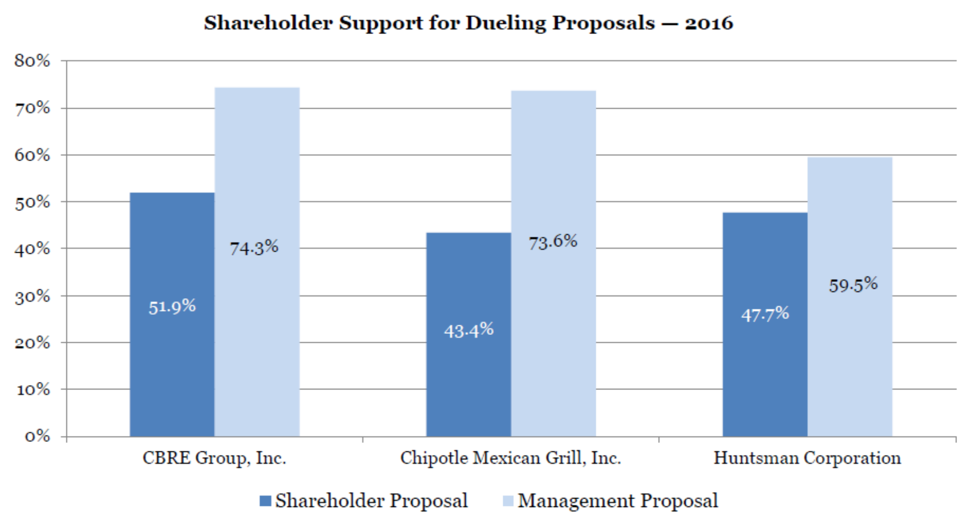
	Company; • Guidance Software, Inc.; • Lockheed Martin Corporation; • Occidental Petroleum Corporation; • Staples, Inc.; • The Boeing Company; • The Home Depot	
2. Include the shareholder proposal with dueling management proposal (3 companies)*	• CBRE Group, Inc.; • Chipotle Mexican Grill, Inc.; • Huntsman Corporation	The proposal at CBRE sought to lower the threshold; it received majority support (Support = 51.9%) The proposals at Chipotle and Huntsman sought to create the right; none received majority support (Shareholder Support at Chipotle = 43.4%) (Shareholder Support at Huntsman = 47.7%)
3. Negotiate with shareholders to include a management proposal at a later date in 2016 (1 company)**	Rofin-Sinar Technologies Inc.	The management proposal sought to create the right with a 25% threshold; failed to receive the 80% support needed to pass.

* In each case where the company submitted a competing management proposal, the management proposal garnered majority support.
** The annual meeting was originally scheduled for March 17, 2016. In connection with that meeting, the company's management actually supported the shareholder proposal to create the right to call a special meeting for holders of 15% of the company's stock, but the meeting was postponed. A subsequent meeting took place on June 29, 2016, at which a management proposal to create the right with a 25% threshold garnered 76.9% of the vote but failed to pass due to an 80% supermajority voting requirement.

D. Trends Among Companies Submitting Dueling Proposals

Three special meeting shareholder proposals were submitted along with dueling management proposals this year; two of them failed and one of them garnered majority support. This result is in contrast to last year, during which there were six pairs of competing special meeting proposals, and in five of those cases, the shareholder proposal received majority support.

Interestingly, the shareholder proposal that garnered majority support this year, which was submitted to a vote at CBRE Group, Inc., was part of a pair of competing proposals in which the management proposal also received majority support. This marks the first instance in which both proposals in a pair of dueling proposals received majority support. CBRE's proxy materials addressed the possibility that both proposals might pass, stating that if the management proposal is approved, "it will be binding" and the management's "Proposed Charter Agreement and related by-law amendments will become effective, regardless of the voting outcome on the Stockholder Proposal." The company's proxy materials further stated that in this scenario, the company "will not implement the Stockholder Proposal irrespective of its voting outcome (and even if the Stockholder Proposal also receives a majority affirmative vote …)."



E. Trends Among Companies That Unilaterally Adopted the Right to Call Special Meetings

In 2016, two companies—Ally Financial Inc. and MetLife, Inc.—chose to amend their bylaws to provide shareholders holding a minimum of 25% of shares with the right to call special meetings and did not submit either a management or shareholder proposal to a vote. The move to provide the right by Ally Financial Inc. arose in conjunction with the company replacing plurality voting with majority voting in uncontested director elections and came shortly after the company appointed a new independent director to its board of directors, thereby expanding its board. Ally's board chairman, Franklin Hobbs, had expressed frustration with what he felt was negative market perception being reflected in the Ally's stock price, and the company was seeking ways to "better align management's and shareholders' interests."

Though there is less context in MetLife's case, the MetLife board stated that the "Board's decision to proactively adopt such shareholder right incorporates feedback received during [its] regular investor outreach and reflects [the company's] commitment to strong governance practices."

F. Threshold Levels

As noted above, 14 of the special meeting shareholder proposals that went to a vote in 2016 sought to lower the ownership threshold of an existing right. Six of these proposals sought to lower the higher existing ownership threshold to a 10% ownership threshold. All but one of these failed, receiving average support of 40.0%. This is relatively consistent with 2015, in which all of these proposals failed, but represents a departure from earlier years. From 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%.

Similar to 2015, the current voting trends seems to indicate 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 support a 10% threshold. At 18 of the 19 companies that received a shareholder proposal in 2016, shareholders seemed to prefer thresholds of at least 15%, but most often 25%. The voting results at these 19 companies can be broken down as follows:

- **Dueling Proposals.** When confronted with a shareholder proposal that competed with a management proposal, two companies' shareholders supported management-sponsored thresholds of 25% and rejected shareholder-sponsored thresholds of 10%. In the case of CBRE Group, Inc. both the management and shareholder proposals received the required majority vote required to pass but management elected to implement the management-sponsored threshold of 30% instead of the shareholder-sponsored threshold of 10%.
- **Shareholder Proposals Seeking to Create the Special Meeting Right.** When confronted with a shareholder proposal to create the special meeting right, three 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% to 50%. Of the fourteen companies affected:
    - At twelve companies, shareholders opted to retain the companies' preexisting thresholds of 15-30% and voted against shareholder proposals seeking to lower the threshold. Ten of these existing thresholds were set at 25%.
    - At one company, shareholders voted in favor of a shareholder proposal to lower the threshold to 15%.
    - At one company, CBRE Group, Inc., shareholders voted in favor of a shareholder proposal to lower the threshold to 10%, but since they also voted in favor of the management proposal, only the management-selected threshold of 30% (down from 50%) was implemented.

Similar to 2015, 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.

V. 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 and the composition of the company's shareholder base.

In light of the SEC's new guidance on the application of Rule 14a-8(i)(9), issuers can no longer rely on Rule 14a-8(i)(9) to exclude a special meeting shareholder proposal by virtue of submitting a management- sponsored proposal with a higher threshold. Some companies will 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 specific 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.

Tab VIII: Multiple-Class Capital Structure

The Untenable Case for Perpetual Dual-Class Stock

Posted by Lucian Bebchuk and Kobi Kastiel, Harvard Law School, on Monday, April 24, 2017

Editor's note: Lucian Bebchuk is the James Barr Ames Professor of Law, Economics, and Finance, and Director of the Program on Corporate Governance, at Harvard Law School. Kobi Kastiel is the Research Director of the Project on Controlling Shareholders of the Program. This post is based on their Article, The Untenable Case for Perpetual Dual-Class Stock, forthcoming in the *University of Virginia Law Review*. The Article is part of the research undertaken by the Project on Controlling Shareholders.

We recently placed on SSRN our study, The Untenable Case for Perpetual Dual-Class Stock. The study, which will be published by the *University of Virginia Law Review* in June 2017, analyzes the substantial costs and governance risks posed by companies that go public with a long-term dual-class structure.

The long-standing debate on dual-class structure has focused on whether dual-class stock is an efficient capital structure that should be permitted at the time of initial public offering ("IPO"). By contrast, we focus on how the passage of time since the IPO can be expected to affect the efficiency of such a structure.

Our analysis demonstrates that the potential advantages of dual-class structures (such as those resulting from founders' superior leadership skills) tend to recede, and the potential costs tend to rise, as time passes from the IPO. Furthermore, we show that controllers have perverse incentives to retain dual-class structures even when those structures become inefficient over time. Accordingly, even those who believe that dual-class structures are in many cases efficient at the time of the IPO should recognize the substantial risk that their efficiency may decline and disappear over time. Going forward, the debate should focus on the permissibility of finite-term dual-class structures—that is, structures that sunset after a fixed period of time (such as ten or fifteen years) unless their extension is approved by shareholders unaffiliated with the controller.

We provide a framework for designing dual-class sunsets and address potential objections to their use. We also discuss the significant implications of our analysis for public officials, institutional investors, and researchers.

Below is a more detailed summary of our analysis:

1990, Viacom Inc., a prominent media company, adopted a dual-class capital structure, consisting of two classes of shares with differential voting rights. This structure enabled Viacom's controlling shareholder, Sumner Redstone, to maintain full control over the company while holding only a small fraction of its equity capital. At the time, Redstone was already one of the most powerful and successful figures in Hollywood. Indeed, three years earlier, he had bought

Viacom in a hostile takeover, exhibiting the kind of savvy and daring business maneuvers that subsequently helped him transform Viacom into a $40 billion entertainment empire that encompasses the Paramount movie studio and the CBS, MTV, and Showtime television networks. Investors during the 1990s could have reasonably been expected to be content with having Redstone safely at the helm.

Fast-forward twenty-six years to 2016: Ninety-three-year-old Redstone faced a lawsuit, brought by Viacom's former CEO and a long-time company director, alleging that Redstone suffered from "profound physical and mental illness"; "has not been seen publicly for nearly a year[;] can no longer stand, walk, read, write or speak coherently; … cannot swallow[;] and requires a feeding tube to eat and drink." Indeed, in a deposition, Redstone did not respond when asked his original family birth name. Some observers expressed concerns that "the company has been operating in limbo since the controversy erupted." However, public investors, who own approximately ninety percent of Viacom's equity capital, remained powerless and without influence over the company or the battle for its control.

Eventually, in August 2016, the parties reached a settlement agreement that ended their messy legal battles, providing Viacom's former CEO with significant private benefits and leaving control in the hands of Redstone. Notably, despite the allegation and the evidence that surfaced, the settlement prevented a court ruling on whether Redstone was legally competent. Note that even a finding of legal competency would have hardly reassured public investors: Legal competence does not by itself qualify a person to make key decisions for a major company. Moreover, once Redstone passes away or is declared to be legally incompetent, legal arrangements in place would require the control stake to remain for decades in an irrevocable trust that would be managed by a group of trustees, most of whom have no proven business experience in leading large public companies. Thus, even assuming that Viacom's governance structure was fully acceptable to public investors two decades ago, this structure has clearly become highly problematic for them.

Let us now turn from Viacom to Snap Inc. The company responsible for the popular disappearing-message application Snapchat has recently gone public with a multiple-class structure that would enable the company's co-founders, Evan Spiegel and Robert Murphy, to have lifetime control over Snap. Given that they are now only twenty-six and twenty-eight years old, respectively, the co-founders can be expected to remain in control for a period that may last fifty or more years.

Public investors may be content with having Spiegel and Murphy securely at the helm in the years following Snap's initial public offering. After all, Spiegel and Murphy might be viewed by investors as responsible for the creation and success of a company that went public at a valuation of nearly $24 billion. However, even if the Snap co-founders have unique talents and vision that make them by far the best individuals to lead the company in 2017 and the subsequent several years, it is hardly certain that they would continue to be fitting leaders down the road. The tech environment is highly dynamic, with disruptive innovations and a quick pace of change, and once-successful founders could well lose their golden touch after many years of leading their companies. Thus, an individual who is an excellent leader in 2017 might become an ill-fitting or even disastrous choice for making key decisions in 2037, 2047, or 2057. Accordingly, as the time since Snap's IPO grows, so does the risk that Snap's capital structure, and the co-founders' resulting lock on control, will generate costly governance problems.

The examples of Viacom and Snap highlight an important dimension—the passage of time since a company's IPO—that has thus far received insufficient attention. This Article seeks to provide a comprehensive, systematic analysis of how the potential costs and benefits of a dual-class structure—and thus the overall efficiency of such a structure—change over time. Our analysis demonstrates that, as time passes, the potential costs of a dual-class structure tend to increase and the potential benefits tend to erode. As a result, even if the structure were efficient at the time of the IPO, there would be a substantial risk that it would not remain so many years later, and this risk would keep increasing as time passes. Furthermore, we show that controllers have strong incentives to retain a dual-class structure even when that structure becomes inefficient over time. Thus, even those who believe that a dual-class structure is often efficient at the time of the IPO should recognize the perils of providing founders with perpetual or even lifetime control.

The debate going forward should focus on the assessment and permissibility of dual-class structures with a finite term—that is, structures that sunset after a fixed period of time (such as ten or fifteen years) unless their extension is approved by shareholders unaffiliated with the controller. We examine how sunsets could be designed, address potential objections to their use, and explain the implications of our analysis for public officials, institutional investors, and corporate governance researchers.

The analysis of our Article is organized as follows. Part I explains the substantial stakes in the policy debate that we seek to reframe. We begin by discussing the importance of dual-class companies in the United States and around the world. A significant number of U.S. public companies, including such well-known companies as CBS, Comcast, Facebook, Ford, Google, News Corp., and Nike, have dual-class structures. Furthermore, since Google decided to use a dual-class structure for its 2004 IPO, a significant number of "hot" tech companies have followed its lead.

Part I also discusses the long-standing debate over the desirability of dual-class structures. The New York Stock Exchange ("NYSE") prohibited dual-class structures for approximately sixty years, until the mid-1980s, and they are still prohibited or rare in some jurisdictions, such as the United Kingdom and Hong Kong. However, the rules now prevailing in the United States, as well as in some other jurisdictions around the world, permit the use of dual-class stock. Moreover, the debate on the subject is still ongoing—both in jurisdictions that prohibit dual-class structures and those that permit them.

In this debate, which has thus far focused on whether and when it is desirable for companies to go public with a dual-class structure, we side with those who are skeptical of the value of dual-class IPOs. In this Article, however, we seek to reorient the debate by focusing on the mid-stream desirability of dual-class structures in long-standing public companies. Showing that dual-class structures are likely to become inefficient over time even if they happen to be efficient at the time of the IPO, we suggest taking one option—a perpetual dual-class structure—off the table. Going forward, the debate should focus on whether companies should be allowed to go public with finite-life dual-class structures—that is, structures with a sunset clause. Perpetual dual-class stock, without any time limitation, should not be part of the menu of options.

Part II analyzes how the potential costs of dual-class structures change over time. These costs tend to increase for two major reasons. To begin, in a dynamic business environment, even a founder who was the fittest leader at the time of the IPO might eventually become an inferior leader due to aging or changes in the business environment, and this risk increases the expected costs of providing the founder with a lifetime lock on control. Indeed, the expected costs of a lifetime lock on control are likely to be especially large when the founder is young or even middle-aged at the time of the IPO. Concerns about the emergence of inferior leadership over time are further aggravated when the dual-class structure enables a transfer of the founder's lock on control to an heir who might be unfit to lead the company.

Furthermore, many dual-class structures enable controllers to substantially reduce their fraction of equity capital over time without relinquishing control, and controllers often do so to diversify their holdings or finance other investments or assets. When the wedge between the interests of the controller and those of the public investors grows over time, the agency costs of a dual-class structure can also be expected to increase.

Part III then analyzes how the potential benefits of a dual-class structure can be expected to change over time. Dual-class structures are often justified on the grounds that the founder of a company going public has skills, abilities, or vision that makes her uniquely fit to be at the helm. Many years later, however, the founder's superiority as the company's leader, and with it the expected value of having the founder retain a lock on control, could erode or disappear altogether. Another potential benefit often ascribed to dual-class structures is that they insulate management from short-term market pressures. However, the expected benefit from such insulation is likely to be larger when the controller is a fitting leader for the company and likely to decline when the passage of time makes the controller ill fitting for the leadership role. Finally, it might be suggested that insulation from market forces might be beneficial to companies that are new to the public market, but any such potential benefit is again expected to decline and eventually disappear as time passes from the IPO.

Part IV explains why public officials and investors cannot rely on private ordering to eliminate dual-class structures that become inefficient with time. We show that controlling shareholders, especially those who hold a small fraction of equity capital, have significant perverse incentives to retain a dual-class structure that has become inefficient, even when dismantling it—via a conversion to a one-share-one-vote structure or a sale of the company—would produce substantial efficiency gains. The reason is that the controller would capture only a fraction of the efficiency gains, which would be shared by all shareholders, but would fully bear the cost of forgoing the private benefits of control associated with the dual-class structure.

To address the distorted incentives of controllers to retain dual-class structures even when those structures become substantially inefficient, IPO dual-class structures can include sunset provisions stipulating the structures' expiration after a fixed period of time, such as ten or fifteen years. Part V discusses the merits and design of such sunset provisions. To enable the retention of structures that remain efficient, we explain that the initially specified duration of the dual-class structure could be extended if such extension is approved by a majority of the shareholders unaffiliated with the controller. We also address potential objections to arrangements that preclude or discourage perpetual dual-class structures. In particular, we respond to objections that (1) perpetual dual-class structures should be presumed efficient if they are chosen by market participants and (2) allowing perpetual structures is necessary to induce founders to go public.

Finally, Part VI discusses the implications of our analysis for policymaking, investors, and corporate-governance research. Public officials and institutional investors should consider precluding or discouraging IPOs that set a perpetual dual-class structure. They should also be attentive to the aggravated agency problems that are posed by companies that went public with perpetual dual-class structures a long time ago. Researchers should take the time dimension into account in their analyses of dual-class structure and should test several empirical predictions that Part VI puts forward. We hope that future assessments of dual-class structures will be informed by the problems that we identify in this Article and the framework of analysis that we put forth.

The Article is available for download here.

Snap, Inc. Reportedly to IPO with Unprecedented Non-Voting Shares for Public

Posted by Rob Kalb and Rob Yates, Institutional Shareholder Services, Inc., on Tuesday, February 7, 2017

Editor's note: Rob Kalp is a Senior Associate and Rob Yates is a Research Analyst at Institutional Shareholder Services, Inc. This post is based on an ISS publication.

SnapChat's ghostly logo represents the "There, then gone" nature of the company's photo sharing service, but it also might ominously foreshadow the soon-to-be-public parent company's plan to offer "phantom" voting rights to its post-IPO investors. On Nov. 15, 2016, Snap filed for a confidential IPO. Filing confidentially, a process allowed under the JOBS Act, shields Snap from the public financial disclosure scrutiny a traditional S-1 filing would entail. While the company has been able to keep most of its IPO plans close to the vest, recent reporting by the *Wall Street Journal* indicates that the company intends to sell exclusively non-voting shares to the public. By doing so, Snap would implement a three-class share structure. Snap's founders would retain super-voting shares, pre-IPO investors' shares would have a lesser voting power, and no votes for IPO shareholders.

The reported Snap plan to offer its IPO shareholders solely non-voting shares is an extreme. The sheer act of going public as a controlled company with a dual or multi-class share structure is not a new occurrence, but many multi-class share companies give at least token voting rights to public shareholders. The most common structure is to give ten votes per share to insiders, and one vote per share to non-insiders.

Recent history reinforces this; for Russell 3000 companies holding their first annual shareholder meeting in 2016, ISS identified 20 companies with a dual-class share structure. Of these, an unequal voting-rights structure with a ratio of one vote per share for public shareholders versus ten votes per share for insiders was used at 11 companies, such as Match Group, Inc., Square, Inc., and The Madison Square Garden Company. By comparison, for companies holding their first annual shareholder meeting in 2015, ten companies utilized a dual-class share structure with one vote per share for public shareholders versus ten votes per share for insiders. A one-to-ten voting-power dual-class structure was also implemented at both Google (now Alphabet) and Facebook at the time of their IPOs in 2004 and 2012, respectively.

At the biggest companies, the practice of dual- and multi-class share structures is in decline, as indicated by the trend since 2013. While the total percentage of R3000 companies with multi-class structure has remained the same in that period, ISS QualityScore data shows that no R3000 company since 2014 has adopted a multi class-structure; rather, companies with existing multi-class structures have moved into the index, companies have IPO'd multi-class, or there was a corporate transaction, like the spinoff at NewsCorp. QualityScore data also shows that 42 companies in the R3000, including seven companies in the S&P 500 (with names such as Visa and PepsiCo on the list) have completely done away with multi-class share structures.

There is no doubt that Google and Facebook have garnered significant positive returns for shareholders since their respective IPOs, but going public as a controlled company with a dual-class unequal-voting-rights structure is not an assurance for positive returns. Within the technology industry alone, Groupon, Inc., Zynga, Inc., and GoPro, Inc., for example, each came public with a dual-class share structure. Fraught with governance concerns, all three companies had ISS QualityScores of 10, indicating the highest levels of governance risk, and the share price of all three has tumbled precipitously since their respective initial public offerings.

Governance Concerns at Controlled Companies

Studies Show Lower Performance and Weaker Controls in Multi-Class Control Structures

Not all of the concerns at controlled companies are extreme examples of behavior that culminate in share price crashes. The lack of external accountability under which controlled companies operate leads to underperformance in a number of key governance and financial metrics. For example, according to a 2016 ISS/IRRC study on controlled companies, “Controlled companies underperformed non-controlled firms over all periods reviewed (one-, three-, five- and 10-year periods) with respect to total shareholder returns, revenue growth, return on equity, and dividend payout ratios.”

Further, governance standards are generally weaker at controlled companies. There is less gender and ethnic diversity in the boardroom, directors have longer average tenures with less board refreshment, and there are more related-party transactions and they are larger in size, as a few examples.

The study found one key point that is particularly relevant to the multi-class offering that Snap, Inc. is reportedly considering—which may portend other IPOs to come in 2017 in the tech sector—*companies with a single class of stock and a controlling shareholder were more like non-controlled firms than they were like multi-class controlled companies.* “Board and key committee independence levels, the prevalence of annually elected boards and majority vote standards for director elections, the frequency of supermajority vote requirements, and the thresholds for shareholders’ right to call a special meeting at controlled firms with single-class capital structures all continue to resemble those at non-controlled firms more so than at controlled multi-class stock firms.”

The documented penchant for secrecy from Snap’s founders, exhibited not only though the confidential IPO filing but also as a company culture, may draw an almost natural comparison to another secretive tech company, Apple. At Snap, however, this lack of forthrightness mixed with little to no ability for IPO shareholders to hold management accountable may not lead to a storybook outcome for investors.

Executive Pay is Higher as Well

Additionally, using data from ISS’ ExecComp Analytics database, the study found that CEOs at multi-class controlled firms are granted significantly more compensation. Average granted chief executive pay at controlled companies with a multi-class capital structure is three times higher (by some $7.2 million) than that at single-class stock controlled firms and is more than 40 percent ($3.3 million) higher than average CEO pay at non-controlled firms. The average CEO pay package at all controlled S&P 500 large-cap firms surpasses that at non-controlled firms by $6.9 million; however, at controlled multi-class stock large-cap firms, average CEO pay exceeds that at controlled companies with a single stock class by $16.2 million and that at non-controlled firms by $9.5 million.

With Less Accountability to Shareholders Comes Greater Risk

Investor Risk Concern Reflected in Investment Considerations and Share Price

Not all controlled firms are created equal, even among companies that have similar control provisions through their respective share structures. Some companies, such as Alphabet, where founders hold near-absolute control, have thrived and outperformed peers, sector, and index while improving in other areas of governance. However, the lack of accountability inherent to a controlled company creates a risk that can make investors nervous, and with good reason, as demonstrated through the aforementioned stock price crashes. In its 2016 policy survey, ISS found that 56 percent of investor respondents consider controlled status before making an investment decision.

Additional investor comments in the survey period indicated an extra layer of concern when it came to investing in controlled companies, especially those of the multi-class variety. Investors who said they distinguish between controlled and non-controlled companies when making investment decisions commented that the presence of a controlling shareholder would result in closer attention paid to board composition and the protection of minority shareholder rights, or, in some cases, result in a decision to forego the investment altogether. A number of investors stated that control via super-voting shares is considered much more problematic than control via majority ownership, as the latter ensures an alignment of economic interests among shareholders while the former does not.

Beyond incorporating the cost of additional risk in a non-voting share, investors have real financial reasons to be wary of these company stocks beyond calamitous price drops. Numerous studies have shown that there is a non-voting share "premium" where these share prices are lower than comparable voting shares. The value of that premium varies by stock and company, and most recognize that performance is ultimately more important than voting rights, but related studies looking at differences in share price for non-investment purposes have assumed a 5-percent difference for shares with no voting rights attached.

ISS Policy Changes Follow Investor Concerns

Due to these shareholder concerns, ISS included a question in the 2016-2017 policy survey asking about companies that come public with multiple share classes with disparate voting rights. A majority of investor respondents, 57 percent, supported negative recommendations for directors at companies that implement such a share structure. Among non-investor respondents, a majority supported negative director recommendations only in cases where provisions for the multi-class share structure were put in place permanently. As implemented for the 2017 proxy season, ISS will review the share structure of newly public companies and may issue negative vote recommendations when companies put unequal voting right structures in place.

Snap, Inc. Unique in the Extremity of its Reported IPO Plans

A Harbinger of Things to Come?

A decision to issue non-voting shares in its IPO would set Snap apart from other recent dual-class IPO examples. When Google, Facebook, and Under Armour each came public they each did so with a dual-class share structure that at least afforded public shareholders one vote per share. Nevertheless, each company subsequently requested shareholder approval for the issuance of a third class of non-voting shares. In each of these three cases, the purpose of creating a new non-voting share class was for insiders to maintain their voting control while at the same time providing insiders access to liquidity. If Snap goes public exclusively with non-voting shares, its options may be limited for new classes, but insiders will not have to worry about losing control of the company.

As investors await more definitive disclosure from Snap regarding its plans to come public, certain questions remain:

- Will Snap's founders issue themselves non-voting shares as part of the IPO? If so, how much?
- While it appears certain pre-IPO investors will receive shares with limited voting power, what happens to these shares when they are sold or transferred? Do they convert to non-voting shares or maintain their voting rights?
- Is the dual-class share structure at Snap subject to a sunset provision?
- Does Snap's non-voting class offering become the standard for other large anticipated IPOs in 2017?

If and when the details of the S-1 become public, ISS will provide further insight into the structure under which Snap plans to issue its first public shares, and any potential concerns of which investors should be aware. Perhaps more concerning, it remains to be seen whether other companies adopt the Snap IPO playbook, and if there is a new standard for tech companies to launch IPOs with multi-class share structure that give public shareholders little or no say in the governance of the company, and that leave management accountable to no one but themselves.

Snap and the Rise of No-Vote Common Shares

Posted by Ken Bertsch, Council of Institutional Investors, on Wednesday, May 24, 2017

Editor's note: Ken Bertsch is Executive Director at the Council of Institutional Investors. This post is based on Mr. Bertsch's recent remarks to the SEC Investor Advisory Committee. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).

Snap Inc.'s IPO [on March 2, 2017], featuring public shares with no voting rights, appears to be the first no-vote listing at IPO on a U.S. exchange since the New York Stock Exchange (NYSE) in 1940 generally barred multi-class common stock structures with differential voting rights.

Members of the Council of Institutional Investors have watched with rising alarm for the last 30 years as global stock exchanges have engaged in a listing standards race to the bottom. With NYSE-listed Snap's arrival with "zero" rights for public shareholders, perhaps the bottom has been reached.

The Snap IPO took place as the Singapore Exchange proposed to permit multi-vote common stock, and Hong Kong Exchange leaders suggested their exchange may revive consideration of the same. The Hong Kong Securities and Futures Commission, which has provided strong leadership on the matter, blocked such a move just two years ago.

It is clear that Singapore and Hong Kong are responding to competitive pressure from low standards at the NASDAQ and the NYSE, just as NYSE was pressured to relax its rules in 1986 by the lack of restrictions on dual-class listings at NASDAQ. The Council of Institutional Investors was founded in 1985, and this was the first issue we confronted. The Council at that time adopted a strong policy setting one-share, one-vote as a bedrock principle. That remains our policy today, with strong support from all of our constituent groups, including asset owners and asset managers with varying investment methodologies.

We believe multi-class common structures and their power to separate ownership from control pose substantial risks with respect to all three aspects of the commission's tripartite mission: protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation. It is time for the SEC to revisit with U.S.-based stock exchanges the rules on new offerings of multi-class common structures with differential voting rights.

If the exchanges are not willing to bar future common share structures with differential voting rights, the SEC should work with U.S.-based stock exchanges to:

- Bar future no-vote share classes;
- Require true and reasonable sunset provisions for differential common stock voting rights(that cannot be overridden by the controlling shareholder, as often happens); and
- Consider enhanced board requirements for dual-class companies to build greater confidence that boards do not simply rubber-stamp founder managers or the controlling family.

Some background: Soon after the NYSE matched NASDAQ on this in the 1980s, the SEC took action itself to sharply limit multi-class share structures with differential voting rights. But the SEC rule was struck down by a court in 1990. Subsequently, the SEC approved new rules from the U.S. stock exchanges themselves. While the rules created consistency between U.S. exchanges, they have proven weak and decreasingly successful in promoting equal voting rights.

The core concern here is corporate governance 101: Separation of ownership and control over time can lead to a lack of accountability, and accountability to owners is necessary for course corrections that are critical in our capitalist system. Private equity owned firms typically have owners who are engaged and able to force change where management is failing. Public company shareholders rely on the board members they elect to do the same. At Snap, public shareholders, who likely will come to be the dominant providers of capital, have *no* role in electing directors. And disclosures may be limited compared with true public companies, including no requirement to file a proxy statement or hold an annual meeting open to public shareholders.

Corporations are led by human beings, who are fallible and who do not always see clearly their own mistakes and limitations. Eventually, every company runs into problems, and there needs to be an effective mechanism of accountability to owners. The vitality of American capitalism stems in large measure from U.S. companies' responsiveness to pressures for change from the providers of capital, even when egos are bruised, strategies are upended and executive careers derailed.

Proponents of shielding founders and managers from a company's owners through multi-class structures say that the public markets too often are impatient, and visionary leaders must be protected from company owners to create value for the long-term. For example, Snap CEO Evan Spiegel says it will be five years before markets will see what he can do.[1] That seems to be the basis for Snap's extreme disenfranchisement of public shareholders.

I believe the assertion is dubious. But even if true, why not sunset the share structure in five years, or at least provide an opportunity at the five-year mark for shareholders to vote on a one-share, one-vote basis on whether to extend this protection for another five years?

Snap has a type of sunset provision, but it is triggered only when both founders die (unless they sell off their shares). One founder is age 26, and the other is age 28. Sumner Redstone turns 94 in May, and problems in recent years at Viacom, which he controls by virtue of dual-class shares, are a good example of long-term pitfalls of multi-class stock companies. Assuming that Mr. Spiegel matches Mr. Redstone in longevity, Snap shareholders may be stuck with current control for the next 66 years.

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[1] We built our business on creativity," Spiegel said. "And we're going to have to go through an education process for the next five years to explain to people how our users and that creativity creates value." See *Los Angeles Times*, at http://www.latimes.com/business/technology/la-fi-tn-evan-spiegel-bobby-murphy-20170302-story.html.

The Council’s membership of asset owners, mostly pension funds, have 25- or 30-year investment horizons. They view the increasing prevalence of ever-worse multi-class share structures as seeding problems that will manifest decades from now, harming pension beneficiaries and others. And all on the basis of a theory for which there is little evidence—that founders and controlling holders can grow companies more successfully if they are insulated from accountability to shareholders.

Evidence is lacking that, on net, the management teams, founders and families protected by dual class shares outperform. An upcoming Council study comparing multi-class companies with other firms finds that a multi-class structure neither increases nor decreases return on invested capital (ROIC). The study, of 1,763 U.S. companies in the Russell 3000 index, looks at ROIC from 2007 through 2015. Similarly, two IRRC Institute studies in recent years, including a 2016 paper, have found no clear advantage at controlled companies with differential voting rights, and some evidence of underperformance.

We hear an argument that as long as disclosure rules are good, multi-class structures are acceptable, as purchasers of shares with inferior voting rights can factor that into pricing. To the extent there is validity to that argument at IPO, it breaks down over the longer term given the present operation of our security markets, with long-term investors acting as universal owners, and portfolios to one extent or another indexed to the entire market.

Indeed, the growing importance of indexed investment in the market has increased the need for strong definitions around categories of securities. The idea of an endless variety of securities offerings, with fuzzy, poorly defined boundaries between categories, is attractive to investment bankers and law firms that can make a lot of money off their creative ideas. Such creative ideas include innovative structures that provide comfort to founder/managers that they will not be challenged by company owners, even as they pull in significant capital from public markets. But at some point there is substantial risk of market confusion, and disenabling of simple passive approaches to investment. We learned in the financial crisis that greater complexity in financial structures can have real downsides.

The Snap offering lacks some components for the definition of “equity security” that our members regard as inherent in the definition of an equity, most importantly voting rights. We have heard suggestions that Snap’s public share class is less like common equity and more like a preferred share, or a derivative, or a master limited partnership unit. There is merit in these comparisons, although the Snap public share class is a poor cousin to all of them as well. Just to take the preferred shares comparison, the Snap security lacks a higher claim on company assets, and there is no mechanism for providing voting rights if the company fails to perform or falls into distress.

CII and a group of our members are approaching index providers to explore exclusion from core indexes, on a prospective basis, of share classes with no voting rights.

But this does not absolve stock exchanges of responsibility. When the SEC worked with U.S. stock exchanges in the 1990s to put the present rules in place, I do not believe many envisioned significant classes of shares with zero voting rights. With the Snap IPO, it is clearer than ever that current rules are ineffective and need to be revisited. With each further step in enabling multi-class stock structures, critical investor protections are eroded and the potential for strong rules recedes. To the extent that Singapore, Hong Kong and other exchanges that have maintained strong standards on multi-class common share listings decide they cannot compete, we will see further decline that will be very difficult to reverse.

We also hear an argument that investors should tolerate multi-class structures as they entice private companies to go public when they might not otherwise. We believe the primary driver of reduced IPO activity relative to other times in history is easy access to private capital, not a fear among founders that their performance as managers will become subject to oversight from the company's owners. In our view, asking public company investors to accept multi-class structures for the sake of IPO growth is as unreasonable as asking private company investors to cease investing in private companies for the sake of IPO growth.

I recognize that the chair-designee of the SEC, Jay Clayton, was intimately involved as a securities lawyer in Alibaba, a Chinese company that succeeded in sharply limiting voting rights of public shareholders only by listing at the NYSE rather than in Hong Kong. Nonetheless, I hope that the Investor Advisory Committee will work with the Commission, including its new chair, assuming that he is confirmed, on reviewing the adequacy of U.S. stock exchange rules.

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Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights

Posted by Blair Nicholas and Brandon Marsh, Bernstein Litowitz Berger & Grossmann LLP, on Tuesday, May 16, 2017

Editor's note: Blair A. Nicholas is a partner and Brandon Marsh is senior counsel at Bernstein Litowitz Berger & Grossmann LLP. This post is based on a Bernstein Litowitz publication by Mr. Nicholas and Mr. Marsh. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).

Recent developments and uncertainties in the securities markets are drawing institutional investors' attention back to core principles of corporate governance. As investors strive for yield in this post-Great Recession, low interest rate environment, large technology companies' valuations climb amid the promises of rapid growth. But at the same time, some of these successful companies are asking investors to give up what most regard as a fundamental right of ownership: the right to vote. Companies in the technology sector and elsewhere are increasingly issuing two classes or even three classes of stock with disparate voting rights in order to give certain executives and founders outsized voting power. By issuing stock with 1/10th the voting power of the executives' or founders' stock, or with no voting power at all, these companies create a bulwark for managerial entrenchment. Amid ample evidence that such skewed voting structures lead to reduced returns long run, many public pension funds and other institutional investors are standing up against this trend. But in the current environment of permissive exchange rules allowing for such dual-class or multi-class stock, there is still more that investors can do to protect their fundamental voting rights.

The problem of dual-class stock is not new. In the 1920s, many companies went public with dual-class share structures that limited "common" shareholders' voting rights. But after the Great Depression, the NYSE—the dominant exchange at the time—adopted a "one share, one vote" rule that guided our national securities markets for decades. It was only in the corporate takeover era of the 1980s that dual-class stock mounted a comeback, with executives receiving stock that gave them voting power far in excess of their actual ownership stake. Defense-minded corporate executives left, or threatened to leave, the NYSE for the NASDAQ's or the American Exchange's rules, which permitted dual-class stock. In a race to the bottom, the NYSE suspended enforcement of its one share, one vote rule in 1984. While numerous companies have since adopted or retained dual-class structures, they remain definitively in the minority. Prominent among such outliers are large media companies that perpetuate the managerial oversight of a particular family or a dynastic editorial position, such as *The New York Times*, CBS, Clear Channel, Viacom, and News Corp.

Now, corporate distributions of non-voting shares are on the rise, particularly among emerging technology companies. They have also been met with strong resistance from influential institutional investors. In 2012, Google—which already protected its founders through Class B shares that had ***ten times*** the voting power of Class A shares—moved to dilute further the voting rights of Class A shareholders by issuing to them third-tier Class C shares with no voting rights as "dividends." Shareholders, led by a Massachusetts pension fund, filed suit, alleging that executives had breached their fiduciary duty by sticking investors with less valuable non-voting shares. On the eve of trial, the parties agreed to settle the case by letting the market decide the value of lost voting rights. When the non-voting shares ended up trading at a material discount to the original Class A shares, Google was forced to pay over $560 million to the plaintiff investors for their lost voting rights.

Facebook followed suit in early 2016 with a similar post-IPO plan to distribute non-voting shares and solidify founder and CEO Mark Zuckerberg's control. Amid renewed investor outcry, the pension fund Sjunde AP-Fonden and numerous index funds filed a suit alleging breach of fiduciary duty. Also in 2016, Barry Diller and IAC/InterActive Corp. tried a similar gambit, creating a new, non-voting class of stock in order to cement the control of Diller and his family over the business despite the fact that they owned less than 8% of the company's stock. The California Public Employees Retirement System (CalPERS), which manages the largest public pension fund in the United States, filed suit in late 2016.[1] Both suits are currently pending.

To forego the ownership gymnastics of diluting existing shareholders' voting rights by issuing non-voting shares as dividends, the more recent trend is to set up multi-class structures with non-voting shares from the IPO stage. Alibaba was so intent on going public with a dual-class structure that it crossed the Pacific Ocean to do so. The company first applied for an IPO on the Hong Kong stock exchange, but when that exchange refused to bend its one share, one vote rule, the company went public on the NYSE. LinkedIn, Square, and Zynga also each implemented dual-class structures before going public. Overall, the number of IPOs with multi-class structures is increasing. There were only 6 such IPOs in 2006, but that number more than quadrupled to 27 in 2015. The latest example is Snap Inc., which earlier this year concluded the largest tech IPO since Alibaba's, and took the unprecedented step of offering IPO purchasers ***no voting rights at all***. This is a stark break from tradition, as prior dual-class firms had given new investors at least some—albeit proportionally weak—voting rights. As Anne Sheehan, Director of Corporate Governance for the California State Teachers' Retirement System ("CalSTRS"), has concluded, Snap's recent IPO "raise[s] the discussion to a new level."

Institutional investors such as CalSTRS are increasingly voicing opposition to IPOs promoting outsized executive and founder control. In 2016, the Council for Institutional Investors ("CII") called for an end to dual-class IPOs. The Investor Stewardship Group, a collective of some of the largest U.S.-based institutional investors and global asset managers, including BlackRock, CalSTRS, the Vanguard Group, T. Rowe Price, and State Street Global Advisors, launched a stewardship code for the U.S. market in January, 2017. The code (discussed on the Forum here), called the Framework for Promoting Long-Term Value Creation for U.S. Companies, focuses explicitly on long-term value creation and states as core Corporate Governance Principle 2 that "shareholders should be entitled to voting rights in proportion to their economic interest." Proxy

[1] Our firm, Bernstein Litowitz Berger & Grossmann, represents CalPERS in this litigation.

advisory firm, Institutional Shareholder Services Inc., has also voiced strong opposition to dual-class structures.

The Snap IPO in particular has elicited investors' rebuke. After Snap announced its intended issuance of non-voting stock, CII sent a letter to Snap's executives, co-signed by 18 institutional investors, urging them to abandon their plan to "deny[] outside shareholders any voice in the company." The letter noted that a single-class voting structure "is associated with stronger long-term performance, and mechanisms for accountability to owners," and that when CII was formed over thirty years ago, "the very first policy adopted was the principle of one share, one vote." Anne Simpson, Investment Director at CalPERS, has strongly criticized Snap's non-voting share model, stating: "Ceding power without accountability is very troubling. I think you have to relabel this junk equity. Buyer beware." Investors have also called for stock index providers to bar Snap's shares from becoming part of major indices due to its non-voting shares. By keeping index fund investors' cash out of such companies' stock, such efforts could help provide concrete penalties for companies seeking to go to market with non-voting shares.

There are many compelling reasons why institutional investors strongly oppose dual-class stock structures that separate voting rights from cash-flow rights. In addition to the immediate deprivation of investors' voting rights, there is ample evidence that giving select shareholders control, that is far out of line with their ownership stakes, reduces company value. Such structures reduce oversight by, and accountability to, the actual majority owners of the company. They hamper the ability of boards of directors to execute their fiduciary duties to shareholders. And they can incentivize managers to act in their own interests, instead of acting in the interest of the company's owners. Hollinger International, a large international newspaper publisher now known as Sun-Times Media Group, is a striking example. Although former CEO, Conrad Black, owned just 30% of the firm's equity, he controlled all of the company's Class B shares, giving him an overwhelming 73% of the voting power. He filled the board with friends, then used the company for personal ends, siphoning off company funds through a variety of fees and dividends. Restrained by the dual-class stock structure, Hollinger stockholders at-large were essentially powerless to rein in such actions. Ultimately, the public also paid the price for the mismanagement, footing the bill to incarcerate Black for over three years after he was convicted of fraud. This is a classic example of dual-class shares leading to misalignment between management's actions and most owners' interests.

The typical retort from proponents of dual-class structures is that depriving most investors of equal voting rights allows managers the leeway to make forward-thinking decisions that cause short-term pain for overall long-term gain. This assertion, however, ignores that many investors—and in particular public pension funds and other long-term institutional investors—are themselves focused on long-term gains. If managers have good ideas for long-term investments, such prominent investors will likely support them.

Academic studies also reveal that dual-class structures underperform the market and have weaker corporate governance structures. For instance, a 2012 study funded by the Investor Responsibility Research Center Institute, and conducted by Institutional Shareholder Services Inc., found that controlled firms with multi-class capital structures not only underperform financially, but also have more material weaknesses in accounting controls and are riskier in terms of volatility. The study concluded that multi-class firms underperformed even other controlled companies, noting that the average 10-year shareholder return for controlled companies with multi-class structures was 7.52%, compared to 9.76% for non-controlled companies, and 14.26% for controlled companies with a single share class. A follow-up 2016 study reaffirmed these findings, noting that multi-class companies have weaker corporate governance and higher CEO pay. As IRCC Institute Executive Director Jon Lukomnik summarized, multi-class companies are “built for comfort, not performance.”

Proponents of dual-class structures also argue that investors who prize voting power can simply take the “Wall Street Walk,” selling shares of companies that resemble dictatorships while retaining shares of companies with a more democratic voting structure. That is often easier said than done. For instance, passively managed funds may not be able to simply sell individual companies’ stock at will. Structural safeguards such as equal voting rights should ensure investors’ ability to guide and correct management productively as events unfold. If the only solution is for investors to abandon certain investments after dual-class systems have done their damage, owners lose out financially and discussions in corporate boardrooms and C-suites across the country will suffer from a lack of diversity, perspective, and accountability.

Ultimately, arguments regarding investor choice also ignore that failures in corporate governance can impose costs not only on corporate shareholders, but also on society at large. When dual-class stock structures prevent boards and individual shareholders from effectively monitoring corporate executives, that monitoring function can be exported to third parties, including the courts and government regulators. Regulators may need to step up disclosure provisions to ensure transparency of such controlled companies, and courts may be called upon to remedy the behavior of unchecked executives. In the monitoring and in the clean-up, the externalities placed upon outsiders make corporate voting rights an issue of public policy.

As the trend of issuing dual-class or multi-class stock continues, institutional investors should remain vigilant to protect shareholders’ voting rights. Pre-IPO investors can oppose the issuance of non-voting shares during IPOs. Investors in publicly traded companies can speak out against proposed changes to share structures or resort to litigation when necessary, such as in the Google, Facebook, and IAC cases. Institutional investors may also lobby Congress, regulators, and the national exchanges to revive the traditional ban on non-voting shares or make it harder to issue no-vote shares. For instance, in the wake of the Snap IPO, CII Executive Director Ken Bertsch and other investors met with the SEC Investor Advisory Committee. They encouraged the SEC to work with U.S.-based exchanges to (1) bar future no-vote share classes; (2) require sunset provisions for differential common stock voting rights; and (3) consider enhanced board requirements for dual-class companies in order to discourage rubber-stamp boards. Whether by working with regulators, securities exchanges, index providers, or corporate boards, institutional investors that continue to fight for shareholder voting rights will be working to promote open and responsive capital markets, and the long-term value creation that comes with them.

Harvard Law School Forum on
Corporate Governance and Financial Regulation
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The "Corporate Governance Misalignment" Problem

Posted by David J. Berger, Wilson Sonsini Goodrich & Rosati, on Thursday, March 23, 2017

Editor's note: David J. Berger is Partner at Wilson Sonsini Goodrich & Rosati. This post is based on Mr. Berger's recent remarks at the SEC Investor Advisory Committee, available here.

On March 9, 2017, the SEC's Investor Advisory Committee ("IAC") held an open meeting to discuss, among other things, unequal voting rights of common stock. I was one of four presenters to the IAC, and my presentation focused on how what I call the "corporate governance misalignment" has led many successful companies, especially technology companies, to adopt dual-class (or multi-class) stock in recent years.

The presentation asked an important—but unspoken—question in corporate governance today: if corporate governance is fundamental to good corporate performance (as I believe it is) why are many of today's most innovative and successful companies considered to have bad (or at least below average) corporate governance? More broadly, why is the most dynamic sector of this country's economy—the technology sector, best represented by Silicon Valley—also generally viewed to have poor corporate governance?

To answer this question one must understand what I call the "Corporate Governance Misalignment" that exists in today's public markets. This misalignment is the result of two factors: first, the legal rules requiring directors to favor public equity holders over other constituencies in today's corporation; and second, the changed nature of the equity holder in public companies, and in particular the growth of the institutional investor (as well as hedge funds and other activist investors).

The control of public equity investors in public corporations has been well documented. As I (and many others) have previously written, Delaware law today is based upon the concept of stockholder primacy. Put simply, Delaware law requires that directors make decisions based upon how their decisions will ultimately affect and create stockholder value. This means that while directors under Delaware law have substantial discretion to take actions that benefit other corporate constituencies, ultimately a director must give top priority to stockholder value when considering the different alternatives before her.

At the same time Delaware law gives directors substantial discretion to take actions that are in the best long-term interests of the corporation and its stockholders. However the changing nature of the public equity markets, and in particular the rising ownership and control of institutional investors in public equities, including both passive and activist investors, has led corporate boards to take actions that favor short-term profits at the expense of long-term growth or risk-taking.

The growth of the institutional investors has been well documented. According to SEC Commissioner Stein, institutional investors today own approximately 70% of the shares of all public companies, while just three institutional investors held the largest stock position in 88% of the companies in the S&P 500. Because the money managers who select the stocks (or index funds) that these institutions invest in are incentivized to outperform their peers on a short-term basis, these fund managers are generally looking at short-term results.

This short-term focus has had a particularly large impact on technology companies. As discussed in my remarks to the IAC, technology companies have become the prime targets of activist investors. Activist investors often favor technology companies because of their strong balance sheets and cost structures, which include high investments in employees and R&D. Such investments are often easy to cut to improve short-term results.

Yet technology companies, particularly many of our most innovative companies, often want to take a longer-term view. This includes focusing on such issues as building great products, investing in R&D (even with the recognition that such investment may ultimately not be successful), paying extra to train and retain great talent and taking other actions that may require a longer-term focus than the current market environment allows for boards. As a result, and following Google's (now Alphabet's) successful IPO in 2004, a number of leading technology companies have adopted a dual-class (or multi-class) share structure as part of a successful IPO, at least in part to avoid the pressure to maximize short-term returns.

This does not mean, of course, that all dual-class structures (or technology companies) will be successful. Rather, it simply means that as long as this "corporate governance misalignment" continues to exist, we are likely to continue to see companies try and adopt governance structures that give them greater flexibility to respond to the misalignment.

A full copy of my remarks can be found here.

Dual-Class Stock and Private Ordering: A System That Works

Posted by David J. Berger, Wilson Sonsini Goodrich & Rosati, on Wednesday, May 24, 2017

Editor's note: David J. Berger is Partner at Wilson Sonsini Goodrich & Rosati. This post is based on a Wilson Sonsini publication by Mr. Berger, Steven E. Bochner, and Larry Sonsini. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).

Dual-class stock has become the target of heightened attention, particularly in light of Snap's recent IPO. While the structure remains popular for companies trying to respond to the short-term outlook of public markets—including companies in the technology and media sectors, as well as companies in more traditional industries ranging from shipping and transportation to oil and gas, and everything in between—dual-class stock continues to be the subject of considerable attack by various investor groups and some academics. Further, while a majority of dual-class companies are not technology companies, young technology companies continue to be the primary focus of governance activists.[1]

Despite the controversy over dual-class stock, we believe that the present system of private ordering with respect to dual-class stock will—*and should*—continue. Private ordering allows boards, investors, and other corporate stakeholders to determine the most appropriate capital structure for a particular company, given its specific needs. So long as the company makes appropriate disclosure of its capital structure, including the implications of this structure to its investors, we believe there is no need for further regulation on this issue.

The benefits of a system of private ordering have become increasingly apparent in the U.S. and across the globe. For example, both Nasdaq and the NYSE continue to actively solicit and list companies with multi-classes of stock. According to a recent Council of Institutional Investors (CII) study, about 10 percent of publicly listed companies have multi-class structures. This includes not just newly public and/or prominent technology companies such as Alphabet (formerly Google), Facebook, and Snap, or even numerous media companies such as CBS, Liberty Media, Sinclair Broadcast Group, Scripps, and Viacom, but also companies in every industry ranging from financial services (Berkshire Hathaway, Evercore, Houlihan Lokey, etc.) to consumer products (Constellation Brands, Coca-Cola Bottling Co., Nike, Panera Bread, etc.) to transportation and industrial companies (Swift Transportation, TerraForm, Quaker Chemical, Nacco Industries, etc.).

[1] The Council of Institutional Investors recently published a list of dual-class companies in the Russell 3000. The list can be found here: http://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf.

As the companies identified above demonstrate, many of the dual- or multi-class companies listed by the NYSE and Nasdaq continue to be among the most successful in the world—both financially and from a governance perspective. The success and prominence of these companies make it unlikely that there will be a broad effort among the exchanges to require them to change their governance structure.

The success of many dual-class companies has also led both Nasdaq and the NYSE to continue to support dual-class listings. For example, Nasdaq recently released a report (discussed on the Forum here) that included an endorsement of dual-class stock, including laying out the arguments why companies with dual-class stock should continue to be listed.[2] Among the reasons cited by Nasdaq was the recognition that encouraging entrepreneurship and innovation in the U.S. economy is best done by "establishing multiple paths entrepreneurs can take to public markets." Because of this, each "publicly traded company should have flexibility to determine a class structure that is most appropriate and beneficial for them, so long as this structure is transparent and disclosed up front so that investors have complete visibility into the company. Dual-class structures allow investors to invest side-by-side with innovators and high-growth companies, enjoying the financial benefits of these companies' success.[3]" While the NYSE has not recently issued any public statements on multi-class stock, it continues to actively seek to list companies with multi-class stock, including Alibaba, which chose to list on the NYSE after the Hong Kong stock exchange raised significant questions about its governance structure.

The trend towards private ordering on dual-class shares can also be seen globally. For example, less than two years ago, Hong Kong's stock exchange rejected a proposal to allow companies with dual-class stock to list on its exchange. However, the Hong Kong Securities and Futures Commission (SFC) recently announced a new study to determine whether to permit dual-class listings (including possibly creating a separate exchange for companies listing dual-class stock). While the SFC's decision includes consideration of a new trading exchange in Hong Kong for companies with multi-class structures, its actions have been widely interpreted as essentially reversing its prior decision. Additionally, the SFC's chairman recently announced that the SFC "supports the consultation to allow the public to share their views on the dual-shareholding structure," and he made it clear that the SFC was "open minded" about the possibility of listing dual-class companies.

Singapore appears to be going through a similar transition. Singapore also historically did not allow listings of dual-class companies, but in February 2017, the country released a paper titled "Possible Listing Framework for Dual-Class Share Structures." The proposal has been the subject of considerable debate, with many large institutional investors (including those based in the U.S.) opposed to allowing any type of dual-class listing. At the same time, the head of Singapore's Investors Association, which represents more than 70,000 retail investors and is the largest organized investor group in Asia, has become an outspoken advocate of dual-class stock, arguing that "retail investors are not idiots" and that any "capital market that is aspiring to be leading" should offer this alternative.

The trend can also be seen in Europe. In 2007, the EU considered imposing a one-share/one-vote requirement on publicly traded companies, but abandoned the idea at the time of the 2008

[2] A copy of Nasdaq's Blueprint for Market Reform can be found here: http://business.nasdaq.com/media/Nasdaq%20Blueprint%20to%20Revitalize%20Capital%20Markets_tcm5044-43175.pdf, discussed on the Forum here.

[3] *Id*. at 16.

financial crisis. Now many EU countries are adopting some form of "time-based voting" shares, to encourage long-term investors by giving more votes to shareholders who own their shares for longer periods.[4] For example, France has adopted the "Florange Act," which generally provides that shareholders who own their shares for two years will receive two votes per share. Italy has also considered loyalty shares, while in many of the Nordic countries companies with shares with multiple voting rights are common.[5]

At the same time, critics of dual-class stock in the U.S., especially within the institutional investor community, remain quite vocal. For example, the Securities and Exchange Commission's (SEC's) Investor Advisory Committee recently held a hearing on dual-class stock, where its use was sharply criticized by Commissioner Stein (whose term ends in June), as well as a representative from CII.[6] During the meeting, representatives from CII and other institutional investors urged the SEC to use its regulatory authority over the exchanges to limit the ability of companies to have dual-class structures, while also calling upon the companies that create the benchmark indexes to exclude companies with non-voting stock from these indexes (ironically, many of the same companies that create these indexes are CII members and among the world's largest institutional investors).

More recently, two of the country's leading academics, Harvard Law School professors Lucian Bebchuk and Kobi Kastiel, published an article (discussed on the Forum here) calling for a mandatory sunset provision on all dual-class stock for public companies.[7] The Bebchuk and Kastiel piece argues that "public officials and investors cannot rely on private ordering to eliminate dual-class structures that become inefficient with time," and for that reason "[p]ublic officials and institutional investors should consider precluding or discouraging IPOs that set a perpetual dual-class structure." Bebchuk and Kastiel conclude that "[p]erpetual dual-class stock, without any time limitation, should not be part of the menu of options" for public companies.

We disagree with Bebchuk and Kastiel on the need for additional regulation in this area and, further, do not believe that the SEC will adopt the Bebchuk and Kastiel proposal. While the SEC has not recently taken a formal position on dual-class stock, its new leadership is certainly familiar with the issue. For example, while Chairman Clayton was a partner at Sullivan & Cromwell, he represented many companies with dual-class share structures, and William Hinman, the SEC's new Director of Corporate Finance, represented Alibaba in its IPO. Mr. Hinman, who was based in Silicon Valley before taking his new position at the SEC, was also involved in a number of other IPOs where companies have dual-class stock. While it is impossible to predict the future positions of the SEC, Chairman Clayton has emphasized that one of his top priorities is to reverse the decline in U.S. public companies that has occurred over the last 20 years. As Nasdaq recognized, one way to foster increased numbers of IPOs (as well as

[4] For a lengthier discussion on time-based voting and its possibilities in the U.S., *see* David J. Berger, Steven Davidoff Solomon, and Aaron Jedidiah Benjamin, "Tenure Voting and the U.S. Public Company," 72 *Business Lawyer* 295 (2017).

[5] According to ISS, 64 percent of Swedish companies have two share classes with unequal votes, while 54 percent of French companies have shares entitled to double-voting rights. *See* "ISS Analysis: Differentiated Voting Rights in Europe" (2017), available at https://www.issgovernance.com/analysis-differentiated-voting-rights-in-europe/.

[6] WSGR partner David J. Berger was also a panelist at this forum, and explained why companies and investors may support dual-class shares (or at least allow for private ordering on this issue). A copy of Mr. Berger's remarks can be found here: https://www.sec.gov/spotlight/investor-advisory-committee-2012/berger-remarks-iac-030917.pdf.

[7] *See* Lucian Bebchuk and Kobi Kastiel, "The Untenable Case for Perpetual Dual-Class Stock," available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954630 (discussed on the Forum here).

companies staying public rather than going private) is by allowing companies (and entrepreneurs) the option of dual-class shares and other alternative capital structures.

We agree with Nasdaq and believe that dual-class stock is an issue that is best left to private ordering. For some companies, dual-class stock is both necessary and appropriate to respond to the corporate governance misalignment that exists in our capital markets today. In particular, many of the rules governing our capital markets have the practical impact of favoring short-term investors. When responding to this governance misalignment it is understandable that some companies may choose dual-class (or multi-class) stock. While multiple classes of stock are obviously not the right model for all companies (and it must be noted that there are many different types of capital structures even within the multi-class framework), there is no single capital structure that is right for all companies. Given the dynamics of our capital markets and the ever-changing needs of entrepreneurs and companies, a company's capital structure is best left to a company's investors and a system of private ordering based upon full disclosure.

S&P Dow Jones Indices Announces a Consultation on the Eligibility of Non-Voting Share Classes

NEW YORK, APRIL 3, 2017: S&P Dow Jones Indices ("SPDJI") is conducting a consultation with members of the investment community on the eligibility of non-voting share classes in S&P DJI indices. This potential change may affect some or all S&P and Dow Jones-branded benchmark and investable equity indices.

QUESTIONS:

1. **If the only listed share classes of a company do not have voting rights, should that company be eligible for inclusion in an index?**
2. **For companies with multiple-class structures where one or more listed share class is non-voting:**
   - **Should only the non-voting share classes be ineligible?**
   - **Should all share classes be ineligible?**
   - **Should all share classes be eligible?**
3. **If the company does not file information statements regarding shareholder ownership, should the company be ineligible for inclusion?**
4. **If the methodology were to exclude all share classes so the company is not eligible, should current constituents be "grandfathered" and remain in the index?**
5. **Should eligibility of non-voting shares differ in benchmark vs investable index families?**
6. **Do you have any additional comments?**

Your participation in this consultation is important as we gather information from various market participants in order to properly evaluate your views and preferences. Your responses will be kept confidential. Please respond to this survey by **May 3, 2017.** After this date, S&P Dow Jones Indices will no longer accept survey responses. Prior to the Index Committee's final review, S&P Dow Jones Indices will consider the issues and may request clarifications from respondents as part of that review. Alternative options to the proposed questions after the deadline require that the consultation be re-opened to the public.

To participate in this consultation, please respond to *www.surveymonkey.com/r/EONVSC*.

Please contact S&P Dow Jones Indices at *index_services@spglobal.com* for any questions regarding this consultation.

Please be advised that all comments from this consultation will be reviewed and considered before a final decision is made; however, S&P Dow Jones Indices makes no guarantees or is under any obligation to comply with any of the responses. The survey may result in no changes or outcome of any kind. If S&P Dow Jones Indices decides to change the index methodology, an announcement will be posted on our website.

Thank you for taking the time to complete this survey.

For more information about S&P Dow Jones Indices, please visit *www.spdji.com*.

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