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Tab I: The Upcoming Proxy Season

Proxy Advisors and Investors Prep for 2017 Proxy Season

Posted by Shirley Westcott, Alliance Advisors LLC, on Thursday, December 22, 2016

Editor's note: Shirley Westcott is a Senior Vice President at Alliance Advisors LLC. This post is based on an Alliance Advisors publication. Related research from the Program on Corporate Governance includes Universal Proxies by Scott Hirst (discussed on the Forum here).

As 2016 draws to a close, shareholder proponents and proxy advisors have begun laying the groundwork for the 2017 proxy season. Institutional Shareholder Services (ISS) and Glass Lewis recently released their U.S. voting policy updates which address a range of issues including directors' outside board service, restrictions on the submission of binding shareholder proposals, governance provisions at newly public companies, and gender pay parity.[1] Although the revisions are marginal for most companies, ISS has also made some technical changes to its approach to executive and director compensation, which will be detailed in an upcoming FAQ.

Among shareholder campaigns, proxy access once again is shaping up to be the preeminent issue next year, though the focus of many proposals has shifted to secondary provisions. To date, 331 companies, including 47% of S&P 500 firms, have adopted proxy access, with 75% of their bylaws conforming to the popular "3/3/20/20" standard, whereby an aggregate of 20 shareholders owning at least three percent of the shares for three years may nominate up to 20% of the board, often with a two-director minimum.

Shareholder proponents are also teeing up a record volume of resolutions on climate change, along with another wave of requests for lobbying and political spending disclosure. Other emerging areas of focus include workplace diversity, prescription drug pricing, mutual fund voting practices, and various issues related to factory farms. These and other upcoming proxy season issues are summarized below.

Proxy Advisor Policy Changes

In mid-November, ISS and Glass Lewis issued their policy updates for the 2017 proxy season, which will be effective for annual meetings on or after February 1, 2017 (ISS) and January 1, 2017 (Glass Lewis). Overall, the key changes, which are discussed below, will impact only a limited number of U.S. companies.

[1] ISS's 2017 policy updates at https://www.issgovernance.com/policy-gateway/2017-policy-information/. See Glass Lewis's 2017 policy updates at http://www.glasslewis.com/2017-proxy-season-asian-guidelines-available.

Overboarded Directors (ISS and Glass Lewis)

ISS's and Glass Lewis's new policies on overboarded directors, which were announced last year, will take effect in 2017. ISS will recommend against directors who are not public company CEOs if they serve on more than five public company boards (the current limit is six), and against public company CEOs if they serve on more than three public company boards (the current limit). Glass Lewis will generally recommend against directors who are executive officers of public companies if they sit on more than two public company boards (the current limit is three), and against other directors who sit on more than five public company boards (the current limit is six). In applying their policies, the proxy advisors will not oppose overcommitted CEOs (ISS) or executives (Glass Lewis) at their home company boards.

In determining if a director's service is excessive, Glass Lewis will consider other relevant factors:

- The size and location of the companies,
- The director's board duties,
- Whether the director serves on the board of any large privately-held companies,
- The director's tenure, and
- The director's attendance record.

Glass Lewis will also take into account whether the company provides sufficient rationale for an overextended director's continued board service, including the scope of his commitments and his contributions to the board.

Impact on issuers: During 2016, ISS and Glass Lewis included cautionary language in their proxy reports of companies that would be impacted by this policy change. Therefore, affected directors have had a one-year grace period to make any adjustments to their board commitments. According to ISS QualityScore data, only 26 directors currently serve on more than five public company boards where at least one board is an S&P 1500 firm.

Issuers should, in any case, review their top holders' policies regarding the optimal number of directorships, which may deviate from the views of the proxy advisors. Relatively few directors receive high opposition votes solely for being overboarded. According to ISS's 2016 post-season report, only one director at a Russell 3000 company received less than majority support for holding too many board seats.

Unilateral Board Actions—Initial Public Offerings (ISS and Glass Lewis)

ISS is expanding its policy on adverse governance provisions at newly public companies to include multi-class capital structures with unequal voting rights. If adopted prior to or in connection with an initial public offering (IPO), ISS will recommend against individual directors, committee members, or the full board (except new nominees)—potentially on a continued basis—unless there is a "reasonable" sunset on the provision or until the provision is unwound. ISS will no longer accept a commitment by the company to seek shareholder approval of the provision within three years of the IPO.

In applying the policy, ISS will consider additional factors as follows:

- The level of impairment of shareholders' rights caused by the provision,
- The disclosed rationale for adopting the provision,
- Shareholders' ability to change the governance structure in the future (e.g., supermajority requirements or other limitations on amending the charter/bylaws)
- Shareholders' ability to hold directors accountable through annual director elections, and
- Other relevant factors.

Glass Lewis has clarified its approach to corporate governance at newly public entities by delineating the provisions it believes severely curtail shareholder rights:

- Anti-takeover provisions such as a classified board or poison pill
- Supermajority vote requirement to amend the charter/bylaws
- Exclusive forum or fee-shifting provisions
- No shareholder right to call special meetings or act by written consent
- Plurality voting in director elections
- No shareholder ability to remove directors without cause
- Evergreen provisions in equity compensation plans

Pre-IPO boards that adopt any of these measures may face an adverse recommendation from Glass Lewis at their first annual meeting—either against the governance committee members or the directors who served at the time adoption, depending on the severity of the concern. Glass Lewis will make exceptions for companies that provide a sound rationale for adopting the measure or that commit to phasing out the provision or putting it to a shareholder vote at the first post-IPO annual meeting.

Impact on issuers: ISS's policy change was prompted by the increase in companies going public with a multi-class capital structure. However, it will affect a relatively small number of firms. According to ISS, only 17 companies holding their first annual meeting in 2016 would have fallen into this category.

The revision also reflects more stringent approaches being taken by some institutional investors in regards to multi-class stock. For example, T. Rowe Price amended its voting policies in 2016 to oppose the lead director or independent board chair, as well as members of the governance committee, at any company that has dual-class stock with unequal voting rights. The Council of Institutional Investors (CII) also adopted a statement of investor expectations for IPOs that advocates sunsetting problematic governance features, such as multi-class capital structures with differential voting rights.

Restrictions on Binding Shareholder Proposals (ISS)

ISS will recommend against governance committee members at companies that have placed "undue" restrictions on shareholders' ability to submit resolutions to amend the bylaws. These include an outright prohibition on the submission of binding shareholder proposals or imposing stock ownership and holding requirements beyond Rule 14a-8 requirements ($2,000 of stock held for one year) to submit such proposals. The negative recommendations will be ongoing until the restrictions are repealed.

Impact on issuers: The revision will largely be felt by Maryland-incorporated real estate investment trusts (REITs). Maryland law permits REITs to vest the right to amend the bylaws solely in the board and not shareholders. According to ISS, two-thirds of Maryland REITs take advantage of this provision. In recent years, labor activists such as UNITE HERE have launched campaigns at REITs that do not provide shareholders with the right to amend the bylaws. Some companies have responded by offering alternative management proposals that would require higher stock ownership and/or holding periods for shareholders to submit a binding resolution.[2]

Gender Pay Equity (Glass Lewis)

Glass Lewis has codified its policy on shareholder resolutions calling for increased disclosure of company efforts to reduce gender pay gaps. Glass Lewis will evaluate these proposals on a case-by-case basis, taking into account the following factors:

- The company's current policies, efforts and disclosure with regard to gender pay equity,
- The practices and disclosures of company peers, and
- Any relevant legal and regulatory actions at the company.

Glass Lewis will consider supporting well-crafted shareholder resolutions requesting more disclosure if the company has not adequately addressed gender pay disparities and there is credible evidence that such inattention poses a risk to the company and its shareholders.

Impact on issuers: Gender pay equity is expected to be an ongoing focus of environmental and social (E&S) investors. During 2016, Arjuna Capital and Pax World Management targeted nine Silicon Valley firms with proposals to report on company policies and goals to reduce gender pay disparities. Seven of the firms agreed to make their pay gap public and take steps to close it, including eBay, where the proposal received majority support. Building off this year's successful engagements, the proponents are refiling their resolutions at the two tech sector holdouts—Alphabet and Facebook—and expanding their campaign to banks, financial services firms, and retailers.

Board Evaluation and Refreshment (Glass Lewis)

In a guideline clarification, Glass Lewis states its preference for a robust board evaluation process rather than age or tenure limits for promoting board refreshment. Per its current policy, Glass Lewis may recommend against the nominating and/or governance committee members for waiving any term or age limits in effect without sufficient explanation.

Capital Authorizations (ISS)

ISS clarified the wording of its capital authorization policy. ISS will generally support increases in authorized common shares for stock splits and stock dividends as long as the "effective increase"

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[2] For example, in 2016, Chesapeake Lodging Trust countered a UNITE HERE proposal with a management resolution to allow holders of 0.015% of the stock for one year to submit proposals to adopt, amend or repeal bylaws. The company proposal was defeated.

in authorized shares (rather than the “increase”) is within the allowable cap under ISS’s common stock authorization policy.

Pay-for-Performance Methodology (ISS)

ISS will continue to evaluate misalignments between CEO pay and performance using total shareholder return (TSR). However, it will supplement this with six additional financial metrics: return on equity, return on assets, return on invested capital, revenue growth, EBITDA growth, and cash flow from operations growth. Beginning February 1, 2017, ISS’s U.S. proxy research reports will contain a standardized table comparing a company’s three-year CEO pay and financial performance ranking, based on a weighted average of the six metrics, to its ISS-defined peer group.

Impact on issuers: The new financial metric comparisons will be referenced in ISS’s qualitative PFP review, but will not affect its quantitative screening results, at least during the 2017 proxy season. In ISS’s recent policy survey, investors and issuers expressed strong support for using metrics beyond TSR in PFP evaluations.

Director Compensation (ISS)

ISS is expanding its framework for evaluating non-employee director (NED) compensation to include eight qualitative factors, listed below. These will apply to management proposals to ratify NED compensation and to NED-specific equity plans that exceed the applicable shareholder value transfer (SVT) or burn rate benchmarks.

- The relative magnitude of director compensation as compared to companies of similar profile,
- The presence of problematic pay practices relating to director compensation,
- Director stock ownership guidelines and holding requirements,
- Equity award vesting schedules,
- The mix of cash and equity-based compensation,
- Meaningful limits on director compensation,
- The availability of retirement benefits or perquisites, and
- The quality of disclosure surrounding director compensation.

Impact on issuers: The change was prompted by the growing number of companies that are seeking shareholder ratification of NED pay programs to avoid potential lawsuits alleging excessive director pay. The qualitative factors are largely consistent with those currently used by ISS in evaluating NED equity plans.

Cash and Equity Plan Amendments (ISS)

ISS is clarifying its policy on amendments to cash and equity incentive plans. ISS will generally support amendments to administrative features of the plan, as well as plan amendments that require shareholder approval under Section 162(m) of the Internal Revenue Code, as long as the administrating committee consists entirely of independent directors.

ISS will review plan amendments on a case-by-case basis if they bundle material amendments with those for 162(m) purposes, or if the plan is being presented to shareholders for the first time since the company's IPO. Equity plan amendments that increase the transfer of shareholder value to employees will be assessed using both the Equity Plan Scorecard (EPSC) approach and an analysis of the overall impact of the amendments.

Equity Incentive Compensation Plans (ISS)

ISS made several adjustments to its EPSC factors for evaluating equity-based compensation plans:

- Dividends payable prior to award vesting is being added as a new factor under plan features. Full points will be earned if the plan expressly prohibits the payment of dividends on unvested awards (accrual of dividends payable upon vesting is acceptable). No points will be given if the plan is silent on the matter or incomplete (i.e., the prohibition is not applicable to all award types).
- Modifications were made to the minimum vesting factor. ISS will only give full credit on this factor if the plan contains a one-year minimum vesting period on all award types and cannot be overridden in individual award agreements.

Shareholder Proposals

Proxy Access

In an effort to curb "lite" versions of proxy access and avoid substantial implementation challenges, James McRitchie, John Chevedden, Kenneth Steiner, and Myra Young introduced two new proposal variations this fall. The first type of resolution seeks specific amendments to existing proxy access bylaws.[3] The second requests companies to adopt a proxy access bylaw with certain "essential elements for substantial implementation."[4] All of the proposals call for some combination of the following: a 3%/3-year ownership threshold, unlimited group aggregations, a 25% board seat cap with a two-director minimum, no post-meeting shareholding requirement, counting recallable loaned shares in the ownership threshold, and no restrictions on the renomination of access candidates based on voting support.

Notwithstanding the new proposal language, recent SEC no-action letters confirm that companies may exclude resolutions to *adopt* proxy access as substantially implemented if they subsequently institute a proxy access bylaw that meets the proposal's essential objective—namely, a 3%/3-year eligibility requirement. During the 2016 proxy season, nearly 22% of proxy access proposals were omitted on this basis.

[3] To date, these have been filed at Apple, H&R Block, Microsoft, Oshkosh, United Natural Foods, Walgreens Boots Alliance, Walt Disney, and Whole Foods Market. The resolutions typically call for the adoption of a "proxy access enhancement package" of amendments to existing bylaws with "essential elements for substantial implementation."

[4] To date, these have been filed at Berry Plastics Group, Cisco Systems, Costco Wholesale, Reed's, and WD-40.

In contrast, to date only one issuer—Oshkosh—has been allowed to omit a retail investor resolution under Rule 14a-8(i)(10) seeking to *amend* the terms of a previously adopted proxy access bylaw.[5] In response to the filing, Oshkosh implemented half of the requested changes, including reducing the ownership threshold from 5% to 3%, eliminating the one-year post-meeting shareholding period, and rescinding the 25% support threshold for renomination of access candidates. However, the company did not comply with the proponent's request to permit unlimited group aggregations, remove the power-to-recall requirement for loaned shares, and raise the board seat cap from 20% to 25% with a two-director minimum. The SEC concluded that Oshkosh's revised bylaw compared favorably with the guidelines of the shareholder proposal, though it is unclear which of the changes were essential to that decision.[6]

In view of these no-action responses, companies that already have proxy access in place should expect a surge of resolutions in 2017 from retail investors to make amendments to their bylaws. Because of the uncertainty surrounding exclusion, companies that receive "fix-it" proposals should consult their major shareholders before modifying any provisions. Those that go to a vote will in all likelihood fare poorly. During the 2016 proxy season, proposals with similarly prescriptive features sponsored by corporate gadflies failed at every company that had adopted a 3/3/20/20 bylaw. "Fix-it" proposals at H&R Block, Microsoft, and Reed's received only 29.9%, 26.8%, and 33% to avoid negative recommendations against directors.[7]

According to an August report, ISS opposed the governance committee members at two companies this year—CBL & Associates and Cheniere Energy—for not adequately responding to a 2015 resolution that received majority support.[8] Although the firms had adopted bylaws conforming to the standard 3/3/20/20 formulation, ISS took issue with restrictive secondary provisions without any rationale or disclosure of shareholder engagement efforts, coupled with a supermajority requirement for shareholders to amend the bylaws.

Finally, the first occurrence of a proxy access nominee materialized in November at National Fuel Gas. The board ultimately rejected the nomination after concluding that the nominator—GAMCO

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[5] The SEC denied H&R Block, Microsoft, Walgreens Boots Alliance, Walt Disney, and Whole Foods Market no-action relief under Rule 14a-8(i)(10) on the basis that their existing 3/3/20/20 bylaws did not compare favorably with the guidelines of the shareholder proposal. Walgreens, Walt Disney, and Whole Foods were also unsuccessful in omitting the proposals under Rule 14a-8(c)—namely, that the filings constituted separate proposals with no single well-defined unifying concept.

[6] During the 2016 proxy season, NVR was granted no-action relief under Rule 14a-8(i)(10) after it made changes to its proxy access bylaw sought by the New York City Comptroller. These included reducing the ownership threshold from 5% to 3% and increasing the timeframe for recalling loaned shares in order to count as owned. However, NVR did not implement the proposal's other provisions—eliminating the group aggregation limit or the one-year post-meeting shareholding requirement.

[7] See ISS's March 14, 2016 FAQ at https://www.issgovernance.com/finer-points-proxy-access-bylaws-come-microscope. To date, 21 out of 42 companies have implemented 2016 proxy access proposals that received majority support. Only one firm—Old Republic International—has declined to adopt proxy access despite the majority vote. The company believes its current system of corporate governance has effectively served the long-term interests of shareholders.

[8] ISS reversed its negative recommendation on Cloud Peak Energy's governance committee members after the company amended its proxy access bylaw to increase the board seat cap from 20% to 25%, eliminated the 20-shareholder aggregation limit, and removed other secondary provisions that ISS considered to be overly restrictive. See https://www.issgovernance.com/finer-points-proxy-access-bylaws-come-microscope and here. ISS also opposed the full boards at Nabors Industries and Netflix for not taking steps to implement a 2015 majority vote on proxy access.

Asset Management—possessed an intent to change or influence control of the company, contrary to the terms of the proxy access bylaw. The nominee was subsequently withdrawn. Nevertheless, this serves as a reminder that issuers that have proxy access in place will need to be vigilant of their shareholder base and any serious investor concerns. support, respectively, notwithstanding the endorsement of ISS (Glass Lewis opposed them). Companies responding to majority votes on proxy access should be mindful of ISS's guidelines, in order

Other Shareholder Initiatives

Climate change will headline next year's E&S campaigns, spurred by the prospect of a rollback in environmental regulations by President-elect Donald Trump. According to Ceres, U.S. companies will face a record 200 resolutions on climate matters in 2017, compared to 174 such resolutions during 2016.

Mutual funds are among those being challenged this year, specifically over incongruities between their voting records and their stated positions on climate change. E&S investors have submitted proxy voting review resolutions at five financial firms—Bank of New York Mellon, BlackRock, Franklin Resources, JPMorgan Chase, and T. Rowe Price Group—while McRitchie has begun investing in various fund companies in order to file similar resolutions in the future.[9] In view of these pressures, issuers should be attentive to any changes to their investors' voting policies and practices. For example, Fund Votes reported that State Street backed 51% of shareholder resolutions on climate change this year at S&P 500 companies, compared to only 14% in 2015.

Agribusinesses are facing greater scrutiny as well over environmental and public health risks. This year, E&S proponents are reprising resolutions on water stewardship, food waste, deforestation, and antibiotic resistance, and have launched a new initiative calling on global food corporations to cut their reliance on meat and diversify into plant-based sources of protein.

E&S activists are also expanding their diversity agendas in 2017 from the boardroom to the workplace and suppliers. Trillium Asset Management has filed proposals at nine financial and technology companies to issue workforce diversity reports, which would include a breakdown of employees by race and gender across 10 employment categories and disclosure of company policies for increasing diversity in the workplace.

Trillium has additionally targeted BlackRock with a new proposal to explain its lack of support for resolutions to protect LGBT employees from workplace discrimination. Separately, the New York City Pension Funds sent letters this fall to 16 portfolio companies to establish and disclose supplier diversity goals to include businesses owned by minorities, women, LGBT individuals, veterans, and disabled individuals.[10] A similar letter-writing campaign in 2014 resulted in over half of the 20 recipients increasing disclosure of their supplier diversity programs and progress.

[9] See http://www.corpgov.net/2016/08/gadflies-at-the-gate-why/#more-27412. McRitchie filed and ultimately withdrew a proxy voting review resolution at BlackRock in 2016.
[10] See here.

Also on the horizon is a revival of proposals on prescription drug pricing—last seen on proxy ballots in 2015—and on reinstating in-person annual meetings— last submitted in 2014. Additional shareholder resolutions in the pipeline are noted in the accompanying table.

Other reforms are being pursued off-ballot. Through letters, the Council of Institutional Investors (CII) and California Public Employees' Retirement System (CalPERS) are continuing their advocacy of majority voting in director elections at mid- and small-cap companies, while the United Brotherhood of Carpenters' Pension Fund is in its fifth year of promoting enhanced disclosures on auditor independence.[11] Various investors are also urging more engagement with issuers on capital allocation strategies—particularly stock buybacks—and on proxy fight settlements in order to preserve long-term value.[12]

Looking Ahead

Aside from annual meeting matters, the incoming Trump Administration hopes to dismantle much of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. Coupled with the imminent departure of SEC Chair Mary Jo White, further rulemaking on executive pay mandates will grind to a standstill. Proposed rules on mandatory clawbacks, PFP disclosures, hedging policies, and, more recently, universal proxy ballots could ultimately be modified or eliminated, along with the controversial CEO pay ratio rule, which is scheduled to take effect in 2018. In all, 2017 will usher in an array of changes and challenges, and Alliance Advisors will keep issuers apprised of developments as they unfold.

[11] See more on the CII, CalPERS, and Carpenters initiatives here, here, and http://www.gtlaw.com/portalresource/carpenters-fund-disclosure.

[12] See more on the "Share Buybacks Disclosure Initiative" here. See State Street Global Advisors' framework on settlement agreements at https://www.ssga.com/market-commentary/protecting-long-term-shareholder-interests-in-activist-engagements.pdf.

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Preparing for the 2017 Proxy Season

Posted by Tom Christopher & Tony Richmond, Latham & Watkins LLP, on Tuesday, January 31, 2017

Editor's note: Thomas W. Christopher and Tony Richmond are partners at Latham & Watkins LLP. This post is based on a Latham publication by Mr. Christopher, Mr. Richmond, Brian Miller, Tiffany Fobes Campion, Jessica Lennon, and Danit Tal.

Many public companies have received shareholder proxy access proposals in connection with their upcoming 2017 annual meetings and additional companies are likely to receive proposals in the coming months. Proxy access is a mechanism that gives shareholders the right to nominate directors for inclusion in the company's annual meeting proxy statement. Proxy access gained significant momentum in 2015 and 2016, with more than 200 proposals submitted to shareholders and approximately 58% of those proposals receiving shareholder approval.[1]

Accordingly, public companies may wish to consider proxy access and develop a plan for responding to a shareholder proxy access proposal. Based on lessons learned in recent years, this post summarizes:

1. Actions a public company can take to prepare for receiving a proxy access proposal
2. Whether a company should wait and react to a specific shareholder proxy access proposal or preemptively adopt its own proxy access regime
3. Alternatives available to a company following receipt of a proxy access proposal

1. Preparatory Actions in Anticipation of the 2017 Proxy Season

Companies can take a number of actions now in advance of the 2017 proxy season, including:

- Evaluating the company's shareholder base and understanding shareholders' voting policies and positions relating to proxy access.
- Engaging constructively with shareholders on business and governance matters to build positive relationships and a mutual understanding of objectives, which may temper any perceived need for either the implementation of proxy access or amendments to a proxy access regime that has already been adopted and, at a minimum, establishes the groundwork for future resolution of any shareholder proposal.
- Staying abreast of developing market practice for the specific terms of proxy access, particularly with respect to the size of nominating groups and caps on the number or percentage of shareholder-nominated candidates.

[1] Sharkrepellent.net, last accessed on January 11, 2017. At meetings in 2015 and 2016, 212 proposals have been submitted to shareholders and 207 proposals have been voted on, with 120 proposals receiving a passing vote.

- Ensuring the board and management are aligned with respect to appropriate responses to a shareholder proxy access proposal, as outlined below.

Proxy Access: What's the Point?

- Historically shareholders gained seats on a public company's board through either a negotiated agreement with the company or successful proxy fight. Proxy access provides a third route for gaining board representation. The purpose of proxy access is to permit significant, otherwise passive shareholders meeting certain requirements to include their director nominees in the company's proxy statement rather than requiring such shareholders to prepare and distribute their own proxy statement to shareholders. Proxy access is not intended as a new path to the boardroom for activists seeking to influence the company, and the prevailing proxy access construct specifically forecloses the ability of non-passive investors to use proxy access.
- The real usefulness of proxy access to obtain board representation has yet to be determined. To date, the only shareholder to submit a proxy access nominee was deemed ineligible due to its past, very public, activist conduct with respect to the target company, and promptly withdrew its nominee. For shareholders that are more ambiguous or private about their intentions, eligibility for proxy access is uncertain, and will likely be determined on a case-by-case basis depending on the facts and circumstances. This scenario underscores the importance of the thoughtful consideration required for adoption and application of any proxy access regime, particularly while this area of corporate governance continues to evolve.

2. Taking a Wait-and-See Approach Versus Preemptively Adopting Proxy Access

As the 2017 proxy season draws closer, companies will again be confronted with the question of which approach to take with respect to proxy access. A company has at least two available alternatives:

Option A: Wait and see

- Allows a shareholder to take the first step with respect to proxy access through a public pronouncement of its position on proxy access generally, in a private dialogue with the company or through submission of a proxy access proposal
- Prevents a company from adopting or proposing a proxy access regime that is more liberal than shareholders might have proposed or one that is so restrictive it risks being rejected out of hand by shareholders
- Provides time for the further development of market practice regarding the specific terms and implementation details of proxy access
- Delays vulnerability to fix-it proposals seeking to modify and enhance the terms of an adopted proxy access regime that proponents perceive to be off-market or overly restrictive (see box, *New in 2017: Shareholders Submit "Fix-It" Proposals*)

- Is consistent with market practice for all but the largest cap companies—only 12% of Russell 3000 companies have adopted proxy access[2]
- Does not foreclose any of the company's options if the company receives a proxy access proposal, as outlined below

Option B: Preemptively adopt proxy access

- Does not bar fix-it shareholder proposals seeking to modify the terms of the adopted proxy access regime, requiring the board to revisit the bylaw
- Will likely not permit a board to obtain no-action relief from the Securities and Exchange Commission (SEC) to exclude fix-it proposals from the company's proxy materials on the ground that the proposal has already been substantially implemented,[3] unless the company amends its proxy access regime to adopt some of the proposal's suggested amendments[4]

New in 2017: Shareholders Submit "Fix-It" Proposals

Traditionally, after a company adopts the crux of a shareholder proposal, the proponent of the proposal moves on to another company or to another governance issue. However, during the second half of 2016, proponents of proxy access proposals that were dissatisfied with certain proxy access terms adopted by companies declined to move on and opted instead to submit new shareholder proposals requesting that the company amend the offensive terms. These "fix-it" proposals, each of which typically suggests multiple, discrete changes, most frequently address and request:

- **Cap on Aggregating Shareholders—**the removal of the cap on the number of shareholders that can aggregate their shares to meet the minimum ownership threshold.
- **Cap on Board Nominees—**an increase in the number of shareholder-nominated candidates eligible to be included in the company's proxy materials to 25% of the board (with a minimum of 2).
- **Re-nomination Restrictions—**the elimination of restrictions on the re-nomination of directors in future years based on the percentage of votes received.
- **Post-Meeting Ownership Requirements—**the elimination of the requirement for a nominating shareholder to hold its shares for a period of time following the annual meeting.
- **Loaned Shares as "Owned"—**the inclusion of loaned shares among the shares counted to satisfy the percentage ownership threshold so long as the shares are recallable within a specified timeframe.

To date, very few of the fix-it proposals have received shareholder approval, particularly where the target company had implemented proxy access for shareholders with 3% stock ownership for

[2] Sharkrepellent.net, last accessed on January 11, 2017.
[3] Pursuant to Rule 14a-8(i)(10) of the Securities Exchange Act of 1934 (Exchange Act). See H&R Block, Inc., SEC No-Action Letter (Jul. 21, 2016), available here. Microsoft Corporation, SEC No-Action Letter (Sept. 27, 2016), available here. Apple Inc. , SEC No-Action Letter (Oct. 27, 2016), available here. Whole Foods Market, Inc., SEC No-Action Letter (Nov. 3, 2016), available here.
[4] See NVR, SEC No-Action Letter (Mar. 25, 2016), available here. Oshkosh Corporation, SEC No-Action Letter (Nov. 4, 2016), available here.

three years, rather than at higher thresholds. As proxy season progresses, we will continue to monitor investor reaction to fix-it proposals.

3. Options After Receiving a Proxy Access Proposal

After receiving a shareholder proposal regarding proxy access, and assuming the proposal complies with the SEC's procedural requirements, a company has at least three available alternatives:

Option A: Submit the shareholder proposal to shareholders *without* an alternative proposal from the company

- Many institutional investors, including T. Rowe Price, BlackRock, TIAA-CREF, CalPERS and CalSTRS support proxy access for a shareholder or shareholder group owning 3% or more of the company's common stock for at least three years.
- However, retail shareholders continue to be less likely to support proxy access—in 2016 just 15% of retail shareholders voted their shares in favor of proxy access proposals, while 60% of institutional shareholders voted their shares in favor of such proposals.[5]
- The identity of the proponent matters. Shareholders are less likely to vote in favor of proxy access proposals submitted by frequent shareholder proposal proponents John Chevedden, James McRitchie and William Steiner; shareholders approved less than 31% of their proposals, while shareholders approved more than 66% of proposals submitted by New York City Comptroller Scott Stringer and the New York City Pension Funds.[6]
- Institutional Shareholder Services (ISS) generally will recommend a vote in favor of proxy access proposals requiring a maximum of 3% ownership for three years, as long as the proposals impose minimal or no limits on the number of shareholders whose shares can be aggregated to satisfy the 3% threshold and the shareholders can nominate a number of nominees who, if elected, would constitute not less than 25% of the board. Glass, Lewis & Co. reviews proposals on a case-by-case basis.
- Note that combative responses to shareholder proposals made by credible proponents may result in stronger shareholder support for the proposal.

Option B: Implement the company's own form of proxy access and seek to exclude the shareholder proposal

- The company may be able to negotiate with the shareholder proponent to withdraw its proposal in exchange for the board's adoption of a proxy access regime with certain modified terms, including the number of shareholders whose shares can be aggregated to attain the 3% level, the number or percentage of directors that can be nominated and

[5] Broadridge Financial Solutions and PricewaterhouseCoopers, 2016 Proxy Season Review (3rd ed. 2016), available here.

[6] Sharkrepellent.net, last accessed on January 11, 2017. At meetings in 2015 and 2016, 45 proposals have been submitted to shareholders by John Chevedden, James McRitchie and William Steiner and 43 proposals have been voted on, with 13 proposals receiving a passing vote, whereas 80 proposals have been submitted to shareholders by the New York City Retirement Systems and 80 proposals have been voted on, with 53 proposals receiving a passing vote.

limitations on the ability of a shareholder or shareholder group to nominate directors in successive years.
- In lieu of a negotiated withdrawal, the company may be able to obtain SEC no-action relief allowing the company to exclude the shareholder proposal from the company's proxy statement on the basis that the company has substantially implemented the proposal.[7]
- During the 2016 proxy season, the SEC indicated that if a company adopts a proxy access regime with an ownership threshold matching that of the shareholder proposal (typically 3% for three years), then the SEC may be willing to permit exclusion of the shareholder proxy access proposal from the company's proxy statement that otherwise proposes terms that vary slightly from the regime adopted by the company.[8]

Option C: Submit the shareholder proposal to shareholders *along with* an alternative proposal from the company

- This option differs from Option B above because instead of actually adopting proxy access, the company merely puts forth an alternative, competing proposal for shareholders to consider.[9]
- In 2015 and 2016, 12 companies presented competing proposals. Six of the company proposals passed, five of the shareholder proposals passed, and in one case both proposals were voted down. In no case did shareholders approve both the shareholder proposal and the management proposal.
- A company can ask the shareholder or shareholder group to voluntarily withdraw its proposal if the company puts forth its own proposal.
- Excluding a shareholder proposal without an appropriate basis for doing so risks litigation and negative investor backlash. ISS will recommend a withhold vote on directors if a company omits a shareholder proposal without voluntary withdrawal, SEC no-action relief or a US district court ruling.

4. After Shareholders Approve a Proxy Access Proposal

If shareholders approve a proxy access proposal, the board may discuss whether, how and when to implement the provision. If the proposal was a non-binding precatory proposal, which is the case with most shareholder proposals, the board may consider, among other options, whether to implement the proposal exactly as proposed and approved by the shareholders or to deviate from the proposal in certain respects and potentially face future fix-it proposals. We expect shareholder opinion and market practice regarding the implementation of proxy access proposals to continue

[7] Pursuant to Rule 14a-8(i)(10) of the Securities Exchange Act of 1934 (Exchange Act).
[8] See Newell Rubbermaid Inc., SEC No-Action Letter (Mar. 9, 2016), available here. See also Fluor Corporation, SEC No-Action Letter (Mar. 3, 2016), available here and Xylem Inc., SEC No-Action Letter (Mar. 3, 2016), available here.
[9] Note that it is not possible for a company to obtain SEC permission to exclude a shareholder proxy access proposal based on the argument that the shareholder proposal "directly conflicts" with a proxy access proposal put forth by the company itself, pursuant to Rule 14a-8(i)(9) of the Exchange Act. Specifically, the SEC has stated that shareholder and management proxy access proposals with conflicting terms still seek a "similar objective," and accordingly shareholders "although possibly preferring one proposal over the other, could logically vote for both proposals." See Staff Legal Bulletin No. 14H (Oct. 22, 2015), available at https://www.sec.gov/interps/legal/cfslb14h.htm.

to evolve over the coming months and years, providing further clarity on the extent to which shareholders, as well as the SEC and proxy advisory firms, are willing to accept proxy access terms that a company implements which diverge from the terms that shareholders approved or requested.

Conclusion

Taking appropriate preparatory steps and understanding the alternatives available upon receipt of a proxy access proposal should provide a framework for companies to address the issue of proxy access in the upcoming 2017 proxy season.

Are Top Investors Listening to Proxy Advisors on Pay?

Posted by Seth Duppstadt, Proxy Insight, on Thursday, February 2, 2017

Editor's note: Seth Duppstadt is Senior Vice President at Proxy Insight. This post is based on a Proxy Insight publication authored by Mr. Duppstadt.

Large investors are not following the recommendations on executive compensation set out by Proxy Voting Advisers ("PVA"), a study by data company Proxy Insight has found.

Proxy Insight analyzed voting on Advisory Say on Pay ("SoP") resolutions in the US and UK in 2015 and 2016 for 10 of the largest institutional investors and compared each vote to the recommendations from ISS and Glass Lewis. While voting by top investors correlated with ISS 90% of the time and Glass Lewis 83% of the time for all SoP resolutions, the link is drastically reduced for votes where ISS and/or Glass Lewis recommend against a SoP proposal.

Correlation between Top Investor Voting and PVA recommendations on SoP resolutions in UK & US

	For & Against Recommendations		Just Against Recommendations	
	ISS	Glass Lewis	ISS	Glass Lewis
2016	90.3%	83.2%	51.4%	29.5%
2015	90.5%	84.4%	53.8%	33.6%

In aggregate, the 10 investors matched ISS on only 51.4% of recommendations to vote against management on SoP in 2016, and 29.5% of Glass Lewis'. In each case, the level of opposition was sharply reduced compared to the year before.

The picture is even more noteworthy when *both* ISS and Glass Lewis recommended voting Against management. Since 2015, the top investors only voted Against 61.8% of SoP resolutions where both ISS and Glass Lewis recommended against.

Commenting on the analysis, Proxy Insight Managing Director, Nick Dawson remarked: "Not only does the data provide a more realistic measure of the influence of Proxy Advisors, which is often overblown, but it also suggests increasing reluctance from investors to oppose management on the perennial issue of compensation."

The breakdown for the 10 investors is as follows:

Voting on advisory SoP in UK & US by 10 largest investors 2015 and 2016

	All Recommendations		Just Against Recommendations	
	ISS	Glass Lewis	ISS	Glass Lewis
BlackRock	91.0%	84.8%	25.4%	16.0%
Dimensional Fund Advisors, Inc.	93.6%	92.8%	100.0%	87.1%
Vanguard Group, Inc.	92.4%	86.4%	35.0%	21.3%
State Street	93.0%	85.4%	44.6%	23.6%
Fidelity Management & Research	92.4%	85.7%	34.6%	23.0%
BNY Mellon	67.5%	63.7%	83.0%	58.2%
Goldman Sachs Asset Management LP	95.8%	88.1%	40.7%	17.6%
Northern Trust	90.0%	83.3%	12.7%	5.9%
T. Rowe Price	92.3%	83.4%	56.5%	27.8%
AllianceBernstein LP	97.7%	83.6%	93.1%	37.6%

Tab II: The New Administration and Corporate Governance

SEC's Reconsideration of Pay Ratio Rule Implementation

Posted by Michael S. Piwowar, U.S. Securities and Exchange Commission, on Monday, February 6, 2017

Editor's note: Michael S. Piwowar is Acting Chairman of the U.S. Securities and Exchange Commission. This post is based on a recent public statement issued by Mr. Piwowar.

The Commission adopted the pay ratio disclosure rule in August 2015 to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The rule requires a public company to disclose the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer.

Based on comments received during the rulemaking process, the Commission delayed compliance for companies until their first fiscal year beginning on or after January 1, 2017. Issuers are now actively engaged in the implementation and testing of systems and controls designed to collect and process the information necessary for compliance. However, it is my understanding that some issuers have begun to encounter unanticipated compliance difficulties that may hinder them in meeting the reporting deadline.

In order to better understand the nature of these difficulties, I am seeking public input on any unexpected challenges that issuers have experienced as they prepare for compliance with the rule and whether relief is needed. I welcome and encourage the submission of detailed comments, and request that any comments be submitted within the next 45 days.

I have also directed the staff to reconsider the implementation of the rule based on any comments submitted and to determine as promptly as possible whether additional guidance or relief may be appropriate.

I understand that issuers need to be informed of any further Commission or staff action as soon as possible in order to plan and adjust their implementation processes accordingly. I encourage commenters and the staff to expedite their review in light of these unique circumstances.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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U.S. Corporate Governance: Will Private Ordering Trump Political Change?

Posted by Marc S. Gerber, Skadden, Arps, Slate, Meagher & Flom LLP, on Wednesday, February 15, 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 publication.

Introduction

Overview

The year 2017 begins amid significant shifts in the world's geopolitical order. Recent events such as the U.S. Presidential election and the United Kingdom's historic vote to leave the European Union have brought with them a great deal of both political and economic uncertainty. At the same time, the ever-increasing dependence on technological advances characterizing all aspects of business and modern life has been accompanied by a rapidly growing threat of cyberattack and cyberterrorism, including to the world's most critical commercial infrastructure. As political and commercial leaders grapple with these new realities, corporate risk taking and the monitoring of corporate risk continue to take prominence in the minds of boards of directors, investors, legislators and the media. Major institutional shareholders and proxy advisory firms now evaluate risk oversight matters when considering withhold votes in uncontested director elections and routinely engage companies on risk-related topics. This focus on risk management has also led to increased scrutiny of the relationship between compensation arrangements throughout the organization and excessive risk taking. Risk management is no longer simply a business and operational responsibility of management. It has also become a governance issue that is squarely within the purview of the board. Accordingly, oversight of risk should be an area of regular board assessment. This overview highlights a number of issues that have remained critical over the years and provides an update to reflect emerging and recent developments.

Both the law and practicality continue to support the proposition that the board cannot and should not be involved in actual day-to-day risk *management*. Directors should instead, through their risk *oversight* role, satisfy themselves that the risk management policies and procedures designed and implemented by the company's senior executives and risk managers are consistent with the company's strategy and risk appetite; that these policies and procedures are functioning as directed; and that necessary steps are taken to foster an enterprise-wide culture that supports appropriate risk awareness, behaviors and judgments about risk and recognizes and appropriately escalates and addresses risk-taking beyond the company's determined risk appetite. The board should be aware of the type and magnitude of the company's principal risks and should require that the CEO and the senior executives are fully engaged in risk management. Through its oversight role, the board can send a message to management and employees that comprehensive risk management is not an impediment to the conduct of business nor a mere supplement to a firm's overall compliance program. Instead, it is an integral component of strategy, culture and business operations. In addition, the roles and responsibilities of different board committees in overseeing specific categories of risk should be reviewed to ensure that, taken as a whole, the board's oversight function is coordinated and comprehensive. In that regard, a recent PricewaterhouseCoopers' survey of directors reported that 83% of directors believe there is a clear allocation of risk oversight responsibilities among the board and its committees, but nearly 20% of the directors surveyed suggested the clarity of the allocation of these responsibilities could still be improved.

Cybersecurity's Increasing Importance

Cybersecurity has been producing more and more headlines in recent years, and 2016 continued this trend. According to a study performed by Symantec, the identities of over 429 million people were wrongfully exposed through cyberattacks last year. As recent examples (*e.g.,* the hacking of computer networks belonging to the Democratic National Committee) have highlighted, online security breaches, theft of personal data, proprietary or commercially sensitive information and damage to IT infrastructure are omnipresent threats and can have a significant financial and reputational impact on companies and organizations. In today's highly technological world, virtually all company functions across all industries utilize some form of information technology. Industry-leading experts recommend that in order to be effective, companies must not only have an effective and well-vetted cybersecurity breach response plan, but such plans must also be periodically tested in simulated situations to ensure that key personnel understand their precise roles and the real-time decisions that must be made.

Lawmakers and regulators have recently focused their attention on cybersecurity risk. In October 2016, federal banking regulators sought comments (due in early 2017) on enhanced cyber risk-management standards for major financial institutions. In addition, the New York State Department of Financial Services (DFS) announced in 2016 detailed regulations requiring covered institutions—entities authorized under New York State banking, insurance or financial services laws—to meet strict minimum cybersecurity standards, and the Department of Treasury's Financial Crimes Enforcement Network (FinCEN) issued an advisory on the reporting of cyber events under the Bank Secrecy Act. On December 28, 2016, DFS released revised regulations (see our previous memorandum here), which, subject to notice and comment, are set to become effective on March 1, 2017. In May 2016, federal legislation regarding the application of the Sarbanes-Oxley Act of 2002 (SOX) certifications and internal controls requirements to a company's information and technology systems and cybersecurity-related controls, and whether companies must publicly explain why they do not have at least one director with specific cybersecurity-related expertise, was referred to the House Committee of Financial Services. As of the date of this publication, such proposed legislation has not moved out of committee.

The SEC has recently voiced its support of the Framework for Improving Critical Infrastructure Cybersecurity released by the National Institute of Standards and Technology (NIST) and indicated that as part of fulfilling their risk oversight function, boards should at a minimum work with management to ensure that corporate policies are in-line with the Framework's guidelines. The Framework is divided into three central components: the Framework core (*i.e.,* a set of cybersecurity activities and informative references that are organized around particular outcomes designed to enable communication of cyber risk across an entire organization); the Framework profile (*i.e.,* the alignment of industry standards and best practices to the Framework core in particular implementation scenarios which supports prioritization and measurement in conjunction with factoring in relevant business needs); and the Framework implementation tiers (*i.e.,* a description of how cybersecurity risk is managed by an organization and the degree to which the risk management practices exhibit key characteristics). On January 10, 2017, NIST released, and is seeking public comment on, proposed updates to the Framework. In addition to the NIST Framework, the International Organization for Standardization (ISO), an independent, non-governmental international organization, published its own information security standard known as the ISO/IEC 27001, which provides a similar framework for cybersecurity implementation.

Strong Institutional Investor Focus

The focus on risk management is a top governance priority of institutional investors. A PricewaterhouseCoopers survey report issued in 2014 indicated that risk management was a top priority for investors, and a 2016-2017 National Association of Corporate Directors (NACD) survey revealed that one in ten boards that met with institutional investors specifically discussed risk oversight. In exceptional circumstances, this scrutiny can translate into shareholder campaigns and adverse voting recommendations from ISS. ISS will recommend voting "against" or "withhold" in director elections, even in uncontested elections, when the company has experienced certain extraordinary circumstances, including material failures of risk oversight. In 2012, ISS clarified that such failures of risk oversight will include bribery, large or serial fines or sanctions from regulatory bodies and significant adverse legal judgments or settlements. Thus, in connection with the ongoing FCPA investigation at Wal-Mart, ISS recommended voting against the chairman, CEO and audit committee chair "due to the board's failure to adequately communicate material risk factors to shareholders, and to reassure shareholders that the board was exercising proper oversight and stewardship and would hold executives accountable if appropriate." ISS has made similar withhold recommendations at other companies, too, in connection with perceived risk oversight issues.

Tone at the Top and Corporate Culture

The board and relevant committees should work with management to promote and actively cultivate a corporate culture and environment that understands and implements enterprise-wide risk management. Comprehensive risk management should not be viewed as a specialized corporate function, but instead should be treated as an integral, enterprise-wide component that affects how the company measures and rewards its success.

The assessment of risk, the accurate evaluation of risk versus reward and the prudent mitigation of risk should be incorporated into all business decision-making. In setting the appropriate "tone at the top," transparency, consistency and communication are key: the board's vision for the corporation, including its commitment to risk oversight, ethics and intolerance of compliance failures, should be communicated effectively throughout the organization. As noted in a 2014 speech by former SEC Chair Mary Jo White, "[e]nsuring the right 'tone at the top' . . . is a critical responsibility for each director and the board collectively." Risk management policies and procedures and codes of conduct and ethics should be incorporated into the company's strategy and business operations, with appropriate supplementary training programs for employees and regular compliance assessments.

The Risk Oversight Function of the Board of Directors

A board's risk oversight responsibilities derive primarily from state law fiduciary duties, federal and state laws and regulations, stock exchange listing requirements and certain established (and evolving) best practices, both domestic and worldwide.

Fiduciary Duties

The Delaware courts have taken the lead in formulating the national legal standards for directors' duties for risk management. The Delaware courts have developed the basic rule under the *Caremark* line of cases that directors can only be liable for a failure of board oversight where there is "sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists," noting that this is a "demanding test." In re Caremark International Inc. Derivative Litigation, 698 A.2d 959, 971 (Del. Ch. 1996). Delaware Court of Chancery decisions since *Caremark* have expanded upon that holding, while reaffirming its fundamental standard. The plaintiffs in In re Citigroup Inc. Shareholder Derivative Litigation, decided in 2009, alleged that the defendant directors of Citigroup had breached their fiduciary duties by not properly monitoring and managing the business risks that Citigroup faced from subprime mortgage securities, and by ignoring alleged "red flags" that consisted primarily of press reports and events indicating worsening conditions in the subprime and credit markets. The court dismissed these claims, reaffirming the "extremely high burden" plaintiffs face in bringing a claim for personal director liability for a failure to monitor business risk and that a "sustained or systemic failure" to exercise oversight is needed to establish the lack of good faith that is a necessary condition to liability.

In In re The Goldman Sachs Group, Inc. Shareholder Litigation, decided in October 2011, the court dismissed claims against directors of Goldman Sachs based on allegations that they failed to properly oversee the company's alleged excessive risk taking in the subprime mortgage securities market and caused reputational damage to the company by hedging risks in a manner that conflicted with the interests of its clients. Chief among the plaintiffs' allegations was that Goldman Sachs' compensation structure, as overseen by the board of directors, incentivized management to take on ever riskier investments with benefits that inured to management but with the risks of those actions falling to the shareholders. In dismissing the plaintiffs' *Caremark* claims, the court reiterated that, in the absence of "red flags," the manner in which a company evaluates the risks involved with a given business decision is protected by the business judgment rule and will not be second-guessed by judges.

Overall, these cases reflect that it is difficult to show a breach of fiduciary duty for failure to exercise oversight and that the board is not required to undertake extraordinary efforts to uncover non-compliance within the company, provided a monitoring system is in place. Nonetheless, while it is true that the Delaware Supreme Court has not indicated a willingness, to date, to alter the strong protection afforded to directors under the business judgment rule which underpins *Caremark* and its progeny, boards should keep in mind that cases involving particularly egregious facts and circumstances and substantial shareholder losses necessarily risk more unfavorable outcomes, particularly in cases brought outside of Delaware. Companies should adhere to reasonable and prudent practices and should not structure their risk management policies around the minimum requirements needed to satisfy the business judgment rule.

Federal Laws and Regulations

Dodd-Frank. The Dodd-Frank Act created new federally mandated risk management procedures principally for financial institutions. Dodd-Frank requires bank holding companies with total assets of $10 billion or more, and certain other non-bank financial companies as well, to have a separate risk committee which includes at least one risk management expert with experience managing risk of large companies.

Securities and Exchange Commission. In 2010, the SEC added requirements for proxy statement discussion of a company's board leadership structure and role in risk oversight. Companies are required to disclose in their annual reports the extent of the board's role in risk oversight, such as how the board administers its oversight function, the effect that risk oversight has on the board's process (*e.g.*, whether the persons who oversee risk management report directly to the board as a whole, to a committee, such as the audit committee, or to one of the other standing committees of the board) and whether and how the board, or board committee, monitors risk.

The SEC proxy rules also require a company to discuss the extent to which risks arising from a company's compensation policies are reasonably likely to have a "material adverse effect" on the company. A company must further discuss how its compensation policies and practices, including those of its non-executive officers, relate to risk management and risk-taking incentives.

Industry-Specific Guidance and General Best Practices Manuals

Various industry-specific regulators and private organizations publish suggested best practices for board oversight of risk management. Examples include reports by the National Association of Corporate Directors (NACD)—Blue Ribbon Commission on Risk Governance, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the Business Roundtable's 2016 Principles of Corporate Governance. The 2009 NACD report provides guidance on, and principles for, the board's risk oversight activities, the relationship between strategy and risk and the board's role in relation to particular categories of risk. These principles include understanding key drivers of success and risks in the company's strategy, crafting the right relationship between the board and its standing committees as to risk oversight, establishing and providing appropriate resources to support risk management systems, monitoring potential risks in the company's culture and incentive systems and developing an effective risk dialogue with management.

In June 2016, COSO sought public comment on a draft of an updated version of its internationally recognized enterprise risk management framework, which it originally released in 2004. The comment period concluded in October 2016. As proposed to be revised, the COSO approach presents five interrelated components of risk management: risk governance and culture (the tone of the organization); setting objectives; execution risk (the assessment of risks that may impact achievement of strategy and business objectives); risk information, communication and reporting; and monitoring enterprise risk management performance. Additional changes proposed to be adopted in the revised framework are a simplified definition of enterprise risk management designed to be accessible to personnel not directly involved in risk management roles; a clear examination of the role of culture; an elevated discussion of strategy; a renewed emphasis between risk and value; an enhanced alignment between performance and enterprise risk management; a more explicit linking of enterprise risk management to decision-making; an enhanced focus on the integration of enterprise risk management; a refined explanation of the concept of risk appetite and acceptable variation in performance (*i.e.,* risk tolerance); and a clear delineation between enterprise risk management and internal controls. A COSO 2009 enterprise risk management release recommends concrete steps for boards, such as understanding a company's risk philosophy and concurring with its risk appetite, reviewing a company's risk portfolio against that appetite and knowing the extent to which management has established effective enterprise risk management and is appropriately responding in the face of risk. In its 2010 progress report, COSO recommends that the board focus, at least annually, on whether developments in a company's business or the overall business environment have "resulted in changes in the critical assumptions and inherent risks underlying the organization's strategy." By understanding and emphasizing the relationship between critical assumptions underlying business strategy and risk management, the board can strengthen its risk oversight role.

In June 2015, The Conference Board Governance Center published a report, The Next Frontier for Boards: Oversight of Risk Culture (discussed on the Forum here), that contains useful recommendations for board-driven risk governance. Among other useful suggestions, the report suggests that boards receive periodic briefings (whether from chief internal auditors, outside subject matter experts or consulting firms) on board oversight of risk culture expectations.

The Business Roundtable's 2016 Principles of Corporate Governance includes a set of seven "Guiding Principles of Corporate Governance," one of which is that the board approve corporate strategies that are intended to build long-term value and growth. As part of that function, the board should allocate capital for assessing and managing risks and set a "tone at the top" for ethical conduct. In describing the board's key responsibilities, the report also suggests that boards should understand the inherent risks in the company's strategic plan and how risks are being managed and, consistent with the COSO release, suggests that the board work with senior management to agree on the company's risk appetite and satisfy itself that the company's strategy is consistent with it.

Recommendations for improving risk oversight

Risk management should be tailored to the specific company, but, in general, an effective risk management system will (1) adequately identify the material risks that the company faces in a timely manner; (2) implement appropriate risk management strategies that are responsive to the company's risk profile, business strategies, specific material risk exposures and risk tolerance thresholds; (3) integrate consideration of risk and risk management into strategy development and business decision-making throughout the company; and (4) adequately transmit necessary information with respect to material risks to senior executives and, as appropriate, to the board or relevant committees.

Specific types of actions that the appropriate committees may consider as part of their risk management oversight include the following:

- review with management the company's risk appetite and risk tolerance, the ways in which risk is measured on an aggregate, company-wide basis, the setting of aggregate and individual risk limits (quantitative and qualitative, as appropriate), the policies and procedures in place to hedge against or mitigate risks and the actions to be taken if risk limits are exceeded;

- establish a clear framework for holding the CEO accountable for building and maintaining an effective risk appetite framework and providing the board with regular, periodic reports on the company's residual risk status;
- review with management the categories of risk the company faces, including any risk concentrations and risk interrelationships, as well as the likelihood of occurrence, the potential impact of those risks, mitigating measures and action plans to be employed if a given risk materializes;
- review with management the assumptions and analysis underpinning the determination of the company's principal risks and whether adequate procedures are in place to ensure that new or materially changed risks are properly and promptly identified, understood and accounted for in the actions of the company;
- review with committees and management the board's expectations as to each group's respective responsibilities for risk oversight and management of specific risks to ensure a shared understanding as to accountabilities and roles;
- review the company's executive compensation structure to ensure it is appropriate in light of the company's articulated risk appetite and risk culture and to ensure it is creating proper incentives in light of the risks the company faces;
- review the risk policies and procedures adopted by management, including procedures for reporting matters to the board and appropriate committees and providing updates, in order to assess whether they are appropriate and comprehensive;
- review management's implementation of its risk policies and procedures, to assess whether they are being followed and are effective;
- review with management the quality, type and format of risk-related information provided to directors;
- review the steps taken by management to ensure adequate independence of the risk management function and the processes for resolution and escalation of differences that might arise between risk management and business functions;
- review with management the design of the company's risk management functions, as well as the qualifications and backgrounds of senior risk officers and the personnel policies applicable to risk management, to assess whether they are appropriate given the company's size and scope of operations;
- review with management the primary elements comprising the company's risk culture, including establishing "a tone from the top" that reflects the company's core values and the expectation that employees act with integrity and promptly escalate non-compliance in and outside of the organization; accountability mechanisms designed to ensure that employees at all levels understand the company's approach to risk as well as its risk-related goals; an environment that fosters open communication and that encourages a critical attitude towards decision-making; and an incentive system that encourages, rewards and reinforces the company's desired risk management behavior;
- review with management the means by which the company's risk management strategy is communicated to all appropriate groups within the company so that it is properly integrated into the company's enterprise-wide business strategy;
- review internal systems of formal and informal communication across divisions and control functions to encourage the prompt and coherent flow of risk-related information within and across business units and, as needed, the prompt escalation of information to senior management (and to the board or board committees as appropriate); and
- review reports from management, independent auditors, internal auditors, legal counsel, regulators, stock analysts and outside experts as considered appropriate regarding risks

the company faces and the company's risk management function, and consider whether, based on individual director's experience, knowledge and expertise, the board or committee primarily tasked with carrying out the board's risk oversight function is sufficiently equipped to oversee all facets of the company's risk profile—including specialized areas such as cybersecurity—and determine whether subject-specific risk education is advisable for such directors.

In addition to considering the foregoing measures, the board may also want to focus on identifying external pressures that can push a company to take excessive risks and consider how best to address those pressures. In particular, companies have come under increasing pressure in recent years from hedge funds and activist shareholders to produce short-term results, often at the expense of longer-term goals. These demands may include steps that would increase the company's risk profile, for example, through increased leverage to repurchase shares or pay out special dividends, or spinoffs that leave the resulting companies with smaller capitalizations. While such actions may make sense for a specific company under a specific set of circumstances, the board should focus on the risk impact and be ready to resist pressures to take steps that the board determines are not in the company's or shareholders' best interest.

Special Considerations Regarding Cybersecurity Risk

As cybersecurity risk continues to rise in prominence, so too has the number of organizations that have begun to specifically situate cybersecurity and cyber risk within their internal audit function. A 2016 Internal Audit Capabilities and Needs Survey, conducted by Protiviti, found that 73% of the organizations surveyed now include cybersecurity risk as part of their internal audit function, a 20% increase from 2015. Directors should assure themselves that their organization's internal audit function is performed by individuals who have appropriate technical expertise and sufficient time and other resources to devote to cybersecurity risk. Further, these individuals should understand and periodically test the organization's risk mitigation strategy, and provide timely reports on cybersecurity risk to the audit committee of the board. In addition to the considerations discussed above, boards should, in satisfying their risk oversight function with respect to cybersecurity, evaluate their company's preparedness for a possible cybersecurity breach, as well as the company's action plan in the event that a cybersecurity breach occurs. With respect to preparation, boards should consider the following actions, several of which are also addressed in The Conference Board's "A Strategic Cyber-Roadmap for the Board" released in November 2016:

- identify the company's "Crown Jewels"—*i.e.,* the company's mission-critical data and systems—and work with management to apply appropriate measures outlined in the NIST Framework;
- ensure that an actionable cyber incident response plan is in place that, among other things, identifies critical personnel and designates responsibilities; includes procedures for containment, mitigation and continuity of operations; and identifies necessary notifications to be issued as part of a preexisting notification plan;
- ensure that the company has developed effective response technology and services (*e.g.*, off-site data back-up mechanisms, intrusion detection technology and data loss prevention technology);
- ensure that prior authorizations are in place to permit network monitoring;
- ensure that the company's legal counsel is conversant with technology systems and cyber incident management to reduce response time; and

- establish relationships with cyber information sharing organizations and engage with law enforcement before a cybersecurity incident occurs.

Situating the Risk Oversight Function

Most boards delegate oversight of risk management to the audit committee, which is consistent with the NYSE rule that requires the audit committee to discuss policies with respect to risk assessment and risk management. In practice, this delegation to the audit committee may become more of a coordination role, at least insofar as certain kinds of risks will naturally be addressed across other committees as well (*e.g.,* risks arising from compensation structures are frequently considered in the first instance by the compensation committee). Financial companies covered by Dodd-Frank must have dedicated risk management committees. The appropriateness of a dedicated risk committee at other companies will depend on the industry and specific circumstances of the company. Boards should also bear in mind that different kinds of risks may be best suited to the expertise of different committees—an advantage that may outweigh any benefit from having a single committee specialize in risk management, so long as overall risk oversight efforts are properly coordinated and communicated. In recent years, the number of boards that have created a separate risk committee has grown. According to a 2016 Ernst & Young survey of S&P 500 companies, more than 75% of boards have at least one committee in addition to the mandatory committees, up from 61% in 2013, and of such boards, 11% have a separate risk committee. To date, however, separate risk committees remain uncommon outside the financial industry (according to the same Ernst & Young survey, of companies that have a separate risk committee, 73% are in the financial industry followed by 6% for industrials). Regardless of the delegation of risk oversight to committees, the full board should satisfy itself that the activities of the various committees are coordinated and that the company has adequate risk management processes in place.

If the company keeps the primary risk oversight function in the audit committee and does not establish a separate risk committee or subcommittee, the audit committee should schedule time for periodic review of risk management outside the context of its role in reviewing financial statements and accounting compliance. While this may further burden the audit committee, it is important to allocate sufficient time and focus to the risk oversight role.

Risk management issues may arise in the context of the work of other committees, and the decision-making in those committees should take into account the company's overall risk management system. Specialized committees may be tasked with specific areas of risk exposure. Banks, for instance, often maintain credit or finance committees, while energy companies may have public policy committees largely devoted to environmental and safety issues. Fundamental risks to the company's business strategy and risks facing the industries in which the company operates are often discussed at the full board level. Where different board committees are responsible for overseeing specific risks, the work of these committees should be coordinated in a coherent manner both horizontally and vertically so that the entire board can be satisfied as to the adequacy of the risk oversight function and the company's overall risk exposures are understood, including with respect to risk interrelationships. It may also be appropriate for the committee charged with risk oversight to meet in executive session both alone and together with other independent directors to discuss the company's risk culture, the board's risk oversight function and key risks faced by the company.

The board should formally undertake an annual review of the company's risk management system, including a review of board- and committee-level risk oversight policies and procedures, a presentation of "best practices" to the extent relevant, tailored to focus on the industry or regulatory arena in which the company operates, and a review of other relevant issues such as those listed above. To this end, it may be appropriate for boards and committees to engage outside consultants to assist them in both the review of the company's risk management systems and also assist them in understanding and analyzing business-specific risks. But because risk, by its very nature, is subject to constant and unexpected change, boards should keep in mind that annual reviews do not replace the need to regularly assess and reassess their own operations and processes, learn from past mistakes and seek to ensure that current practices enable the board to address specific major issues whenever they may arise. Where a major or new risk comes to fruition, management should thoroughly investigate and report back to the full board or the relevant committees as appropriate.

Lines of Communication and Information Flow

The ability of the board or a committee to perform its oversight role is, to a large extent, dependent upon the relationship and the flow of information between the directors, senior management and the risk managers in the company. If directors do not believe they are receiving sufficient information—including information regarding the external and internal risk environment, the specific material risk exposures affecting the company, how these risks are assessed and prioritized, risk response strategies, implementation of risk management procedures and infrastructure and the strengths and weaknesses of the overall system—they should be proactive in asking for more. Directors should work with management to understand and agree on the type, format and frequency of risk information required by the board. High-quality, timely and credible information provides the foundation for effective responses and decision-making by the board.

Any committee charged with risk oversight should hold sessions in which it meets directly with key executives primarily responsible for risk management, just as an audit committee meets regularly with the company's internal auditors and liaises with senior management in connection with CEO and CFO certifications for each Form 10-Q and Form 10-K. In addition, senior risk managers and senior executives should understand they are empowered to inform the board or committee of extraordinary risk issues and developments that need the immediate attention of the board outside of the regular reporting procedures. In light of the *Caremark* standards discussed above, the board should feel comfortable that "red flags" or "yellow flags" are being reported to it so that they may be investigated if appropriate.

Legal Compliance Programs

Senior management should provide the board or committee with an appropriate review of the company's legal compliance programs and how they are designed to address the company's risk profile and detect and prevent wrongdoing. While compliance programs will need to be tailored to the specific company's needs, there are a number of principles to consider in reviewing a program. As noted earlier, there should be a strong "tone at the top" from the board and senior management emphasizing that non-compliance will not be tolerated. This cultural element is taking on increasing importance and receiving heightened attention from regulators as well. A well-tailored compliance program and a culture that values ethical conduct continue to be critical factors that the Department of Justice will assess under the Federal Sentencing Guidelines in the event that corporate personnel engage in misconduct. In addition, the DOJ's heightened focus on individual accountability for wrongdoing deriving from the 2015 "Yates memo" is likely to remain a feature of the enforcement landscape, thus magnifying the importance of responding in an appropriate manner to indications of possible misconduct.

A compliance program should be designed by persons with relevant expertise and will typically include interactive training as well as written materials. Compliance policies should be reviewed periodically in order to assess their effectiveness and to make any necessary changes. There should be consistency in enforcing stated policies through appropriate disciplinary measures. Finally, there should be clear reporting systems in place both at the employee level and at the management level so that employees understand when and to whom they should report suspected violations and so that management understands the board's or committee's informational needs for its oversight purposes. A company may choose to appoint a chief compliance officer and/or constitute a compliance committee to administer the compliance program, including facilitating employee education and issuing periodic reminders. If there is a specific area of compliance that is critical to the company's business, the company may consider developing a separate compliance apparatus devoted to that area.

Anticipating Future Risks

The company's risk management structure should include an ongoing effort to assess and analyze the most likely areas of future risk for the company, including how the contours and interrelationships of existing risks may change and how the company's processes for anticipating future risks are developed. Anticipating future risks is a key element of avoiding or mitigating those risks before they escalate into crises. In reviewing risk management, the board or relevant committees should ask the company's executives to discuss the most likely sources of material future risks and how the company is addressing any significant potential vulnerability.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Congress Rolls Back SEC Resource Extraction Payments Rule

Posted by Nicholas Grabar and Sandra L. Flow, Cleary Gottlieb Steen & Hamilton LLP, on Thursday, February 16, 2017

Editor's note: Nicolas Grabar and Sandra L. Flow are partners at Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb publication by Mr. Grabar, Ms. Flow, and Nina E. Bell.

The review of financial regulation under the new administration has its first victim. On February 3, the Senate passed a resolution under the Congressional Review Act that disapproves the SEC's rule on resource extraction payments. The House of Representatives had already passed the resolution, so the SEC's rule is no longer in effect.

The target of the joint resolution is a rule requiring each SEC reporting company engaged in commercial development of oil, natural gas or minerals to file annual disclosures on payments it makes to governments. The rule has already had a tortured history, which left it vulnerable to action under the Congressional Review Act (CRA).

The story begins in 2010, with the Dodd-Frank Act. Section 1504 of the Act required the SEC to adopt a rule on resource extraction payments by April 2011. This mandate, like the conflict minerals rule required by Section 1502 of Dodd-Frank, was unrelated to the broader financial regulatory purposes of most of the Act. It was intended, as the SEC concluded, to promote U.S. foreign policy interests in supporting global efforts to improve transparency in the extractive industries. Together with the conflict minerals rule, it presented special challenges for the SEC, because Congress sought to use the SEC disclosure system to promote public policy objectives that were not directly related to the usual purposes of corporate disclosures.

The SEC, with an unprecedented volume of rulemaking required by Dodd-Frank, missed the statutory deadline and finally adopted a rule in August 2012. Industry groups then challenged the rule, and the U.S. federal district court for the District of Columbia vacated the rule in July 2013, finding that the SEC had misread the statute on one point and acted arbitrarily on another. Oxfam, a supporter of resource extraction payment disclosures, then sued in the federal district court in Massachusetts to compel the SEC to implement the statutory mandate, and in September 2015, that court held that the SEC had acted unlawfully by failing to adopt a final rule. Under a schedule filed with the court, the SEC adopted a final rule for the second time in June 2016. The rule took effect in September 2016, but the first disclosures were not due until 2019.

This long path to final adoption meant that the rule was available for disapproval by the new Congress under the Congressional Review Act. That statute requires federal agencies to submit adopted final rules to Congress and allows Congress to disapprove a rule within a specified period following submission. The period for the resource extraction payment rule had not yet run when the 114th Congress adjourned, so the 115th Congress had an opportunity to review it. The CRA makes a fast-track procedure available, under which each house of Congress can act by simple majority without the possibility of a filibuster in the Senate. According to the Congressional Research Service, only once before has an adopted rule been invalidated under the CRA—in 2001, when a rule on ergonomic standards, adopted by the Occupational Safety and Health Administration in the twilight of the Clinton Administration, was disapproved in the early days of the Bush Administration. The President's signature is not required for a disapproval resolution to be effective, but President Bush did sign that resolution. The President can, however, veto a disapproval resolution. President Obama did so on five occasions and Congress did not override those vetoes.

An already effective rule that is disapproved under the CRA is treated as though it had never taken effect, and it may not be reissued in substantially the same form unless the reissuance is specifically authorized by a law enacted after the date of disapproval. Earlier this week, the President's office expressed its support for the joint resolution, so clearly there will be no veto. The CRA also provides that any statutory deadline for agency action relating to a disapproved rule is extended for one year from enactment of the disapproval resolution.

The result for affected issuers is clear: the existing rule is gone. The CRA even expressly provides that Congressional disapproval is not subject to judicial review. For the SEC, the details are more complicated, but the big picture is that the rule will probably not come back from the dead a second time. The mandate under Section 1504 is still law, with a new deadline in February 2018, although it might be challenging to craft a rule that meets both the detailed prescriptions of Section 1504 and the CRA prohibition on reissuing a rule after disapproval. Of course, Congress may yet repeal Section 1504 itself, as House Financial Services Chair Jeb Hensarling already proposed in the Financial CHOICE Act in 2016. But even if it does not, it is hard to imagine the new SEC making adoption of a new rule a high priority unless it is again compelled to do so by a court.

Meanwhile, the SEC's conflict minerals disclosure rule, adopted in August 2012, remains in effect—for now. It requires reporting companies to provide disclosure about the sources of specified minerals, with the aim of impeding the financing of armed conflict in the Congo. On January 31, 2017, acting SEC Chairman Piwowar directed the SEC staff to reconsider its guidance under that rule and whether any additional relief might be appropriate, stating that the disclosure requirements have resulted in a *de facto* boycott of minerals from parts of Africa and that it is unclear whether the costs associated with the rule have resulted in any of the desired benefits. The SEC is soliciting comments from interested parties on all aspects of the rule and guidance. Congress will presumably also consider repealing Section 1502 of the Dodd-Frank Act.

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Predictions on Dodd-Frank's Executive Compensation Provisions

Posted by Joseph A. Hall, Davis Polk & Wardwell LLP, on Wednesday, December 14, 2016

Editor's note: Joseph A. Hall is a partner and head of the corporate governance practice at Davis Polk & Wardwell LLP. This post is based on a Davis Polk memorandum. Related research from the Program on Corporate Governance includes Regulating Bankers' Pay by Lucian Bebchuk and Holger Spamann (discussed on the Forum here); How to Fix Bankers' Pay by Lucian Bebchuk (discussed on the Forum here); and Rationalizing the Dodd–Frank Clawback by Jesse Fried (discussed on the Forum here). Additional posts addressing legal and financial implications of the incoming Trump administration are available here.

With President-elect Donald Trump's transition underway, speculation has been rife as to the impact of his Administration and a Republican-controlled Congress on a variety of issues, including executive compensation. While one might assume that all of the recent executive compensation rules mandated by the Dodd-Frank Act are headed out the window, the fate of those rules will depend on two key variables:

- The first is the timing of the rules' effective and compliance dates as compared to the timing feasibility of the potential rollback vehicles, such as the Financial CHOICE Act, introduced by the chairman of the House Financial Services Committee earlier this year.
- The second variable consists of the views of the Trump Administration, its new SEC Commissioners and others about the policy goals and content of the rules, including the level of emphasis that they choose to give to executive compensation as a strategic matter.[1]

This memorandum predicts the fate of proposed and final executive compensation rules, recognizing that predictions are just that and that it is particularly difficult to make them in view of the relatively unconventional way in which the Trump transition team has operated thus far. We also explain the different potential vehicles for regulatory rollback and illustrate hypothetical timetables for each executive compensation rule, showing key compliance dates and the potential timing for any repeal or amendment of the relevant rule.

Our Current Prognosis

Based on the information that we have to date, here is our current prognosis for the following Dodd-Frank rules:

[1] For more information on the possible reorientation of the financial regulatory framework more generally, see our earlier memorandum.

Pay ratio disclosure: This rule is already final and effective, although it is likely near the top of the list of executive compensation provisions targeted for repeal by the Republican-controlled Congress and many individuals with influence within the Trump transition team. If the CHOICE Act were to be enacted as is, the Dodd-Frank statutory basis for the rule would be repealed, but, as a practical matter:

- Enactment of CHOICE Act may not be realistic until mid-2017 at the earliest and possibly later into 2018; and
- The basis for the SEC's rule requiring pay ratio disclosure (i.e., Item 402(u) of Regulation S-K) is predicated on more statutory authority than just the Dodd-Frank Act. Accordingly, the mere elimination of the Dodd-Frank statutory basis would still leave the rule in effect, unless the CHOICE Act were revised or additional legislation were enacted to also repeal the rule. The SEC itself could instead take action to repeal or amend the rule (subject to a notice and comment period).

In addition, while the CHOICE Act makes it clear that many Republicans in Congress are critical of the pay ratio rule, it is less clear whether the new Republican coalition uniformly views the rule as anathema.

Given this, our advice to calendar-year companies is to continue to prepare to include the pay ratio disclosure in their 2018 proxy statements. Non-calendar year companies will have at least one more year of breathing room, because the first applicable reporting period is a company's first full fiscal year commencing on or after January 1, 2017.

Clawback: Companies can reasonably expect not to be required to adopt clawback policies in the form prescribed in the proposed SEC rule, much less comply with the SEC disclosure requirement, in 2017, given that a final rule has not yet been adopted. Even if the rule were finalized, it has a drawn-out compliance date that involves further implementing action by the national securities exchanges. The provisions of the CHOICE Act would replace the Dodd-Frank clawback requirement with a narrower rule that would limit clawbacks to current or former executive officers who had control or authority over the company's financial reporting that resulted in an accounting restatement. That said, clawback policies generally enjoy strong investor and popular support. As a result, many companies, including financial institutions swayed by European requirements, have already implemented clawback policies of their own that are largely predicated on finding fault. We anticipate that this trend will continue.

Say-on-pay: The CHOICE Act would amend the rule to require say-on-pay votes only when there are material changes made to a company's executive compensation. However, say-on-pay is now a well-accepted corporate governance practice and has the support of many institutional investors. For companies, the say-on-pay vote serves as a safety valve measure by which shareholders can express their disapproval of companies' pay practices without voting against directors. Thus, we anticipate that say-on-pay practices will continue in the near term and that, even in the event of a change in law, any resulting change in practice will likely be implemented over time.

Pay-versus-performance disclosure: This rule is still in proposed form and is not covered by the CHOICE Act. Companies can reasonably expect not to be required to provide the Dodd-Frank-mandated disclosure in 2017 and likely longer. That said, institutional investors will continue to care deeply that companies remunerate their executive officers on the basis of performance and that they disclose pay decisions in a clear and transparent manner.

Hedging disclosure: This rule is still in proposed form, and the CHOICE Act would repeal the statutory basis for this disclosure requirement. Companies can reasonably expect not to be required to provide the Dodd-Frank mandated disclosure in 2017 and likely longer. However, many companies already have policies that prohibit some form of hedging by their directors and executive officers, and we do not expect that to change.

Compensation committee and advisor independence: This rule has been in effect since

2012 and separately reflected in the listing standards of the national securities exchanges, and there has not been any push to repeal or amend it. Thus, companies can reasonably expect to continue to be required to comply with this rule for the foreseeable future.

For financial institutions, prohibitions on certain kinds of incentive compensation: This proposed rule is highly unlikely to be finalized before inauguration, given that it is required to be approved by six separate independent agencies. Post-inauguration, we do not expect the Trump Administration to focus on this proposal, which would prohibit incentive compensation arrangements of covered financial institutions that are excessive or that could lead to the financial institution's material financial loss, in the way that the Obama Administration did. In addition, the CHOICE Act would repeal the Dodd-Frank basis for the proposed rule. Finally, even if the statutory requirement were not repealed and the rule were finalized, it has a drawn-out compliance date. Thus, financial institutions can reasonably expect not to be required to be subject to this rule until at least 2019, if ever. That said, financial institutions that are supervised by the Federal Reserve, the FDIC or the OCC will remain subject to the existing safety and soundness guidance regarding incentive compensation, which has resulted in voluntary deferrals and clawbacks, unless that guidance itself is later modified.

As a reference, *Appendix A (*available in the complete publication here) provides a chart of the Dodd-Frank provisions, a summary of their current status and their proposed treatment under the CHOICE Act. *Appendix B* provides examples of public statements by different policymakers and advisors who appear to be influential with President-elect Trump and who have been vocal about their disapproval of many of these rules.

Process for Regulatory Rollback

As explained in our financial regulatory reform blog, any rollback of the Dodd-Frank Act and its implementing regulations will likely be complex and messy, and may take longer than it may first appear. In the case of the Dodd-Frank's executive compensation provisions, there are a few avenues to repeal or amendment:

Repeal of statute: Congress could enact a new statute, such as the CHOICE Act, or select portions of it, that immediately repeals or amends the Dodd-Frank Act, which would have the effect of nullifying any regulations adopted solely under the repealed statute's authority. This would require a majority of votes in the House and, because of the threat of a filibuster, 60 votes in the Senate. The new Republican majority will need several Democratic Senators to achieve this number, the precise number perhaps turning on whether any Democratic Senators accept appointments in the Trump Administration. If the Senate can link the statutory act, whether repeal or amendment, to the federal budget, it can propose budget reconciliation legislation, which would only require a simple majority to pass. Even assuming that financial services reform in general is a priority for the Trump Administration's first 100 days, the importance of executive compensation to the new Republican coalition is unclear.

As the hypothetical timetables below illustrate, assuming that Congress were to pass legislation repealing some or all of the Dodd-Frank executive compensation provisions within 100 days after President-elect Trump's inauguration (i.e., by May 1, 2017), the 2017 proxy season will be well underway and calendar-year companies will likely have already filed their proxy statements. How quickly Congress acts, if at all, will depend not only on the general political support for financial regulatory relief, but also on the other policy priorities of Republicans for the new Administration's first year in office. As noted, however, the implementing rules for most of the Dodd-Frank executive compensation provisions will likely not affect the 2017 proxy season, and the most onerous of the rules that have been finalized (i.e., the pay ratio rule) do not require compliance until 2018, all of which may cause Republicans to deprioritize compensation legislation.

Statutory repeal of regulation: A new statute could also repeal a regulation. For example, Congress could repeal the final pay ratio rule, rather than, or in addition to, repealing the Dodd-Frank statutory basis for the pay ratio rule. In either case, the timing would be the same as above: the process could be either quick or slow and would require 60 votes in the Senate.

Agency repeal or change of final rule: An agency, under new leadership, could propose to repeal or amend a final rule with a notice and comment process that is likely to take several months to accomplish.

It should be noted that when SEC Chair Mary Jo White steps down at the end of the Obama Administration, the SEC will only have two Commissioners—one Republican and one Democrat. It is reasonable to assume that no significant SEC action will be taken to repeal or amend any Dodd-Frank rule until at least one new Commissioner is nominated and confirmed.[2] In the last several Administration changes, it took approximately six months from the new President's inauguration for the new Administration's first SEC nominee to be confirmed,[3] and it is possible that Congressional Republicans will be in no rush to fill the SEC vacancies.

Suspension of midnight regulations: Although it appears unlikely for these rules, an agency could attempt to finalize a rule between now and Inauguration Day, issuing what is often referred to as a "midnight regulation." The effectiveness of the rule, like all federal regulations, would require its publication before Inauguration Day in the Federal Register, which typically takes two weeks to two months on average. Incoming Presidents can order executive agencies to withdraw from publication in the Federal Register any final regulations that have not yet been published. While the authority of the President to send similar directives to independent agencies is less certain, in the past, some independent agencies have voluntarily complied with a Presidential directive to withdraw recently voted-upon regulations from publication. Relevant for purposes of

[2] Generally, the SEC requires three Commissioners to be present to constitute a quorum. There is a special rule allowing for a quorum if there are less than three Commissioners in office. As a practical matter, the two Commissioners would effectively be unlikely to take significant action, given the party-line split.

[3] An exceptional case is that of Mary Schapiro, who was nominated and confirmed in 2009 within seven days after President Obama's inauguration in the midst of the financial crisis.

this memorandum, the FDIC, Federal Reserve, FHFA, NCUA, OCC and SEC are all independent agencies.

Congressional Review Act: Under a rarely used statute called the Congressional Review Act, Congress could, until well into the first quarter of 2017, invalidate regulations promulgated as far back as June 2016 under fast-track procedures with a simple majority in each house. The CRA would not apply to any of the already final and effective Dodd-Frank executive compensation rules, because they were finalized before June 2016, but it could apply to any proposed executive compensation rules that become midnight regulations.

Proposed rules dying on the vine: If an agency does not approve a proposed rule as final, it remains in proposed form. It may languish, or be withdrawn, re-proposed or voted upon by agency leaders appointed by the incoming Administration. We currently do not have any insight into the priorities of a new SEC Chair, who may also consider the views of the Administration that appointed him or her.

Hypothetical Timetables

Over the next few pages (of the complete publication, available here), we make our predictions as to the likelihood, or not, of Dodd-Frank's executive compensation rules surviving intact in the Trump Administration and the Republican-controlled Congress, and provide hypothetical timetables that show the earliest plausible timing for any repeal or amendment.

The timetables make a number of assumptions, most of which are highly unlikely, as they assume that the Trump Administration and Congress would include executive compensation in its initial set of priorities and move at breakneck speeds to act to repeal or amend the relevant rules. Nonetheless, we thought it would be useful as a thought exercise to illustrate what the earliest plausible dates might be for rule changes in relation to proxy deadlines and compliance dates.

The assumptions are:

- The current SEC approves all rules that have not yet been finalized at the end of 2016 and these rules are published in the Federal Register before January 20, 2017, making them midnight regulations potentially subject to repeal by the CRA. We note that, unlike with other Dodd-Frank rules, the SEC has not stated any desire to finalize and publish the outstanding rules on executive compensation provisions by the end of this year. In addition, as can be seen from the timetables, midnight regulation is virtually impossible, with less than six weeks left to finalize and publish rules before Inauguration Day.
- Congress passes a version of the CHOICE Act, with the relevant executive compensation provisions, into law on the 100th day after inauguration (i.e., May 1, 2017).
- Republican SEC Commissioners are appointed on July 1, 2017.
- The SEC, with its new Commissioners, immediately issues proposals relating to applicable regulations (including to repeal prior rules), and the regulations are effective 30 days after a 30–90 day comment period (i.e., 60–120 days following the proposal).
- The company operates on a calendar-year fiscal year, with a proxy filing deadline of April 30

The complete publication, including Appendices, is available for download here.

Tab III: Relationship between Issuers and Investors

Corporate Governance and Stewardship Principles

Posted by Investor Stewardship Group, on Tuesday, February 7, 2017

Editor's note: This post is a policy statement issued by the Investor Stewardship Group, a collective of some of the largest U.S.-based institutional investors and global asset managers, along with several of their international counterparts.

The Investor Stewardship Group (ISG) is a collective of some of the largest U.S.-based institutional investors and global asset managers, along with several of their international counterparts. The founding members are a group of 16 U.S. and international institutional investors that in aggregate invest over $17 trillion in the U.S. equity markets. At launch, the Investor Stewardship Group comprises BlackRock, CalSTRS, Florida State Board of Administration (SBA), GIC Private Limited (Singapore's Sovereign Wealth Fund), Legal and General Investment Management, MFS Investment Management, MN Netherlands, PGGM, Royal Bank of Canada Global Asset Management, State Street Global Advisors, TIAA Investments, T. Rowe Price Associates, Inc., ValueAct Capital, Vanguard, Washington State Investment Board, and Wellington Management. The ISG is being led by each member's senior corporate governance practitioners.

The ISG was formed to bring all types of investors together to establish a framework of basic standards of investment stewardship and corporate governance for U.S. institutional investor and boardroom conduct. The result is the framework for U.S. Stewardship and Governance comprising of a set of stewardship principles for institutional investors and corporate governance principles for U.S. listed companies.

The corporate governance framework articulates six principles that the ISG believes are fundamental to good corporate governance at U.S. listed companies.[1] They reflect the common corporate governance beliefs that are embedded in each member's proxy voting and engagement guidelines, and are designed to establish a foundational set of investor expectations about corporate governance practices in U.S. publicly-listed companies.

The corporate governance principles are not intended to be prescriptive or comprehensive in nature. There are many ways to apply a principle. However, as guidance, the ISG has provided the rationale and expectations that underpin each principle. Collectively, the members of the ISG are supportive of the corporate governance principles, though members of the group may differ on specific standards (as outlined in their public-facing voting policies/guidelines) regarding corporate governance practices that are expected of companies.

[1] The Corporate Governance principles do not apply to U.S.-registered investment companies and business development companies, because they are not operating companies and have unique corporate governance practices as provided by law.

The ISG encourages shareholders' elected representatives—company directors—to apply the corporate governance principles at the companies on whose boards they serve. The ISG will evaluate companies' alignment with these principles, as well as any discussion/disclosure of alternative approaches that directors maintain are in a company's best interests.

The stewardship framework seeks to articulate a set of fundamental stewardship responsibilities for institutional investors.

Listed companies should recognize that some of their largest investors now stand together behind these principles.

As with the corporate governance principles, investors should implement the stewardship principles in a manner they deem appropriate. As guidance, the rationales and expectations that underpin each principle have been articulated. The ISG encourages institutional investors to be transparent in their proxy voting and engagement guidelines and to align them with the stewardship principles. These principles should not restrict investors from choosing to adopt more explicit and/or stronger stewardship practices.

The framework for U.S. Stewardship and Governance is not intended to replace or supersede any existing federal or state law and regulation, or any listing rules that apply to a company or an institutional investor. The framework is also not intended to be static and will be evaluated and revised periodically, with the consensus of its members, as expectations of corporate governance and investment stewardship evolve.

We welcome and encourage other investors to sign up and support the framework for U.S. Stewardship and Governance.

The framework goes into effect January 1, 2018 to give U.S. companies time to adjust to these standards in advance of the 2018 proxy season.

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.

Principle A. Institutional investors are accountable to those whose money they invest.

A.1 Asset managers are responsible to their clients, whose money they manage. Asset owners are responsible to their beneficiaries.

A.2 Institutional investors should ensure that they or their managers, as the case may be, oversee client and/or beneficiary assets in a responsible manner.

Principle B. Institutional investors should demonstrate how they evaluate corporate governance factors with respect to the companies in which they invest.

B.1 Good corporate governance is essential to long-term value creation and risk mitigation by companies. Therefore, institutional investors should adopt and disclose guidelines and practices that help them oversee the corporate governance practices of their investment portfolio companies. These should include a description of their philosophy on including corporate governance factors in the investment process, as well as their proxy voting and engagement guidelines.

B.2 Institutional investors should hold portfolio companies accountable to the Corporate Governance Principles set out in this document, as well as any principles established by their own organization. They should consider dedicating resources to help evaluate and engage portfolio companies on corporate governance and other matters consistent with the long-term interests of their clients and/or beneficiaries.

B.3 On a periodic basis and as appropriate, institutional investors should disclose, publicly or to clients, the proxy voting and general engagement activities undertaken to monitor corporate governance practices of their portfolio companies.

B.4 Asset owners who delegate their corporate governance-related tasks to their asset managers should, on a periodic basis, evaluate how their managers are executing these responsibilities and whether they are doing so in line with the owners' investment objectives.

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.

C.1 The proxy voting and engagement guidelines of investors should generally be designed to protect the interests of their clients and/or beneficiaries in accordance with their objectives.

C.2 Institutional investors should have clear procedures that help identify and mitigate potential conflicts of interest that could compromise their ability to put their clients' and/or beneficiaries' interests first.

C.3 Institutional investors who delegate their proxy voting responsibilities to asset managers should ensure that the asset managers have appropriate mechanisms to identify and mitigate potential conflicts of interest that may be inherent in their business.

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.

D.1 Institutional investors that delegate their proxy voting responsibilities to a third party have an affirmative obligation to evaluate the third party's processes, policies and capabilities. The evaluation should help ensure that the third party's processes, policies and capabilities continue to protect the institutional investors' (and their beneficiaries' and/or clients') long-term interests, in accordance with their objectives.

D.2 Institutional investors that rely on third-party recommendations for proxy voting decisions should ensure that the agent has processes in place to avoid/mitigate conflicts of interest.

Principle E: Institutional investors should address and attempt to resolve differences with companies in a constructive and pragmatic manner.

E.1 Institutional investors should disclose to companies how to contact them regarding voting and engagement.

E.2 Institutional investors should engage with companies in a manner that is intended to build a foundation of trust and common understanding.

E.3 As part of their engagement process, institutional investors should clearly communicate their views and any concerns with a company's practices on governance-related matters. Companies and investors should identify mutually held objectives and areas of disagreement, and ensure their respective views are understood.

E.4 Institutional investors should disclose, in general, what further actions they may take in the event they are dissatisfied with the outcome of their engagement efforts.

Principle F: Institutional investors should work together, where appropriate, to encourage the adoption and implementation of the Corporate Governance and Stewardship Principles.

F.1 As corporate governance norms evolve over time, institutional investors should collaborate, where appropriate, to ensure that the framework continues to represent their common views on corporate governance best practices.

F.2 Institutional investors should consider addressing common concerns related to corporate governance practices, public policy and/or shareholder rights by participating, for example, in discussions as members of industry organizations or associations.

Corporate Governance Framework for U.S. Listed Companies [1]

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.

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.

Principle 1: Boards are accountable to shareholders.

1.1 It is a fundamental right of shareholders to elect directors whom they believe are best suited to represent their interests and the long-term interests of the company. Directors are accountable to shareholders, and their performance is evaluated through the company's overall long-term performance, financial and otherwise.

1.2 Requiring directors to stand for election annually helps increase their accountability to shareholders. Classified boards can reduce the accountability of companies and directors to their shareholders. With classified boards, a minority of directors stand for elections in a given year, thereby preventing shareholders from voting on all directors in a timely manner.

1.3 Individual directors who fail to receive a majority of the votes cast in an uncontested election should tender their resignation. The board should accept the resignation or provide a timely, robust, written rationale for not accepting the resignation. In the absence of an explicit explanation by the board, a director who has failed to receive a majority of shareholder votes should not be allowed to remain on the board.

1.4 As a means of enhancing board accountability, shareholders who own a meaningful stake in the company and have owned such stake for a sufficient period of time should have, in the form of proxy access, the ability to nominate directors to appear on the management ballot at shareholder meetings.

1.5 Anti-takeover measures adopted by companies can reduce board accountability and can prevent shareholders from realizing maximum value for their shares. If a board adopts such measures, directors should explain to shareholders why adopting these measures are in the best long-term interest of the company.

1.6 In order to enhance the board's accountability to shareholders, directors should encourage companies to disclose sufficient information about their corporate governance and board practices.

Principle 2: Shareholders should be entitled to voting rights in proportion to their economic interest.

2.1 Companies should adopt a one-share, one-vote standard and avoid adopting share structures that create unequal voting rights among their shareholders.

2.2 Boards of companies that already have dual or multiple class share structures are expected to review these structures on a regular basis or as company circumstances change, and establish mechanisms to end or phase out controlling structures at the appropriate time, while minimizing costs to shareholders.

Principle 3: Boards should be responsive to shareholders and be proactive in order to understand their perspectives.

3.1 Boards should respond to a shareholder proposal that receives significant shareholder support by implementing the proposed change(s) or by providing an explanation to shareholders why the actions they have taken or not taken are in the best long-term interests of the company.

3.2 Boards should seek to understand the reasons for and respond to significant shareholder opposition to management proposals.

3.3 The appropriate independent directors should be available to engage in dialogue with shareholders on matters of significance, in order to understand shareholders' views.

3.4 Shareholders expect responsive boards to work for their benefit and in the best interest of the company. It is reasonable for shareholders to oppose the re-election of directors when they have persistently failed to respond to feedback from their shareholders.

Principle 4: Boards should have a strong, independent leadership structure.

4.1 Independent leadership of the board is essential to good governance. One of the primary functions of the board is to oversee and guide management. In turn, management is responsible for managing the business. Independent leadership of the board is necessary to oversee a company's strategy, assess management's performance, ensure board and board committee effectiveness and provide a voice independent from management that is accountable directly to shareholders and other stakeholders.

4.2 There are two common structures for independent board leadership in the U.S.: 1) an independent chairperson; or 2) a lead independent director. Some investor signatories believe that independent board leadership requires an independent chairperson, while others believe a credible independent lead director also achieves this objective.

4.3 The role of the independent board leader should be clearly defined and sufficiently robust to ensure effective and constructive leadership. The responsibilities of the independent board leader and the executive chairperson (if present) should be agreed upon by the board, clearly established in writing and disclosed to shareholders. Further, boards should periodically review the structure and explain how, in their view, the division of responsibilities between the two roles is intended to maintain the integrity of the oversight function of the board.

Principle 5: Boards should adopt structures and practices that enhance their effectiveness.

5.1 Boards should be composed of directors having a mix of direct industry expertise and experience and skills relevant to the company's current and future strategy. In addition, a well-composed board should also embody and encourage diversity, including diversity of thought and background.

5.2 A majority of directors on the board should be independent. A board with a majority of independent directors is well positioned to effectively monitor management, provide guidance and perform the oversight functions necessary to protect all shareholder interests.

5.3 Boards should establish committees to which they delegate certain tasks to fulfill their oversight responsibilities. At a minimum, these committees should include fully independent audit, executive compensation, and nominating and/or governance committees.

5.4 The responsibilities of a public company director are complex and demanding. Directors need to make the substantial time commitment required to fulfill their responsibilities and duties to the company and its shareholders. When considering the nomination of both new and continuing directors, the nominating committee should assess a candidate's ability to dedicate sufficient time to the company in the context of their relevant outside commitments.

5.5 Attending board and committee meetings is a prerequisite for a director to be engaged and able to represent and protect shareholder interests; attendance is integral to a director's oversight responsibilities. Directors should aim to attend all board meetings, including the annual meeting, and poor attendance should be explained to shareholders.

5.6 Boards should ensure that there is a mechanism for individual directors to receive the information they seek regarding any aspect of the business or activities undertaken or proposed by management. Directors should seek access to information from a variety of sources relevant to their role as a director (including for example, outside auditors and mid-level management) and not rely solely on information provided to them by executive management.

5.7 Boards should disclose mechanisms to ensure there is appropriate board refreshment. Such mechanisms should include a regular and robust evaluation process, as well as an evaluation of policies relating to term limits and/or retirement ages.

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

6.1 As part of their oversight responsibility, the board or its compensation committee should identify short- and long-term performance goals that underpin the company's long-term strategy. These goals should be incorporated into the management incentive plans and serve as significant drivers of incentive awards. Boards should clearly communicate these drivers to shareholders and demonstrate how they establish a clear link to the company's long-term strategy and sustainable economic value creation. All extraordinary pay decisions for the named executive officers should be explained to shareholders.

6.2 A change in the company's long-term strategy should necessitate a re-evaluation of management incentive structures in order to determine whether they continue to incentivize management to achieve the goals of the new strategy.

Investor Coalition Publishes U.S. Stewardship Code

Posted by Abe M. Friedman, CamberView Partners, LLC, on Thursday, February 9, 2017

Editor's note: Abe M. Friedman is CEO of CamberView Partners, LLC. This post is based on a CamberView publication, and relates to the Corporate Governance and Stewardship Principles released by the Investor Stewardship Group, discussed on the Forum 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).

On January 31, 2017, the Investor Stewardship Group, a coalition of sixteen investors, premiered the Framework for U.S. Stewardship and Governance (the Framework; discussed on the Forum here), outlining a set of six fundamental governance principles for U.S. listed companies and stewardship principles for U.S. institutional investors. The Framework is an investor-led effort written by senior corporate governance staff at each shareholder. Some elements of the Framework overlap with the joint company and investor statements in the Commonsense Corporate Governance Principles published in July 2016. The Investor Stewardship Group covers $17 trillion in assets under management including BlackRock, State Street, T. Rowe Price, ValueAct and Vanguard as well as other asset managers and pension funds, with a call for additional signatories.

The six governance principles within the Framework are already well known to companies. The Framework's governance principles state that: **(1)** Boards are accountable to shareholders; **(2)** Shareholders should be entitled to voting rights in proportion to their economic interest; **(3)** Boards should be responsive to shareholders and be proactive in order to understand their perspectives; **(4)** Boards should have a strong, independent leadership structure; **(5)** Boards should adopt structures and practices that enhance their effectiveness; and **(6)** Boards should develop management incentive structures that are aligned with the long-term strategy of the company.

Companies should be aware that this document extends some of the specific requirements within the six principles to a "comply or explain" framework similar to that seen in certain European market stewardship codes. Some key points of the Framework include:

Traditional Investor Rights:

- **No Dual Class Structures**—Companies that do not have a one-share, one-vote structure in place should "establish mechanisms to end or phase out" controlling or dual-class voting structures at an "appropriate time." Investors will look to companies with dual-class structures to take action or risk being deemed unresponsive to shareholder concerns.

- **Annual Board Elections**—Companies should require directors to stand for election annually, as classified, or staggered, boards "can reduce the accountability of companies and directors to their shareholders."
- **Majority Voting**—Directors who do not receive majority support in an annual election should resign from the board and companies should provide an explicit explanation for any situation in which that director remains on the board.

Investor Focus Areas:

- **Director Engagement & Accountability**—Companies should make available independent directors to engage in dialogue with shareholders on matters of significance. Directors who have "persistently failed to respond to feedback from their shareholders," should expect investors to oppose their re-election.
- **Independent Board Leadership**—The Framework explicitly notes a split in views among the signatories on this issue, but states that independent board leadership may be achieved through either an independent chairperson or a lead independent director with a robust role. Where there is an executive chairperson and a lead independent director, boards should periodically review the structure and explain how a division of responsibilities is intended to maintain integrity of oversight.
- **Board Refreshment**—Boards should disclose mechanisms to ensure appropriate board refreshment, including evaluation processes. Additionally, policies relating to term-limits and/or retirement ages should be reviewed regularly. Notably, there are no prescriptive limits set forth on board tenure or retirement ages.
- **Compensation Aligned to Long-term Strategy**—Boards should clearly communicate short and long-term strategic drivers for the company, and establish a clear link to the company's incentive programs. Extraordinary awards should be explained to shareholders. Change in a company's long-term strategy should trigger a re-evaluation of compensation programs.
- **Explanation of Defensive Mechanisms**—Companies that have anti-takeover measures in place should explain why those measures are in the long-term interest of a company.

While "the Framework is not intended to be prescriptive," the website does, however, include a countdown to the implementation date. The implication is that once the Framework goes into effect on January 1, 2018, companies may be at risk of opposition from shareholders on issues where they do not comply or explain reasonably the need for non-compliance. In the Framework's policies governing stewardship by investors, ultimate decisions to oppose directors at specific companies are left to the individual investors based on their independent decision making processes.

The Framework's corporate governance guidelines establish a common ground of expectations for companies and investors. Investor engagement will continue to provide the best texture and insight into the evolving views of individual investors. Companies should be thoughtful in their approach to addressing the issues outlined by the Investor Stewardship Group.

The American Prosperity Project

Posted by The Aspen Institute, on Tuesday, December 20, 2016

Editor's note: This post is a policy statement issued by the Aspen Institute's American Prosperity Project, a nonpartisan framework for policy action, and signed by thirty signatories including CEOs, directors of large business enterprises, and prominent legal and management advisors. Related research from the Program on Corporate Governance includes The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here).

America's economic health depends on sustained, long-term investment to support our families and communities and to reinvigorate the economic engine that creates jobs and prosperity. There is no viable model under which either business or government can or should shoulder the responsibility for long-term investment alone; both are required.

The time is right for a national conversation about **long-term investment** in infrastructure, basic science, education and training for workers who feel the brunt of globalization and technology. We need to focus on the critical levers for economic growth along with sources of revenue to help pay for it, as well as ways to overcome the short-term thinking currently baked into government policy and business protocols.

The ideas offered here have been developed under the auspices of the Aspen Institute in consultation with a non-partisan working group of experts in public policy formation, tax and regulation, business, and corporate law and governance. While these ideas enjoy support across party lines, breaking the log jam and taking action will require a coalition of leaders across the private and public sectors who are committed to the health of the commons and America's prosperity.

The problem in brief:

- Decades of inadequate investment in America's infrastructure undermine our nation's safety and productivity. Once a global leader, **the US now ranks 25th in infrastructure quality** per the National Association of Manufacturers.
- Underinvestment in basic science research—by business and government—threatens America's leadership in technological innovation. The OECD reports that, relative to GDP, the **US has fallen to 10th in R&D investment**. At current rates, China will surpass the US in total investment in basic science research by 2019.
- CEOs and directors of our public companies report persistent pressure for short-term financial performance; a 2013 McKinsey survey reports that **short-term pressures have increased in recent years**. The overwhelming majority of corporate leaders believe a longer time horizon would positively affect corporate performance, strengthen financial returns, and drive innovation.

- Short-term pressures also influence business investment. Despite record profitability, **fixed capital investment by American corporations is the lowest since 1952 and employer-paid skills training declined 28% between 2001 and 2009**.
- Perverse incentives in our corporate governance system undermine the health of capitalism itself. **Short-termism is baked into our tax system and is evident in the decisions, regulations and rules that govern corporations and capital markets**. Changes to the rules of the game are a necessary step to rebuild the public's trust in our economic system

The issues involved are complex. The work involved in identifying and adopting supportive policies is formidable but by no means insurmountable—and, in this moment, there is both challenge and opportunity.

America's incentive system for long-term investment is broken. It must be repaired to work effectively in a globally competitive market and to address today's most vexing "grand challenges"—from economic opportunity to new forms of energy and the need to rebuild America's physical infrastructure. The goal is a better deal for Americans working to support their families and communities—and the restoration of public trust in capitalism itself as an economic system that works for all.

There are parts of this proposal that each of us might not find ideal. As signatories, we do not endorse every idea in the framework, but we do endorse the principles that inform it. Long-term investment as a national priority transcends partisan divisions and this framework merits consideration to serve the best interests of our society as a whole, over the self-interests of a few. It is in that spirit that we advance and support this comprehensive approach to stimulate long term investment in our economy.

The American Prosperity Project Signatories

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Our framework for this national conversation and for subsequent action has three goals:

1. **Focus government investment on recognized drivers of long-term productivity growth and global competitiveness**—namely, infrastructure, basic science research, private R&D, and skills training—in order to close the decades-long investment shortfall in America's future. Building this foundation will support good jobs and new business formation, support workers affected by globalization and technology, and better position America to address the national debt through long-term economic growth.
2. **Unlock business investment by modernizing our corporate tax system** to achieve one that is simpler, fair to businesses across the spectrum of size and industry, and supportive of both productivity growth and job creation. Changes to the corporate tax system could reduce the federal corporate statutory tax rate (at 35%, the highest in the world), broaden the base of corporate tax payers, bring off-shore capital back to the US, and reward long-term investment, and help provide revenues to assure that America's long-term goals can be met.
3. **Align public policy and corporate governance protocols to facilitate companies' and investors' focus on long-term investment**. Complex layers of market pressures, governance regulations, and business norms encourage short-term thinking in business and finance. The goal is a better environment for long-term investing by business leaders and investors, and to provide better outcomes for society.

Although these goals defy seemingly intractable politics-as-usual, they are broadly shared across a wide spectrum of leaders in both public and private sectors. The ideas outlined here have many sources and they require more conversation, debate, and action to reach the targeted outcomes of creating good jobs, encouraging innovation, and combatting economic short-termism.

When it is resolved in a course of action, the United States of America has the ability to do great things and make the necessary and sometimes difficult choices. In this case, national conversation and action on these ideas can give us ways to secure a bright future for all Americans, rebuilding the American dream now and for generations to come.

Goal # 1 Rebuild the foundation for America's global economic leadership: Invest in widely-recognized drivers of productivity and economic growth

Restore America's infrastructure

A nation's infrastructure is the foundation that secures its standard of living. America's infrastructure was once the envy of the world. Today, the National Association of Manufacturers **ranks the US 25th in the world on infrastructure quality**; the American Society of Civil Engineers (ASCE) grades America's overall infrastructure at D+.

Quality infrastructure creates a better business environment: it enhances safety, productivity, and quality of life for citizens; and it supports good jobs. Well-planned investments generate robust returns for decades, whereas the consequences of inadequate infrastructure take years, sometimes even decades, to be revealed. If the decades-long underinvestment is not addressed, the ASCE claims by 2020 the economy will "lose almost $1 trillion in business sales, resulting in a loss of 3.5 million jobs…" translating to a loss of $6,000 in disposable personal income, per household, per year, from 2021 to 2040.

In 2016, with both the Republican and Democratic Party platforms acknowledging the need to invest in infrastructure, this investment transcends politics and offers America an opportunity to unite in common cause for a better future. Further, in the current environment of low interest rates and material costs, under-employment, and promising technologies capable of enhancing the efficiency of new infrastructure, the conditions for investment in infrastructure have rarely been so good.

The way forward

To restore America's global leadership in infrastructure requires integrated long-term planning and substantial investment—with credible estimates calling for an additional $200 to 260 billion per year.

Financing such an investment in a fiscally responsible way will require local, state, and federal government involvement, as well as private sector contributions. A range of proposed funding ideas worth serious consideration include user fees, federal grants, a self-funding infrastructure bank, private investment through bonds and public-private partnerships, and targeted taxes.

In addition to identifying sources of funding, we also need to streamline project approvals to optimize return on investment. Worker training programs, including enhanced public-private partnerships, will need special attention to meet demand for new jobs and to support those most affected by economic dislocation.

Economic returns on infrastructure investments are promising. A May 2014 report by Standard & Poor's cites that **a $1.3 billion infrastructure investment in America would likely add 29,000 jobs to the construction sector and beyond, boost economic growth by $2 billion, and reduce the federal deficit by $200 million for the year.** But these returns may also be lost through poor coordination and cumbersome bureaucracy among local, state, and federal agencies. Adequate funding, streamlined approval processes, and integrated long-term planning are essential.

Investments in roads, airports, public transit, communications and energy systems, waterways, and schools will create jobs, increase productivity, and improve quality of life; they create the physical conditions for shared economic prosperity.

Invest in research and development

Federal funding for basic scientific research is an investment in Americans' prosperity, security, and quality of life. **The OECD reports that the US is now 10th in R&D investment relative to GDP, and that China is set to surpass the US in total investment in basic science research by 2019.** The Information Technology and Innovation Foundation ranks the US 22nd out of 30 nations in levels of university research.

In September, 2016, more than three dozen American CEOs called for federal funding of basic science for greater “prosperity, security and well-being,” but lagging investment in R&D is not just a public sector problem. The National Science Board (NSB) describes industry support for in-house basic research as “fairly stagnant” and financing of academic R&D has declined to a level “not seen in more than two decades.” An increasing share of corporate R&D investment occurs outside the US, due in part to our dated corporate tax code (see Goal #2.) Further, modern business R&D investment is often aimed at new product development rather than basic research needed for transformative innovation and breakthroughs—like the research once conducted at Bell Labs and Xerox PARC, which enabled the growth of today’s technology sector.

According to the NSB, federal support for university R&D began to fall in 2005 and the National Science Foundation reports that federal funding for higher education R&D declined by over 11% from 2012 to 2014, the longest multiyear decline since 1972.

Investment in scientific research is critical to the kinds of technological breakthroughs that increase productivity, enhance national security, spawn entire new industries, and enhance quality of life. Such breakthroughs typically emerge from a combination of government-funded basic science research and robust private sector research; many of today’s major scientific breakthroughs are outside the US. For example, MIT reports that of the four major global scientific breakthroughs in 2014, none were achieved in the US. In order to secure America’s long-term prosperity, these trends must be reversed.

Hurdles for private investment in research and development include short-term pressures from capital markets and a tax code that discourages US multinational companies from investing at home. The pressures on corporations to make payouts to shareholders and meet quarterly financial expectations outweigh incentives to retain earnings and invest in R&D. According to Barclays, 82% of business leaders believe short-termism impedes their ability to think and plan for the long term, and among large companies, R&D investment is viewed as “the biggest loser.”

The way forward

The US federal government has always been and must continue to be an essential source of funding for basic science research. The American Academy of Arts and Sciences recommends an annual growth rate of at least 4%15 in basic science research funding and the American Physical Society has received bipartisan support for a $100 billion National Research Bank. Experts also acknowledge the need for better and more efficient collaboration between and among government, industry and academia in funding basic science research.

Private investment is also critical and increasing the US R&D tax credit to compete with other major world economies is a place to start. Equally important is the need to shift market incentives to encourage long term corporate investment in basic scientific research. Creating a policy environment more conducive to long-term investment can help business do what it does best: innovate and bring new products and services to market that solve real problems, create jobs and provide for the needs of consumers.

Goal #2 Modernize our corporate tax system: Level the playing field, simplify tax collection, and promote long-term investment

The reforms and changes proposed reward long-term investment and patient capital and provide revenues for critical infrastructure and R&D. They also price externalities to leverage market capital investment. The revenues proposed come from a variety of sources and in each case will increase America's competitiveness over the long term. We acknowledge that new sources of revenue must be sufficient to cover expenditures, but this initiative and these proposals do not attempt to offer a plan for reducing the national deficit, per se.

Modernize corporate tax

The US corporate tax code inhibits long-term investment. It must be changed to be both fair and globally competitive and reduce the incentive to keep cash offshore. It must encourage capital investment at home, level the playing field, and produce needed revenue. The US has the highest statutory corporate tax rate in the OECD and yet collects less revenue from corporate taxes relative to GDP than our OECD counterparts. Despite clear needs for long-term business investment in good jobs, infrastructure, and innovation, it is estimated that US companies have several trillion dollars parked offshore. Further, a complex array of special purpose tax credits, carve-outs, and loopholes have accumulated over time that benefit certain industries

and individual companies pursuing their own competitive advantage. But the net effect is a weaker, less fair, and less efficient business environment; America is poorer for it.

The way forward

A modernized tax code can broaden America's corporate tax base and level the playing field for all companies. Simplifying the code may also reduce costs of tax compliance and collection. Debate is likely over whether corporate tax reform should be revenue neutral or should generate new revenues for national priorities, but closing loopholes and leveling the playing field have broad appeal.

A smarter, more productive corporate tax system would:

- **Eliminate loopholes and special deductions** that allow some companies and industries to pay very little or no taxes while others pay close to the top statutory rate.
- **Reward investment in America.** Our current system of allowing companies to defer taxes on foreign income until repatriated encourages tax avoidance and discourages investments in America. There are many ideas on the table for rationalizing the system and assuring full participation and adequate revenue for needed infrastructure and services. The ultimate solution must encourage business investment at home and generate adequate revenue for investments in our future.
- **Encourage long-term capital expenditures** that support productivity growth, including tax incentives for evidence-based drivers of long-term productivity.

Inevitably, any of the changes listed will benefit some and reduce subsidies for others. These will involve complicated policy choices but the end game is a more fair, less complex and cumbersome competitive environment in pursuit of America's long-term goals. Fixing the tax system will redirect corporate resources toward productive investment and value creation, over tax avoidance and value extraction.

Curb excessive speculation on corporate securities without undermining beneficial trading with a Financial Transaction Tax

Excessive securities trading funnels capital away from productive long-term investment, undermines trust in our capital markets, and introduces noise and unproductive volatility into the economy. Most investors are best served by indexed "buy and hold" strategies over active trading. Companies are well served by patient capital that allows long term strategy and investments to pay off.

Today's capital markets, however, are marked by high frequency trading (HFT) that benefits neither long-term savers nor operating companies in need of patient capital. It is estimated that HFT conducted by computer algorithms accounts for more than 60% of all US stock trades today. Frequent trading is immensely profitable for financial middlemen who earn trading fees, and for those seeking a technological speed advantage, at the expense of the financial system as a whole.

Regulation that prohibits excessively speculative and high frequency trading would be extremely complicated and difficult to enforce. However, a Financial Transactions Tax (FTT) could curb these practices, support the shared long-term goals of average investors and companies, and raise revenue to pay for long-term national priorities. The key to success is the level of taxation envisioned by proponents who favor a "fractional" tax—a fraction of 1% that is well below the sales tax that consumers in almost all states take for granted for purchase of retail goods—and that is thus likely to have little, if any, effect on long-term savers and investors.

The way forward

A well-designed US trading tax would curb excessive trading without undermining *beneficial* trading that supports market liquidity and facilitates price discovery. **Proponents of a Financial Transaction Tax ("Tobin Tax") believe taxing speculative trading can reduce high speed arbitrage without complicated and expensive regulation**. Other major economies around the world are addressing this problem with a "fractional" tax. For example, the EU is considering a 0.1% tax on stocks and 0.01% tax on derivatives. Britain, Hong Kong and Singapore have financial transactions taxes.

Despite the experience of the OECD, the concept of an FTT remains controversial in the US where some members of the financial community argue that an FTT would impose costs on average investors and hurt market liquidity.

In 2009, the Aspen Institute's Corporate Values Strategy Group and two dozen prominent signatories recommended such a policy. In 2011 the Joint Tax Committee estimated that a **0.03% trading tax would raise $352 billion over 9 years (2013 to 2021). A 2016 study by the nonpartisan Tax Policy Center found that an FTT could raise a maximum of 0.4 percent of GDP ($75 billion in 2017) in the US.** At these levels, an FTT would be internationally competitive, raise revenue to help fund infrastructure and basic science research, and could tilt the system towards real investment and away from speculation and arbitrage.

Restructure capital gains tax to reward longer term holdings

There is considerable evidence that humans naturally overvalue the short term and undervalue the long term. This phenomenon is not limited to Wall Street or corporate boardrooms, however **our current capital gains tax structure exacerbates a natural tendency towards short-termism in business and capital markets.** The IRS paradoxically treats a one-year investment horizon as "long term." Assets held for less than one year are taxed as ordinary income; holdings of just one year (and more) are treated as "long term" and taxed at the much lower rate of 15%.

The way forward

As a starting point, we need to update the IRS definition of long-term holdings. Five years is an appropriate target, although a range of thoughtful approaches advocate for slightly shorter and longer periods. Research suggests that markets do respond to preferential rates, so utilizing the capital gains structure to encourage patient capital is a natural step to influence behavior.

A more ambitious (and also more complex) approach would be to institute a gradual scale for capital gains taxes that assigns higher rates for short-term holdings and lower rates for long-term investment. This has broad appeal. Investors, corporate executives, labor leaders, and corporate governance experts proposed a sliding capital gains tax rate in the 2009 Aspen Institute policy recommendations. BlackRock CEO, Larry Fink, has also advocated for a sliding scale.

Price carbon to simplify regulation and stimulate investment

Carbon emissions are a textbook example of a negative externality—a cost imposed on society that is not fully priced in the sale of a good or service. Costs of carbon emissions are widespread and well documented, ranging from health effects to negative impacts on food prices, insurance, and disaster relief from extreme weather. These costs are rarely borne immediately, and are typically passed on to individuals and governments.

A predictable carbon price for all companies creates greater market certainty and incentives for companies to invest in innovation. The American Conservative states, "The best policy to address greenhouse gas emissions, while adhering to conservative principles, is a carbon tax combined with tax and regulatory reform." The least-intrusive, most predictable and most effective incentive to address the problem is a direct tax on carbon emissions, dubbed "the Reagan Way" by President Reagan's Secretary of State, George Schultz.

Scientists and economists support a phased in carbon tax or fee as a best first step to reduce emissions. The nonpartisan Citizen's Climate Lobby argues that "phased-in carbon fees on greenhouse gas emissions (1) are the most efficient, transparent, and enforceable mechanism to drive an effective and fair transition to a domestic-energy economy, (2) will stimulate investment in alternative-energy technologies, and (3) give all businesses powerful incentives to increase their energy-efficiency and reduce their carbon footprints in order to remain competitive."

Business executives from resource intensive industries, among others, already calculate a carbon tax in their internal budgets and scenario planning and US CEOs in a growing number of companies support internal carbon pricing to prepare for that likelihood of public policy. A number of global oil companies support a carbon tax on the grounds that it would create a transparent, level playing field for free market competition.

The way forward

Beyond mitigating the costs described above, shifting incentives away from a carbon-intense economy to one that is cleaner, more durable, and independent of foreign sources of energy, will spur technological innovation, new industries, and jobs. It can also be a source of funding for regions and workers facing the greatest dislocations from reduction in the use of fossil fuels. A carbon tax can be a source of significant revenue. **In 2011, the CBO estimated that a price of $20 per metric ton on greenhouse gas emissions in the United States in 2012, raised 5.6 percent per year thereafter, would yield a total of $1.2 trillion in revenues from 2012 to 2021**. Others have implemented or advocate pricing at $25 to 40/ metric ton.

Even at the low end of this range, a carbon tax creates market incentives to reduce carbon emissions and invest in new technologies. A carbon tax enables companies innovating around low-carbon products, services, and business models to compete in the marketplace.

Carbon tax programs already exist in developed economies. An effective carbon tax must be well-priced, phased in over an appropriate period of time, and predictable—while applying to the entire economy and stringently avoiding loopholes.

Goal #3 Make it easier for business and capital markets to focus on the long-term: Align policy, regulation and business protocols

The majority of American investors are saving for long-term goals like retirement and college tuition. Meanwhile, companies need patient capital to invest in workers, innovation, and productive assets. Aligning the long-term interests of average investors, and the companies who need capital, is a critical lever for securing our long-term prosperity. The ideas and recommendations in this section are designed to align private incentives and regulations with the public good.

Update fiduciary duties and disclosures for financial intermediaries and investing institutions

Institutions that manage other people's money occupy a privileged position in our economy. Most American adults invest in the stock market, primarily through pension funds, mutual funds and private investment (or "hedge") funds. They are saving for long-term goals such as retirement and a child's college tuition. Thanks to the influx of these average investors, large institutions now hold nearly 70% of all equity issued in US public markets on behalf of these average investors—a nine-fold increase from 8% in 1950.28 But too often, the long-term orientation of average investors gets lost in the layers of intermediation between these investors and the companies that seek their capital.

Institutional investors are the linchpin that ensures that Americans save for the future while assuring companies have access to capital for their long-term growth. These investing institutions, however, increasingly depend on the services of other intermediaries to make investing decisions and to manage corporate governance responsibilities. Federal policy should adapt to this reality in order to secure the strength and vibrancy of our economy and protect the financial assets of American households. What is required to better serve the long-term interests of average investors?

What would be required to better serve the long-term interests of average investors?

The way forward

The fiduciary duties of financial intermediaries are outlined in the Investment Advisers Act of 1940 and ERISA, the 1974 federal law that governs private pension plans. While the principles that underpin these policies are sound, rapid changes and the complexity of modern capital markets require us to ensure that all intermediaries remain faithful to the needs and time horizons of the ultimate investors and savers. The following recommendations reflect the work of scholars and practitioners of corporate governance:

- Ensure that the standards of the 1940 Act and ERISA, which govern private pension plans, apply to all intermediaries who substantially advise or influence ERISA fiduciaries or invest retirement savings that are under the care of ERISA fiduciaries.
- Create institutional investor disclosure standards-a "nutrition label on accountability-" on relevant compensation, incentives, trading practices and policies on proxy voting and other indicators of compatibility with the goals of long term savers.
- Require more immediate disclosure from investors who acquire a significant stake of a company's stock so that all investors can make informed investment decisions based on this material information. (Currently, investors have ten days to disclose they have reached a 5% ownership threshold. This is outdated and undermines transparency for other investors.)
- Ensure that the shareholder litigation brought by ERISA fiduciaries is in the interest of plan beneficiaries.

Make it easier for public companies to act long term

A sound long-term policy agenda should help relieve corporate leaders from short-term distractions that are endemic to governance protocols and market demands. We can expect better long-term corporate decisions by dampening the drumbeat of quarterly expectations and amplifying the voice of the long-term holders of capital. Critical points of intervention include the following:

- Discourage short-term earnings guidance and encourage more transparency on drivers of long-term corporate value, by requiring companies who offer guidance to do so within the context of the company's long-term strategy.
- Consider the most appropriate interval between shareholder votes on executive pay. The SEC requires a "say on pay" vote *at least* every 3 years; companies that establish a 3 year cycle enable investors to evaluate executive performance over a longer timeframe.

- Incentivize patient capital through enhanced shareholder voting rights and/or dividends that vest over time.

Conclusion

We believe that American families, government, and businesses can unite in common cause to secure our long-term global economic leadership.

Short-term thinking undermines economic growth and prosperity. Short-termism is prevalent in human nature—but also inflamed by the decision rules, incentives, and norms that structure our economic system. To secure a long-term view and plan we need to address the incentives for long-term investment. Properly structured, these incentives will generate revenues needed to rebuild America's capacity for critical investment in research, transportation, and education for the 21st century workforce.

The changes offered here, as a catalyst to a national conversation, are an investment in securing the future for our children and grandchildren. The time is ripe for change.

* * *

The complete publication, including footnotes, is available here.

Succeeding in the New Paradigm for Corporate Governance

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Friday, January 27, 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 The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here), and The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here).

Recognizing that the incentive for long-term investment is broken, leading institutional investors are developing a new paradigm (discussed on the Forum here) that prioritizes sustainable value over short-termism, integrates long-term corporate strategy with substantive corporate governance and requires transparency as to director involvement. We believe that the new paradigm can reduce or even eliminate the outsourcing of corporate governance and portfolio oversight to ISS and activist hedge funds.

Based on a series of statements by these investors over the past few years, we offer practical options for companies to consider as they adjust to the new paradigm and decide what and how to communicate. For example, the January 23, 2017 corporate governance letter from Laurence Fink, Chairman and CEO of BlackRock, to the CEO's of the S&P 500 companies contains the following advice with respect to engagement:

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.

Each company should make its own independent decision as to content, persons, venues and intensity of its communications and what adjustments, if any, to its strategy and operations may be appropriate to meet the expectations of investors who have embraced the new paradigm.

What to Communicate

Lead with the Strategy. In the new paradigm, the company's long-term strategy, its implementation and the company's progress in achieving it take center stage. Check-the-box governance fades into the background. Define the company and its vision, explain key drivers of strategy and business outcomes and articulate how a portfolio of businesses and assets fit together and are reviewed. Discuss key risks and mitigation methods and share how the company evaluates whether the strategy remains viable as the business environment, competitive landscape and regulatory dynamic change. Discuss how a business model has transformed, and if the company is in the midst of a strategic transformation or a well-conceived turnaround plan that requires time to execute, explain it.

Confirm Board Involvement in the Strategy. The company should also explicitly describe how the board has actively reviewed long-term plans and that it is committed to doing so regularly. Proactively share with these investors how directors are integrated into strategic planning, exercise robust oversight and test and challenge both strategy and implementation. In the new paradigm, be clear and direct about the board's role in guiding, debating and overseeing strategic choices.

Make the Case for Long-Term Investments, Reinvesting in the Business for Growth and Pursuing R&D and Innovation. The company should clearly explain how such investments are reviewed and articulate why and how they matter to long-term growth and value creation. For investments that will take time to bear fruit, acknowledge that and explain their importance, timing and progress.

Describe Capital Allocation Priorities. This also includes discussing the board's process for reviewing and approving capital allocation policies. Where return of capital is a pillar of the company's value creation framework, demonstrate thoughtfulness about the timing, pacing and quantum of buybacks and/or dividends and an awareness of relative tradeoffs. If maintaining an investment-grade or fortress balance sheet is a priority, clarify why.

Explain Why the Right Mix of Directors Is in the Boardroom. Present the diverse skills, expertise and attributes of the board as a whole and of individual members and link those to the company's needs and risks. Be transparent about director recruitment processes that address future company and board needs. Disclose the policy for ensuring that board composition and practices evolve with the needs of the company, including views on balance, tenure, retaining institutional knowledge, board refreshment and presence or absence of age or term limits. Carefully explain procedures for increasing the diversity of the board and for ensuring that directors possess the skills required to direct the course of the company. Discuss director orientation, tutorials and retreats for in-depth review of key issues. Show that board, committee and director evaluations are substantive exercises that inform board roles, succession planning and refreshment objectives.

Address Sustainability, Citizenship and ESG/CSR. The company should integrate relevant sustainability and ESG matters into strategic and operational planning and communicate these subjects effectively. Sharing sustainability information, corporate responsibility initiatives and progress publicly on the company's website and bringing them to these investors' attention are significant actions in the new paradigm.

Articulate the Link Between Compensation Design and Corporate Strategy. Describe how compensation practices encourage and reward long-term growth, promote implementation of the strategy and achievement of business goals and protect shareholder value.

Discuss How Board Practices and Board Culture Support Independent Oversight. Clearly articulate the actual practices and responsibilities of the lead director or non-executive chair, independent directors, committee chairs and the board as a whole in providing effective oversight, understanding shareholder perspectives, evaluating CEO performance and organizing themselves to ensure priorities are met.

How to Communicate

Periodic "Letters" to Investors. Periodic "letters" to shareholders on behalf of the management and/or board focusing on the issues deemed important for satisfaction of the new paradigm are valuable. Letters from management can articulate management's vision and plans for the future, explain what the company is trying to achieve and discuss how it plans to win in the market. Letters from the board can convey board-level priorities and involvement. Depending on the circumstances, statements or letters may be separate, jointly signed by the CEO and the lead director or non-executive chair, come from particular committees as to matters within their ambit or be from the full board.

Investor Days. The company should use "Investor Days" to articulate a long-term perspective on company prospects and opportunities and provide "deep dives" into strategy, performance and capital allocation. Challenges should also be candidly addressed and responsive initiatives outlined. Deciding which long-term metrics, goals and targets should be shared is an area in active evolution. All of the company's major long-term investors, including "passive" investors and index funds, should be extended an invitation. Key materials from a completed Investor Day can also be separately circulated to investors, including index funds. The company may also invite directors to attend. In certain cases, it may be useful for a director to participate in an Investor Day to validate and communicate board involvement and priorities.

Quarterly Communications. Quarterly earnings rituals remain, for now, a fact of life in the U.S. Nevertheless, the company can place quarterly results in the context of long-term strategy and objectives, discuss progress towards larger goals and articulate higher priorities, all while eschewing quarterly guidance.

Proxy Statements, Annual Reports, Other Filings and the Company's Online Presence. Proxy statements, annual reports/10-Ks, SEC filings, presentations and voluntary disclosures provide communication opportunities. For example, the customary proxy section entitled "The Board's Role in Risk Oversight" will ultimately evolve into section(s) covering "Board Oversight of *Strategy and* Risk." The company should present information online in readily accessible, user-friendly and well-organized formats.

Investor Engagement. Disciplined, direct and periodic two-way dialogue with institutional investors is advisable, supported by written communications and tailored presentations. Opening channels of communication in advance of a crisis or activist challenge is extremely important. Communicate engagement procedures and activity. Prepare for director-level interactions with major shareholders and know when and how to involve directors—proactively or upon appropriate request—without encroaching upon management effectiveness. Do not hesitate to reach out to investors, even during proxy season, if there is a matter of importance to discuss. Coordinate internal outreach across the different categories of shareholders and have a superstar corporate governance executive and a superstar investor relations executive.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

Some Thoughts for Boards of Directors in 2017

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Thursday, December 8, 2016

Editor's note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Steven A. Rosenblum, and Karessa L. Cain. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here), and The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here). Critiques of the Bebchuk-Brav-Jiang study by Wachtell Lipton, and responses to these critiques by the authors, are available on the Forum here.

The evolution of corporate governance over the last three decades has produced meaningful changes in the expectations of shareholders and the business policies adopted to meet those expectations. Decision-making power has shifted away from industrialists, entrepreneurs and builders of businesses, toward greater empowerment of institutional investors, hedge funds and other financial managers. As part of this shift, there has been an overriding emphasis on measures of shareholder value, with the success or failure of businesses judged based on earnings per share, total shareholder return and similar financial metrics. Only secondary importance is given to factors such as customer satisfaction, technological innovations and whether the business has cultivated a skilled and loyal workforce. In this environment, actions that boost short-term shareholder value—such as dividends, stock buybacks and reductions in employee headcount, capital expenditures and R&D—are rewarded. On the other hand, actions that are essential for strengthening the business in the long-term, but that may have a more attenuated impact on short-term shareholder value, are de-prioritized or even penalized.

This pervasive short-termism is eroding the overall economy and putting our nation at a major competitive disadvantage to countries, like China, that are not infected with short-termism. It is critical that corporations continuously adapt to developments in information technology, digitalization, artificial intelligence and other disruptive innovations that are creating new markets and transforming the business landscape. Dealing with these disruptions requires significant investments in research and development, capital assets and employee training, in addition to the normal investments required to maintain the business. All of these investments weigh on short-term earnings and are capable of being second-guessed by hedge fund activists and other investors who have a primarily financial rather than business perspective. Yet such investments are essential to the long-term viability of the business, and bending to pressure for short-term performance at the expense of such investments will doom the business to decline. We have already suffered this effect in a number of industries.

In this environment, a critical task for boards of directors in 2017 and beyond is to assist management in developing and implementing strategies to balance short-term and long-term objectives. It is clear that short-termism and its impact on economic growth is not only a broad-based economic issue, but also a governance issue that is becoming a key priority for boards and, increasingly, for large institutional investors. Much as risk management morphed after the financial crisis from being not just an operational issue but also a governance issue, so too are short-termism and related socioeconomic and sustainability issues becoming increasingly core challenges for boards of directors.

At the same time, however, the ability of boards by themselves to combat short-termism and a myopic focus on "maximizing" shareholder value is subject to limitations. While boards have a critical role to play in this effort, there is a growing recognition that a larger, systemic recalibration is also needed to turn the tide against short-termism and reinvigorate the willingness and ability of corporations to make long-term capital investments that benefit shareholders as well as other constituencies. It is beyond dispute that the surge in activism over the last several years has greatly exacerbated the challenges boards face in resisting short-termist pressures. The past decade has seen a remarkable increase in the amount of funds managed by activist hedge funds and a concomitant uptick in the prevalence and sophistication of their attacks on corporations. Today, even companies with credible strategies, innovative businesses and engaged boards face an uphill battle in defending against an activist attack and are under constant pressure to deliver short-term results. A recent *McKinsey Quarterly* survey of over a thousand C-level executives and board members indicates most believe short-term pressures are continuing to grow, with 87% feeling pressured to demonstrate financial results within two years or less, and 29% feeling pressured over a period of less than six months.

The Emerging New Paradigm of Corporate Governance

One of the most promising initiatives to address activism and short-termism is the emergence of a new paradigm of corporate governance that seeks to recalibrate the relationship between corporations and major institutional investors in order to restore a long-term perspective. In essence, this new paradigm conceives of corporate governance as a collaboration among corporations, shareholders and other stakeholders working together to achieve long-term value and resist short-termism.

A core component of this new paradigm is the idea that well-run corporations should be protected by their major shareholders from activist attacks, thereby giving these corporations the breathing room needed to make strategic investments and pursue long-term strategies. In order to qualify for this protection, a corporation must embrace principles of good governance and demonstrate that it has an engaged, thoughtful board and a management team that is diligently pursuing a credible, long-term business strategy. A corporation that meets these standards should be given the benefit of the doubt by institutional investors, and its stock price movements and quarterly results should be considered in the context of its long-term objectives. The new paradigm contemplates that investors will provide the support and patience needed to permit the realization of long-term value, engage in constructive dialogue as the primary means for addressing issues, embrace stewardship principles, and develop an understanding of the corporation's governance and business strategy.

A number of groups have recently issued corporate governance principles and guidelines that outline the respective roles and responsibilities of boards and other stakeholders in the new paradigm. The Commonsense Principles of Corporate Governance (discussed on the Forum here) was issued earlier this year by a group of large companies and investors led by Jamie Dimon of JPMorgan Chase, and an updated Principles of Corporate Governance 2016 was issued by the Business Roundtable (discussed on the Forum here). The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth was prepared by Martin Lipton and issued by the International Business Council of the World Economic Forum. Each of these corporate governance frameworks is a synthesis of prevailing best practices for boards with an amplified emphasis on shareholder engagement, rather than an articulation of new ways to structure and manage the board's oversight role. In effect, they provide a roadmap for how boards can build credibility with shareholders and how shareholders can support such boards in the event of an activist attack focusing on short-term goals or proposals.

To be clear, the new paradigm does not foreclose activism or prevent institutional investors from supporting an activist initiative where warranted. Underperforming companies may be able to benefit from better board oversight, fresh perspectives in the boardroom, new management expertise and/or a change in strategic direction. Responsible and selective activism can be a useful tool to hold such companies accountable and propel changes to enhance firm value, and institutional investors can benefit from the budget and appetite of activists who drive such reforms. However, the new paradigm seeks to restore a balanced playing field, so that activism is focused on improving companies that are truly mismanaged and underperforming, rather than on using financial engineering indiscriminately against all companies in an effort to boost short-term stock prices.

Support for the New Paradigm

There have been a number of recent developments that suggest this new paradigm of corporate governance may be gaining real traction and that, although it is a non-binding framework susceptible to diverging interpretations, it can make a tangible difference in the outcomes of activist attacks and the long-term strategies adopted by corporations. Indeed, the effectiveness of a private ordering approach to reform is clearly demonstrated by the widespread adoption of standardized governance practices by most public companies. For example, only 10% of S&P 500 companies now have a classified board structure, and approximately 43% have recently adopted a proxy access bylaw. A key driver of the impact of this private ordering exercise is the remarkable concentration of power over virtually all major corporations in the hands of a relatively small number of institutional investors. As these major institutions have pushed for such governance practices, and as large public companies have adopted them, it is reasonable to look to the institutional investors to use their additional power to promote the long-term sustainable success of the companies in which they invest.

Thus, it is encouraging that several leading institutional investors have expressed grave concern that short-termism and attacks by short-term financial activists are significantly eroding long-term economic prosperity. BlackRock, State Street and Vanguard have each issued strong statements supporting long-term investment, criticizing the short-termism afflicting corporate behavior and the national economy, and rejecting financial engineering to create short-term profits at the expense of sustainable value. In his annual letter to CEOs, BlackRock's Larry Fink emphasized that reducing short-termist pressures and “working instead to invest in long-term growth remains an issue of paramount importance for BlackRock’s clients, most of whom are saving for retirement and other long-term goals, as well as for the entire global economy.” State Street Global Advisors recently issued a statement acknowledging the “inherent tension between short-term and long-term investors,” and expressed concern that settlements with activists may promote short-term priorities at the expense of long-term shareholder interests.

In addition, FCLT Global (formerly Focusing Capital on the Long Term), which started as an initiative in 2013 by Canada Pension Plan Investment Board and McKinsey & Company, recently grew into an independent organization with BlackRock, The Dow Chemical Company and Tata Sons added as founding members in addition to a number of leading asset managers, asset owners, corporations and professional service firms who are also members. The organization’s mission is to develop practical tools and approaches that encourage long-term behaviors in business and investment decision-making. In the U.K., leading British institutional investors, acting through The Investment Association, have issued a Productivity Action Plan that “seeks to deliver ambitious and achievable remedies to the ills of some of the most serious causes of short-term thinking in the British economy.”

In academic circles, the concerns expressed by institutional investors about activism and short-termism have been echoed in a growing body of research. The notion that activist attacks increase, rather than undermine, long-term value creation has now been discredited by a number of studies. Furthermore, after decades of academic thinking animated by agency cost theory and a conviction that expanding shareholder rights will reduce such costs and thereby increase firm value, a new study suggests an important counterweight—namely, “principal costs,” which have been largely overlooked by academics. In Principal Costs: A New Theory for Corporate Law and Governance, Professors Zohar Goshen and Richard Squire posit that there is an unavoidable tradeoff between principal costs and agent costs, and that the optimal balance and governance structure for any given company will depend on firm-specific factors, such as industry, business strategy and personal characteristics of investors and managers. This principal cost theory casts doubt on the core assumptions that have been used by academics to justify activism and a one-sided embrace of increasing shareholder power.

Finally, there have been a number of initiatives brewing in the political and regulatory arena which suggest that, in the absence of an effective private sector solution, legislative reforms are on the horizon. For example, this past spring, the Brokaw Act was introduced in the Senate to call for amendments to Section 13(d) reporting rules that would require greater transparency from activist hedge funds who accumulate large stealth positions in public company securities. Co-sponsoring Senator Jeff Merkley remarked, “Hollowing out longstanding companies so that a small group of the wealthy and well-connected can reap a short-term profit is not the path to a strong and sustainable economy for our nation.” Shortly thereafter, the Corporate Governance Reform and Transparency Act of 2016 was introduced in the House of Representatives to propose an oversight framework for ISS and Glass Lewis.

In addition, a variety of other ideas are being actively considered in a number of jurisdictions, including tax reforms to encourage long-term investment and discourage short-term trading; prohibiting quarterly reports and quarterly guidance; regulating executive compensation to discourage managing and risk taking in pursuit of short-term objectives; imposing enhanced disclosure obligations on both corporations and institutional investors; and imposing fiduciary duties on institutional investors and asset managers to take into account the long-term objectives of the ultimate beneficiaries of the funds they manage.

In short, there is growing recognition by corporations, investors, academics, policymakers and other stakeholders that short-termism is a profound threat to the long-term health of the economy, and that activism has been a significant source and accelerant of short-termist pressures.

Conclusion

We conclude our Thoughts for 2017 as we began, by noting that the most important issue that boards confront today is to work with management to convince investors and asset managers to support investments for sustainable long-term growth and profitability and to deny support to activist hedge funds seeking short-term profits at the expense of well-conceived, long-term strategies. We urge boards of directors to approve The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth, issued by the International Business Council of the World Economic Forum, and to authorize their corporations to endorse it, to work with management to obtain its acceptance and endorsement by the investors and asset managers who are invested in their corporations, and to support the efforts of the World Economic Forum and others, in order to combat short-termism and promote investment for long-term sustainable growth.

Tab IV: Boards of Directors

Harvard Law School Forum on
Corporate Governance and Financial Regulation

Corporate Governance Update: Prioritizing Board Diversity

Posted by David A. Katz and Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, on Monday, January 30, 2017

Editor's note: David A. Katz is a partner and Laura A. McIntosh is a consulting attorney at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton publication by Mr. Katz and Ms. McIntosh.

In what has been called a "breakout year" for gender diversity on U.S. public company boards, corporate America showed increasing enthusiasm for diversity-promoting measures during 2016. Recent studies have demonstrated the greater profitability of companies whose boards are meaningfully diverse. In many cases, companies have collaborated with investors to increase the number of women on their boards, and a number of prominent corporate leaders have publicly encouraged companies to prioritize diversity. The Business Roundtable, a highly influential group of corporate executives, recently released a statement that explicitly links board diversity with board performance in the two key areas of oversight and value creation. Likewise, a group of corporate leaders—including Warren Buffett, Jamie Dimon, Jeff Immelt, and Larry Fink, among others—published their own "Commonsense Principles of Corporate Governance," (discussed on the Forum here) an open letter highlighting diversity as a key element of board composition.

Momentum toward gender parity on boards is building, particularly in the top tier of public corporations. Pension funds from several states have taken strong stances intended to encourage meaningful board diversity at the 25 percent to 30 percent level. Last year, then-SEC Chair Mary Jo White cited the correlation of board diversity with improved company performance and identified board diversity as an important issue for the Commission, signaling that it may be a priority for regulators going forward. Boards should take note of the evolving best practices in board composition and look for ways to improve, from a diversity standpoint, their candidate search, director nomination, and board refreshment practices. We recommend that boards include this issue as part of an annual discussion on director succession, similar to the annual discussion regarding CEO succession.

Diversity and Performance

A board of directors has two primary roles: oversight and long-term value creation. This year, the Business Roundtable released updated governance guidelines (discussed on the Forum here) that link a commitment to diversity to the successful accomplishment of both goals. Its 2016 guidelines include a statement on diversity that reads, in part, "Diverse backgrounds and experiences on corporate boards … strengthen board performance and promote the creation of long-term shareholder value." In a statement accompanying the guidelines, Business Roundtable leader John Hayes noted that a “diversity of thought and perspective … adds to good decision-making” and enables “Americans, as well as American corporations, to prosper.” Board success and competence thus is recast to include diversity as an essential element rather than as an afterthought or as a concession to special interests.

Similarly, the “Commonsense Principles of Corporate Governance” (discussed on the Forum here) outlined over the summer by a group of corporate leaders highlights diversity on boards—multi-dimensional diversity—and correlates that diversity with improved performance. The signers of the principles, including an activist investor, a pension plan, and various chief executives, stated unequivocally in their accompanying letter that “diverse boards make better decisions.” A consensus seems to be emerging among corporate leaders that, as stated by the Business Roundtable, boards should include “a diversity of thought, backgrounds, experiences, and expertise and a range of tenures that are appropriate given the company’s current and anticipated circumstances and that, collectively, enable the board to perform its oversight function effectively.” With regard to oversight, a recent study by Spencer Stuart and WomenCorporateDirectors Foundation (discussed on the Forum here) found that female directors generally are more concerned about risks, and are more willing to address them, than are their male colleagues. Boards should, where possible, develop a pipeline of candidates whose career paths are enabling them to acquire the relevant professional expertise to be valuable public company directors in their industry.

In order to promote diversity in board composition, boards should become familiar with director search approaches to identify qualified candidates that would not otherwise come to the attention of the nominating committee. Executive search firms, public databases, and inquiries to organizations such as 2020 Women on Boards are a few of the ways that boards can find candidates that may be beyond their typical field of view. Organizations exist to help companies in their recruitment efforts. *Crain’s Detroit Business*, for example, has compiled a database of qualified female director candidates in Michigan, who are invited to apply and are vetted for inclusion. Boards may wish to commit to including individuals with diverse backgrounds in the pool of qualified candidates for each vacancy to be filled.

The Future of Diversity

In 2016, shareholder proposals on board diversity met with increased success. The numbers are still small: Nine proposals made it onto the ballot last year, nearly double the total in 2015 and triple the total in 2014. Nonetheless, support reached unprecedented levels in certain cases: A diversity proposal—which was not opposed by management—at FleetCor Technologies received over 70 percent shareholder support. Another diversity proposal—which was opposed by management—at Joy Global received support from 52percent of the voting shares (though the proposal did not pass due to abstentions). Diversity proposals are generally supported by the proxy advisory firms, including Institutional Shareholder Services and Glass Lewis.

Perhaps more significantly, shareholder proposals in several cases resulted in increased board diversity without ever coming to a vote. The pension fund Wespath submitted proposals this year seeking to increase diversity at three major corporations, and in each case withdrew the proposals when the subject companies agreed to add women to their boards. A spokesperson for Wespath stated that the fund had privately communicated their desire for increased diversity and had filed proposals as a “last resort” to spur change.

In a similar effort, CalSTRS recently submitted 125 letters to boards at California corporations whose boards had no women directors; in response, 35 of the companies appointed female board members. CalSTRS has indicated that if its private approaches are unsuccessful, it will proceed with shareholder proposals. The Wespath and CalSTRS examples are valuable for boards. Listening to investors, being responsive, and staying out in front of issues to forestall shareholder proposals is far better than reacting to frustrated investors who feel compelled to resort to extreme measures to get corporate attention. It is also greatly preferable to a situation in which activist investors press for legislative actions such as quotas or other mandatory board composition requirements, as we have seen in other countries.

2017 is likely to be a year in which progress toward greater board diversity significantly accelerates. Indeed, it is becoming clear that gender diversity—if not gender parity—one day will be a standard aspect of board composition. While the process of realizing that future should not be artificially or counterproductively hastened, it should be welcomed as a state of affairs that will be beneficial to all corporate constituents and, beyond, to the greater good of U.S. business and American culture.

Gender Parity on Boards Around the World

Posted by Institutional Shareholder Services, Inc., on Wednesday, January 4, 2017

Editor's note: The following post comes to us from Institutional Shareholder Services, Inc. and is based on an ISS publication by Albertine d'Hoop-Azar, Katryna Martens, Peter Papolis, and Eduardo Sancho.

Perhaps no major issue in governance has risen up as ubiquitously across the globe as that of gender diversity in the boardroom. Board diversification has been embraced in principle by members of the issuer and investor communities alike—but in many countries, we're clearly living in a "do as I say, not as I do" regime. The annual PwC director survey found 43 percent of directors surveyed believed that there should be equality or near-equality (41-50 percent women), and another 43 percent believed it should be 21-40 percent women. However, taking the United States as an example, ISS QualityScore data shows that among the Russell 3000, only 28 percent of boards have at least one-fifth of their respective seats held by women—and only 1.7 percent have at least two-fifths held by women.

Investors are beginning to take note, and gender representation on the board is already having a measurable impact on director election results. Utilizing ISS' Voting Analytics database, we found a significant disparity in support for companies with at least one female director on the board versus companies with an all-male board. After analyzing almost 34,000 Russell 3000 director elections from July 2014 to June 2016, we found that average support for director nominees on boards with at least one female member stood at 96 percent. By comparison, average support for nominees at companies with all-male boards stood at 91 percent.

And while we are focusing on gender diversity here, we want to acknowledge that boardroom diversity can reference any number of attributes; tenure, age, experience and background, ethnicity, race, and gender are among the differences that boards often cite when seeking a diverse composition. Gender diversity has received the most attention recently, and progress is starting to be made. Current progress varies dramatically, with some countries, such as Norway, with an average of over 40-percent female board representation, down to South Korea's 2.3 percent. A number of factors drive these differences.

Using data from ISS' QualityScore, we looked at the average gender diversity on boards at companies in 30 countries around five continents. We compared the differences, and analyzed the drivers, including factors such as regulation and culture.

Global Trends in the Boardroom: Gender Diversity

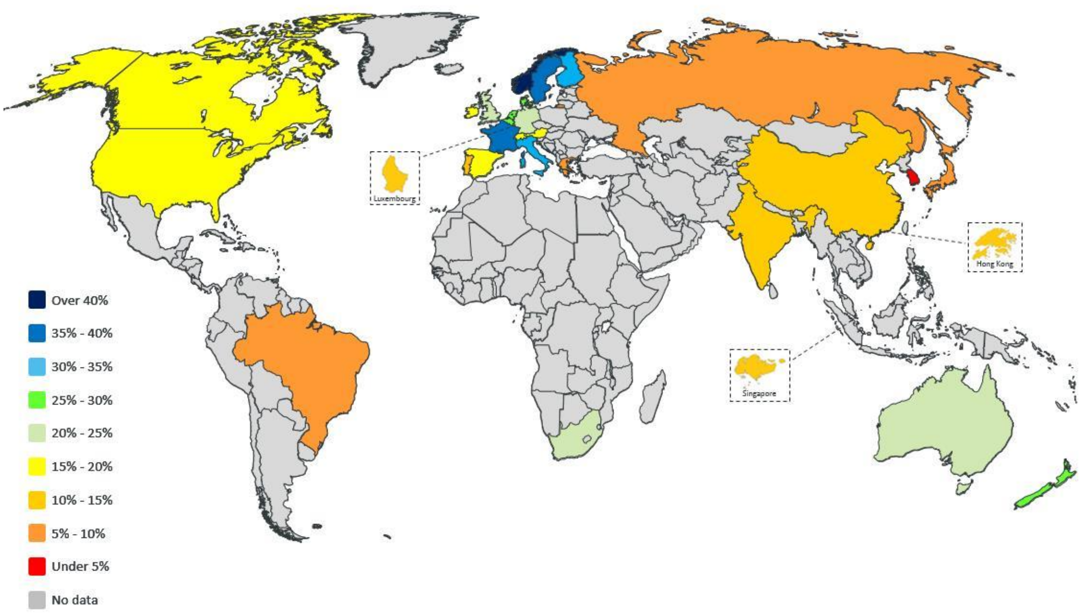
Globally, the number of women on boards has been increasing for at least the last three years. According to ISS QualityScore data, overall female representation has increased on boards from

14.5 percent in 2014, to 15.3 percent in 2015, and 16.9 percent in 2016. While this is still a small proportion of all directorships, the 1.6 percentage point increase from last year through this year is a large jump, and also represents a significant number of global directorships now held by women.

At first glance, the greatest predictor of a more gender-diverse board seems to be the strength of any regulation mandating some minimum level of diversity. Stronger regulations with mandates for minimum gender representations are in place in many of the markets with the highest percentage of female directors, while markets with less stringent regulations or no mandates tend to have fewer female directors. However, this is somewhat of a simplistic approach; the reality is that social norms in various markets often drive the regulatory framework, and how that regulatory framework is fulfilled—and in some regions, social norms seem to have obviated the need for regulation entirely. For example, the Scandinavian countries Sweden and Finland are among the countries with the highest number of females on boards, whereas they have no targets regarding gender diversity.

With this recognition, we'll begin by examining the global regulatory framework for gender diversity—and then take a closer look at the impact of social norms. As a starting point, we've taken a snapshot, among companies covered by ISS QualityScore, at the level of gender diversity on boards in each region, as of fall 2016:

2016 Gender Diversity Percentage



Not All Regulation is Created Equal

The type of regulation has a significant impact on the rate of women on boards. Most of the countries of the world that have passed hard laws and hard gender quotas are in Europe. For example, Norwegian law defines precise and strict quotas that depend on the size of the board: (i) if the board of directors has two or three members, both sexes shall be represented; (ii) if the board of directors has four or five members, each sex shall be represented by at least two members; (iii) if the board of directors has six to eight members, each sex shall be represented by at least three members; (iv) if the board of directors has nine members, each sex shall be represented by at least four members, and if the board of directors has more members, each sex shall represent at least 40 percent of the members of the board; and (v) the rules apply correspondingly for elections of deputy members of the board of directors. This has resulted in an average of 42 percent diversity on Norwegian boards in 2016. India has a law mandating that at least one director be female. France's regulation has gotten stricter over the past few years.

Many markets have guidance, a soft law, or a comply-or-explain provision. For example, while the U.K. does not have a hard law on the books, the U.K. government-backed 2011 Davies Review set a non-binding target of 25 percent women on the boards of directors of FTSE 100 companies by the end of 2015. Whereas the QualityScore data, which covers the FTSE All-Share (ex-investment trusts), shows that the current ratio of women is 20.8 percent as of Oct. 2016, all FTSE 100 boards have met the target of 25 percent, with an overall average of 26.7 female directors. Subsequently, in the five-year review, this target was raised to 33 percent on FTSE 350 boards by 2020.

Conversely, other markets demonstrate that the absence of any of sort regulations may prevent the country from progressing in gender diversity. This is the case in the United States, China, Russia, Greece, South Korea, and Japan; in a number of these countries, gender diversity remains very low.

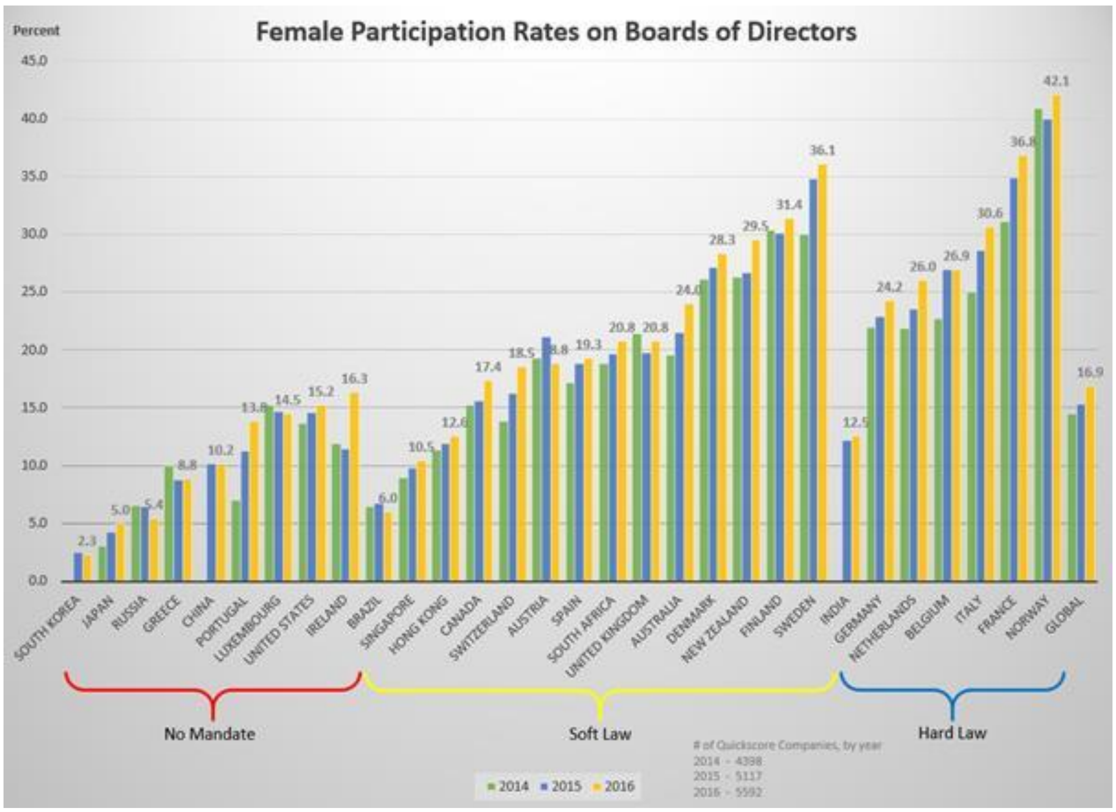
South Africa's female board representation currently hovers around 20 percent. In 2003, the South African government implemented the Broad-Based Black Economic Empowerment (B-BBEE) Act with the aims of combating systematic racism of its black citizens via economic empowerment. One of the objectives of this act is to increase "the extent to which black women own and manage existing and new enterprises, and increasing their access to economic activities, infrastructure and skills training."

The Socio-Cultural Context

Why Regulation May Matter Less than the Attitudes Behind it

It is apparent that having a law requiring some mandatory minimum level of female board representation is effective in causing companies to bring female directors on at a rate that satisfies those legal requirements. It is also clear that countries without regulation tend to lag those with both hard and soft laws. However, the potency of these regulations, especially in terms of their ability to affect real change, is determined to a large degree by the general outlook of the locality where they are enacted. As mentioned above, Sweden has no quota for female board representation, but boards in Sweden are among the best in gender parity in the world. In fact, all the Nordic countries have much higher levels of female board representation than their global counterparts. Finland does not have a hard law, similar to Sweden, and so a willingness to comply with the soft law and enhance gender parity on boards is driving the relatively high number of female directors. Even in Norway, which does have a 40-percent minimum hard law, and has the highest degree of gender parity on boards in the world, the country was the first to pass a law—enacted in 2003 and enforced since 2006—reflecting a more progressive attitude toward female board representation. In addition, Scandinavian countries also have laws in place which facilitate women in combining professional careers and family life.

Contrast this with some of the lowest performing companies in terms of gender parity—for example, South Korea, where hermetically-sealed, family-contained chaebols run a significant number of companies, and traditional attitudes around gender roles run strong. South Korea has the lowest gender parity of any country in the ISS QualityScore universe. China, Russia, and Japan also fit this category. It is difficult to say if the fealty to the status quo is a result of a desire by executives and directors to maintain the control they have over these companies, as opposed to a traditionalist viewpoint that is skeptical of gender diversification, but the outcome of the resistance to change in these markets is clear in its impact on boardroom diversity.



Another category is countries where there is not yet regulation, but attitudes are changing, and the results reflect this. The United States is probably the best example of this. In the United States, the ratio of women on boards in the Russell 3000 index has risen from 13.6 percent in 2014 to 15.2 percent in 2016. There is no legal requirement nor code of best practice that specifically targets the participation of women on boards of U.S. companies, but several grass-roots campaigns have come about to accelerate the rate at which companies increase participation by women. For instance, 2020 Women on Boards is a national campaign to increase the percentage of women on U.S. company boards to 20 percent or greater by the year 2020, and the Thirty Percent Coalition is a national organization that is committed to the goal of women holding 30 percent of board seats across public companies. Another private sector initiative backed by the Center for Economic Development to increase gender diversity on U.S. boards is the Every Other One initiative aimed at getting companies to appoint a woman to every other board seat that opens up. Finally, 29 resolutions regarding this topic were filled by shareholders this year. Sometimes, as in the U.K. and Canada, changing attitudes in markets where there is no regulation, lead to the development of rules or guidance.

Finally, there are countries like India, where a law exists, but in name only in the case of many companies. In India, the law requires that every board have at least one female director, or risk paying a fine or worse penalties imposed by SEBI (the market regulator) for non-compliance. Virtually all Indian companies that fall under the ambit of this rule have complied. However, according to QualityScore data, the average board size in India is 9 directors. Given that just under 13 percent of directors in India are female, this strongly suggests that many companies in India are bringing on one female director to meet the minimum requirement. The average number of female directors in India is just over 1 per board, and just 16.5 percent of the 739 Indian companies under QualityScore coverage in 2016 have more than one female. Only 28 companies have more than 2 female directors, and only 2 companies have 4 female directors. Further, there are a number of companies where the female director is related to a member of the board. Stories about the chair bringing on his wife are readily found in the news, and female directors in India are only independent 59 percent of the time. Only 13 percent of female directors are executives at the company, suggesting that companies in India are bringing in female directors to meet the law's minimum requirements, but who have significant ties to a male on the board.

Conclusion

Given the number of studies that strongly correlate more diverse boards with higher performance on any number of financial metrics, the pressure to continue to diversify the boardroom will likely continue to increase. And while progressive societal norms are the most effective way to build meaningful and impactful gender diversity on corporate boards, regulations also clearly have significant impact on increasing gender diversity levels in boardrooms. However, these laws generally take time to foment change, and this "brute force" method can have other potential drawbacks. In some countries where there is regulation but not societal acceptance, many companies fulfill the requirements at the absolute minimum level with little regard paid to creating any impetus for change. There is no "one size fits all" solution to increasing gender diversity; each region has different levels of societal acceptance for gender equality, and regulation would have different impacts in each region.

In other countries that have a high degree of success in increasing representation of males and females to near equal levels without regulations, a simple "guidance" for diversity can be enough. For the countries with more diverse boards, much of this is driven by cultural norms in that market, which are often reflected in policies and educational programs that are in place to facilitate female participation in the workforce.

This brief analysis of ISS QualityScore data shows us that there is clear progress being made in increasing gender diversity at the board level, and this holds true to some degree for most of the world. However, this is unfortunately not the case for CEOs. For instance, in the U.S., only 4 percent of S&P 500 CEOs are women. Among EU Stoxx 600 companies, only 3.5 percent of the CEOs are women.

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Broadening the Boardroom

Posted by Emmet McNamee, Glass, Lewis & Co., LLC, on Monday, January 23, 2017

Editor's note: Emmet McNamee is a Research Associate at Glass, Lewis & Co., LLC. This post is based on a Glass Lewis publication by Mr. McNamee.

UK Prime Minister Theresa May has recently backtracked on her proposals to increase employee representation on boards. It was an idea which had largely been confined to the wilderness of UK governance for several decades after seeing its heyday in the 1970s with the publication of the Bullock Report. Mrs May's proposal has been lauded and criticised in equal measures, and it is unclear now whether it will be abandoned altogether or merely watered down.

Given the increasingly visible disparities between the pay of executives and employees, and a US election largely characterised by discussions over income inequality and the outsourcing of jobs overseas, it is perhaps unsurprising that the question of employee representation on boards is back in the spotlight. There is widespread sentiment that public companies are not adequately serving all their stakeholders, and that increased worker voice could in some way enhance the "social licence" of companies to operate. But what are the effects of such moves on the board's ability to oversee the business, and ultimately on shareholder value?

Two of the most frequently made objections to employee directors relate to qualifications and allegiances. Directors are typically nominated by the existing board for the experience they could bring and skill gaps they could fill on the board. There is a risk, then, of underqualified directors being appointed, and the board's primary oversight function being subverted in favour of representativeness. Though it should be noted that in markets with more concentrated ownership structures, such as France, it is common practice for representatives of a variety of significant shareholders to sit on the board. Catastrophe has not struck yet.

There is also the question of to whom these employee directors would owe their fiduciary duty. They would presumably be primarily chosen by and accountable to employees, yet under section 172 of the Companies Act 2000, directors are entrusted with "the success of the company for the benefit of its members [shareholders] as a whole," while "having regard" to employee interests. Indeed, in a recent green paper the government highlighted the UK's traditional reliance on "a unitary board system where all the directors have the same set of duties, and collective responsibility applies." Further clarity would be needed on this point, particularly regarding the extent to which employee directors should consider the sectional interests of employees, and the extent to which they are bound by confidentiality.

That being said, there are potential benefits to a strengthened employee voice in the boardroom. Currently the majority of information that outside directors receive on the inner workings of a company come from executives; employee representatives could provide an alternative view, enhancing non-executive directors' ability to challenge company insiders. As a significant stakeholder in the company, the employee's perspective and insights would likely be of value in making board decisions, and could help the long-term interests of the company. Other studies have found that employee representation can lead to reduced striking, and an improved ability to weather economic crises; moreover, the practice has been positively received by boards.

Employee directors could even be instrumental in addressing that problem with which government and shareholders alike are continually grappling—excessive executive pay. While annual binding shareholder votes on pay are likely to be introduced in the UK and France, they may not be the silver bullet that some hope for; certainly the experience in Switzerland, where salaries remain among the highest in Europe, would show that such provisions may not herald the shift that some desire. With shareholders reticent to utilise their powers in light of the potential consequences of a failed binding vote, increasing employee influence over pay through a presence in the boardroom could prompt a culture shift towards more equitable structures and quantum levels.

Ultimately, much will depend on the specifics of the proposals brought forward by the government and how they might be applied. Fully-fledged employee directors? This seems unlikely in light of May's recent comments, and critics point to the likes of Volkswagen as a dystopian example of what can go wrong under that structure. Directors nominated by employees who cannot be drawn from the employee pool or trade unions, as in the Netherlands? Employee advisory panels, who consult and make a public statement in the annual report? Whatever form it takes, any proposal will need to incorporate that hallmark feature of British corporate governance: flexibility.

Board Refreshment Trends at S&P 1500 Firms

Posted by Jon Lukomnik, IRRC Institute, on Thursday, February 9, 2017

Editor's note: Jon Lukomnik is the Executive Director of the Investor Responsibility Research Center Institute (IRRC). This post is based on a co-publication from IRRC and Institutional Shareholder Services, Inc. Related research from the Program on Corporate Governance includesThe "New Insiders": Rethinking Independent Directors' Tenure by Yaron Nili (discussed on the Forumhere).

"Refreshment" is among the most hotly-debated topics across U.S. boardrooms and within the broader corporate governance community. While shareholders, directors, and other market constituents vary as to the reasons for their refreshment concerns, they typically include snail-paced board turnover, sky-rocketing tenures, stagnant skillsets and deficient diversity.

Investor respondents to ISS' 2016-2017 Global Policy Survey (conducted between Aug. 2, 2016 and Aug. 30, 2016) were asked which tenure-related factors—with multiple answers allowed—would give rise to concern about a board's nominating and refreshment processes. Among the 120 institutional investors (one-third of whom each own or manage assets in excess of $100 billion) who responded, 68 percent pointed to a high proportion of directors with long tenure as cause for concern, 53 percent identified an absence of newly-appointed independent directors in recent years as a potential problem, and 51 percent flagged lengthy average tenure as problematic. Just 11 percent of the investor respondents said that tenure is not a concern, although even several of those respondents indicated that an absence of newly-appointed directors is a concern. In their comments, several investors identified other factors of concern, such as directors' ages, a high overlap between the tenure of the CEO and the tenure of the non-executive directors, and lengthy average tenure coupled with underperformance.

Suggested remedies vary as well. Some investors and board members urge wider use of "forced exit" mechanisms such as mandatory retirement ages or term limits. Other boardroom observers seek process improvements such as board/director evaluations, continuous boardroom succession planning and enhanced disclosure of these procedures.

A growing number of investors have begun to take refreshment matters into their own hands. Some shareholders routinely oppose the reelection of long-tenured directors to encourage turnover and fresh blood. Importing a practice from the U.K. and other global markets, other investors threaten to slap "affiliated" (non-independent) labels on long-tenured board members in hopes of spurring boardroom succession. While long tenure, by itself, is typically not enough to sway an election result, it can create a tipping point in contested elections. Notably, hedge funds increasingly seek to tap into investors' angst over refreshment by targeting long-serving board members.

Diversity has become a lightning rod with respect to refreshment. Activists target low-diversity boards with shareholder resolutions and letter-writing campaigns. Disenchanted with the slow pace of progress, some players even urge market regulators to follow the lead of some of their global counterparts by using quotas and other best practice rules (including enhanced disclosure of nominating procedures) to speed up changes in boardroom composition.

Largely missing from this debate is hard data on: (1) the scope of the perceived problem, (2) the most effective methods for promoting board refreshment and (3) the benefits and possible side-effects of adopting them.

This study examines the aforementioned boardroom attributes for firms in the S&P 1500 Composite Index as of January 1, 2016, and includes director data for index constituents with annual general meeting (AGM) dates through to October 12, 2016.1 When relevant, the data is stratified into three market cap segments: S&P 500 (large-cap), S&P 400 (middle market) and S&P 600 (small-cap).

Board Tenure

Tenure Trends Reversing… And May Reverse Again: Investors' concern—warranted or not—over rising director/board tenure is based in reality. Average boardroom tenure steadily rose from 8.4 years in 2008 to a peak of nine years in 2013 before slowly reversing course from 2014 to 2016 (YTD). As a result, average director tenure at S&P 1500 firms now stands at a level—8.7 years—last recorded in 2010. Moving in a similar pattern, median board tenure across all S&P 1500 directorships rose from six years to seven years in 2009, but has remained steady from 2010 to 2016. Absent intervention by boards, however, structural issues—especially rising mandatory retirement ages—could cause average and median tenures to climb again in a few years.

Gender Tenure Gap Opens: An influx of new female board members in recent years has created a sizable gender tenure gap—relative to both male directors and minority directors (regardless of gender). Male directors currently have average tenures (9.2 years, down from a high of 9.3 years during the 2013-2015 time period) that run nearly three years longer than the average service period (6.4 years) for women directors. Notably, the average tenure for women directors in 2016 is identical to the level recorded in 2008. The median tenure for male directors at study companies jumped by two years—from six years to eight years—over the study period, although it has remained constant since 2013. Meanwhile, the median tenure for female directors initially moved up by one year (from five years in 2008 to six years in 2010), but fell back to its starting point by 2015 and hit a study-period low of four years in 2016.

Director Age

Greying of Boards Has Slowed: The typical director serving on the board at an S&P 1500 firm is 62.5 years old, which is the age high watermark for the 2008-2016 (YTD) study period. While the average age jumped by two years (from 60.5 years in 2008) over the study period, it held steady from 2015 to 2016. Meanwhile, the median age of directors on boards at S&P 1500 firms is 63 years. Between 2008 and 2012, the median age jumped by two years (from 61 years in 2008). The median age has held steady since that time. This slowdown in the board aging process, which is consistent with leveling off of average and median board tenure in recent years, appears to reflect the recent surge in refreshment.

Gender Age Gap Widens: An average three year-plus age gender gap separates the typical male director (63.1 years old) on S&P 1500 boards from his female boardroom peers (59.8 years old). The median gender gap is four years—64 years for male directors versus 60 years for female board members.

Distribution of Ages

Older Directors Claim More Board Seats: Directors who are in their seventies and eighties were the only age groups to claim bigger slices of the S&P 1500 boardroom seat pie over the 2008-2016 (YTD) time period. The share of all S&P 1500 directorships held by 70-something board members rose from 11.7 percent in 2008 to 18.6 percent in 2016 (YTD). The board seat tally for directors aged 80 or older steadily inched upward, though admittedly from a small base—from 1.2 percent in 2008 to 1.8 percent in 2016. These two age classes combine to fill 20.4 percent of all S&P 1500 board seats in 2016, the highest level recorded over the entire study period. Meanwhile, the total board seats held by individuals who are under 50 years old steadily dropped from 10.8 percent in 2008 to 6.1 percent in 2016.

Bulk of Board Seats Occupied by Directors in Their 50s and 60s: Despite the shifts at both ends of the boardroom age brackets, individuals in their 50s and 60s continue to fill the lion's share (73.6 percent) of board seats at S&P 1500 companies. While both groups have ceded some space around the typical boardroom table to older directors over the study period, they remain the two biggest age group constituents in boardrooms.

Generational Shift Occurs in Boardrooms: The 2008-2016 study period coincides with a demographic boardroom shift from directors who are members of the so-called "silent generation" (born from roughly 1925 to 1945) to "baby boomer" board members (born from 1946 to 1964). At the beginning of the survey period in 2008, the oldest boomer directors were 62 years old and their sixty- and seventy-something silent generation boardroom peers still held the lion's share of board seats. While silent generation directors (aged 71 to 91 in 2016) have not gone quietly into the boardroom night thanks to rising retirement ages and U.S. investors tacit acceptance of double-digit tenures, they now hold fewer than 20 percent of total board seats at index firms. By 2016, the oldest boomers had hit 70 years of age and the youngest of them, at 52, will soon reach their professional primes in the corporate and investment realms. As most remaining silent generation directors leave boards over the next few years, boomers will establish virtual demographic hegemony over boardrooms at S&P 1500 firms. Notably, the oldest Generation X nominees (born between roughly 1965 and 1979) turned 51 years old in 2016 and their fellow baby busters will not hit their boardroom prime until after 2025. Absent revolutionary changes in nominating practices, millennials (born from roughly 1980 to 1995) will continue to have little more than token status in corporate boardrooms over the next two decades.

Renewal and Retention Rates

Bumper Crops of "New" Directors in Recent Years: Contrary to common wisdom, no shortage of "fresh blood" exists in the overall S&P 1500 directorship pool. The pace of adding "new" directors (defined as individuals with "0 years" of board service) to S&P 1500 boards accelerated in the latter half of the 2008-2016 (YTD) time period as the external focus—from investors and the media—on "refreshment" grew. The "renewal rate" nearly doubled over the 2008-2016 study period. "New" nominees claimed less than six percent of total directorships prior to 2012, but their prevalence steadily rose over the remainder of the study period. By 2016, almost one out of every ten directors (9.5 percent) serving on S&P 1500 boards is "new."

Fewer Boards Stand Pat: In 2015, for the first time since 2008 (and perhaps ever), more than one-half of the companies in the S&P 1500 added one or more "new" directors to their boards. For the first half of the study period, two-thirds or more of the companies in the index added no new members in any given year. From 2012 to the present, however, the prevalence of such "zero change" boards has steadily dropped.

Power Shifting Towards Newer Board Members: The large, recent incoming classes of "new" directors have (temporarily) tipped the balance of power in S&P 1500 boardrooms towards recent arrivals. The combination of directors who are classified as "new" (0 years) or "recent" (defined as "one to three years" of service) nominees now account for a larger slice of the total directorship pie at S&P 1500 companies than the cohort of "rising" directors (defined as those board members serving for "between four and nine years"), who had constituted the most populous tenure segment over the bulk of the 2008-2016 study period. The prevalence of directors in "rising" tenure category peaked in 2011 at 38.9 percent. Since that time, however, the share of directorships falling into this demographic "sweet spot" (some academic literature suggests that nine years of service may represent "peak" performance in the boardroom) has fallen progressively—dropping below the 30 percent prevalence line for the first time in 2016. Notably, "rising" directors' share of directorships (29.6 percent) fell below the combined seats (32.4 percent) occupied by "new" and "recent" nominees in 2016.

Double-digit Directors Now Claim Larger Share of Seats: Gains for "new" nominees have not come at the expense of lengthy-tenured directors. While boardrooms at S&P 1500 firms are being rejuvenated by annual infusions of "new" nominees, this refreshment rate is offset by the rising retention rate for directors with ten years or more of service. "Long-tenured" (defined as "ten to 14 years" of service) and "extended-tenure" (defined as "15 or more years" of service) directors were the only sitting director tenure categories to pick up larger shares of S&P 1500 seats over the study period. Thanks to rising retirement ages (and one would assume better health and longevity), directors in the "long-" and "extended-" tenure director camps now combine to claim 38 percent of the total directorships at index companies up from 33.2 percent in 2008.

Women, 50-somethings and Leaders Dominate "New" Director Demographics: Incoming director classes are changing the face of corporate boards. In 2016, women claimed nearly one-quarter (24.4 percent) of the "new" spaces around boardroom tables at S&P 1500 companies, up from a study low-point of 12.2 in 2009. Individuals between 50 and 59 years of age filled the lion's share (45.3 percent in 2016) of new board seats. Ten director skillsets account for about 73 percent of all the "new" directors profiled by ISS' data team in 2016, down marginally from three-quarters of all directors in 2015. The five most prevalent skillsets found for "new" nominees at board of firms in the S&P 1500 are: (1) leadership, (2) financial/investment expertise, (3) relevant industry experience, (4) CEO experience and (5) operational experience.

Diversity

Steady, But Slow Gains on Board Gender Diversity: Diversity shortfalls, especially as they relate to gender, catalyzed the refreshment debate. While nearly all constituents in the U.S. concede the existence of a problem, the slow-to-develop consensus on solutions and self-interest—boosts in diversity, by definition, require expanding board size or boosting attrition rates by sitting directors—clearly favor status quo and inertia over urgency and action. Despite nonstop hand-wringing by many market constituents, the data demonstrates that the pace of change in boardroom diversity in response to current director recruitment practices remains slow in the U.S., especially at middle-market and small-cap companies. Pressure from investors, regulators, the media and other constituencies is driving an increase in gender diversity on boards, but progress remains gradual as the share of S&P 1500 board seats held by women crept up to 17.8 percent in 2016 from 11.9 percent in 2008. While all-male boards (13.8 percent of S&P 1500 boards in 2016, down from 33 percent in 2008) are becoming an endangered species, they still far outnumber boards (just 6.8 percent of the S&P 1500 boards) with four or more women directors.

Multiples Matter: In 2016, the most prevalent headcount of female directors on S&P 1500 boards ticked up—for the first time—from one to two as U.S. boards as a whole started to move beyond gender tokenism. The importance of this milestone should not be underestimated.

Many women directors are quick to note that having multiple female board members changes the boardroom dynamic. The presence of a “token” woman over an extended period of time, for example, may indicate a box-ticking mentality in the boardroom rather than a true desire to include diverse viewpoints. While this progress is encouraging, most boards remain well-below the 30 percent goal set by the 30 Percent Coalition. Notably, the gap between the number of boards with at least 25 percent women directors and those with at or above 30 percent or more is rising. Given the typical nine-seat board at S&P 1500 firms, some observers may ask: Is two women directors the new boardroom glass ceiling?

Boards Make Slow Progress on Adding Minority Representation: Progress in adding more minority directors to boardroom rosters is sluggish, at best. Minority directors now fill slightly more than ten percent of the total directorships at S&P 1500 firms, but these board seats are not evenly spread across the index. Large-cap firms are more likely than not to have one or more minority directors on their rosters. Meanwhile, the typical minority director headcount at small cap firms is zero.

Assessing Board Refreshment Tools

Tool Box

Boards Have Limited Tools to Drive Refreshment: Traditionally, the boardroom toolbox has offered limited options for directors when it comes to promoting refreshment. The three primary refreshment mechanisms in use today focus on an individual director’s age (retirement policies), length of service (term limits) or absolute or relative performance (board evaluations). Notably, some boards use more than one of these tools. Each of the popular refreshment mechanisms has benefits and potential costs. Retirement ages and term limits force periodic refreshment by creating vacancies, but both may cause some directors to leave boards at a time when they are still highly-effective contributors, and reliance on these mechanical devices may allow some less productive directors to remain on boards until they reach the term or age limit. Evaluations aim to assess directors' contributions and competence in real time, but may be ineffective in fostering the replenishment of directors' skill sets in the absence of true boardroom succession planning.

Mandatory Retirement Ages

Four of Every Ten Boards Feature Mandatory Retirement Ages: For the purpose of this study, ISS requires that a retirement policy do more than "suggest" an exit age for board members to be considered as a mandatory retirement policy. Even using this strict definition, retirement age policies were identified at more than 40 percent of S&P 1500 firms in 2016. The popularity of these retirement provisions declines in lock step with diminishing market capitalization. More than one-half of large-cap S&P 500 firms have retirement ages in place. In contrast, 39 percent of mid-cap companies and 30 percent of small-cap concerns maintain retirement age policies.

Retirement Ages Move Toward 75: The most common retirement age cited in policies currently in place at S&P 1500 companies is 72. Seventy-five appears to be in the process of becoming the new 72, however, as more boards push back their retirement ages. Seventy-two remains the top choice at large-cap and middle-market firms, but it is the runner-up at small-cap firms where 75 already emerged as the most prevalent cut-off age found in retirement policies. It also is now the second most popular threshold at large- and mid-cap firms.

Age Limits Produce Younger Directors: Companies in the S&P 1500 index with retirement age policies in place generally have slightly lower average director ages than those firms without such limits. The average director age at all companies with such limits in place is 62.4 compared with an average age of 62.7 on boards without age limits. While directors are generally younger at firms with age restrictions compared with boards without such limits, the average director age on boards subject to retirement policies jumped from 60.4 years to 62.4 years over the 2008-2015 timeframe. The median director age at S&P 1500 firms with retirement policies also generally increased over the study period from 61 years in 2008 to 63 years in 2016.

Term Limits

Tenure/Term Limits Remain Rare: Term limits for boardroom service are rare at U.S. companies. Only about five percent of S&P 1500 firms had term limits in place as of their most recent annual meeting. Notably, large-cap firms, which are often first adopters of many governance reforms, actually lag their mid-sized siblings in using such director tenure ceilings. The highest usage (six percent) of term limits is found at S&P 400 mid-cap firms. Tenure guillotines are slightly less popular (5.4 percent) at large-caps and almost nonexistent (3.7 percent) at small-cap S&P 600 firms. The most common term limits currently in place in the S&P 1500 universe of firms are, in order of prevalence, 15 years, 12 years, and ten years.

Term Limits are Effective in Managing Board Tenure: The average board tenure at a company with term limits in place is substantially lower than the typical stay for directors on boards without such measures. The tenure gap is more than a year and one-half—7.1 years for term-limited boards versus 8.8 years for S&P 1500 firms without tenure restrictions. While age is not the direct target of tenure restrictions, term limits lead to lower average board ages. The average director age on S&P 1500 company boards with term limits (61.3) is more than a full year less than that of directors at boards at firms without such policies in place (62.6). Moreover, firms with term limits in place tend to have a higher proportion of board seats filled by younger directors and a lower proportion of directorships occupied by boardroom elders.

Term Limits Promote Turnover: Despite their relatively low usage, term limits appear to be highly effective in spurring boardroom refreshment. If a board's goal is turnover, tenure limits appear to be the right tool for the job. Firms with term limits in place show a higher proportion (more than 40 percent) of "new" and "recent" directors (with zero to three-year tenures) than those without term limits (slightly above 30 percent).

Evaluations

Board Evaluations Are Widespread: Usage of boardroom evaluations is close to universal (97 percent) at S&P 1500 firms. More than 99 percent of large-cap company boards disclose their use. Assessing the effectiveness of these evaluation programs is difficult, however, since very few boards disclose any details about the outcomes of these assessments.

Annual Board Evaluations Are Most Common Type of Review: Annual cadences for evaluations are the norm with more than 90 percent of evaluations occurring at least once per year. Most annual board evaluations do not include assessments of individual directors, but such deeper dives are growing in popularity, as 43.4 percent of S&P 1500 boards now do combined board process and individual reviews each year. U.S. boards have not followed a growing number of their European counterparts, however, by augmenting their annual reviews with periodic (triennial is typical) use of external third parties to evaluate boards or directors.

Widespread Use of Evaluations Makes It Hard to Assess Impact: While the small group of boards that do not disclose the use of evaluation processes tend to have older and longer serving directors, there is limited evidence that the use of an evaluation process, by itself, has a significant impact on board turnover or succession. S&P 1500 firms without any board evaluation policies—just four percent of firms in 2015 and three percent of firms in 2016 (YTD)—have higher average director tenures and director ages than those at boards with evaluation processes in place. For all S&P 1500 companies, the average board tenure gap between firms without and with board assessments was 2.4 years in 2015 and three years in 2016 YTD. Companies with no board assessment process in place generally have higher average director ages, over the study period, compared with firms that perform such assessments. Similar observations generally hold true with respect to median director age, except that median age largely remained unchanged at both firms with and without board evaluation policies between 2015 and 2016 YTD. The type of review—board-only versus board and director—also appears to make little difference in board tenures, director ages or turnover.

Governance Practices That Impact Board Refreshment

Other Refreshment Influencers

Committee Service, Independence, and Size Changes Impact Refreshment: ISS examined a wide variety of governance structures to determine their impact on refreshment. Many of these factors had little impact—positive or negative—on refreshment. An examination of vote results in director elections, for example, did not yield any significant relationship between significant negative votes and directors' age or tenure. A trio of governance attributes—service on key board committees, maintaining high levels of boardroom independence and ad hoc changes in board size—all appear to impact refreshment.

Service on Key Board Committees

Service on Key Board Committees May Lead to Longer Tenures: Over the past decades, a significant portion of the overall boardroom workload has shifted to the three key committees—audit, compensation, and nominating/governance. Today, these board panels are generally required (by stock market listing standards or SEC rules) to be populated by "independent" directors. In light of the growing importance of the work of these committees and their role in shareholder engagement, there may be pressure on boards to retain the subject-matter expertise developed by directors who serve on these key panels and to maintain continuity.

Nominating Panels Attract Older Directors: Nominating committees tend to attract the longest-tenured and oldest members (and chairs) compared to their audit and compensation counterparts. Nominating committee members and their chairs also tend to be older and longer-serving than the general boardroom population. Service by older and long tenured directors on nominating committees may have an impact on boardroom succession planning and refreshment since such directors may have a self-interested bias towards longer service and higher exit ages. Notably, nominating committees tend to drive both director evaluations and boardroom recruitment efforts. Nominating panels are also typically responsible for recommending and administering other governance mechanisms such as waivers of mandatory retirement ages and term limits. In contrast, audit panels and their chairs have shorter board tenures than their counterparts on nominating and compensation committees. The wearing workload carried by audit panel members and the need to refresh their "financial expertise" may help to explain this tenure gap. Average director tenures and ages for members of compensation committees (and their chairs) fall between those of their nominating and audit counterparts.

Boards Turn to Older Directors to Serve as Committee Chairs: On average, chairs of each of the key committees tend to be older and longer tenured than their fellow committee members and the overall boardroom population. While it is not surprising that boards turn to more experienced members when filling leadership positions, it may reinforce the subtle bias in favor of extended board service.

Board Independence

Board Independence Levels Continue to Rise: Thanks to stock exchange listing requirements and shareholder pressure, director independence levels at companies in the S&P 1500 continue to rise to new heights. The proportion of S&P 1500 board seats occupied by independent (as defined by ISS) directors has increased by almost five percentage points to 81.5 percent at the study companies over the 2008-2016 study period. Both average and median board independence at S&P 1500 companies show a steady upward rise between 2008 and 2016, increasing by five and six percentage points to 81.1 percent and 83.3 percent, respectively, in 2016.

Boards May Limit Refreshment to Maintain High Levels of Independence: In recent years, a growing number of global markets have adopted tenure-triggered disclosure requirements (or, in rare instances, restrictions) regarding independent directors. These provisions, which are typically based on the “comply or explain” model, set recommended maximum tenure for corporate directors that range from nine to 12 years. The U.S. market is not subject to such a requirement and only a small minority of investors in the market change directors’ independence status based on tenure alone. U.S. boards benefit from investors’ compartmentalization as longer director tenures generally do not appear to have a negative impact on independence levels. Board refreshment generally appears to drive higher boards towards higher independence levels. The addition of one or two new directors on the typical S&P 1500 board appears to have a positive impact on board independence levels. Notably independence levels appear rise even in the absence of board refreshment. Non-refreshed boards at S&P 1500 firms—those with zero “new” directors in a given year—actually experienced gains in the “highest” (i.e., 90 percent-plus independence) category over the study period.

Board Size Changes

Boards Change Size Frequently: While average board size (hovering at nine seats at S&P 1500 firms ranging from 11 at large caps to eight at small caps) remained static over the entire study period, board size limits do not appear to handcuff boards with respect to board refreshment. Over 90 percent of firms in the S&P 1500 composite index changed the size of their boards between 2008 and 2016 (YTD). Slightly more than one-half (51.3 percent) of the firms in the S&P 1500 that altered their board size over the study period increased the size of their boards.

Boosting Board Size Benefits Women and Ethnic/Racial Minority Candidates: Ad hoc changes in board size appear to provide boards with more flexibility to add women and (to a lesser degree) ethnic or racially diverse candidates to their boards. Notably, such board expansions may allow boards to bring more diverse candidates onto their rosters without the necessity of replacing specific skill sets of sitting directors who will soon exit the boardroom. Board size changes do not typically translate to board committee size changes—the average board committee size (of four members) did not change over the study period.

Harvard Law School Forum on
Corporate Governance and Financial Regulation
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2016 Annual Corporate Directors Survey

Posted by Paula Loop, PricewaterhouseCoopers LLP, on Thursday, October 27, 2016

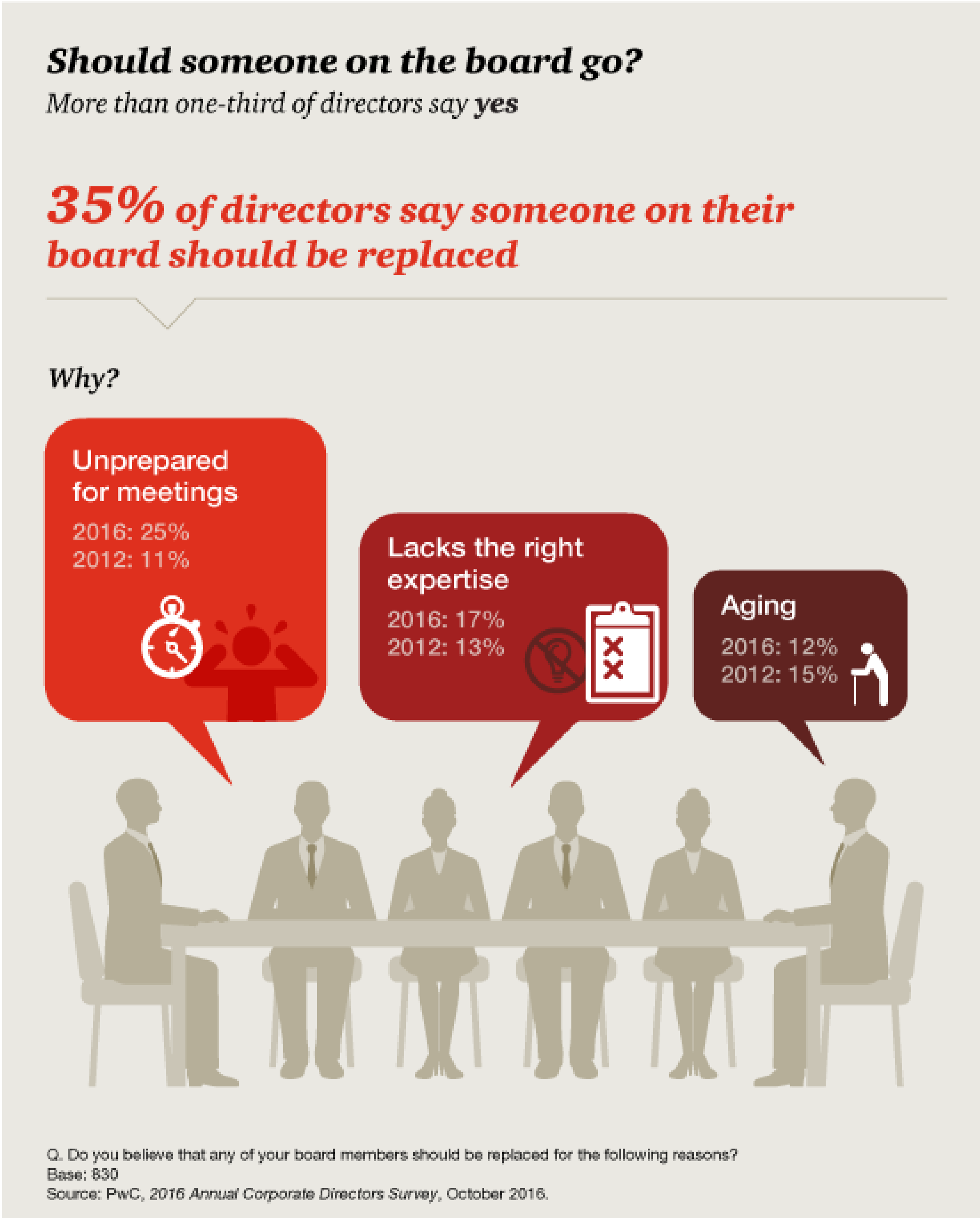
Editor's note: Paula Loop is Leader of the Governance Insights Center at PricewaterhouseCoopers LLP. This post is based on a PwC publication by Ms. Loop, Catherine Bromilow, Terry Ward, and Paul DeNicola.

Overseeing a company is no small task. Disruptive technologies are changing companies' business models, geopolitical turmoil is impacting supply chains and investment opportunities, and increased regulatory complexity is affecting innovation. Institutional investors and shareholder activists are also playing a more powerful role shaping corporate governance. Boards of directors have to keep up with all of these changes in order to be effective.

Our 2016 survey uncovered 10 key findings that have a major impact on how boards perform. Diversity in the boardroom remains a topic of debate in the governance world, and male and female directors have differing opinions about its benefits. Directors are aware of their fellow board members' performance—but not all are impressed. More than one-third of directors think someone on the board should be replaced. And despite their increasing oversight responsibilities and the many new issues boards have to understand, most directors say their workload is manageable. Investors are also a factor in corporate governance changes. They are pushing for changes to board composition and capital allocation strategy—and are often getting their way.

1. How do you measure up compared to your fellow board members?

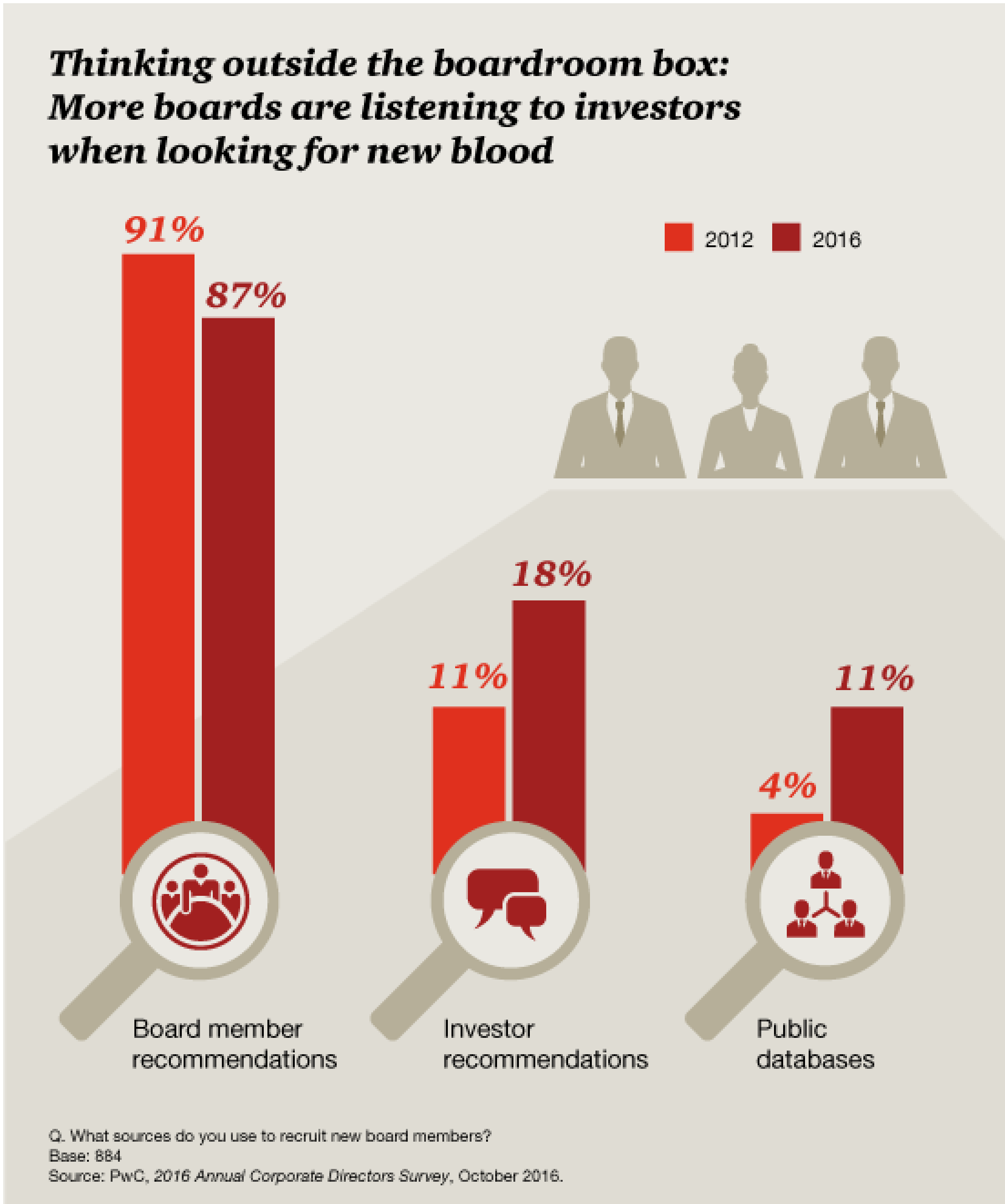
Sitting on a board of directors requires preparation, attention to detail, and having the right skills for the job. But more directors are saying someone on their board isn't measuring up. Thirty-five percent of directors say someone on their board should be replaced—a sentiment that directors have had since 2012. The most common reasons why: they're not prepared for meetings and they lack the right expertise. Some directors also cite aging as the reason, while others say someone is overstepping the boundaries of his or her oversight role.



So what can boards do to right the ship? Self-evaluations are one tool boards can use to rethink their board composition and address a director's poor performance. But 51% of directors say their boards didn't make any changes as a result of their last self-evaluation process.

2. The search for new blood

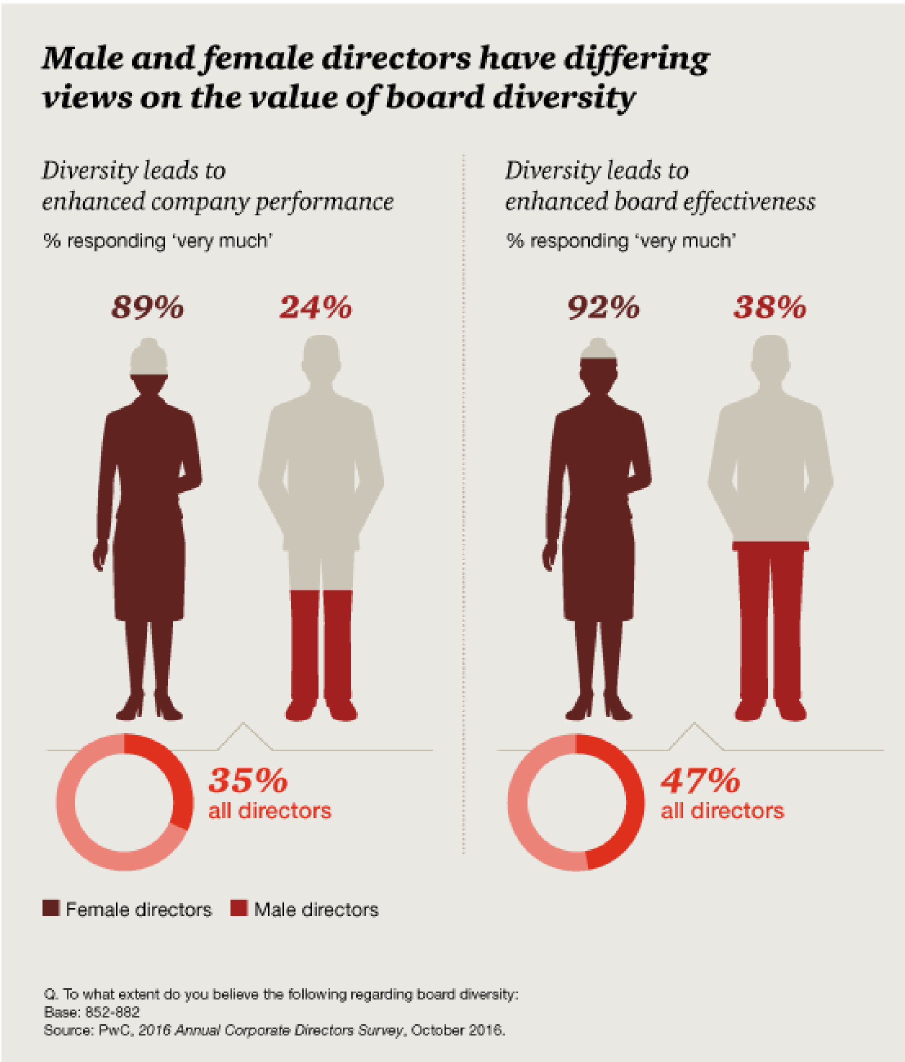
Most board members don't look far beyond the boardroom for new directors. In most cases, they still turn to what they know: themselves. In fact, the most common source is fellow board member recommendations. This likely contributes to the "same old, same old" criticism that some observers have of boards, as well as concerns about a lack of board diversity.



Some also use search firms and management recommendations as sources for recruiting efforts. But a shift is starting to happen. Calls for board diversity and investor influence on board composition have prompted some boards to use less traditional sources to find new directors.

3. How beneficial is diversity on the board? It depends on who you ask

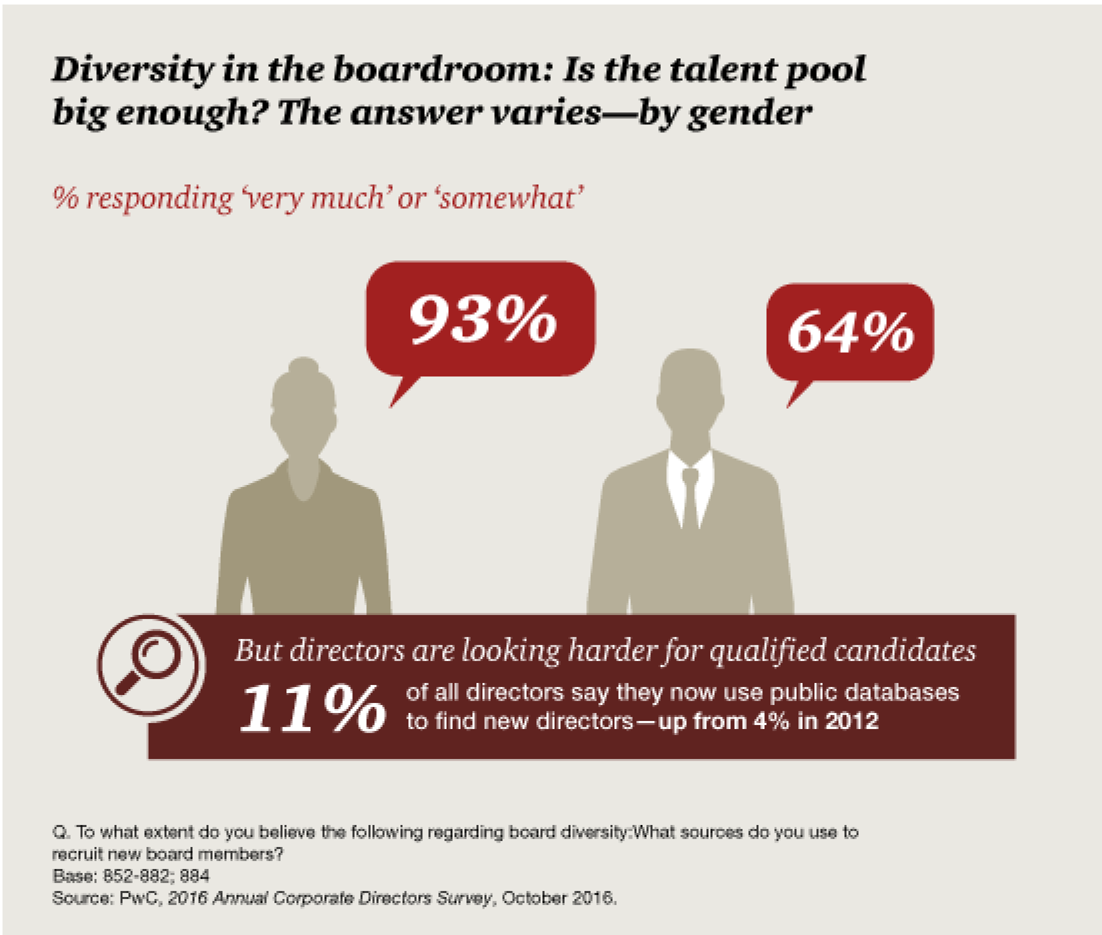
Nearly all directors (96%) agree that diversity is important. But how important it is and how much it helps depend on whom you ask. Female directors have a much stronger opinion about the benefits of board diversity than male directors. One issue in the debate is disagreement about whether there are qualified diverse board candidates to tap for director service. Virtually all female directors say there are sufficient numbers of such people, while only about two-thirds of male directors say the same. A contributing factor cited by some is a lack of diversity in the C-suite, where many boards look for potential director candidates. So some boards are using public databases, many of which can highlight diverse candidates, in their search for new board members.



In 2015, women made up 20% of S&P 500 boards, up only 5 percentage points in a decade. [1] The majority of directors today say anywhere from one-fifth to one-half of the board should be female. But 10% of directors—overwhelmingly male—believe that the optimal percentage should be what it is today or less. This seems to suggest that it may take much longer than the government's estimate of 40 years to reach gender parity on boards. [2]

4. Differing views on where to find good, diverse board talent

One of the main difficulties in adding diversity to the board is that many boards look to current or former CEOs as potential director candidates. But only 4% of S&P 500 CEOs are female, [3] and only 1% of the Fortune 500 CEOs are African-American. [4] So where can boards find qualified diverse candidates? First, the pool of potential director candidates needs to expand. And then boards will have to look in different places. There are often many untapped, highly qualified, and diverse candidates a few steps below the C-suite—people who drive strategies, run large segments of the business, and function like CEOs.



But female directors think there are far more qualified diverse potential directors out there than male directors do. Still, boards are starting to use public databases in their talent search—an indication that they may be looking for diverse qualities in those new candidates.

5. Directors are less concerned about their workload

For years, we have heard how overloaded directors were with their board work. That no longer seems to be the case. Directors aren't concerned with their workload, according to the vast majority of respondents to our survey. The same goes for committee work. But directors still spent an average of 248 hours on their board work in 2015. [5]

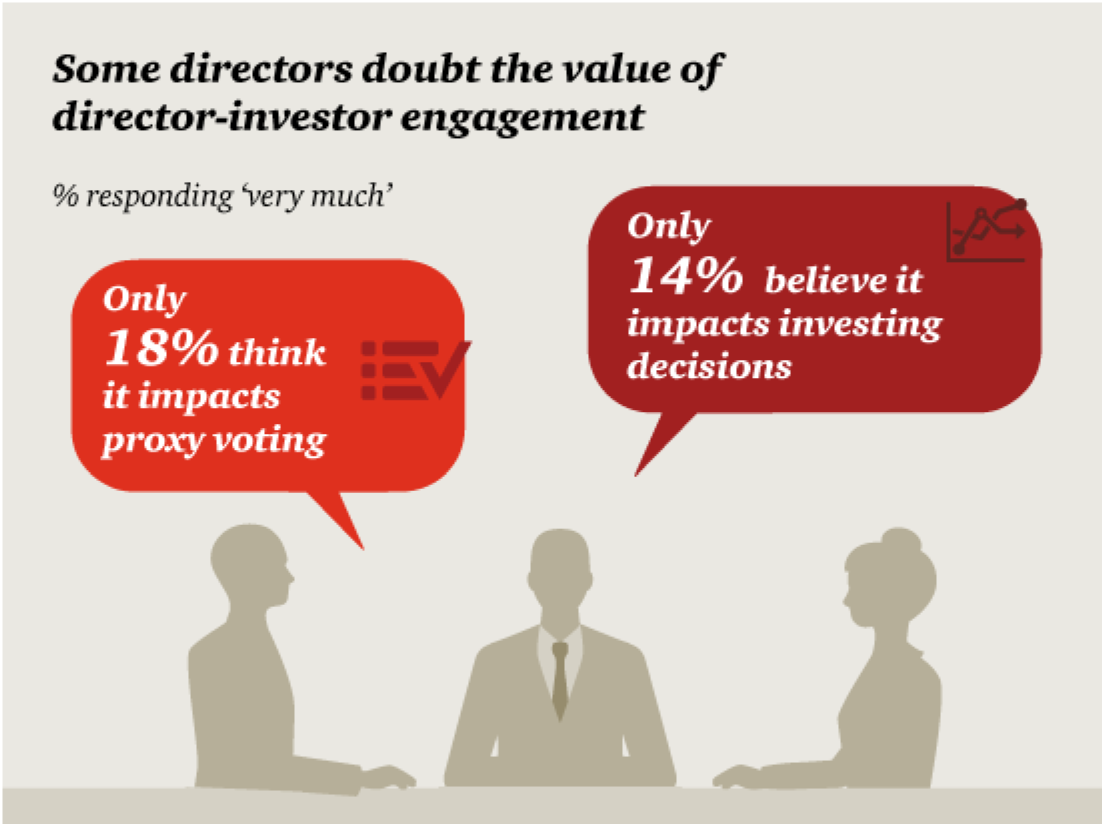
6. Challenges to CEO succession planning

CEO succession is arguably the most important responsibility of the board. The CEO develops the company's strategy, drives execution, and sets the "tone at the top." The board has oversight of all of this—and having the right person at the helm is critical. But not all boards prioritize CEO succession planning, and about half of directors say they want to spend more time on the topic.

Directors say that the current CEO's performance is the biggest challenge to more timely and effective CEO succession planning—the CEO's good performance. But complacency with performance should not be a barrier to succession planning. In fact, the CEO turnover rate at the world's largest 2,500 companies was 16.6% in 2015, the highest in 16 years, according to our Strategy& CEO Successstudy. While some of that turnover was planned or due to M&A activity, some of it wasn't. Emergency situations happen—a family crisis, a scandal, illness, or even death—so companies and boards need to be prepared.

7. Does dialogue with investors really matter?

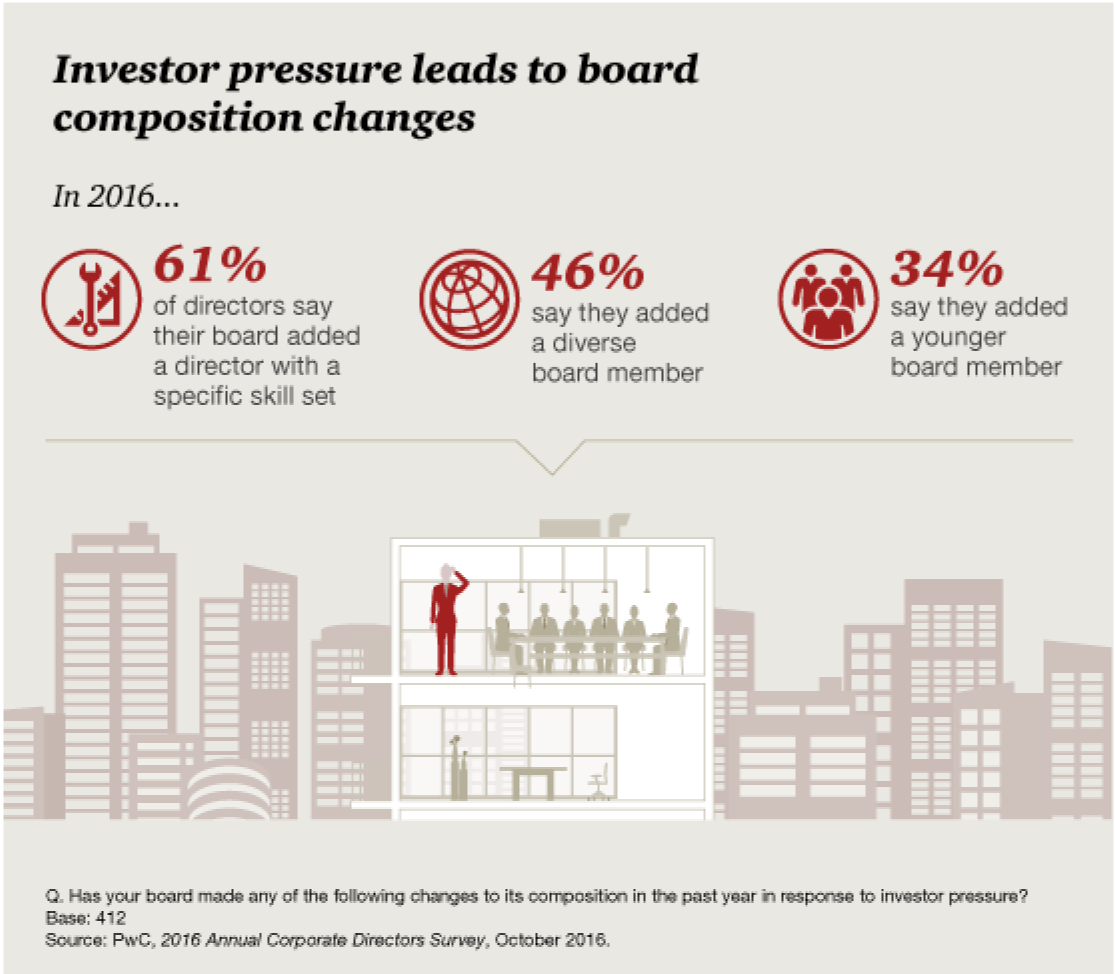
Direct engagement between boards and investors has become much more commonplace over the past few years. In fact, 54% of directors said their boards engage directly with their investors. And more directors are open to discussing topics that, just a few years ago, might have been off-limits—including board composition and company strategy. But not all directors think the engagement is useful—21% of directors said they didn't receive any valuable insights from directly engaging with investors. Directors are also skeptical that engagement actually impacts investor behavior.



Q. To what extent do you agree with the following regarding your board's direct engagement with investors:
Base: 328-543
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

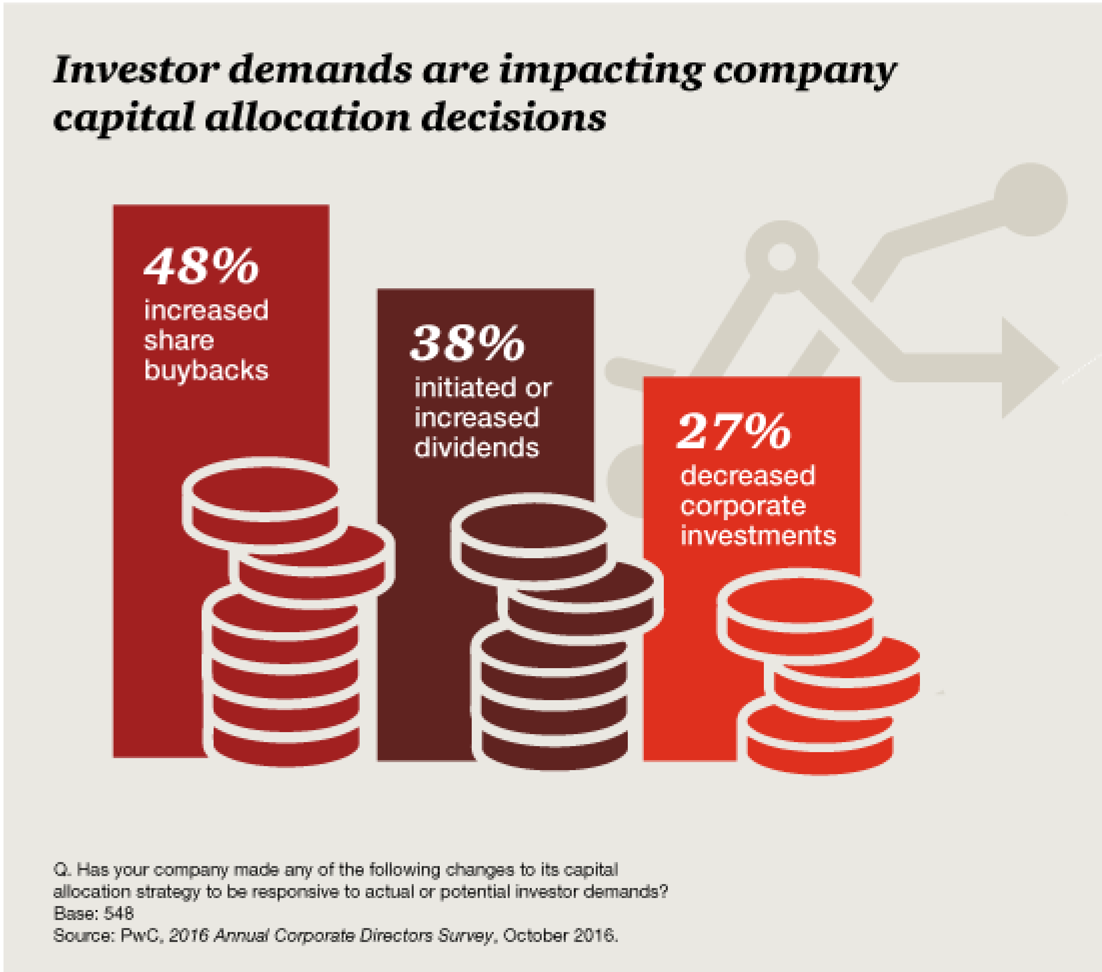
8. Investors flex their muscles about board composition

Companies face many challenges and disruptions in today's changing business environment. So having a board made up of the right people with the right experience and expertise is critical. Many investors have become more vocal about who's sitting in the boardroom. They want more information about a company's director nominees, and they want boards to think about tenure and diversity. Directors have paid attention, and many have changed their board composition as a result.



9. Companies respond to investor demands about capital allocation

A company's capital allocation plan gets to the very center of the long- versus short-term investment debate. And most investors agree that companies need to have a balanced capital allocation plan. But when the $170 billion of activist assets under management combines with the more than $1.4 trillion in cash on companies' balance sheets, [6] the picture changes. Companies sitting on excess cash often find themselves a target of activism—with activists pushing them to return that cash to shareholders. Other investors are also starting to voice opinions about how companies use their resources.



Directors (67%) are also open to discussing the company's use of cash with investors. Discussing this with investors can provide confidence that the company is appropriately focusing on long-term value creation.

10. Are activists good for business? Most directors actually say yes

No company is immune to shareholder activism. Some activists go after companies with financial performance vulnerabilities, such as missing quarterly numbers, a stagnant stock price, or comparatively weak revenue growth. Others might target the board's corporate governance issues. While many companies look for strategies to stay out of activists' cross hairs, they may not be able to stay under their radar. As of September 2016, there were 263 activist campaigns in the US. [7] Some critics charge that activists are too focused on short-term results, and 96% of directors agree. Even so, many directors concede that shareholder activism can ultimately be good for business, compelling companies to evaluate strategy and improve capital allocation.

Boards are also responding to the threat of shareholder activism. About half of directors said their board regularly communicated with the company's biggest investors and used a stock-monitoring service to get updates on ownership changes. Actively engaging with investors and understanding who owns the company's stock can help companies and boards stay a step ahead of activists.

The full report is available here.

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Delaware Supreme Court Rules on Director Independence

Posted by Edward B. Micheletti and Edward P. Welch, Skadden, Arps, Slate, Meagher & Flom LLP, on Monday, January 16, 2017

Editor's note: Edward B. Micheletti and Edward P. Welch are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden publication by Mr. Micheletti, Mr. Welch, and Keenan Lynch, and is part of the Delaware law series; links to other posts in the series are available here.

The Delaware Supreme Court recently issued an important decision on the subject of director independence. In *Sandys v. Pincus*, No. 157, 2016 (Del. Dec. 5, 2016), the Delaware Supreme Court held that certain directors of Zynga, Inc. (Zynga or the company) were not independent because of personal and professional connections to Mark, J. Pincus, the company's founder and controlling stockholder, and Reid Hoffman, an outside director. The *Sandys* opinion and the Supreme Court's reasoning underlying its specific decisions concerning director independence should be carefully considered by boards of directors of companies faced with stockholder derivative lawsuits, particularly for companies that have a controlling stockholder.

Background

A Zynga stockholder brought derivative claims for breach of fiduciary duty against certain directors and officers of the company who sold shares in a secondary stock offering in April 2012. Shortly after the secondary offering, the company's per-share trading price fell dramatically. The plaintiff asserted that the directors and officers who sold in the secondary offering did so improperly on the basis of their inside knowledge of the company's declining performance. The plaintiff further alleged that current and former members of the Zynga board of directors (the board) breached their fiduciary duties by approving exceptions to certain lockup agreements and other trading restrictions, thereby permitting the allegedly wrongful stock sales.

In an opinion dated February 29, 2016, Chancellor Andre G. Bouchard of the Delaware Court of Chancery dismissed the complaint under Rule 23.1 for failure to plead that the demand was excused as futile. At the time the complaint was filed, the board was comprised of nine directors, only two of whom—Mr. Pincus, Zynga's founder, former CEO and controlling stockholder, and Mr. Hoffman, an outside director—had sold shares in the secondary offering. After considering the allegations against five of the board members, Chancellor Bouchard held that the plaintiff had failed to allege facts that would create a reasonable doubt as to the ability of a majority of the nine-member board to act independently of Mr. Pincus and Mr. Hoffman for purposes of considering a derivative demand. The court therefore dismissed the complaint under Rule 23.1 for failure to plead that the demand was futile. The plaintiff appealed.

The Supreme Court's Opinion in *Sandys v. Pincus*

On appeal, the Delaware Supreme Court, in a 4-1 split decision, reversed Chancellor Bouchard's ruling. Writing on behalf of the majority, Chief Justice Strine held that the plaintiff had pleaded "particularized facts regarding three directors that create a reasonable doubt that these directors can impartially consider a demand." As a result, he found that the plaintiffs had adequately pled that the demand was futile because five board members out of nine were conflicted for purposes of considering a demand. Specifically, the Supreme Court concluded that one of the three directors in question—Ellen Siminoff, an outside director—was not independent for purposes of considering the demand because she and her husband co-owned a private airplane with Mr. Pincus. Chief Justice Strine wrote that the co-ownership "signaled an extremely close, personal bond between Pincus and Siminoff, and between their families," and that the "unusual fact" created an inference "that Siminoff cannot act independently of Pincus."

The Supreme Court also rejected Chancellor Bouchard's determination as to the independence of directors William Gordon and John Doerr, who both were partners at Kleiner Perkins Caufield & Byers (Kleiner Perkins), which owned equity in Zynga. Chief Justice Strine's opinion emphasized that the company did not consider Mr. Gordon and Mr. Doerr independent under the NASDAQ listing standards. Chief Justice Strine stated that "although we do not know the exact reason the board made this determination," the court was persuaded that because Zynga was controlled by Mr. Pincus and because neither Mr. Gordon nor Mr. Doerr had been designated as "independent" for NASDAQ purposes, neither of them could independently consider whether to initiate a derivative suit under the circumstances. The majority's opinion also noted that in addition to owning 9.2 percent of Zynga's equity, Kleiner Perkins also was invested in One Kings Lane (a company co-founded by Mr. Pincus' wife) and Shopkick, Inc. (another company where Mr. Hoffman is a director). The court found that this "mutually beneficial ongoing business relationship … might have a material effect on the parties' ability to act adversely toward each other." Because Mr. Gordon, Mr. Doerr and Ms. Siminoff were found to lack independence, the board did not have a majority of disinterested and independent directors for purposes of considering the plaintiff's derivative demand.

Justice Karen L. Valihura dissented. Though describing it as "a close case," Justice Valihura wrote that she would have affirmed Chancellor Bouchard's dismissal because these "relationships among venture capitalists and entrepreneurs, as alleged, are not sufficient to raise a reasonable doubt as to Gordon and Doerr's independence." As to Ms. Siminoff, Justice Valihura stated that the complaint alleged "[n]othing more" than a business relationship, "let alone facts suggesting th[e] kind of familial loyalty and intimate friendship" that the majority's opinion inferred from her co-ownership of the airplane with Mr. Pincus.

Implications

The Delaware Supreme Court's opinion in *Sandys v. Pincus* is a rare example of a non-unanimous ruling on a matter of fundamental importance to corporation law—namely, the determination of when a director is interested or lacks independence in connection with a particular transaction. Boards of directors should carefully consider with their advisers several aspects of this notable opinion:

- A company's decision as to whether a certain director is independent under the relevant stock exchange rules may affect whether that director is considered independent for purposes of Delaware law.
    - In holding that Mr. Gordon and Mr. Doerr were not independent for purposes of the stockholder's derivative claim in this case, Chief Justice Strine wrote that although "the Delaware independence standard is context specific and does not perfectly marry with the standards of the stock exchanges in all cases," it nevertheless "creates cognitive dissonance" to presume that directors are independent when their "own colleagues will not accord them the appellation of independence[.]" On the other hand, Justice Valihura dissented in part because the complaint "lack[ed] of any explanation as to why Gordon and Doerr were identified as 'not independent' for NASDAQ purposes." Companies determining to designate a certain director as non-independent under stock exchange rules should consider the potential impact of future litigation, regardless of the underlying reason for the non-independence determination.
    - The *Sandys* opinion is particularly pertinent for controlled companies. In a seemingly categorical assertion, Chief Justice Strine held that "[i]n the case of a company like Zynga, which has a controlling stockholder, Pincus, who wields 61% of the voting power, if a director cannot be presumed capable of acting independently because the director derives material benefits from her relationship with the company … she necessarily cannot be presumed capable of acting independently of the company's controlling stockholder."
- Close personal and professional relationships between directors may be considered by the court to affect the board's ability to maintain control of derivative lawsuits.
    - Delaware courts long have held that personal or business relationships do not render a director incapable of considering a derivative demand unless the relationship is significant enough to be "bias-producing." The majority opinion in *Sandys* held that this standard "does not require a plaintiff to plead a detailed calendar of social interaction to prove that directors have a very substantial personal relationship rendering them unable to act independently of each other." By contrast, Justice Valihura's dissent emphasized that in cases such as *Beam v. Stewart*, the Delaware Supreme Court has considered directors still to be independent despite allegedly being a "longtime personal friend" of or having a "longstanding personal relationship" with the defendant director. 845 A.2d 1040,1047-49 (Del. 2004). Agreeing with Chancellor Bouchard's ruling, Justice Valihura viewed the *Sandys* complaint as failing to create a reasonable inference that the challenged directors' relationships with Mr. Pincus and Mr. Hoffman were so substantial that the director would "put at risk her reputation by disregarding her duties."
    - In *Sandys*, the majority opinion contains strong language about the fact that Ms. Siminoff and her husband co-owned a private airplane with Mr. Pincus, stating it "suggests that the Pincus and Siminoff families are extremely close to each other and are among each other's most important and intimate friends," because an airplane is "a personal asset" that "requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship." The Court found the relationship between airplane co-owners to be "the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment." This language is especially notable because, as Justice Valihura noted in her dissent,

the complaint's allegations on this point were sparse and repeatedly described the co-ownership as a "business relationship."

- The *Sandys* opinion also contains notable language about relationships among venture capital investors and board nominees. Because of the overlapping involvement of Gordon, Doerr, Pincus and Hoffman in several different companies, the majority's opinion found that "Gordon and Doerr have a mutually beneficial network of ongoing business relations with Pincus and Hoffman that they are not likely to risk by causing Zynga to sue them."
- Chief Justice Strine opined that "the reality is that firms like Kleiner Perkins compete with others to finance talented entrepreneurs like Pincus, and networks arise of repeat players who cut each other into beneficial roles in various situations." While Chief Justice Strine found "nothing at all wrong with that," he nevertheless held that it undermined the independence of Mr. Gordon and Mr. Doerr for purposes of evaluating the stockholder derivative demand. The majority's holding on this point is notable because, as Justice Valihura's dissent emphasized, "the plaintiff failed to plead any facts about the size, profits, or materiality to Gordon and Doerr of these investments or interests."

Tab V: Shareholder Proposals

Building Meaningful Communication and Engagement with Shareholders

Mary Jo White, [excerpt, from remarks at the Society of Corporate Secretaries and Governance Professionals]
June, 2015

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Building Meaningful Communication and Engagement with Shareholders

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

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

I am honored to be with you here in Chicago at the Society's 69th National Conference. Over the years, the Society has consistently provided thoughtful comments to the Division of Corporation Finance and the Commission on a wide variety of issues and proposed rules. You understand the complexities that can affect multiple parties and recognize the importance of the interests of shareholders. All of you play a critical role in corporate governance. It is the decisions you make, the practical solutions you advance and the views you share with your boards that can, in large part, dictate the relationship between shareholders and companies.

Because of your central roles in your companies, many of the Commission's initiatives are of interest to you: our disclosure effectiveness review; the audit committee disclosures concept release the staff is working on; and any number of our rulemakings. My hope is that you will see near-term activity in these and other areas, including rules mandated by the Dodd-Frank Act, such as the clawbacks rule as required by Section 954, the pay ratio rule under Section 953(b) and the joint rulemaking on incentive compensation as required by Section 956. So stay tuned for those developments.

But today my focus is on a selection of proxy-related issues, another area of particular interest to you. And my overall theme complements the theme of your conference, "Connect, Communicate, Collaborate." Be proactive in building meaningful communication and engagement with your shareholders.

One of the most important ways that shareholders have to express their views to company management is through the annual proxy process. We know of your deep involvement and interest in maintaining a fair and efficient proxy voting system, a priority we share at the SEC. So, this morning, I will offer some of my thoughts on four proxy-related subjects that are topics currently under discussion: the delivery of preliminary proxy voting results by intermediaries; the concept of a universal proxy ballot; so-called "unelected" directors; and shareholder proposals.

Each of these issues has frequently placed companies and shareholders at odds and each has been the subject of calls for Commission or staff action to clarify the scope of our rules, to step-in to mediate a dispute, and, in certain cases, to write new rules. And we and the staff of the Division of Corporation Finance are reviewing the concerns raised to determine what the Commission or the staff can and should do in response. But, I ask you, as I share with you my views on these topics, to also consider what you could and should be doing in each of these areas.

Preliminary Voting Results

I will start with preliminary proxy vote information. As you know, in advance of a company's annual meeting, companies seek voting authority from their shareholders who do not plan to attend the annual meeting. Under the current system, proxy materials are distributed to shareholders directly, in the case of registered shareholders, and indirectly through brokers and banks, in the case of "street name" shareholders who own shares through their brokerage and bank accounts. Today, over 80% of the outstanding equity securities for publicly listed U.S. companies are estimated to be in street name.

The vast majority of banks and brokers retain an agent to send out the request for voting authority. In addition to delivering proxies to the company reflecting the instructions received from the beneficial owners, the agent makes preliminary vote tallies available to the company before the meeting. This allows the company to determine whether it will meet its quorum requirement. In addition to providing information on the quorum, access to this information also allows the company to assess the "direction" a vote is taking and to adjust its proxy solicitation strategy. That information is obviously not just valuable to companies, but also to the other participants who are conducting solicitations.

In the past, Broadridge, which is the single largest agent collecting vote tallies, had established the practice of providing the voting tallies of street name shares to a shareholder proponent when the proponent had mailed exempted soliciting materials to shareholders and signed a confidentiality agreement. It did this so long as the banks and brokers did not raise an objection. But, in May 2013, certain brokers objected to the early release of voting data to shareholder proponents. Broadridge's response was that, as an agent, it is contractually bound to follow the directions of the brokers. As a result, it no longer provides the preliminary voting tallies to shareholder proponents who have distributed exempted solicitation materials and are willing to sign a confidentiality agreement, unless the company subject to the solicitation affirmatively consents. Investor groups and academics have expressed concern about this turn of events and argue that equal access to the information is required.

A variety of interested parties have asked the Commission to either interpret existing rules or adopt new rules to clarify that brokers are obligated to require their agents to deliver preliminary vote tallies to all interested participants. The SEC's Investor Advisory Committee, for example, has stated that the requirement that brokers and their agents act in an impartial fashion in distributing proxy materials should include the delivery of preliminary voting information. The Advisory Committee and others have criticized the selective disclosure of such information to companies and not shareholders and its potential effect on voting results.

The proxy rules are silent on preliminary vote tallies. The staff in the Division of Corporation Finance, after reviewing the various rules that govern proxy solicitations, has acknowledged that the current rules do not address directly whether a broker (or its agent) is required or permitted to share such preliminary vote tallies with other parties.

Our rules, of course, do not prohibit issuers from sharing this information. As I have said on other occasions, companies should seek to engage in a constructive dialogue with their shareholders and work to facilitate constructive solutions to issues they raise. In this context, since companies have direct access to the voting results, they should themselves consider leveling the field by agreeing or consenting to a mechanism that provides the interim vote tallies to shareholder proponents. We understand that it is customary in a contested, non-exempt solicitation for companies and shareholder opponents to share each other's voting information in advance of the meeting. So we know it can be done. I would ask you to consider whether providing this information to the shareholder in an exempt solicitation is really that different.

If the Commission were to advance a rulemaking in this area, it could take several forms. A rule could condition the broker's exemption from the proxy rules on an overall "impartiality" requirement to level the playing field, such that everyone gets preliminary vote tallies, or nobody gets them. Alternatively, a rule could permit brokers to provide issuers with the total votes that have been cast only in order to determine quorum, rather than a preliminary vote tally that would indicate how the shareholders have voted.

As with many issues, while rulemaking certainly can provide a remedy, I would like you to consider whether rulemaking is the only way to solve these concerns. I understand that a possible solution was being worked on by the Society, the Council of Institutional Investors and Broadridge, but those discussions broke down. That is unfortunate. A solution that you and the other interested parties develop together can achieve a good compromise and strengthen relationships. Indeed, companies should see this not as a problem to be solved, but as an opportunity to improve investor relations.

Universal Proxy Ballots

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

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

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

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

As you know, we held a roundtable in February on ways to improve the proxy voting process. One panel focused on the state of contested director elections and whether changes should be made to the federal proxy rules to facilitate the use of universal proxy ballots. It was, as always, a lively discussion.

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

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

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

“Unelected” Directors

Let me turn to the issue of directors who do not receive a majority of shareholder votes but who continue to serve on the board, sometimes—and not fondly—dubbed as “unelected” directors. A recent study showed that 85% of these directors were still board members two years after an unfavorable vote.

Although such situations are rare, the seeming indifference of management when they do occur has understandably garnered significant interest. What does the continued presence of such directors say about a company’s general responsiveness to its shareholders?

In recent years, there has been a shift away from corporate practices that simply allow directors to remain when less than a majority of shareholders wants them there. “Plurality plus resignation” and majority voting regimes have become the norm at larger companies, and require at least some action by the director and board.

Under a plurality plus resignation voting regime, the director nominees agree in advance to resign if they receive a majority of withhold votes. The remaining directors then determine, in their discretion, whether to accept or reject the resignation. Under a majority voting regime, directors are elected only if they receive a majority of the votes cast. But as a result of the “holdover” rule under state law, an incumbent director who does not receive the requisite votes may remain in office until the earlier of the successor’s election and qualification or the incumbent director’s resignation or removal. In these instances, the board may determine not to accept the incumbent director’s resignation until a successor joins the board.

Some recent data suggests that shareholders’ expression of disapproval in uncontested elections do have an impact. A 2015 study, for example, shows that withheld votes are associated with increased director turnover. The same study showed that directors who face even a 30% dissent rate are more likely to depart from the board, and if they remain, they are more likely to be moved to less prominent positions on the board.

Views differ on whether individuals should be prohibited from continuing to serve on boards when they do not receive a majority of shareholder votes. Ultimately, whether an individual can remain on the board following an election where they do not receive majority support is a question of state law and the governance decisions made by boards. Some, however, have recommended that the Commission require companies to disclose the specific reasons why the board chose to retain a director who did not receive a majority vote regardless of the type of voting regime in place. Others favor an approach where the NYSE and NASDAQ would impose new listing standards requiring listed companies to adopt a majority voting regime that imposes reasonable limits on the ability of boards to reject the resignation of such directors.

If a director receives a majority withhold vote and remains on the board, the company should consider that its shareholders may want to know about that director’s service on the board and the decision to let the board member remain. It is hard, indeed, to imagine that a company would not want to provide its shareholders with a specific explanation of the board’s thinking on retaining the board member.

We could certainly amend our proxy rules to, among other things, mandate more specific disclosures on these board decisions. But, any company that is serious about good corporate governance should provide such information on its own. It should share the board's thought process and reasons with shareholders—inform the shareholders in clear terms why the board member's resignation was not accepted, why the director was considered important for the strength of board decision-making, for the growth of the company, for the relevant experience represented, or for the expertise that would be lost. Be specific, and avoid boilerplate. Shareholders are interested and likely quite willing to listen to reasonable explanations. To be sure, they could evaluate the additional information and express disagreement with the decision not to remove the board member, which would provide further information for you to consider about your shareholders' views on removal.

Shareholder Proposals

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

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

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

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

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

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

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

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

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

Conclusion

The four areas I talked about today obviously represent only a small part of the broader company-shareholder relationship and a small sample of proxy-related issues we are considering at the Commission. We are very interested in what you think and how you are approaching the full range of issues and practices that relate to enhanced shareholder engagement and more meaningful communications. Your leadership can help to constructively address the issues and to develop and share best practices. I wish you success at that and a very productive conference. Thank you for all you do.

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

Exceptions to Rule 14a-8 Shareholder Proposals Exclusion

Posted by David A. Katz, Wachtell, Lipton, Rosen & Katz, on Monday, October 26, 2015

Editor's note: David A. Katz is a partner specializing in the areas of mergers and acquisitions and complex securities transactions at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton memorandum by Mr. Katz and Sabastian V. Niles. Mr. Niles is counsel at Wachtell Lipton specializing in rapid response shareholder activism and preparedness, takeover defense, corporate governance, and M&A.

Yesterday [October 22, 2015], the Staff of the Securities and Exchange Commission's Division of Corporation Finance issued Staff Legal Bulletin No. 14H. SLB14H formally narrows the long-standing approach to interpreting Rule 14a-8(i)(9), which permits a company to exclude a shareholder proposal that otherwise complies with Rule 14a-8 from its proxy statement "[i]f the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting."

Prior to the 2015 proxy season, the exclusion applied in many corporate governance, shareholder rights and executive compensation contexts to avoid the risk of inconsistent and confusing meeting results, to facilitate private ordering and to promote the gradual and deliberative evolution of company practices and investor perspectives. For example, under the historical approach that the SEC Staff acknowledged had been applied "for decades," if a shareholder submitted a Rule 14a-8 proposal seeking the right to call special meetings at a 10% threshold, companies could, in their fiduciary judgment, put to a vote giving shareholders the right to call a special meeting at a higher threshold (*e.g.*, 25%) without also putting the 10% formulation to a vote at the same meeting. During the 2015 proxy season, in the context of several proxy access proposals, the rule allowing shareholder proposals to be excluded on this basis became mired in controversy, and the SEC Staff suspended its review of company requests for no-action relief under the rule.

For the 2016 proxy season, under SLB14H companies may obtain no-action relief to exclude "directly conflicting" shareholder proposals in favor of the company's own proposals only if "a reasonable shareholder could not logically vote in favor of both proposals, *i.e.*, a vote for one proposal is tantamount to a vote against the other proposal" as "they are, in essence, mutually exclusive proposals." The exemption could not be used to exclude proposals that "propose different means of accomplishing an objective, but do not directly conflict" or where "a reasonable shareholder, although possibly preferring one proposal over the other, could logically vote for both." Whether a shareholder proposal is binding or precatory or "came first" will not impact the availability of the exclusion.

Accordingly, and as the SEC Staff makes clear, companies should not expect to get no-action relief under this exception to:

- Exclude shareholder proposals seeking new proxy access, special meeting, written consent or other rights simply by putting company-sponsored versions of such new rights to a vote; or
- Exclude shareholder proposals relating to executive compensation matters, such as those seeking new clawback policies or modified approaches to accelerated change of control vesting, simply because the company seeks approval at the same meeting for a new compensation plan that vests discretion over such matters in the compensation committee.

Thus, SLB14H's new interpretation effectively nullifies the "directly conflicts" rule in the vast majority of cases. Procedural questions have been raised, with the Business Roundtable expressing its disappointment that "this departure from long-established practice was adopted without a formal rulemaking process."

As issued, SLB14H would apply the "directly conflicts" exclusion to prevent shareholders from circumventing the SEC's proxy rules by, for example, using Rule 14a-8 to solicit in opposition to a management proposal. For example, if a company is seeking shareholder approval to approve a merger, Rule 14a-8(i)(9) can be used to stop a shareholder from using Rule 14a-8 to include in the company's own proxy statement a proposal asking shareholders to vote against the merger. Another example of a permitted exclusion (unlikely to occur in practice) would be where a Chair/CEO separation proposal is submitted for consideration at the same meeting that the company seeks approval of bylaw provisions requiring the CEO to always be the Chair of the Board.

Rule 14a-8's other substantive bases for exclusion continue to be available. These include, among others, the company having already "substantially implemented" the shareholder proposal, the proposal being materially false and misleading (whether because of its vagueness, content or otherwise), or the proposal relating to personal grievances or special interests. With respect to excluding proposals that relate to "ordinary business operations," SLB14H confirmed that the SEC Staff will not change its own approach to interpreting that rule, notwithstanding the U.S. Court of Appeals for the Third Circuit's different analysis in *Trinity Wall Street v. Wal-Mart Stores, Inc.*

SLB14H is not binding, and companies retain the right to seek to invoke the rule as historically applied without obtaining a no-action letter from the SEC. However, proxy advisory firms and certain shareholders have indicated they will consider "withhold" votes from directors if a company omits a properly submitted shareholder proposal without obtaining: (i) the voluntary withdrawal of the proposal by the proponent; (ii) no-action relief from the SEC; or (iii) a federal court ruling confirming that the proposal has been properly excluded. In addition, shareholder proponents may themselves utilize litigation to challenge company attempts to rely on the historical form of the exclusion.

Accordingly, the 2016 proxy season is likely to look like 2015 did after the SEC suspended its Rule 14a-8(i)(9) guidance, with companies needing to:

- Anticipate which shareholder proposals they will receive (*e.g.*, proxy access; special meeting or written consent rights; executive compensation; Chair/CEO separation; ESG and political topics; etc.) and develop an early view with their advisors as to what their responses and options might be if they get one;
- Assess the nature of any proposal received, evaluate what is being asked and confirm that all of the technical and procedural requirements of Rule 14a-8 are met;
- Analyze the company's options, including: (i) negotiating a compromise or alternative outcome with the shareholder proponent; (ii) submitting the proposal to a shareholder vote, advising shareholders of the company's recommendation (which need not necessarily be a recommendation against the proposal) and soliciting accordingly; (iii) preemptively addressing the topic being raised by the proposal, whether through unilateral board action or other means; (iv) submitting a competing management-sponsored proposal (which could be binding *or*precatory) to a vote alongside the 14a-8 proposal and explaining the differences; and/or (v) attempting to exclude the proposal in reliance on SEC rules;
- When opposing a proposal, prepare for more aggressive and organized solicitation campaigns by proponents, featuring exempt solicitations; letters to the board, management and fellow shareholders; use of the media; requests for non-public interim vote tallies; and heightened scrutiny of the details of company counter-proposals (if any) and of the tone and content of a company's opposition statement; and
- Prioritize early and deliberate shareholder engagement by management and, when appropriate, directors, effective advocacy with proxy advisory firms and tailored investor outreach.

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

Leo E. Strine, Jr.

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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-

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

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

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

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

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

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

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

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

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

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

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

120. Id. § 271.

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

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

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

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

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

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

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

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

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

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

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

BlackRock CEO's Annual Letter Asks Companies to Address Impact of Changes in Global Environment

Posted by Cydney S. Posner, Cooley LLP, on Tuesday, February 14, 2017

Editor's note: Cydney S. Posner is special counsel at Cooley LLP. This post is based on a Cooley publication.

This year, in his annual letter to corporate CEOs, Laurence D. Fink, CEO of asset manager BlackRock, challenges companies to address the impact of significant political, economic, societal and technological changes on their current strategies for long-term value creation: "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?"

What are these changes? To Fink, dramatic changes—such as Brexit, global upheaval and the new administration in the U.S.—could affect assumptions underlying many companies' long-term strategic plans, such as plans for continued international expansion. At "the root of many of these changes," he contends, is the "growing backlash against the impact globalization and technological change are having on many workers and communities." Although he continues to believe that, on balance, globalization provides benefits, "there is little doubt that globalization's benefits have been shared unequally, disproportionately benefitting more highly skilled workers, especially those in urban areas." In addition, technology, while creating new jobs for highly skilled employees, is eliminating millions of jobs for other workers, many of whom face "retirement with inadequate savings, in part because the burden for retirement savings increasingly has shifted from employers to employees." The political and economic consequences of these dynamics, he asserts, "impact virtually every global company."

But what is the responsibility of companies in this context? It's particularly interesting to view this year's letter through the prism of the debate about the purpose of corporations—whether the "social responsibility of business is to increase its profits," as suggested by the "shareholder preeminence theory," or whether corporations have a broader spectrum of interests that includes employees, community and society at large. (See this Cooley News Brief.) Notwithstanding BlackRock's status as a major long-term shareholder, or perhaps because of it, Fink's letter suggests that he views the corporation in a larger context with obligations, albeit perhaps not of the fiduciary variety, to a broader group of constituencies.

For example, larger companies, Fink urges, must "fulfill their responsibilities to their employees" by improving internal training and education so that employees can leap over the "skills gap" and increase their earnings potential, "helping the employee who once operated a machine learn to program it." In addition, he encourages companies to addressing the "retirement crisis":

“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” and assist employees in building their financial literacy and learning how to prepare for retirement.

SideBar: See this article in the *NYT*, which discusses efforts by employers, faced “with a skills gap” in the local workforce, to “increasingly [work] with community colleges to provide students with both the academic education needed to succeed in today’s work force and the specific hands-on skills to get a job in their companies.” A study by Ball State University cited in the article found that “nearly nine in 10 jobs that disappeared since 2000 were lost to automation in the decades-long march to an information-driven economy, not to workers in other countries. Even if those jobs returned, a high school diploma is simply no longer good enough to fill them. Yet rarely discussed in the political debate over lost jobs are the academic skills needed for today’s factory-floor positions, and the pathways through education that lead to them.” However, it appears that, in the last decade, investment in worker training actually declined. One academic study using survey data documented a 27.7% reduction in the incidence of employer-provided training from 2001 to 2009, described by the study’s author as a “‘significant disinvestment in the nation’s human capital.’ [The author] further discovered that the largest decline in employer-provided training took place prior to the Great Recession.” (See this PubCo post.)

Companies also need to be responsible members of their communities, Fink maintains, considering ESG factors such as “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.” Moreover, from a shareholder’s perspective, ESG factors “can provide essential insights into management effectiveness and thus a company’s long-term prospects.”

An established foe of short-termism, Fink also takes aim at many of its indicia, such as the “furious pace” of stock buybacks: “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.”

In that context, Fink stresses the importance of investing for the long term—in research and development, technology and, “critically, employee development.” He also advocates changes in tax policy that would encourage a long-term view, such as extending the holding period for long-term capital gains treatment to three years, with a declining rate for each year thereafter. And, if tax policy is changed to favor repatriation of cash from overseas, Fink cautions, “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?”

SideBar: Much attention has been paid to the decline in spending on R&D and capital investments attributed to short-termist myopia. Hedge fund activists have been impugned for pressuring companies to return capital to shareholders in the form of buybacks and dividends at the expense of funding R&D and plant and equipment, thus curtailing innovation and long-term value creation to the detriment of shareholders and the U.S. economy. As reported in this post from Professor John Coffee, a recent study that looked at campaigns launched by activist hedge funds found "that even those targets that escape a takeover still are forced to curtail their R&D expenditures by more than half over the next four years." (See this PubCo post and this PubCo post.) Although there are a number of factors that may have contributed to the decline in investment in employee development, one potential factor identified in this report from the Center for American Progress "is the growing pressure within boardrooms and among CEOs to generate short-term profits. Increasingly, the pressure for short-term earnings forces business leaders to forgo long-term investments in order to provide dividends and stock buybacks." And, unlike R&D, which is at least reflected separately in the financials as a valuable investment, the argument goes, spending on human capital is just reflected as "an increase in general overhead, a measure that managers have shown a proclivity for cutting and whose reduction is often cheered by investors." However, investment in human capital, the report argues, can pay off in enhanced productivity. For example, a 2010 economic study of data from Belgian firms showed that "training increased the productivity of an individual worker at a rate nearly twice that of the corresponding increase in wages. Another study used British panel data to analyze the effects of training on productivity at the industry level and found that a 1 percent increase in the share of trained workers is associated with a 0.6 percent increase in industry productivity and a 0.3 percent increase in hourly wages." (See this PubCo post.)

Ultimately, Fink contends, "it is imperative that companies understand these changes and adapt their strategies as necessary" on a continuing basis, cautioning that BlackRock "will be looking to see how [each company's] strategic framework reflects and recognizes the impact of the past year's changes in the global environment." Companies working on their annual reports or other communications may want to take the hint: in discussing their strategies for long-term value creation, companies may want to consider whether these recent changes in the global environment could have a strategic impact and, if so, how they might pivot to address it.

2016 Proxy Mid-Season Review

Posted by Heidi Welsh, Sustainable Investments Institute, on Friday, September 9, 2016

Editor's note: Heidi Welsh is Executive Director at the Sustainable Investments Institute (Si2). This post is based on a Si2 report.

The total number of environmental and social policy shareholder resolutions filed in 2016 dropped to 431, down from 465 in 2015. But 239 went to votes, more than ever before, and the final tally included nine majority votes (including two not opposed by management). However, the number of withdrawn proposals dropped to the lowest level of the decade, suggesting that proponents and companies are simply not agreeing as much as in the past. Combined with the high votes, this seems to set the stage for more confrontation about the hard questions of sustainability and corporate responsibility in the coming year, as investors and companies prepare for the 2017 proxy season.

Average overall support was 20.9 percent (for resolutions opposed by management), compared with 20.3 percent last year. Notably, the proportion of resolutions withdrawn fell to its lowest level of the last 10 years—just one-third, and the proportion omitted because they failed to meet SEC standards for inclusion in proxy statements fell back to 10 percent again, another historic low matched only by the outcome in 2014.

Figure 1

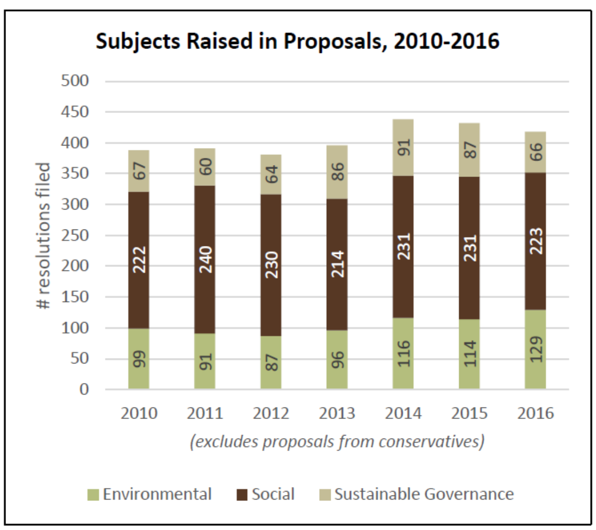


Figure 2

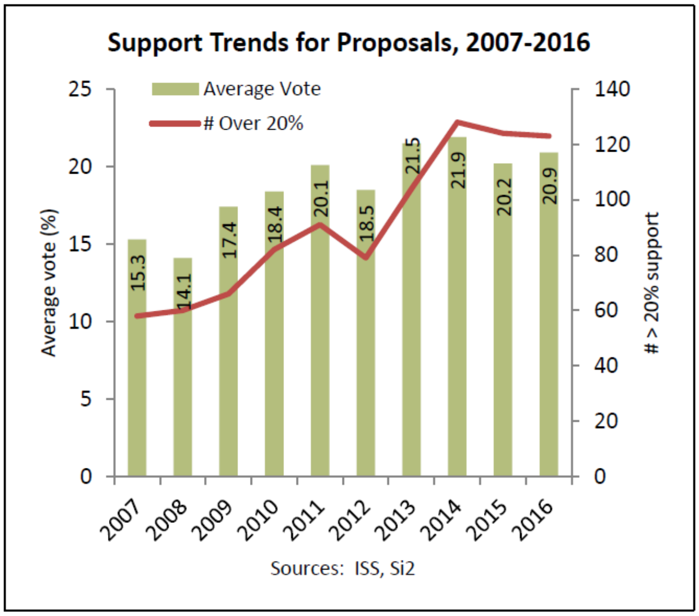
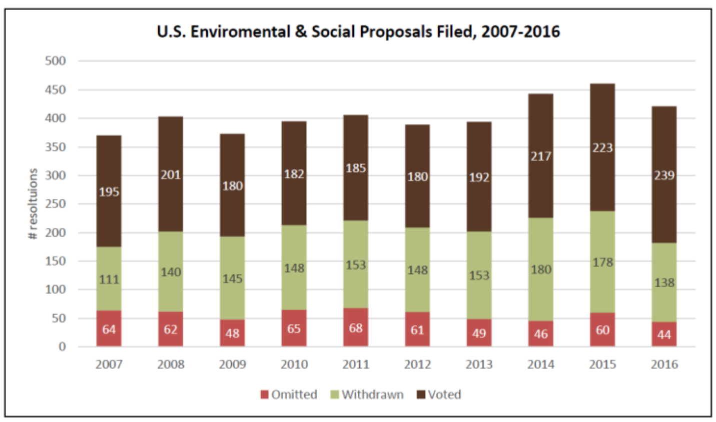


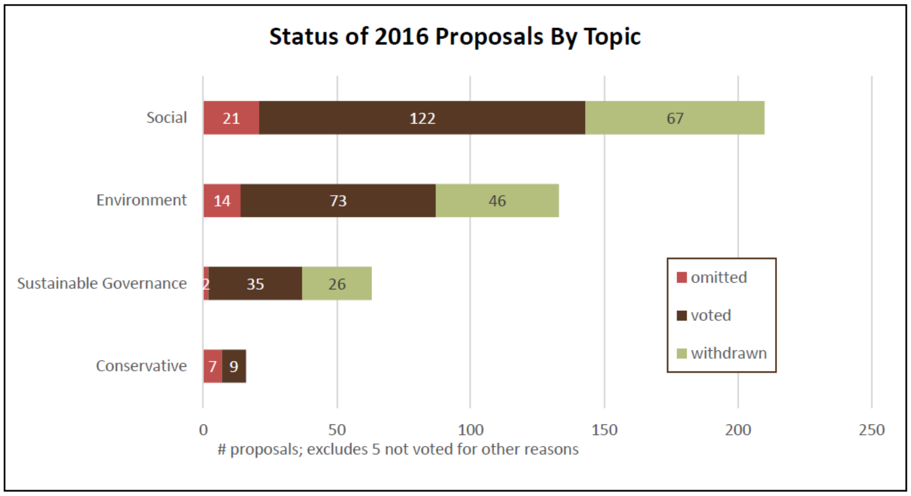
Figure 3



The majority votes ran the gamut from the more expected—for political spending transparency (61.9 percent at Fluor and 50.3 percent at NiSource), LGBT rights (54.7 percent at J.B. Hunt Transport) and board diversity (72.4 percent at FleetCor Technologies and 52.4 percent at Joy Global)—to the unprecedented. Extraordinary results were the 60.8 percent vote for sustainability reporting at Clarcor, 51.2 percent for reporting on gender pay disparity at eBay and 50.8 percent for more transparency about methane emissions and targets at WPX Energy. Additional high votes were near majorities for more election spending reporting at NRG Energy (49.4 percent) and a climate change reporting request at Occidental Petroleum (49 percent). The latter was the highest vote ever on an environmental proposal at a leading energy company.

Proponents measure success not just by vote tallies, but also by negotiated withdrawals. Yet the number of withdrawals continued the drop begun last year, both in volume (138, down from 178 in 2015), but also as a proportion of those filed—32 percent, down from about 40 percent the two previous years. *(See Figure 1)* In 2016, proposals about sustainability were most likely to be withdrawn (41 percent of filings), while those on social issues and environmental matters less likely to be withdrawn (32 percent and 35 percent, respectively). No known proposals from conservatives were withdrawn, but there may have been some on resolutions that were not made public. *(See Figure 4 for final status of proposals by topic areas.)*

Figure 4



High scoring proposals: In addition to the majority votes, another 19 earned between 40 percent and 49 percent. More of the top-scorers related to the environment and sustainability (14) than any other categories, but eight concerned political activity and four were about diversity. A commendation about an animal welfare policy supported by management also earned top marks. *(See table below.)*

2016 Resolutions With More than 40 Percent Support			
Company	**Proposal**	**Proponent**	**Vote (%)**
Kellogg	Commend animal welfare policy	HSUS	98.2*
FleetCor Technologies	Report on board diversity	NYSCRF	72.4**
Fluor	Review/report on political spending	Phila. PERS	61.9
Clarcor	Publish sustainability report	Walden Asset Mgt.	60.8
J.B. Hunt Transport	Adopt sexual orientation/gender ID policy	Trillium Asset Mgt.	54.7

Joy Global	Adopt board diversity policy	Amalgamated Bank	52.4
eBay	Report on female pay disparity	Arjuna Capital	51.2
WPX Energy	Report on methane emissions & targets	CalSTRS	50.8
NiSource	Review/report on political spending	NYSCRF	50.3
NRG Energy	Report on political spending and lobbying	NYC pension funds	49.4
Occidental Petroleum	Report on climate change	Wespath Investments	49.0
Gulfport Energy	Report on methane emissions & targets	CalSTRS	47.6
Emerson Electric	Publish sustainability report	Mercy Investments	47.3
Travelers	Report on lobbying	FAFN	43.9
Chipotle Mexican Grill	Publish sustainability report	Domini Social Investments	43.5
Esco Technologies	Publish sustainability report	Walden Asset Mgt.	43.5
Range Resources	Review/report on political spending	Nathan Cummings Fndn	43.3
Fluor	Adopt GHG reduction targets	NYSCRF	42.9
NextEra Energy	Review/report on political spending	NYSCRF	42.8
PPL Corporation	Report on distributed energy	NYSCRF	42.6
AES	Report on climate change	Mercy Investments	42.2
Anadarko Petroleum	Report on stranded assets business risks	As You Sow	42.0
Western Union	Review/report on political spending	NYSCRF	41.7
HD Supply Holdings	Adopt GHG reduction targets	Calvert Investments	41.5
Chevron	Report on climate change strategy	Wespath Investments	40.8

PNM Resources	Publish sustainability report	Walden Asset Mgt.	40.6
Wyndham Worldwide	Review/report on political spending	Mercy Investments	40.1
*Supported by management **Not opposed by management *All votes figured as a percentage of shares cast in favor divided by those cast for and against; company voting calculations may vary based on their individual voting requirements for passage.*			

2016 Highlights and Synopsis

This section provides a brief synopsis of the topics raised in proxy season, highlighting new issues, continued big campaign and significant results. Six more resolutions remain pending *(see table,* below*)*.

Environment

This post discusses environmental issues in the categories of climate change, environmental management (mostly recycling), toxics and industrial agriculture (including but not limited to animal welfare). A separate section on sustainable governance covers proposals that encompass elements of environmental issues as well as social impacts and related corporate governance.

Climate change and energy: More proposals than ever before addressed climate change—107 compared with 82 in 2015. Forty queried energy extractors and suppliers about how changing global temperatures will affect their operations and how they will respond to changes in government policies that aim to moderate these changes; the core question is how fast—or even *if*—legislative change will occur to implement the climate treaty signed in Paris last December.

Keeping track of carbon emissions—including those from methane releases associated with the U.S. gas boom—prompted 32 proposals, while 25 at utilities and retailers concerned renewable energy and new electricity generation business models. Ten more raised a range of old and new issues on the climate, including new angles on energy reserves accounting and ties to executive pay. Proponents this year were heavily focused on relatively near-term options that can change the U.S. energy mix, addressing energy demand as well as production.

Risk—Some of the climate risk votes were unprecedented. Most prominent were high votes on requests for assessments of the long term effects of new government climate policies, including a 49 percent vote at Occidental Petroleum (the highest-ever climate change vote), 41 percent at Chevron and 38 percent ExxonMobil (the highest votes to date at these companies). In what may be an important development, proponents withdrew when ConocoPhillips promised to provide more information in its sustainability report this year about carbon asset risk scenario planning. Among utilities, the highest vote was about planning to keep global warming to less than 2 degrees Celsius, with 42.2 percent at AES, which generates about 86 percent of its electricity from coal-fired plants. Key withdrawals occurred when American Electric Power and Great Plains Energy both said they would explain more about their plans for change, as aging coal plants are phasing out and the question is how much focus will be on renewable generation and how much energy will be provided by highly efficient natural gas plants that nonetheless emit carbon. Other votes at utilities were between 20 percent to 30 percent.

Accounting—For carbon accounting, with a few exceptions, votes were in the 30 percent to 40 percent range—showing a growing number of investors agree that keeping track of emissions so they can be more tightly managed is a good idea. The highest votes were 43 percent at engineering and construction company Fluor and 42 percent at industrial distributor HD Supply Holdings. Resolutions that broadly asked for emissions accounting got more support than those that requested accounting be extended to company products (at Chevron and Marathon Petroleum resolutions in the latter category got only 8 percent and 15 percent, respectively). A new proposal also asked retailers and industrial firm Deere how they might achieve net-zero greenhouse gas emissions but the two votes were only 7 percent. With regard to methane emissions management and goals setting, the votes were consistently higher and included a majority of 50.8 percent for a proposal at WPX Energy, an oil and gas exploration and services company, from the California State Teachers Retirement System (CalSTRS), a key player on this issue. Another of its proposals, at Gulfport Energy (another exploration firm), also got a near-majority of 47.6 percent. There was a single low vote of just 5.6 percent at Continental Resources, but insiders control nearly 80 percent of its stock. In a development to note, the SEC agreed that a methane report proposal at Dominion Resources was moot given current company reporting, showing proponents must carefully target their resolutions.

<table>
<tr><th colspan="4">Proposals Pending for Late 2016 Votes</th></tr>
<tr><th>Company</th><th>Proposal</th><th>Proponent</th><th>Meeting Date</th></tr>
<tr><td>Cisco Systems</td><td>Disclose workforce breakdown in Israel-Palestine</td><td>Holy Land Principles</td><td rowspan="4">(11/18/15) Sept. 28</td></tr>
<tr><td rowspan="3">FedEx</td><td>Implement Holy Land Principles</td><td>Holy Land Principles</td></tr>
<tr><td>Report on anti-gay law impacts</td><td>NorthStar Asset Mgt.</td></tr>
<tr><td>Report on lobbying</td><td>Green Century</td></tr>
<tr><td>NIKE</td><td>Review/report on political spending</td><td>Investor Voice</td><td>Sept. 22</td></tr>
<tr><td>Procter & Gamble</td><td>Report on anti-gay law impacts</td><td>NorthStar Asset Mgt.</td><td>(10/23/15)</td></tr>
</table>

Renewables—A key focus of the campaigns on renewable energy was on users of energy, as noted. Six retail, health and tech companies reached agreements with proponents, while the four votes on setting renewable energy use targets or reporting on them ranged from a low of 8 percent at PepsiCo to a high of 28 percent at Kroger. In an expanded set of resolutions about distributed energy at utilities, votes were consistently much higher than that, reaching at their apex 42.6 percent at PPL and 37 percent at Entergy. Ceres coalition members working with the Investor Network on Climate Risk plan to continue pushing utilities to increase non-carbon-emitting energy production going forward.

Other climate issues—This year other climate resolutions included several new angles**,** but did not get much affirmation from investors. These included those about calculating energy reserves in BTUs and altering executive bonuses tied to fossil fuel reserve accounting changes; resubmitted proposals addressed boosting dividends given purportedly stranded carbon assets and reporting on the lack of support for climate change shareholder resolutions at mutual funds. None of the eight votes on these issues was above 9 percent and most were lower.

Environmental management: A baker's dozen of environmental management resolutions included familiar requests for more recycling, where the highest vote was on beverage container recycling at Dr Pepper Snapple Group of 37.8 percent. Otherwise, there was a low vote about nuclear plant permits at Dominion Resources of 4.3 percent. Three companies—Chipotle Mexican Grill, Dunkin' Brands Group and Yum! Brands—agreed to cut their waste streams by encouraging on-site recycling of their food and drink packaging so As You Sow withdrew its proposals.

Toxics: Investors and the SEC have yet to warm up to proposals about nanomaterials in food products and gave a resolution about Good and Plenty candy at Hershey only 3.8 percent. But As You Sow did get J.M. Smucker to evaluate its use of nano-titanium dioxide and report—so withdrew. Other resolutions about PCBs in the Hudson River and BPA in packaging were omitted, though.

Industrial agriculture: The highest votes on industrial agriculture issues were 27.4 percent for water management at Sanderson Farms and 26.3 percent on antibiotics in the meat animal supply chain, at McDonald's. Others dealt with genetically modified food, neonicotinoid pesticide use in the supply chain and animal welfare, but little stood out other than further examination by food companies about limiting antibiotic use.

Social Issues

Animals in entertainment: People for the Ethical Treatment of Animals (PETA) focused on orca breeding at SeaWorld Entertainment, and withdrew when it announced an end to this program, but another vote about promoting the use of animals in entertainment at online promoter Groupon earned almost no support (0.4 percent). Still, a resolution about how the Zika virus might spread via research monkeys housed outdoors in Texas, at Laboratory Corporation of America, provided food for thought and earned 5.3 percent. (The company says no such risk exists.)

Corporate political activity: About one-quarter of all social and environmental resolutions were on corporate political activity and more than half (65 proposals) related in some fashion to lobbying, while another 38 were on election spending. The number of resolutions fell this year to 105, down from a high of about 140 in 2014, but an increasing number of companies have adopted more robust oversight and disclosure. The critical sticking point stopping more accords between critics and companies is whether firms should be fully transparent about their contributions to intermediary groups like trade associations that spend on both elections and lobbying. New this year were about half a dozen resolutions about the revolving door between industry and government, from the AFL-CIO, but key coordinators remain the Center for Political Accountability (elections) and AFSCME, with Walden Asset Management (lobbying).

Lobbying—The highest votes were 49.4 percent for a resolution about both election and lobbying spending at NRG Energy, alongside 43.9 percent at Travelers for a lobbying-only disclosure proposal. Most votes were above 20 percent, with an average for the main lobbying resolution of about 24 percent. Seven companies reached agreements with proponents about more disclosure. The highest vote for the new revolving door resolution was 30.5 percent at Citigroup and Bank of America prompted a withdrawal on this issue when it said anyone who leaves to work for the government forfeits accelerated vesting of equity awards—the issue at stake in these resolutions.

Elections—There were two majority votes for the Center for Political Accountability's resolutions—now more than a decade old—on oversight and disclosure of election spending: 61.9 percent at Fluor and 50.3 percent at NiSource. Five others earned more than 40 percent, at McKesson, NextEra Energy, Range Resources, Western Union and Wyndham Worldwide. For 14 of the 15 resolution withdrawals, companies and proponents reached agreements. The average CPA proposal earned 33 percent, a new high water mark.

Decent work: Popular concern about the high economic and social costs of economic inequality drove a slew of new proposals about gender pay equity, income inequality and workplace safety this proxy season. A third of the 30 proposals went to votes, a third were withdrawn after agreements and a third were omitted after SEC challenges.

Wages—A new resolution to a dozen low-wage sector companies about adopting principles for minimum wage reform fell to SEC challenges. On the more positive side, six of the tech companies that Arjuna Capital asked to boost the number of women and minorities who work for them agreed to do so. In a surprise development, one of these that did go to a vote earned a majority, at eBay (51.2 percent).

Safety—Workplace safety was at issue at both chicken processors and industrial firms, and earned the most at Du Pont (30 percent) and Sanderson Farms (24.9 percent, where an Oxfam report in October 2015 described problematic conditions for low-paid workers, mostly in the American South).

Diversity in the workplace: Resolutions seeking protections for lesbian, gay, bisexual and transgender (LGBT) employees continued to decline in number given recent legal affirmation of these rights and all but one were withdrawn after companies agreed to act. The one vote was a majority—54.7 percent at J.B. Hunt Transport, which since has agreed to put the requested policy in place. A new resolution that seeks company reporting on the impact of anti-gay laws may go to votes at FedEx and Procter & Gamble this fall, however; in August, the SEC rejected P&G's contention it was too vague and dealt with ordinary business. Further scrutiny of LGBT protections up and down the value chain may be in the offing, as well, as reflected in a resolution that NorthStar Asset Management filed but then withdrew on this subject at Stryker.

Other equality proposals were on EEO disclosure and they earned in the mid- to high 20 percent range at American Express, Charles Schwab and Omnicom Group and were withdrawn after disclosure agreements at three more firms.

Health: The deadly national opioid epidemic partly inspired a novel new resolution from As You Sow at three drug companies (AbbVie, Johnson & Johnson and Merck), but it earned 7.5 percent or less. It sought to apply the principles of recycling to prescription drug take-backs, arguing this also could reduce environmental hazards associated with improper drug disposal in the consumer waste stream. None of three resolutions about tobacco advertising and childhood obesity went to a vote but there were two votes on tobacco policy, with the highest 8.2 percent at Philip Morris International on a proposal questioning the company's efforts internationally to weaken tobacco control legislation.

Human rights: The most notable feature for human rights proposals in 2016 was the growing emphasis on the conflict between Palestinians and Israel. This accounted for 15 of the 44 proposals in the human rights category, with new proposals about business ties to Israeli settlements and the complicated issues they raise. Eight more resolutions sought implementation of the Holy Land Principles for fair employment. All the Israel-Palestinian conflict proposals earned low marks from investors, getting at the apex 8.6 percent for a Holy Land Principles fair employment resolution at United Parcel Service, and there were no publicly disclosed agreements.

The AFL-CIO went to tobacco and food companies to persuade them to use an international human rights mediation mechanism set up by the Organization for Economic Cooperation and Development; these earned only modest support at six companies, but PepsiCo said it would use the method and the union withdrew there. Proponents also withdrew four of six resolutions seeking human rights risk assessments called for by UN methodology and otherwise saw relatively high votes of about 25 percent at Amazon.com and Kroger. Four trucking companies and a casino company signed on to help stop human trafficking, prompting withdrawals in a success for members of the Interfaith Center on Corporate Responsibility and their continued campaign. The disparate slate of additional proposals included a handful about respecting indigenous rights, criminal justice and gun control and privacy, with notable votes of 21.5 percent at prison company GEO Group and 22 percent on government access to private information at American Express.

Sustainable Governance

Board diversity: The push for more women and minority board members continued from The 30 Percent Coalition, and 15 companies agreed to modify their governance procedures as requested. Two majority votes occurred: One was at FleetCor Technologies when the company did not make a recommendation on the proposal (72.4 percent) and the other at Joy Global (52.4 percent). At Apple, a new resolution from an individual called for greater diversity in upper management as well as on the board, but it earned only 5 percent after the company averred diversity was critical to the company's success.

Board oversight: Resolutions covered in this report for the most part all seek greater corporate board oversight of environmental and social issues, but those that focus only on the mechanism of oversight tend to get little support, as they did this year, earning 6 percent or less in three instances. Proposals that sought environmental experts to be nominated as board members were more successful, with votes of 19 percent at Chevron and Dominion Resources and 21 percent at ExxonMobil.

The Board Room Accountability Project led by New York City Comptroller Scott Stringer, begun last year, gets to the heart of investor concerns about board oversight. It seeks the right for groups holding large stakes in companies to nominate directors on corporate-issued proxy statements—"proxy access." The comptroller targeted companies with low levels of board diversity, high carbon intensity and low investor support for executive pay packages and filed resolutions at 75 companies in 2015 and 72 in 2016. As of June 2016, 230 companies have enacted what the comptroller's office calls "meaningful proxy access," a huge jump from only six at the start of the campaign in November 2014. Thirty-six of the proposals this year were resubmissions at companies that had yet to enact the requested reform, while 36 were new recipients. Full coverage of this issue is beyond the scope of this report but it will remain a matter of keen interest to many in the future, where for the first time in 2017 we may see large investor groups offer up their own board nominees on company proxy statements. Despite the rapid adoption of proxy access rights, not all is pacific: Reaction also includes a new set of principles this month from The Business Roundtable, the association of prominent CEOs, which asserts that investors should not use the shareholder proposal process to "pursue social or political agendas that are largely unrelated and/or immaterial to the company's business, even if permitted by the proxy rules."

Sustainability oversight and reporting: At the peak just three years ago in 2014, investors filed 54 resolutions asking companies to produce sustainability reports and/or link sustainability implementation to executive pay. The number fell to only 30 this year, with 18 asking for reports (down from 28 last year), and 12 seeking pay links. The pay links proposals included a new proposition that said falling oil prices and their impact on reserves accounting should be considered in executive pay calculations; it received 6.9 percent at ConocoPhillips and was withdrawn when Chevron said it already does this. Among others, a resolution at struggling Chipotle Mexican Grill earned the most, with 23.3 percent.

Conservatives

There were fewer proposals from political conservatives in 2016—16 instead of the 18 filed last year. The main actor, the National Center for Public Policy Research and its Free Enterprise Project, used a new human rights frame to question company operations in the Arab world, China and India, saying these were inconsistent with the values espoused by Apple and five other companies. It also used NorthStar Asset Management's political spending values congruency approach from earlier proxy seasons to question other companies' past support for climate change cap-and-trade and health care reform. Additional proposals from individuals sought to turn back LGBT rights protections. None of the votes was more than 4 percent.

Sustainability Practices: 2016 Edition

Posted by Matteo Tonello, The Conference Board, Inc., on Sunday, January 8, 2017

Editor's note: Matteo Tonello is Managing Director at The Conference Board, Inc. This post relates to *Sustainability Practices: 2016 Edition*, an annual benchmarking report authored by Thomas Singer of The Conference Board and the result of a partnership among The Conference Board, Bloomberg, and Global Reporting Initiative (GRI). For details regarding how to obtain a copy of the report or access the online benchmarking Dashboard that accompanies the report, contact matteo.tonello@conference-board.org

The Conference Board recently released the 2016 edition of *Sustainability Practices*, a comprehensive dataset and analysis capturing the most recent disclosure of environmental and social practices of business corporations. The study reviews a total of 75 environmental and social practices of publicly traded corporations included in the S&P Global 1200 index. For benchmarking purposes, data are historically compared with the S&P 500 and the Russell 1000, and further analyzed across 10 business sectors, four revenue groups, and four regions (encompassing North America, Latin America, Europe, and Asia-Pacific).

The following are some of the Key Findings from this year's edition:

Companies are shifting their focus to the materiality of sustainability reporting, and the average disclosure rate across a wide set of sustainability practices increased only slightly. Companies in the S&P Global 1200 had an average disclosure rate of 27 percent across the 75 practices covered, compared to 26 percent in last year's analysis. The increase in disclosure was slightly higher among social practices (e.g. labor standards, diversity, health & safety) than environmental practices (e.g. atmospheric emissions and climate change policies, energy and water consumption, waste and material use levels, etc.).

New regulatory interventions by stock exchanges and financial market authorities in Asia-Pacific countries have driven a 43 percent surge in sustainability disclosure for the region, a stark contrast with the flat reporting rate found across European and U.S. companies. While the change in disclosure is fairly negligible across North America, Europe, and Latin America, this year marked a significant increase in disclosure among companies in Asia-Pacific. Companies in this region had an overall disclosure rate of 33 percent, up from 23 percent last year. This represents the second-highest disclosure rate among the four regions and only 4 percentage points below the disclosure rate of companies in Europe. By comparison, companies in North America had an overall disclosure rate of 17 percent, slightly down from 19 percent last year. The surge in sustainability disclosure in Asia-Pacific is driven in large part by the emergence of regulations encouraging—and in some cases requiring—companies to disclose more nonfinancial information. The approval of CSR reporting requirements by the Taiwan Stock

Exchange and the introduction of Japan's Corporate Governance Code are examples of the reforms in question.

Despite a fivefold increase in the number of companies including sustainability performance metrics in executive compensation, disclosure on the specifics of these metrics remains vague in most instances. Unlike the disclosure rate of most other environmental and social practices, which remained substantially flat, the last year has shown a significant uptick in the number of companies including sustainability metrics as part of their executive compensation schemes. In fact, this particular practice saw an increase in disclosure across all indexes, sectors, revenue groups, and regions. Among the S&P Global 1200 sample, 16 percent of companies now report including sustainability metrics in their incentive plans. The biggest increases come from the energy and utilities sectors, and particularly from companies in Europe and North America. However, there are wide variations in the quality and breadth of such disclosure. In most cases, companies provide only vague statements on how they incentivize executives to pursue sustainability goals, without offering much supporting detail.

While sustainability disclosure rates among the largest companies declined this year, these rates continue to be, on average, 50 percent higher than those of small and medium-sized enterprises. With the exception of companies in the highest revenue group, average sustainability disclosure rates by revenue group changed only slightly compared to last year. Companies with revenues of $100 billion and over, however, saw average disclosure rates drop from 38 percent to 32 percent this year. The biggest decreases were in disclosure of water consumption, GHG emissions, and percentage of women in management positions. Still, the largest companies continue to register some of the highest overall disclosure rates. Across all 75 practices tracked by the study, the largest companies by revenue had an average disclosure rate of 32 percent. By comparison, companies in the lowest revenue group—under $1 billion— had an average disclosure rate of 21 percent.

Disclosure of business risks related to climate change remains low. Only 19 percent of S&P Global 1200 companies discuss these risks in their annual reports. Greater disclosure will be needed as governments begin preparing to meet the goals of the Paris Agreement, adopted at the 2015 United Nations conference on climate change. The agreement aims to strengthen the global response to the threat of climate change by limiting the rise in global temperature and to help countries mitigate the eventual impact of climate change. Investors are taking note: average shareholder support for resolutions asking U.S. companies to disclose climate change risks rose by 10 percentage points in 2016.

Median performance improved across several key environmental practices, including reductions in water consumption and GHG emissions. Among the S&P Global 1200, median water consumption dropped 26 percent from the previous year. There were also notable decreases in energy consumption (down 13 percent), GHG emissions (down 12 percent), and median levels of waste (down 6 percent). Median performance improved across these key environmental practices as companies manage increasingly scarce resources and adapt to a low-carbon future.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

Social Responsibility Resolutions

Posted by Scott Hirst, Harvard Law School, on Monday, October 31, 2016

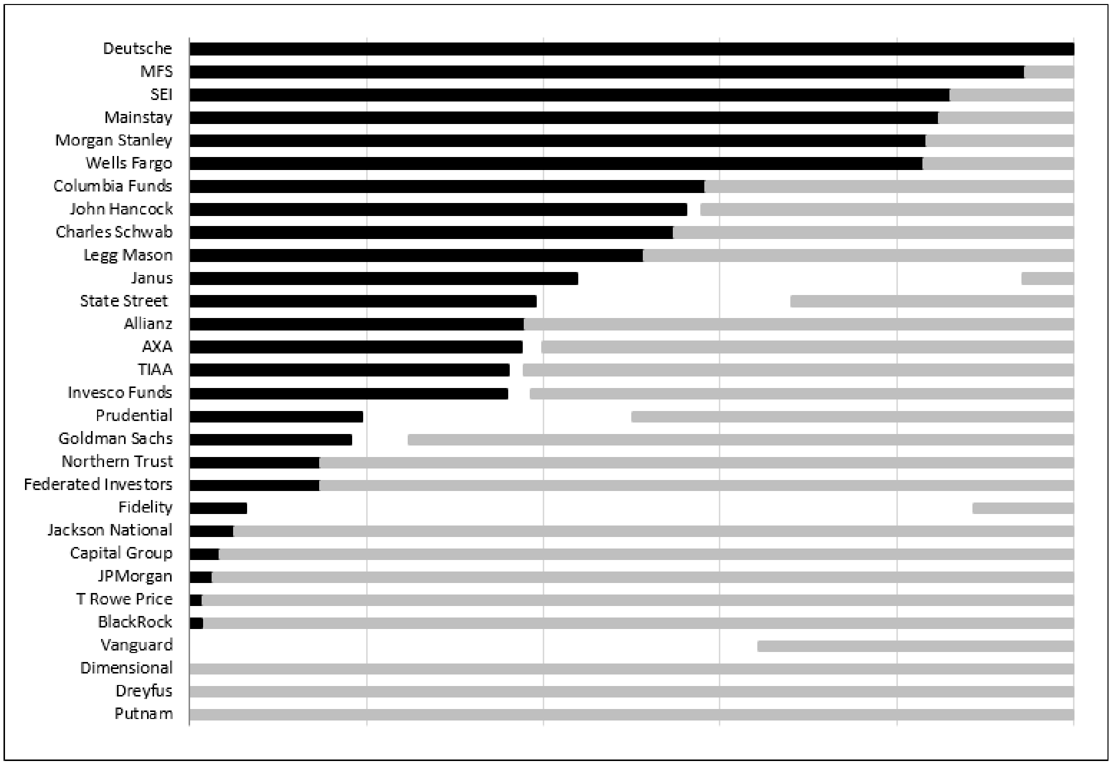
Editor's note: Scott Hirst is a Lecturer on Law at Harvard Law School and Associate Director of the Harvard Law School Program on Corporate Governance. This post is based on a recent article by Dr. Hirst, forthcoming in the *Journal of Corporation Law*.

Shareholders exert significant influence on the social and environmental behavior of U.S. corporations. Shareholders vote on social responsibility resolutions that are put forward at corporations; their success or failure influences the social and environmental behavior of those corporations. The largest shareholders are institutional investors—mutual funds, investment advisers and pension funds. When they vote on social responsibility resolutions, they do so as fiduciaries for their own investors. In a new article, Social Responsibility Resolutions, forthcoming in the *Journal of Corporation Law*, I consider two questions: Do the votes of institutions on social responsibility resolutions follow the *interests* of their own investors? And do the votes of institutions on social responsibility resolutions follow the *preferences* of their own investors? I put forward evidence that many may not, and consider whether this is a problem, and if so, how it could be addressed. The stakes are high: if institutional investors voted on social responsibility proposals as their own investors preferred, corporate behavior on social and environmental matters might be much closer to what investors, and society, would prefer.

The overwhelming majority of investors in corporations do so through fiduciaries—mutual funds, investment advisers and pension funds. Because these intermediaries make voting decisions on their investors' behalves, there is a possibility that the voting decisions may not reflect investors' interests, or their preferences. In examining this issue, I focus on voting by mutual funds, which hold the largest proportion of equity of U.S. corporations, and are the only type of institution for which voting data is widely available. The fiduciary duties of mutual fund directors and investment advisers are generally interpreted as requiring them to vote on resolutions at portfolio corporations, in the best interests of their investors. I focus on their voting on social responsibility resolutions, resolutions requesting that corporations take certain actions on social and environmental matters.

A consideration of the voting records of mutual funds suggests that some of their votes on social responsibility resolutions represent a distortion of either the interests or the preferences of their investors. The chart below presents data for votes by the largest 30 mutual fund families on political spending disclosure resolutions, in decreasing order of the percentage of fund-votes in favor (black denotes the proportion of fund-votes in favor, gray the proportion against, and white the proportion of fund-votes to abstain).

Largest Mutual Fund Family Voting on Resolutions regarding Political Spending Disclosure



Second, the way many of the funds in the chart above vote on political spending resolutions may differ from the views of a majority of their own investors. Two opinion polls considered in the essay suggest that the preferences of the funds' investors may differ significantly from how most funds vote on resolutions concerning political spending disclosure. And because funds vote "all-or-nothing" for, against or abstain, even where funds vote the way a majority of their investors are likely to prefer, there will be a divergence from the preferences of a minority of their investors.

This data suggests two conclusions. First, votes of different mutual funds on social responsibility resolutions diverge widely, even among mutual funds that are likely to have very similar investors with very similar interests. Deutsche Asset Management voted 100% of its fund-votes in favor of political spending resolutions. Yet Dreyfus, Putnam and Dimensional voted 100% of their fund-votes against such resolutions. If there was likely to be significant variation in the investors served by these different fund families—e.g., if some were "socially responsible investment" funds—the variation might be explained by the fund following the preferences of their investors. However, all of these are large, mainstream mutual funds. Given the size and number of investors in these funds, the comparability of their mutual fund offerings, and the robust competition in the mutual fund market, it is likely that there is a significant overlap between the types of investors these funds cover. Funds that vote in radically different ways cannot all be right about which outcome would maximize shareholder value. If there is a way to vote on these resolutions that reflects the best interests of these investors, some mutual funds appear to be voting wrongly on many resolutions.

Even if this is the case, does it matter that mutual fund votes may not follow the preferences of their investors? This is open to debate. If mutual funds can determine better than their own investors what is in the interests of those investors, then this distortion may be optimal. If corporations can determine for themselves the actions that will maximize value on the matters being considered, then the preferences of their investors may be irrelevant. However, if it is considered valuable for corporations to follow the wishes of their investors, then these distortions may represent a significant problem, as they result in corporations being less likely to act as their ultimate investors would prefer. Many resolutions requesting action on environmental and social matters may fail where investors would prefer that they pass. Corporations are less likely to take requested actions where resolutions fail. And proponents are less likely to bring resolutions at other corporations, or bring other kinds of resolutions, given that such resolutions attract less support than they otherwise would. Public officials that consider the results of resolutions as a proxy for investor preferences on these matters will receive distorted information, and may be less likely to take action themselves.

I do not attempt to offer a conclusion regarding whether distortion constitutes a problem, or even whether it is taking place. However, in the event that distortion is taking place and is considered a problem, I consider the alternatives for resolving the problem. One possible solution is for investors to choose mutual funds that vote in the ways that they prefer. This already takes place to limited extent when investors invest in socially responsible investment funds. However, those funds represent a small percentage of aggregate funds invested, and there are significant impediments to widespread sorting among mutual funds, including very limited investor access to the information necessary to make such decisions. The alternative is for mutual funds to consider the preferences of their investors when determining voting policies and decisions. In order to represent investors with preferences representing a minority of investment in the fund as well as those representing a majority, mutual funds could adopt policies whereby they would split their vote in proportions consistent with the preferences of their investors. Vote splitting is currently rare, but as a practical matter it is likely to be relatively straightforward for these well-resourced institutions.

The next step in this debate should be for further consideration of the preferences of investors. The data I use to draw conclusions about investor preferences is limited and imperfect; the investment industry—with the encouragement of the Securities and Exchange Commission—should undertake their own analysis to determine whether their voting differs from how their investors would prefer, and whether this represents a problem.

The full article is available for download here.

Tab VI: Arrangements Governing the Allocation of Authority

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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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 Kalb is a Senior Associate and Rob Yates is Vice President 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.

2016 ISS Study on Controlled Companies

Institutional Shareholder Services, Inc., [excerpt, pp. 4-14]
March 2016

Controlled Companies in the Standard & Poor's 1500

A Follow-up Review of Performance & Risk

By: Edward Kamonjoh

March 2016

Executive Summary

All controlled companies are not created equal. At some companies, founders and their families, or other large investors simply own large blocks of their companies' sole class of voting stock. At these firms, voting power remains directly proportionate to the investor's at-risk capital. More often, controlling shareholders use multi-class capital structures to concentrate voting power without commensurate capital commitments or risk of loss. Supporters of these multi-class structures argue that control of a firm's voting power enables management teams to minimize the impact of short-term market pressure, so as to focus on long-term business prospects. They promise higher returns over time in exchange for public shareholders' loss of control.

Should questionable practices arise at controlled companies, the two main protections available to shareholders are caveat emptor and the so-called Wall Street Rule—sell your shares if you do not like the way the company is managed. Unlike many global markets, the U.S. — at the state, stock market and federal levels—provides limited protection to minority shareholders. The major U.S. stock exchanges, for example, relax their basic governance listing requirements for "controlled companies." As a result, governance provisions which provide safeguards for external shareholders, such as a majority of independent directors on their boards or independent nominating panels do not apply to controlled companies. At least partially as a result of this reduced level of accountability to external company shareholders, controlled companies attract disproportionate attention when questionable practices arise.

Some controlled companies function as benevolent dictatorships. The controlling investors' high degree of alignment with other shareholders drives value creation, while control allows for innovation and speedy decision-making. Some regard Berkshire Hathaway through this lens. Boards at a number of these firms comply with their listing stock market's independence rules despite legally being exempt from these requirements.

At other controlled firms, however, the adage about the corrupting qualities of absolute power rings true. At these companies, self-dealing, poor strategic planning, and other risky behaviors destroy value.

While it is convenient to assign white or black hats to controlled companies, such a view is overly simplistic. In practice, controlled companies generally exhibit both the same types of behaviors—good and bad—as other public firms. When poor practices arise at controlled companies, however, basic oversight mechanisms (such as proxy contests and unsolicited offers) often prove ineffective and meaningful changes in corporate culture are difficult to achieve. As a result, the media narrative for these controlled firms lurches back-and-forth between behavioral extremes like a corporate version of the fictional Dr. Jekyll and Mr. Hyde.

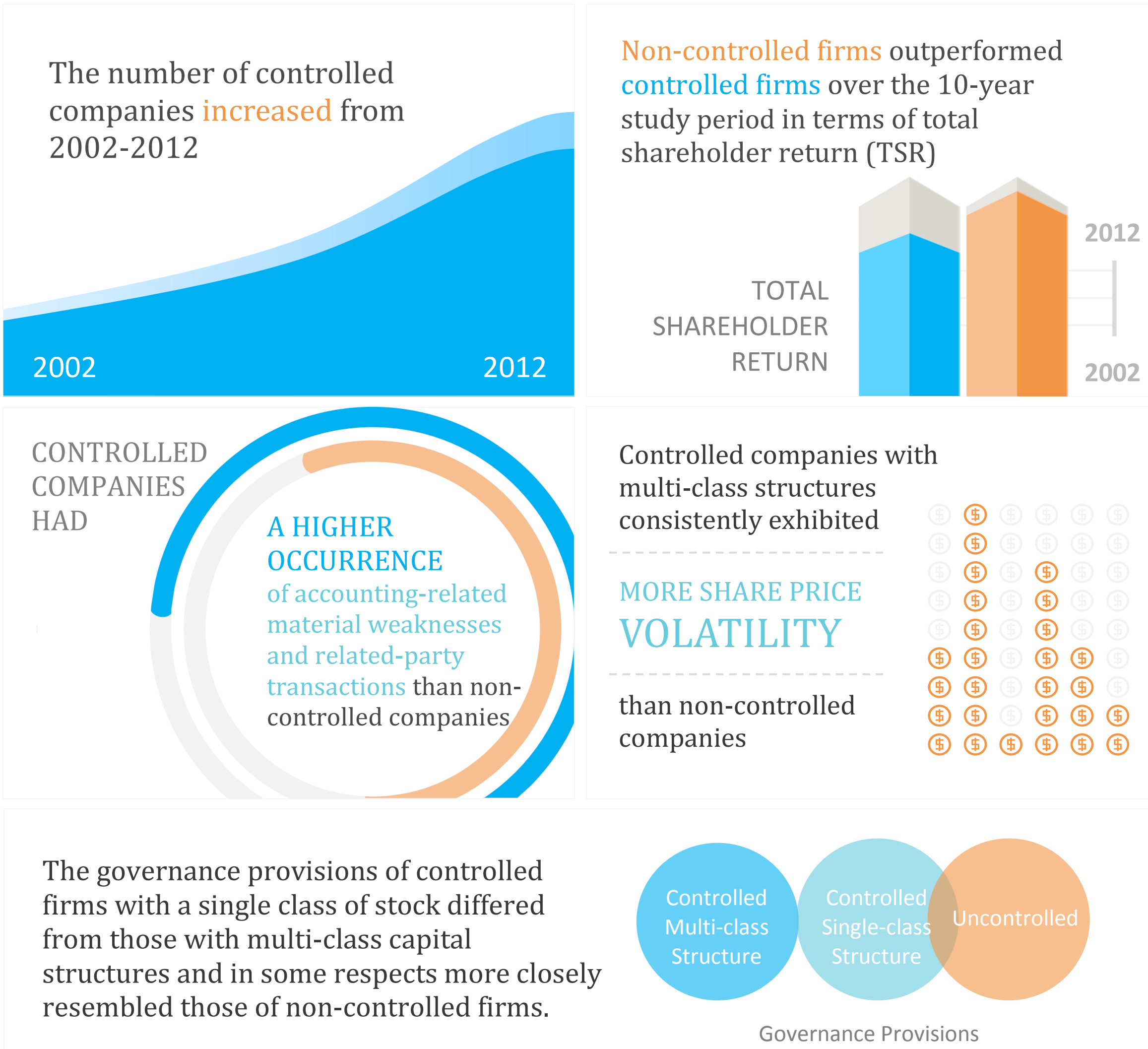
> While it is convenient to assign white or black hats to controlled companies, such a view is overly simplistic.

The issue of corporate control structures received renewed attention in the wake of the initial public offering of Google (now renamed Alphabet) in 2004. Citing Berkshire Hathaway as their role model, Google's founding duo issued a "founder's" letter, an owner's manual of sorts for shareholders, modelled after Warren Buffett's letter to Berkshire's investors, which justified a controlling dual-class stock structure.

A corporate conga line of social media and internet concerns—including LinkedIn Corp., Zynga Inc., Groupon Inc., and Facebook Inc.—soon followed in lockstep.

In response to this wave of multi-class stock issuances, ISS conducted an analysis of Controlled Companies for the IRRC Institute (IRRCi) in 2012. This predecessor report focused on the long-term performance and risk profiles of controlled companies in the S&P 1500 universe.

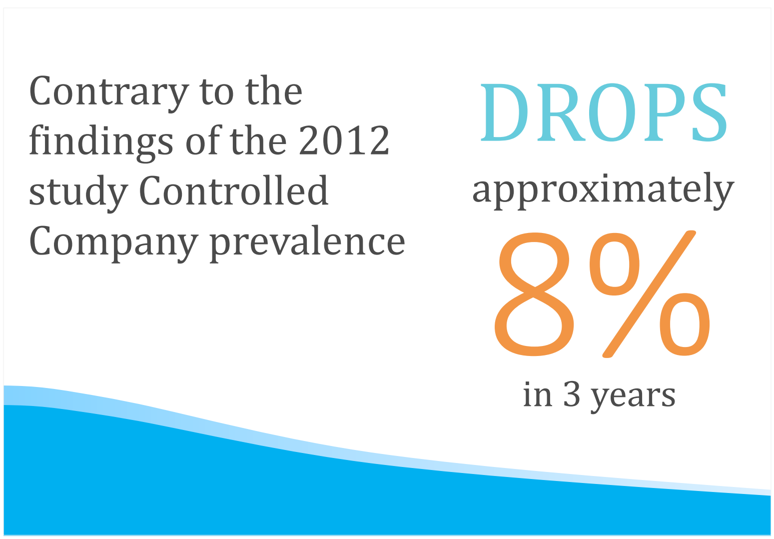
Key findings of the original 2012 study included:



The issue of dual-class controlled corporations continues to be topical. Alibaba made global headlines in the fall of 2013 when it shopped for a stock market that would allow it to adopt a controlled company structure. Hong Kong refused to lift its restrictions on dual-class capital structures, so company founder Jack Ma opted to list on the New York Stock Exchange (NYSE), which had long ago declined to support a mandatory one-share, one-vote standard. T. Rowe Price, a prominent investment manager with over $700 billion in assets under management, recently signaled plans to vote against board chairs (or lead independent directors) and members of the Nominating and Governance Committees at U.S. firms controlled by way of multi-class stock with unequal voting rights following concerns around the proliferation of IPOs with dual-class capital structures. A recent study by law firm Morrison Foerster of 580 "emerging growth companies" that had their IPOs between Jan. 1, 2013 and Dec. 31, 2015 found that 99 (17 percent) qualified as "controlled" and 87 (15 percent) had multiple classes of stock at the time of their public offerings. ISS' examination of recent IPO activity found that IPOs of companies with multiple classes of voting stock has increased in absolute numbers but declined in percentage terms over the study period and that the size of these offerings has soared and, as such, investors' market exposure to their potential risks appears to be rising.

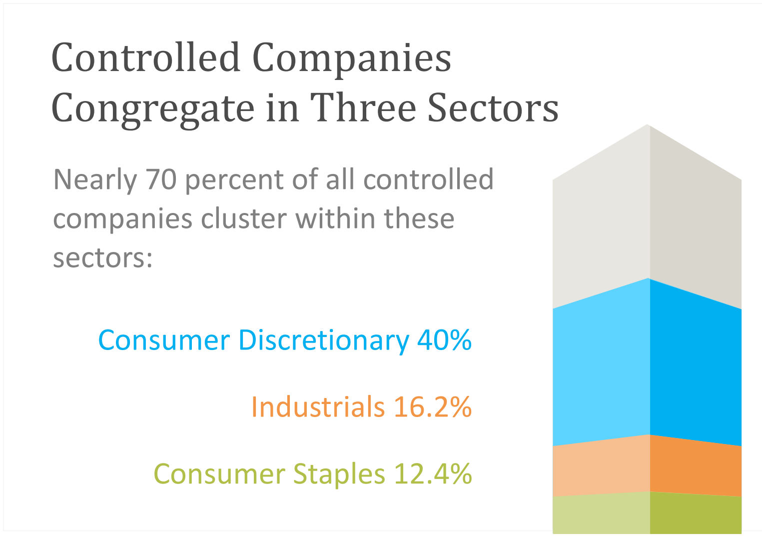
This new report and expands the scope of the original study (2012) to include additional comparative dimensions around controlled companies in the S&P 1500 index.

The key findings of this sequel study (2016) include:



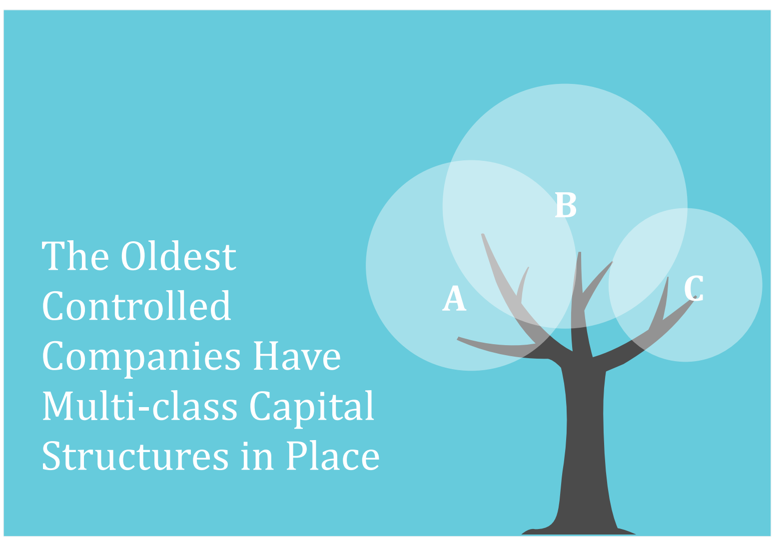
Controlled Company Prevalence Drops

Contrary to the findings of the 2012 study, the number of controlled firms in the S&P 1500 fell by approximately 8 percent from 2012 to 2015.



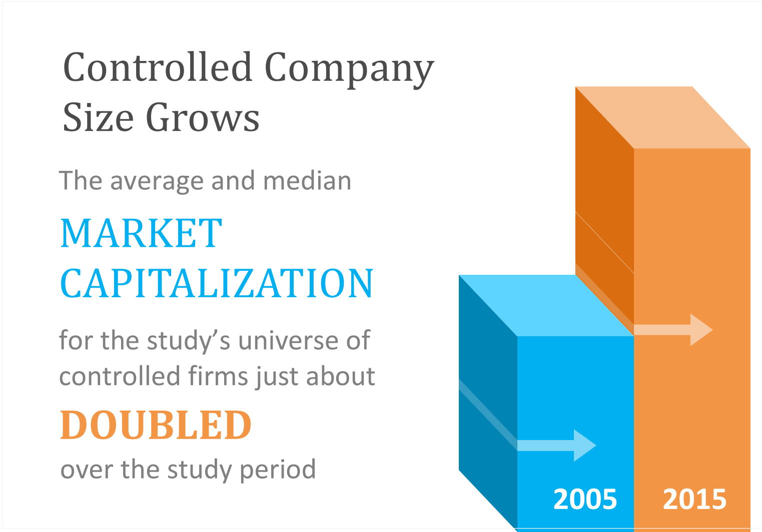
Controlled Companies Congregate in Three Sectors

Nearly 70 percent of all controlled companies cluster in three sectors: Consumer Discretionary (40 percent), Industrials (16.2 percent) and Consumer Staples (12.4 percent).



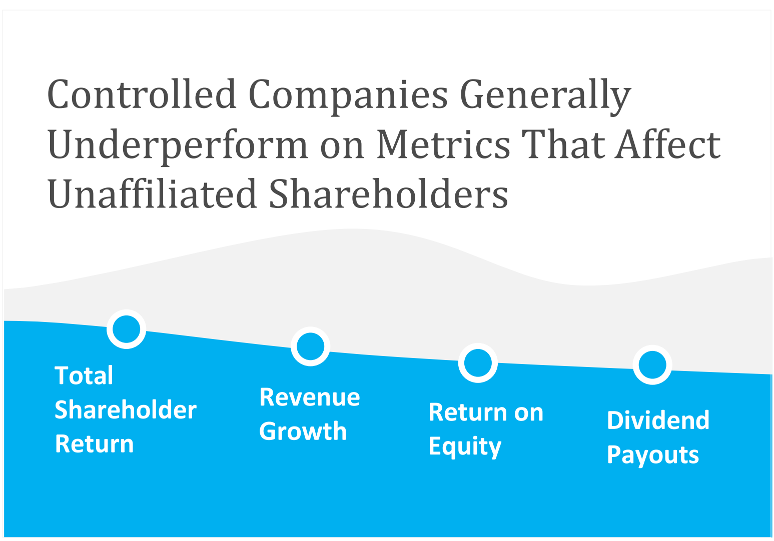
Control Type Influences Control Longevity

The oldest controlled companies have multi-class capital structures in place. The average age of such firms is more than double that at controlled firms with a single class of stock. Conversely, single-class stock controlled companies tend to have limited shelf-lives – over one-half of such firms became controlled after the year 2000, compared with less than one-fifth of multi-class stock controlled firms.



Controlled Company Size Grows

The average and median market capitalization for the study's universe of controlled firms just about doubled over the period of study. The average market capitalization of controlled firms jumped from $8.3 billion in 2005 to $20.6 billion in 2015 and the median market capitalization increased from $1.45 billion in 2005 to $2.8 billion in 2015. Part of this growth, however, simply reflects broader market trends. The average capitalization for all constituents of the S&P 1500 index in 2005 was $9.4 billion and the median capitalization was $2.1 billion. By 2015, the average capitalization was $14.3 billion (1.5 times that in 2005) and median capitalization was $3.2 billion (also 1.5 times that in 2005). The evidence suggests that the market capitalization growth rate of controlled firms was higher than that of the broader market index.



Controlled Companies Generally Underperform on Metrics That Affect Unaffiliated Shareholders

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. However, controlled companies outperformed non-controlled firms with respect to return on assets. Results for returns on invested capital were mixed: controlled companies outperformed marginally (by less than a percentage point) for most time periods, but underperformed over the 10-year period. EBITDA growth at controlled firms outperformed non-controlled company growth rates for the five- and 10-year periods, while non-controlled firms outperformed over the shorter time frames. Balance sheet metrics were also mixed.

No Consistent Difference in Stock Price Volatility Separates Controlled and Non-Controlled Companies

Average volatility at controlled firms is higher than that at non-controlled companies over the one-year and 10-year periods, and lower than that at non-controlled firms over three-year and five-year periods. Controlled firms with single-class stock structures generally have lower average volatility than both non-controlled firms and controlled companies with multiple classes of stock in all periods reviewed with the exception of the 10-year period.

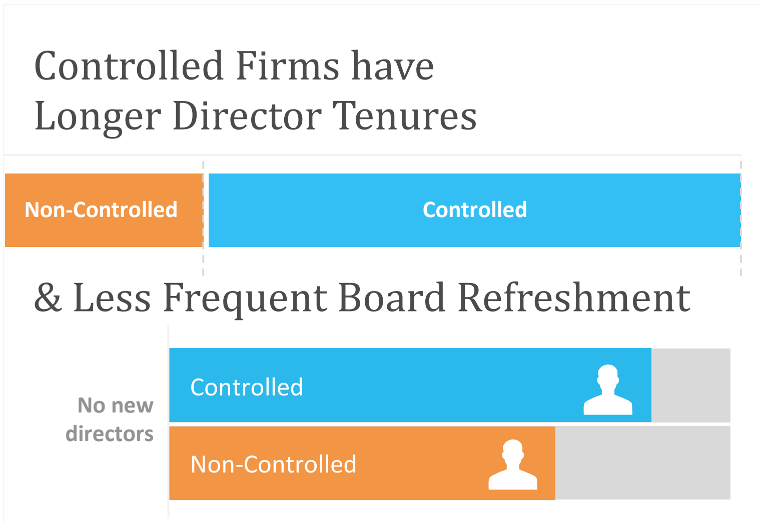
Single-Class Stock Controlled Firm Governance Resembles Non-Controlled Firms

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.

Related Party Dealings Continue at Controlled Companies

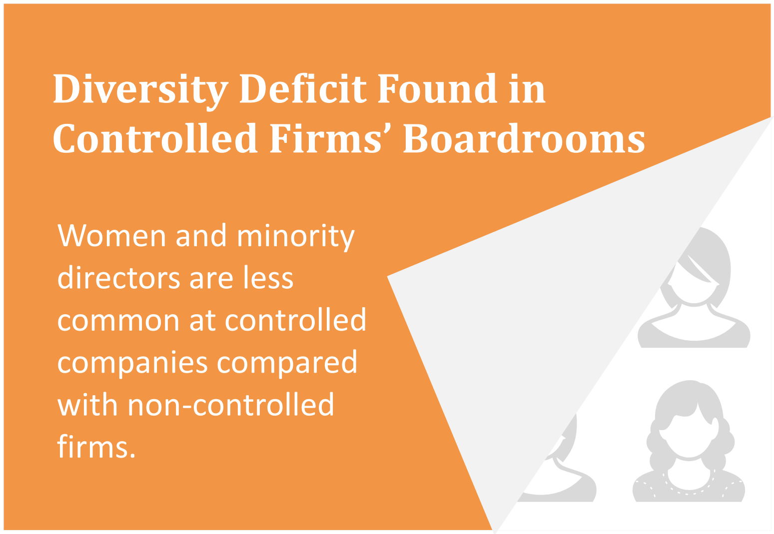
The frequency of related-party transactions (RPTs) at controlled firms declined over the study period but RPT size continues to exceed that at non-controlled firms. The average magnitude of controlled company RPTs is now $245.7 million or five times greater than at non-controlled firms – a significant increase relative to the almost identical average RPT values (of approximately $10 million) between controlled and non-controlled companies identified in the 2012 study. The size of the RPTs is affected primarily by several large related party transactions at Century Aluminum and Reynolds

American. If the RPTs at these two companies are disregarded, the average value of RPTs at controlled firms falls to $4.2 million. No controlled firms with material weaknesses were identified in this updated study compared with almost 4 percent of controlled firms in the 2012 study.



Longer Director Tenures and Less Frequent Board Refreshment Occur at Controlled Firms

Board tenures are generally lengthier at controlled companies compared with non-controlled firms and the rate of board seat refreshment at controlled entities is lower than at non-controlled companies. The proportion of controlled firms where board members average at least 15 years of board service is more than 17 percentage points higher than at non-controlled firms. Almost 80 percent of controlled firms have no new nominees on their board – roughly 10 percentage points higher than at non-controlled companies.

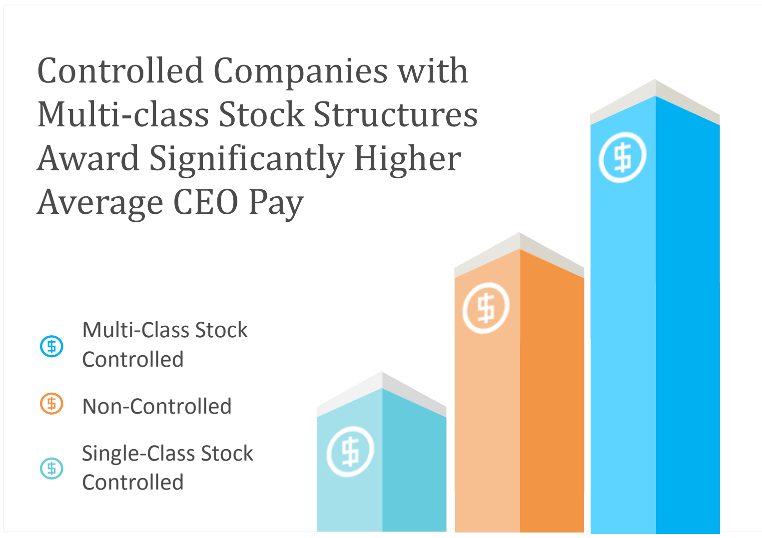


Diversity Deficit Found in Controlled Firms' Boardrooms

Women and minority directors are less common at controlled companies compared with non-controlled firms. The proportion of controlled firms with no female representation on their boards is almost 4 percentage points higher than at non-controlled firms, and the percentage of firms with two women on the board is almost 7 percentage points lower. The prevalence of controlled firms with no minority representation on the board is 20 percentage points higher than at non-controlled companies, and the proportion of firms with two minorities on the board is lower by almost 11 percentage points.

Fewer Financial Experts Serve on Controlled Firms' Boards

A lower proportion of board members have financial expertise at controlled companies compared with non-controlled firms. The proportion of controlled firms with less than ten percent of directors with financial expertise on the board is almost 5 percentage points higher than at non-controlled firms. The percentage of controlled firms with at least 30 percent of financial experts on the board is more than 9 percentage points lower.



Controlled Companies with Multi-class Stock Structures Award Significantly Higher Average CEO Pay

Most-recent-fiscal-year average CEO pay at these firms outstrips that at both non-controlled companies and controlled entities with a single class of stock.

› Average 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. This pay gap is largely attributable to high pay at media firms.

› Including single-class controlled companies, average CEO pay at controlled firms is 19 percent ($1.5 million) higher than that at non-controlled firms. Controlled firms with a single class of stock actually pay their CEOs less than half the broader market average (some $3.9 million less).

- Much of the pay differential between controlled and non-controlled firms is driven by the pay disparities at larger companies. The average CEO pay package at controlled S&P 500 large-cap firms surpasses that at non-controlled firms by $6.9 million and 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. By contrast, average CEO pay at multi-class stock controlled companies does not exceed that at both controlled single-class stock firms and non-controlled companies in the S&P 400 mid-cap index by more than $1.9 million and $74,000, respectively. In the S&P 600 small-cap index, average CEO pay at multi-class stock controlled companies does not exceed that at both single-class stock controlled firms and non-controlled companies by more than $1.1 million and $39,000, respectively.

- On the other hand, median CEO pay at all controlled companies, including both single- and multi-class stock controlled firms, is lower than that at non-controlled companies by $1.21 million. Median CEO pay at non-controlled firms exceeds that at multi-class stock controlled companies by $1.16 million, and exceeds that at single-class stock controlled firms by $2.1 million.

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).

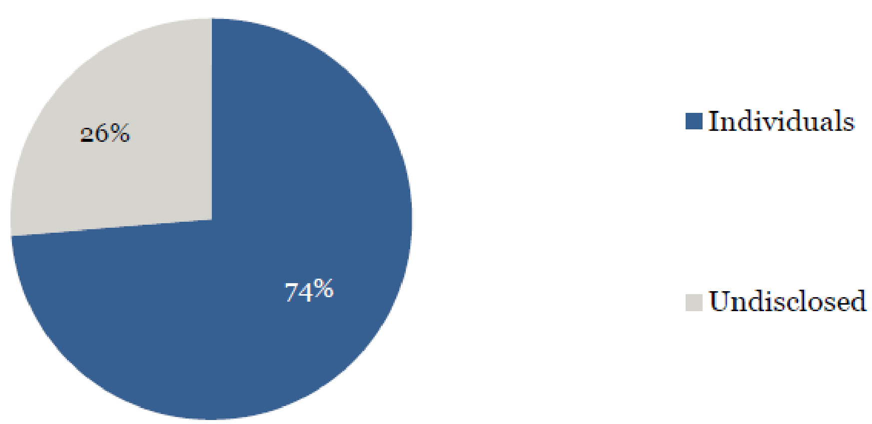
Accordingly, unlike last year, in which 12 no-action requests pertaining to special meeting shareholder proposals were predicated on Rule 14a-8(i)(9), no company submitted a request for no-action relief to exclude a special meeting proposal on the ground that it was submitting a competing management-sponsored 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

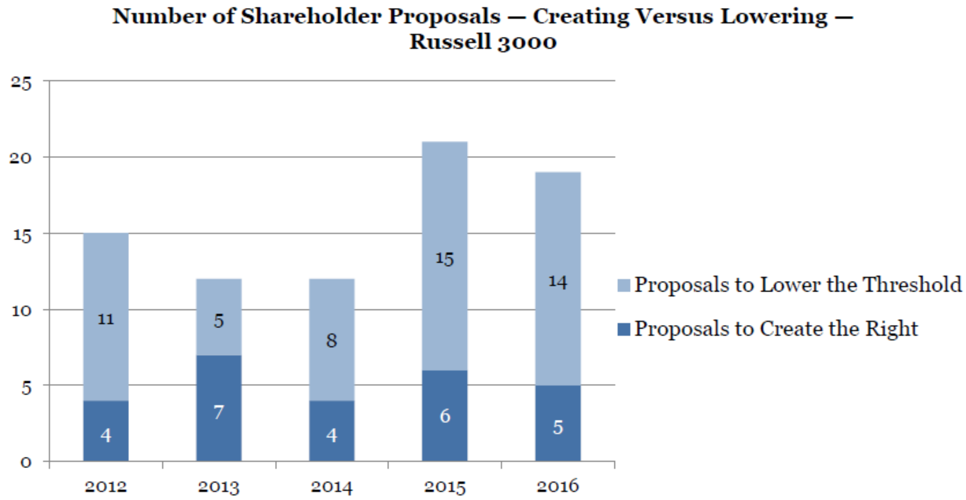
- **This proxy season saw a similar number of special meeting proposals to last year.** The number of proposals submitted by shareholders seeking either to create the right to call special meetings or to lower the threshold requirement for share ownership held steady during 2016, with 19 proposals going 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



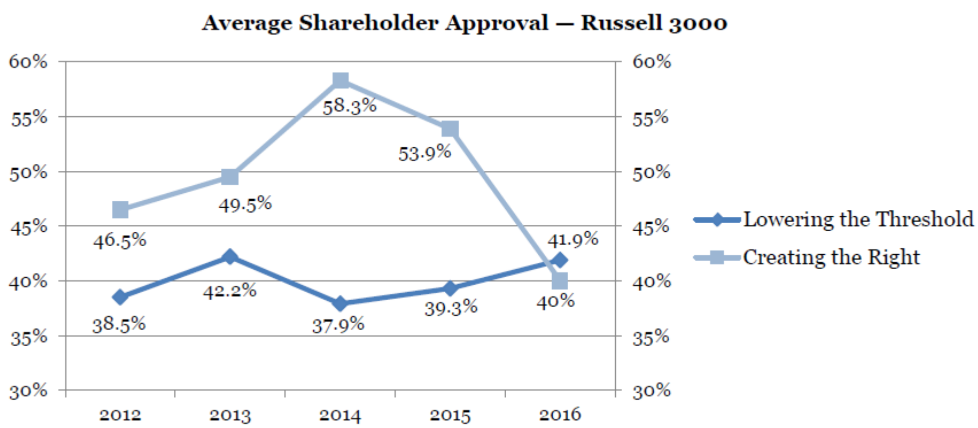
B. Creating the Right Versus Lowering the Threshold

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.

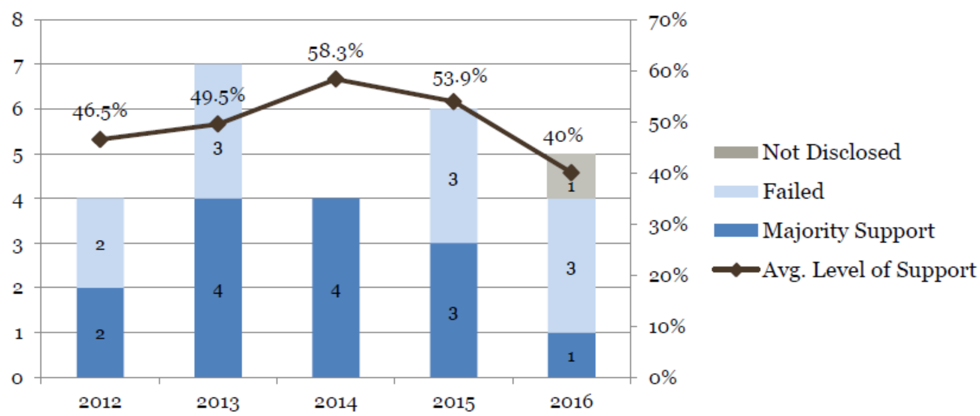


1. Creating the Right

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%.

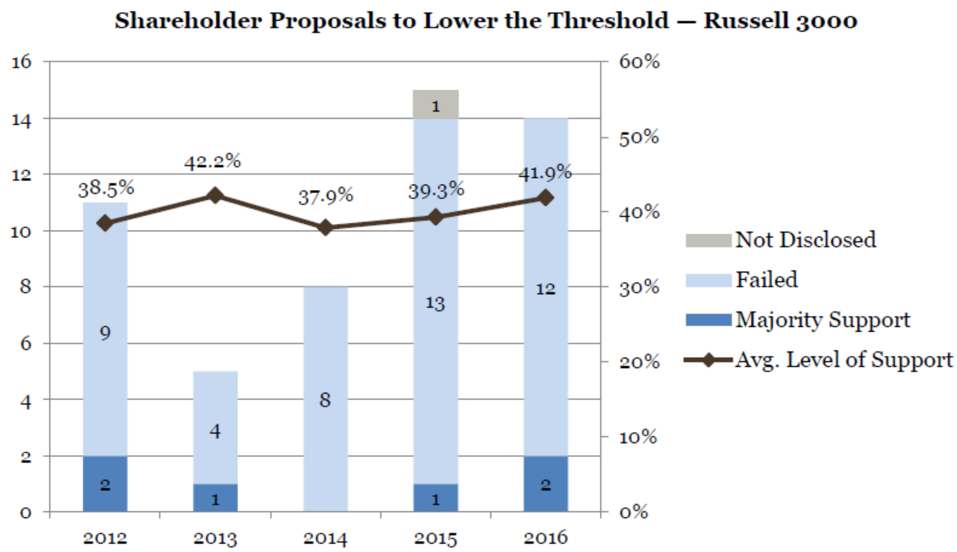
Shareholder Proposals to Create the Right — Russell 3000



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%)

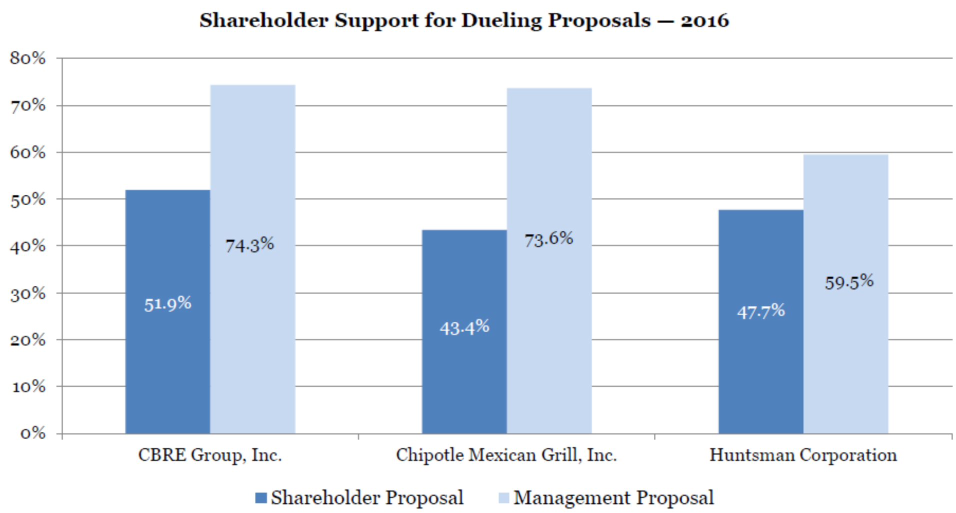
	Company; • Guidance Software, Inc.; • Lockheed Martin Corporation; • Occidental Petroleum Corporation; • Staples, Inc.; • The Boeing Company; • The Home Depot	
2. Include the shareholder proposal with dueling management proposal (3 companies)*	• CBRE Group, Inc.; • Chipotle Mexican Grill, Inc.; • Huntsman 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.