Harvard Roundtable on Corporate Governance

October 24–25, 2017

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Tab I: Environmental and Social Responsibility

ANNUAL LETTER TO CEOS

I write on behalf of our clients...

January 24th, 2017 / by Larry Fink

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Sincerely,

Larry Fink
Chairman and Chief Executive Officer

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

BlackRock 2015 Annual Report

Our foundation drives our ability to anticipate and adapt ahead of change to create better financial futures for out clients.

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- BlackRock's 2014 Annual Report
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- BlackRock's 2012 Annual Report
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Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:

Corporate Governance: Stakeholders

Posted by Martin Lipton, Wachtell Lipton Rosen & Katz, on Sunday, October 1, 2017

Editor's note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton publication by Mr. Lipton.

In response to the recent Green Paper and the U.K. Government Response, the Institute of Chartered Secretaries and Administrators (ICSA-The Governance Institute) and the Investment Association (IA), with U.K. Government approval, have issued a paper, The Stakeholder Voice in Board Decision Making, setting forth core principles for complying with Section 172 of the U.K. Company Law. Section 172 sets forth directors duties and is similar to the constituency statutes in some 30 states, and arguably, based on the 1985 opinion of the Delaware Supreme Court in the Unocal case, Delaware law. Section 172 "states that a director is required to act in the way he or she considers, in good faith, will be most likely to promote the success of the company for the benefit of its members (the shareholders) as a whole," and that in carrying out this duty directors must have regard (amongst other matters) to the following factors:

- the likely consequences of any decision in the long term;
- the interests of the company's employees;
- the need to foster the company's business relationships with suppliers, customers and others;
- the impact of the company's operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct; and
- the need to act fairly as between members of the company.

The core principles put forth by ICSA-IA are:

1. Boards should identify, and keep under regular review, who they consider their key stakeholders to be and why.
2. Boards should determine which stakeholders they need to engage with directly, as opposed to relying solely on information from management.
3. When evaluating their composition and effectiveness, boards should identify what stakeholder expertise is needed in the boardroom and decide whether they have, or would benefit from, directors with directly relevant experience or understanding.
4. When recruiting any director, the nomination committee should take the stakeholder perspective into account when deciding on the recruitment process and the selection criteria.

5. The chairman—supported by the company secretary—should keep under review the adequacy of the training received by all directors on stakeholder-related matters, and the induction received by new directors, particularly those without previous board experience.
6. The chairman—supported by the board, management and the company secretary—should determine how best to ensure that the board's decision-making processes give sufficient consideration to key stakeholders.
7. Boards should ensure that appropriate engagement with key stakeholders is taking place and that this is kept under regular review.
8. In designing engagement mechanisms, companies should consider what would be most effective and convenient for the stakeholders, not just the company.
9. The board should report to its shareholders on how it has taken the impact on key stakeholders into account when making decisions.
10. The board should provide feedback to those stakeholders with whom it has engaged, which should be tailored to the different stakeholder groups.

Each of these core principles is explained in detail in the 31-page, *The Stakeholder Voice in Board Decision Making*. The core principles are not intended to be a rigid check-the-box requirement. They are intended "to help company boards think about how to ensure they understand and weigh the interests of the key stakeholders when making strategic decisions." A company is expected to select and modify the core principles to suit its particular circumstances.

Institutional investors, asset managers, organizations like the Investors Stewardship Group, The Business Roundtable and The Council of Institutional Investors that support sustainable long-term investment, ESG and CSR and are opposed to short-termism and activism should give thought to fashioning and endorsing a U.S. version of *The Stakeholder Voice in Board Decision Making*.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:

The Importance of Nonfinancial Performance to Investors

Posted by Mathew Nelson, EY, on Tuesday, April 25, 2017

Editor's note: Mathew Nelson is Global Leader of Climate Change and Sustainability Services at EY. This post is based on an EY publication.

EY member firms are able to conclude from several years of research of ESG reporting that there is a global trend toward increased interest in nonfinancial information on the part of investment professionals. But the question we continue to seek to answer is whether ESG information is, ultimately, influencing investor decisions. In each of the last three years, research undertaken by EY has documented an expanding role of ESG factors in the decisionmaking of investors around the world.

Recent headlines reflect why meaningful ESG analysis is increasingly important for institutional investors and the companies they follow. "Larry Fink Wants Companies to Talk More About the Future," declared Bloomberg Media when the head of the world's largest investment manager wrote to the CEOs of public companies to extoll the virtues of strong ESG performance and its effect on valuation. Nearly 200 nations met in Paris to negotiate and sign a global climate agreement that will shift financial markets. And one of the world's largest automakers was embroiled in an unprecedented emissions-testing scandal. These and other news-making events in recent months have propelled ESG to the top of the global agenda. This is despite continued uncertainty in the regulatory environment globally.

This year's report on ESG and nonfinancial reporting, available here, provides insights into the views of more than 320 institutional investors on nonfinancial reporting by publicly traded companies and the role ESG analysis plays in their investment decision-making.

Key findings

Investors around the world reveal broad support for the ESG-related themes expressed in the February 2016 memo from Laurence Fink, Chairman and CEO of BlackRock, to the leadership of the world's largest companies. Investors strongly support Fink's call for an annual board-approved strategy statement for public companies. They agree that ESG factors present risks and opportunities that have been neglected for too long. Yes, say investors, sustainable returns require a sharper focus on corporate governance and on environmental and social factors.

The risk of stranded assets remains a substantive concern for institutional investors, continuing a trend documented in last year's report. More than 60% of the investors in our 2016 survey

reported recently decreasing their holdings or monitoring holdings closely due to stranded asset risk.

Investors believe the biggest factors motivating companies to report ESG information are the reputation of companies with their customers and regulatory compliance mandates. Most investors believe that companies don't disclose ESG risks that could affect their business.

Despite the increasing importance placed on nonfinancial performance and disclosures, most of the surveyed investors evaluate environmental and social factors on an informal, not structured, basis.

Disclosure and scrutiny of nonfinancial information will continue to grow in importance in the years ahead. The Paris Climate Conference agreement will lead to an increase in disclosures about companies' climate practices and risk management strategies, say investors. They report that recent environmental and social scandals have driven them to reevaluate nonfinancial disclosures and look more closely at available information.

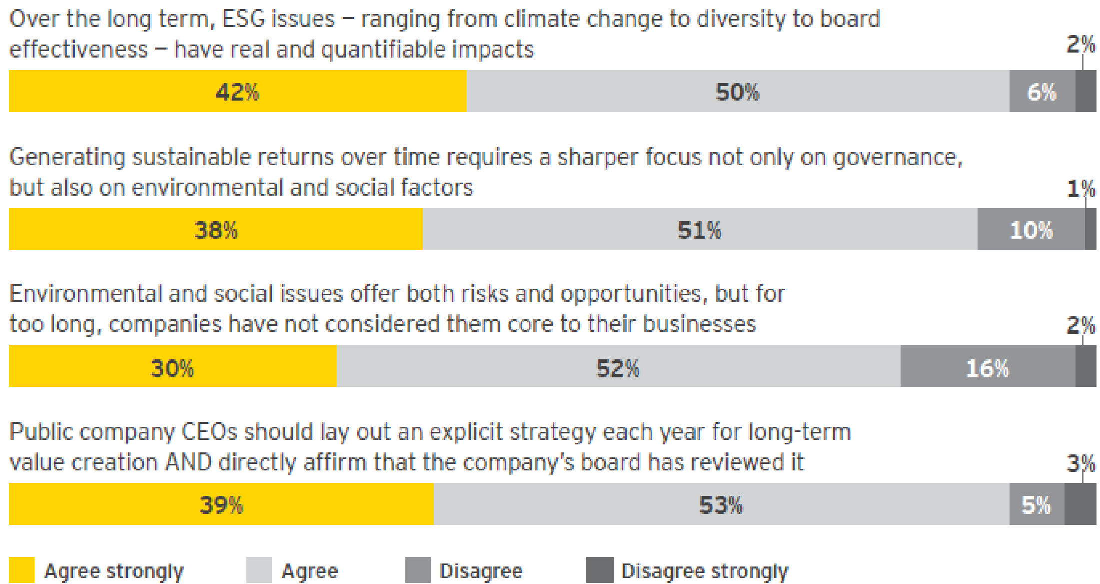
Nonfinancial performance plays a pivotal role in the investment decisions for most of the surveyed investors, and for a greater percentage of investors than in previous years. Also, a dwindling percentage of investors believe that it is unclear whether nonfinancial disclosures are material, down substantially from surveys in 2015 and 2013.

Investors see long-term financial benefits in companies with high ESG ratings

The ESG investing movement received a shot in the arm in February 2016, when the chairman and chief executive officer of BlackRock, the world's largest investment manager, sent a memo to the CEOs of the S&P 500 companies and Europe's largest corporations. His message: focus more on long-term value creation rather than short-term dividend payouts; be open and transparent about growth plans; and focus on environmental, social and governance factors because they have "real and quantifiable financial impacts."

Laurence Fink, whose BlackRock has US$4.6 trillion under management and US$200 billion in sustainable investment strategies, also made a point that mirrors the argument made by many investors who track ESG performance: handling ESG issues well is often a sign of operational excellence at a company.

Our survey of investors found broad support for ESG-related themes expressed in the Fink memo. More than 80% of the survey respondents agreed with four statements related to Fink's points: that CEOs should lay out long-term board-reviewed strategies each year; that companies have not considered environmental and social issues as core to their business for far too long; that generating sustainable returns over time requires a sharper focus on ESG factors; and that ESG issues have real and quantifiable impacts over the long term (see figure 1).



Investors who remain skeptical about the value of nonfinancial factors tend to disregard any causal relationship between a company's ESG performance and financial performance. However, it's commonly understood that serious reputational and environmental risks can and do surface, and they can have very real impacts on the bottom line. Investors who used ESG factors in their analysis point to the long-term benefits of investing in companies that pay close attention to ESG factors, as well as the lower investment risk with those companies.

ESG factors can help in identifying new opportunities and in managing long-term investment risks, avoiding poor company performance that can come from lax governance, or from weak environmental or social practices, says Matt Whineray, chief investment officer of the NZ$30 billion New Zealand Superannuation Fund.

Whineray points to two meta-studies that support the business case for ESG investing. A 2015 report by Oxford University and Arabesque Asset Management—based on more than 200 academic studies, industry reports, newspaper articles and books—found that 88% of the research reviewed shows "solid ESG practices" at companies lead to better operational performance, and that 80% of the studies analyzed showed that a company's stock performance is positively influenced by good sustainability practices.[1] Another report, by Deutsche Bank in 2012, which looked at more than 100 academic studies, concluded that ESG factors are

[1] The study from Oxford University and Arabesque Asset Management appears at the following URL: http://www.sbs.ox.ac.uk/sites/default/files/research-projects/MiB/4-Arabesque-Case-Narrative.pdf.

correlated with superior risk-adjusted returns.[2] The Deutsche Bank study also found that academic studies that tracked fund returns in the "socially responsible investing (SRI)" category may have turned up mixed or neutral results because many SRI managers have historically used exclusionary screens rather than the positive best-in-class investment approaches favored by ESG investors.

Related research undertaken by Harvard Business School and the London Business School, provides evidence that "high sustainability" companies significantly outperform their counterparts over the long term, both in terms of stock market as well as accounting performance measures.[3]

ESG analysis provides investors with an additional lens for reviewing and evaluating companies and assets, not just for equity performance, but for factors that affect bond pricing and real asset valuations, says Adam Kirkman, head of ESG at AMP Capital. The Australia-based investment manager with US$120 billion under management maintains an internal proprietary model portfolio of stocks rated highly based on ESG risk management factors, and the portfolio outperforms relevant indices of stocks not based on ESG factors.

Kirkman also points to specific examples: When AMP Capital's analysts had concerns about some mining companies that were unable to demonstrate acceptable management of environmental and social risks, they underweighted the companies in their portfolio—a move that boosted the overall portfolio's performance by 11 basis points over one year, relative to what the return would have been without the rebalancing move. The firm's analysts had similar ESG concerns with a retailer's stock, so they underweighted the stock and saw a 52-basis-point one-year relative improvement in the portfolio because of the move.

Engaging companies on ESG, even before issues of concern arise, gives investors the ability to influence outcomes that will maximize investment performance, says Kelly Christodoulou, ESG investments manager for AustralianSuper, the AU$100 billion pension fund. Engaging proactively also helps build relationships that can be fruitful if investors need to talk to company management in the future about concerns that arise.

Three years of data beginning to suggest an inflection point

Institutional investors have developed a greater appreciation for the value of ESG factors in the past several years. Three years of survey data, interviews with investors, and recent events and global initiatives offer evidence that ESG information plays an increasingly influential role in investment decision-making.

Analysis of ESG and other nonfinancial information is not a flash-in-the-pan trend among institutional investors.

While the broad change in investor sentiment cannot be attributed to a single incident or cause, it seems that we have reached a subtle but noteworthy inflection point, and ESG investing has

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[2] Deutsche Bank's 2012 report, "Sustainable Investing: Establishing Long-Term Value and Performance," appears at this URL: https://institutional.deutscheam.com/content/_media/Sustainable_Investing_2012.pdf

[3] ³RG Eccles, I Ioannou, S Serafeim; The Impact of Corporate Sustainability on Organizational Processes and Performance; Harvard Business School Working Paper; 2012.

entered the mainstream. This is despite the global uncertainty on where ESG policy development is going.

ESG analysis has evolved over the last decade, from an early emphasis by investors on governance issues to a broader interest in recent years on environmental factors, says Jennifer Anderson, who serves as the Responsible Investments Officer for the Pensions Trust in London, which manages more than £8 billion.

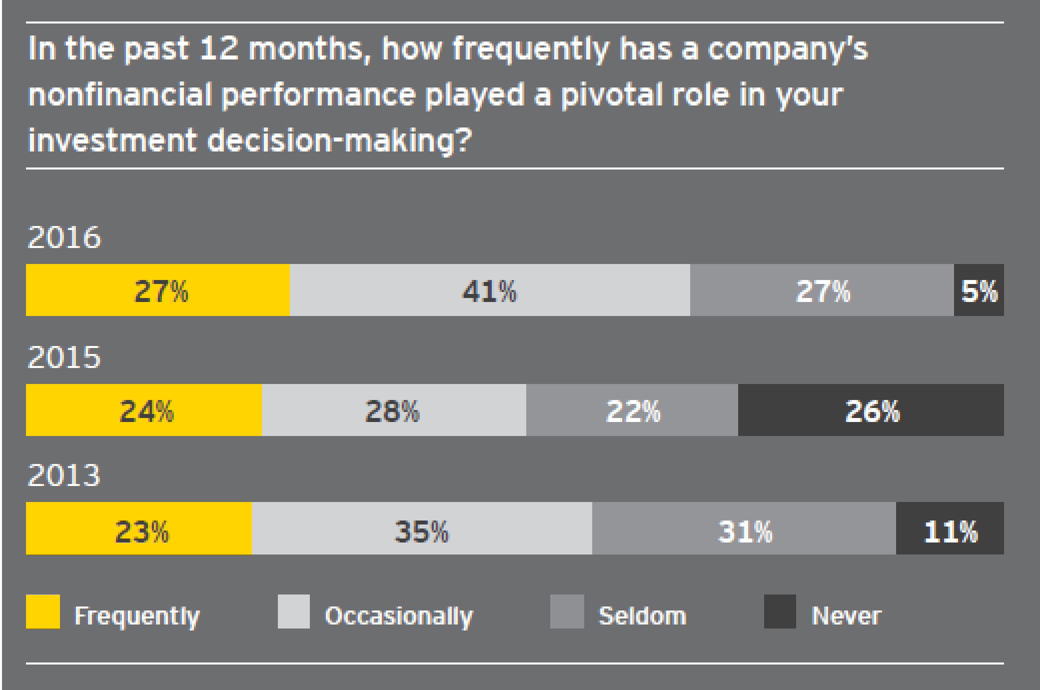
In the past, says Anderson, “the priority was always the governance side. Corporate governance—that was the area that had the most weight or relevance for investors. But in the last year, climate change has really accelerated, environmental risks have really gone up the agenda, and at the moment they seem to be of equal weight and importance in the discussion.”

Recent events have shown that there are material risks and benefits embedded in nonfinancial information from corporate issuers. Investors increasingly see that by understanding these risks and benefits, they can avoid the downside and embrace the upside in a valuation that flows from nonfinancial business activities. And their enthusiasm for analysis of nonfinancial information seems well-founded. Investors often expect that the rising population of millennials—with their views about ESG issues, and the influence gained as an estimated US$30 trillion is transferred to them from their parents and grandparents—will continue to amplify the importance of ESG factors in investing.

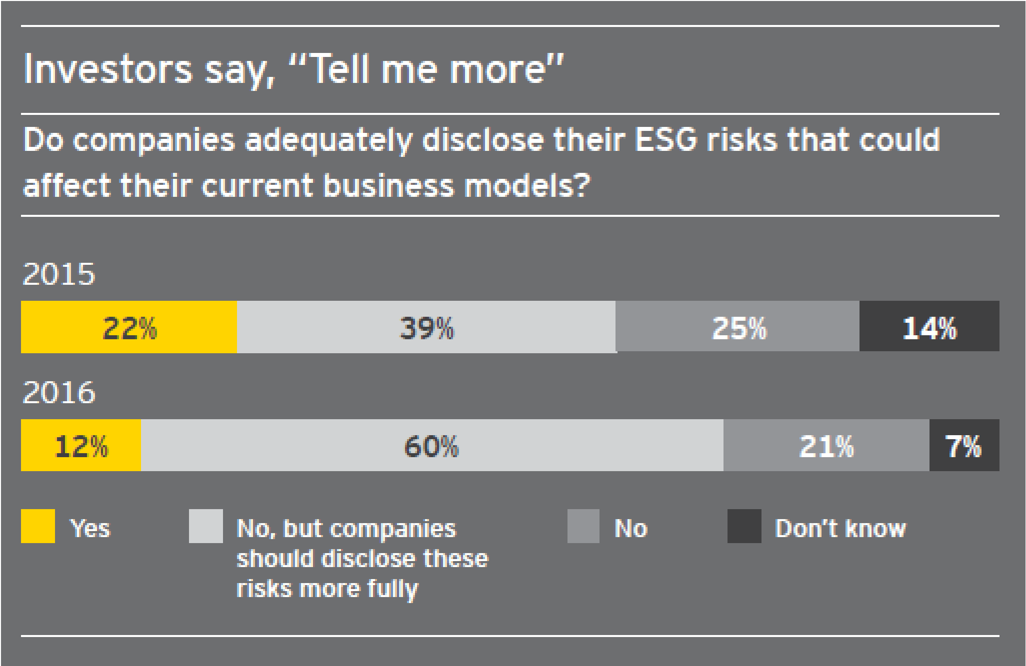
In each of our three studies, we asked investors how frequently a company’s nonfinancial performance had played a pivotal role in their investment decisions in the previous 12 months. In 2016, 68% responded that nonfinancial information played a pivotal role frequently or occasionally, up from 52% and 58% in 2015 and 2013, respectively. Thus, the proportion of investors relying on nonfinancial information—especially those doing so occasionally—has grown notably. More than four in ten respondents say nonfinancial information occasionally plays a pivotal role in decision-making, which suggests that investors and analysts may take an opportunistic and broad-minded approach to their evaluation of nonfinancial information.

As investors acknowledge the impact of nonfinancial information in their decision-making, the proportion who dismiss nonfinancial and ESG information as immaterial or trivial has fallen. We asked about why investors wouldn’t consider ESG issues in their decision-making, and 16% said that it was unclear whether nonfinancial disclosures are material or have a financial impact. That sentiment was down dramatically from 2015, when 52% of the respondents weren’t sold on ESG materiality, and 2013, when 60% of the investors in the survey were unclear as to the potential materiality.

Investors increasingly see a pivotal role for nonfinancial information in investment decision-making



The surveys also indicate a trend toward a greater understanding of the significance of certain ESG disclosures, including corporate governance risks and those related to the treatment of employees worldwide. When investors were asked how the disclosure of a prospective investment's risk or history of poor governance would affect an investment decision, 39% of the respondents in the 2016 survey said they would rule it out immediately, compared to 27% in 2015 and 30% in 2013. When asked about the disclosure of human rights risk from operations, 32% said they would rule it out immediately, compared to 19% and 22% in 2015 and 2013, respectively (see figure 7).

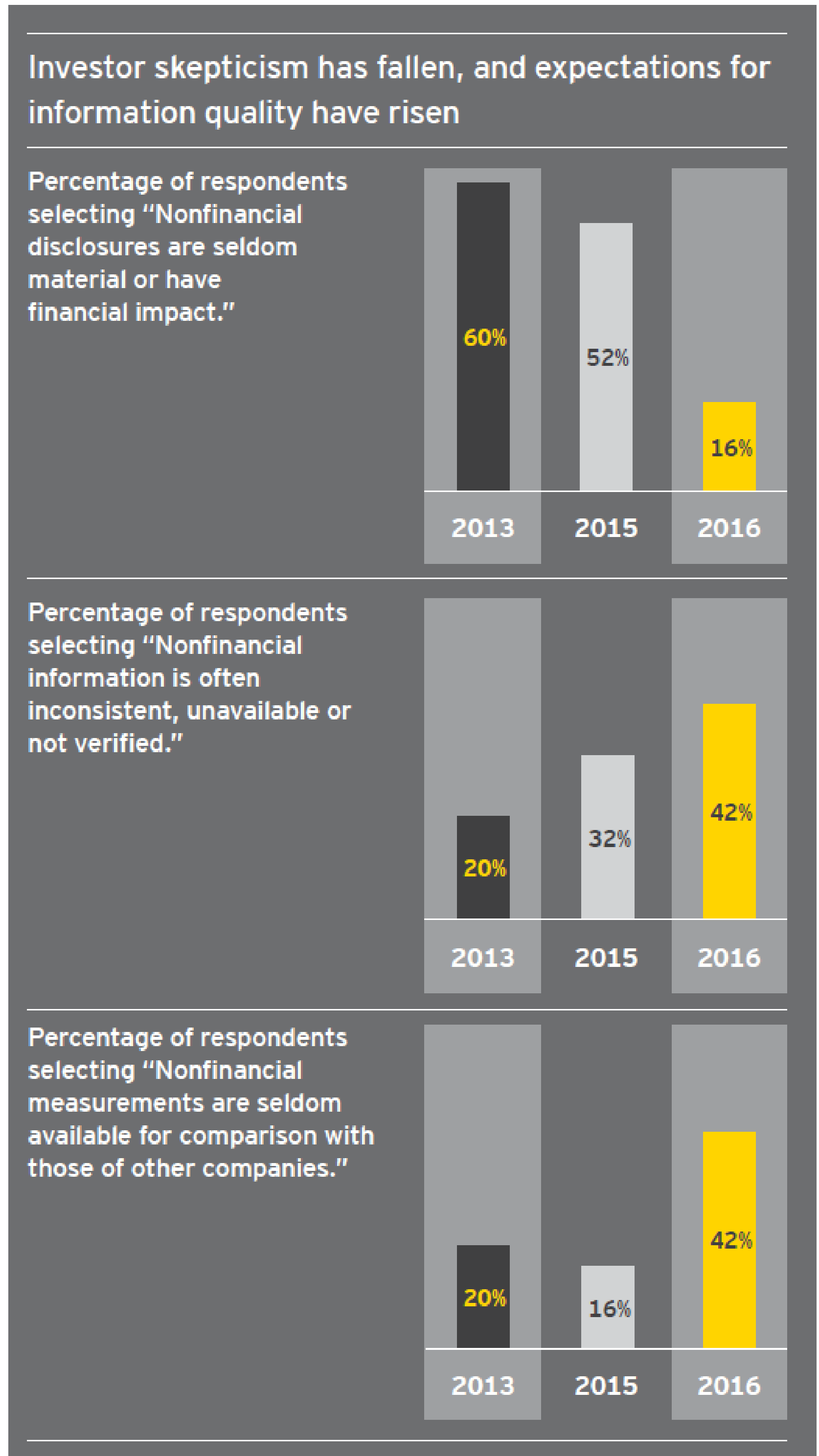


Amid the growing appreciation for ESG information, there appears to be a troubling dissatisfaction among investors with the quality of information available from issuers. In years past, one-third of respondents or fewer said they didn't use nonfinancial information because it was often of poor quality. Now, as investors come to see nonfinancial information as increasingly material, they reveal still higher expectations for it being timely, comparable and verifiable.

Investors are growing more demanding, curious and discerning.

When asked about why they wouldn't consider ESG issues in their decision-making, 42% of respondents in 2016 indicated that nonfinancial information is often inconsistent, unavailable or not verified, up from 32% in 2015 and 20% in 2013. Similarly, a growing plurality of respondents say nonfinancial measurements are seldom available for comparison with those of other companies, which garnered a 42% response in the 2016 survey, up from 16% in 2015 and 20% in 2013.

Finally, investors' views on the quality of nonfinancial information provided by issuers may serve as a poignant wakeup call to chief financial officers and their corporate peers who seek the attention of institutional investors. Asked whether companies adequately disclose ESG risks that could affect their current business models, more than 80% of respondents said no. A solid majority—60%—called for companies to disclose these risks more fully.



What motivates companies' nonfinancial reporting?

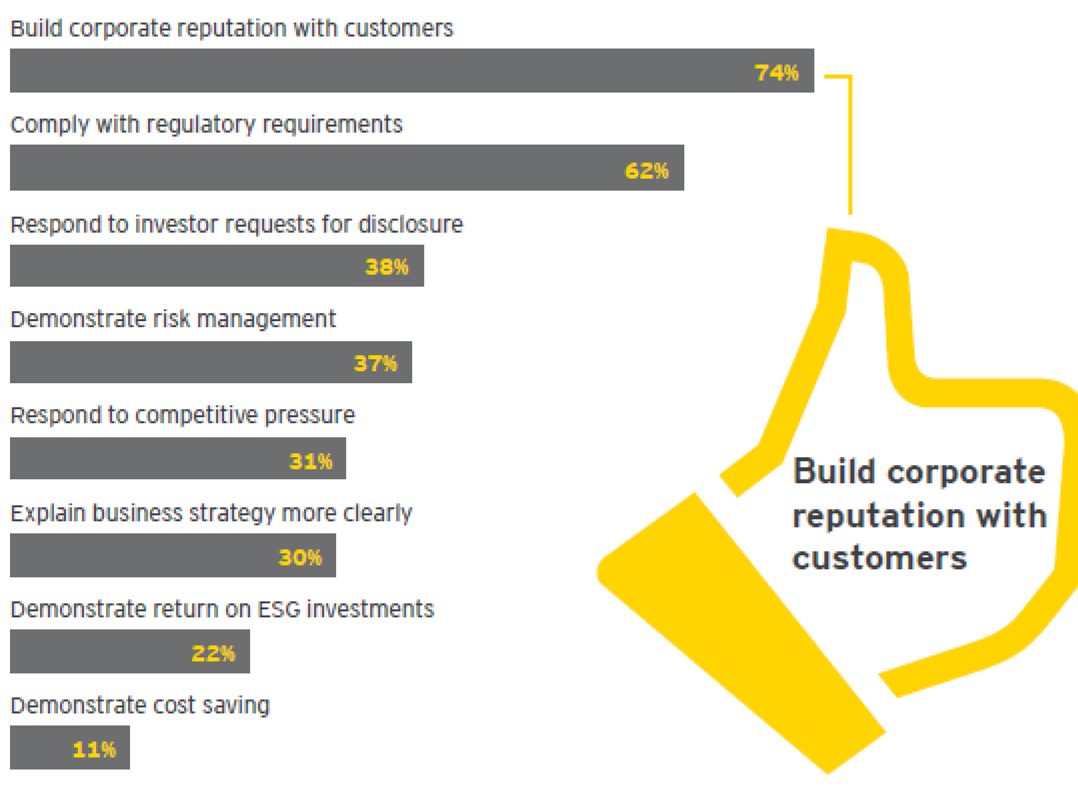
If investors want more issuers to report on their ESG activities, what motivates companies to disclose that information? According to our surveyed investors, the biggest motivating factor for most companies remains building their corporate reputation with customers, followed by complying with regulatory requirements (see figure 2). Investor demands play a role as well, along with the incentive of improving stock valuations, but to a much lesser degree.

"I think companies now are clearly aware that talking about corporate social responsibility is really part of their reputation, and on the way they convince people that there is good management of their business," says Jacky Prudhomme, head of ESG integration and social business investments at BNP Paribas in Paris. "So I think now that most companies do play the game."

Figure 2

Issuers seek to impress customers and meet regulatory requirements with nonfinancial reporting

What do you believe motivates a company to report details on its nonfinancial and ESG activities?



Institutional investors have said that company managers also enjoy the recognition that comes when their companies are named in the lists of ESG leadership companies, or special ESG-

focused indices or portfolios. Companies that are focused on nonfinancial performance issues actually want to be judged versus their peer companies, investors say, and company executives advocate for uniform ESG disclosure standards that may help make those evaluations possible.

Extensive ESG disclosures from a company can also indicate that it is part of an industry sector motivated to convince the financial community that it has a future, in spite of environmental pressures. “For me, it’s clearly a demonstration by the company that they’re thinking of an evolution or transformation of their business,” Prudhomme says.

The results of ESG initiatives and communication may also affect the company’s stock price. That’s why many CEOs now talk about ESG during quarterly results announcements or annual investor meetings, and they invite people in the socially responsible investing or ESG community to face-to-face meetings, Prudhomme says.

Certain institutional investors have been able to identify excess return opportunities when companies improve their ESG ratings, which ties ESG performance to investment opportunities. And for companies that are craving credit and recognition for their ESG performance, investors may demonstrate their recognition through how much they are willing to pay for stock.

Another motivating factor for companies to report and engage on ESG issues is to protect themselves from proxy ballot fights over social and environmental issues. BlackRock’s Fink indirectly threatens that the investment behemoth will back activists if companies don’t make long-range planning a priority, with the help of a focus on ESG factors.

Satisfying investor demand for ESG information has become more and more difficult for companies. Companies have been reporting on nonfinancial factors since the late 1990s, and in the early days, many companies would issue reports just a few pages long. Today, an issuer’s ESG report is sometimes longer than its annual report, complete with explanations of the various best practices for all of the subsidiaries of the company.

In our survey, more investors said that company reports with “sector or industry-specific reporting criteria and key performance indicators” were “very beneficial,” more than with any other category of reporting. In second place was “statements and metrics on expected future performance and links to nonfinancial risks.”

Reporting on work in progress can be difficult for an issuer, especially in an environment where investors are focused on eliminating potential risks from their portfolios. Talking about objectives set in the future, rather than results and achievements already accomplished, can be risky for company managers because it’s possible the objectives won’t be met, or not met on time, Prudhomme says.

“If they fail, they fear that investors will react very negatively to the failures of not being able to achieve some environmental or social progress, according to their big plan,” he says. “We’re in a world that is more and more risk-averse. So if you consider that it’s a weakness for a company not to be able to achieve one of their objectives, you can see it can be difficult for the companies that prefer to control all their communication, especially when talking about ESG (plans).”

One ESG-related risk of particular concern to investors is stranded assets, due to changes in regulation, social expectations, disruptive technology or environmental conditions. More than 60% of survey respondents reported that they had either decreased their holdings within the last 12 months or were likely to monitor holdings closely in the future due to stranded asset risk (see figure 3).

Figure 3

Stranded assets remain a concern for a majority of investors

In the last 12 months, has your fund decreased its holdings of a company's shares due to the risk of stranded assets (e.g., due to changes in regulation, social expectations, disruptive technology or environmental conditions)?

With a company that is exposed to stranded asset risk, it's often difficult for investors to know when that risk will become material to stock performance, says Edmond Schaff, head of selection for Cedrus Asset Management, a €200 million fund-of-funds manager in Paris.

As a policy, it's easier for an investor to completely avoid, or underweight significantly, stocks exposed to stranded-asset risk, Schaff says, because the risk will inevitably be priced in by the market, but it's difficult to know when it will happen.

Some institutional investors base buy, sell and pricing decisions on long-range financial models that calculate how specific environmental issues, such as climate change forcing switching to renewable energy sources, will affect certain sectors a decade or more in the future. For example, some investors sold out of their US coal investments before the overall decline in that market because their models predicted the downturn based on environmental concerns.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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How Directors Can Use Sustainability to Drive Value

Posted by Steven B. Stokdyk and Joel H. Trotter, Latham & Watkins LLP, on Wednesday, April 5, 2017

Editor's note: Steven B. Stokdyk and Joel H. Trotter are partners at Latham & Watkins LLP. This post is based on a Latham publication by Mr. Stokdyk, Mr. Trotter, and Catherine Bellah Keller.

Boards frequently encounter sustainability and other environmental, social and governance (ESG) issues in the oversight of a company's operations, management, financial reporting and public disclosure. Investors increasingly highlight the importance of ESG issues through investment strategies, shareholder proposals and public statements. Industry groups also monitor companies' ESG efforts, and the Securities and Exchange Commission (SEC) has focused public attention on the issue in recent years.

Boards considering ESG issues, particularly sustainability initiatives, will confront several questions: What are the relevant measures and how should the company define them? What are the potential benefits and costs? The particular needs of the company and perspectives of key constituencies will drive these considerations and may differ from company to company.

Your Key Stakeholders Care

Even if sustainability topics do not arise on earnings calls or occupy analysts' attention, the following key constituencies may focus on the topic and expect overt action from the company:

- *Shareholders.* Shareholders may expect particular disclosures and measurement analytics from a company and may publicize their expectations for certain practices. Large institutional shareholders are increasingly adding ESG metrics to their portfolios.
- *Asset Managers and Mutual Funds.* In addition to traditional investors' funds, asset managers are increasingly offering ESG or sustainability-screened investment vehicles. Often these funds seek particular sustainability disclosures or business practices. Companies that lag in this area could risk being screened out of significant investment vehicles.
- *Employees and Other Business Relationships.* Employees, customers and suppliers often care about ESG issues, and that can affect the company's bottom line. Many companies use ESG and sustainability efforts to help attract and retain talent, recognizing that employees care about these issues. Companies also reap value in communicating their efforts to customers and suppliers—recognizing the brand-building effects of caring about ESG concerns and sustainability.
- *Media.* Media outlets increasingly focus on sustainability topics and companies' practices in this area.

Boards may want to consider the reputational benefits of leading in sustainability.

ESG Initiatives Can Build Long-Term Value

Directors may also consider whether sustainability policies or practices can build long-term value for their company.

- Implementing ESG measures can help foster innovation, identify efficiencies and manage risk, with recent data indicating that the boards of approximately one-third of the largest publicly traded US companies engage in sustainability oversight functions.
- Recent studies show a positive correlation between a company's adoption of sustainability policies and its outperformance of counterparts over the long-term in stock market and financial performance.
- Many ESG initiatives not only have potential to build long-term value but are cost-effective even on a short-term basis.
- Disclosure can be tailored appropriately to focus on those areas that are most important to the company and its key stakeholders.

Consider Data Quality and Reliability

Sustainability data and related reporting must be accurate and reliable to function as intended. Many sustainability factors can be difficult to measure and are measured differently across companies and industries. Industry groups have highlighted this issue, and companies may retain third parties to certify or audit ESG data and related disclosures. The Sustainability Accounting Standards Board (SASB), for example, seeks to ensure consistent and reliable quantitative measures of sustainability to facilitate comparability across companies and industries.

When considering data sources and measures of reliability, companies may ask:

- What are the precise data points and how are they measured?
- Is the information qualitative or quantitative? What is the degree of subjectivity or objectivity in the measurements and can they be compared across periods, companies or industries?
- How do sustainability measures compare to other metrics used for evaluating the company and its performance?
- Should the company retain a third party to audit or certify sustainability measures?

Initiatives Look Beyond Legal Requirements

Sustainability and other ESG initiatives represent an area where companies may seek to go well beyond minimum legal requirements. In doing so, many boards have taken steps yielding significant value to the company and its shareholders. While regulators have considered requiring sustainability disclosures, such disclosures remain voluntary. For example, in April 2016, the SEC considered the need for additional disclosure requirements for US public companies specifically relating to sustainability, but stopped short of prescriptive action in this area. Nonetheless, more than 80% of S&P 500 companies voluntarily issue ESG reports today, compared to only 20% in 2011. This trend is likely to continue as US public companies focus on their efforts in this area.

Conclusion

Directors may consider the costs and benefits of integrating sustainability or other ESG factors into their evaluations of business performance and public disclosures. Specific approaches will differ from company to company, but many companies find that leadership in this area can yield significant benefits

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Saving Investors from Themselves: How Stockholder Primacy Harms Everyone

Posted by Frederick Alexander, B Lab, on Wednesday, May 10, 2017

Editor's note: Frederick Alexander is Head of Legal Policy at B Lab. This post is based on Mr. Alexander's recent article, published in the *Seattle University Law Review*.

Communities around the world face many difficult issues, including poverty, climate change, social and economic inequality, the cost and quality of education and healthcare, stagnant wages, financial market instability, disease, and food security. Despite the existential threat that these concerns may raise, there is no consensus on whether or how to address them through regulation, taxation, or other government policy tools. Private enterprise, however, has tremendous potential to address these issues through technology, wages, supply chain maintenance, green operations, efficient delivery of goods and services, and a myriad of other outputs and outcomes. In the U.S., the potential of the private sector to address these issues dwarfs that of the government. The 2015 federal budget was approximately $2.5 trillion (excluding transfer payments like Social Security), while the 2015 gross domestic product (GDP) was about $18 trillion. While numbers go up and down, total government spending (including state and local) typically accounts for about 20% of GDP when transfer spending is netted out. Consumer and business spending account for the other 80%.

In light of this economic reality, harnessing the assets of the private sector is a critical pathway towards addressing pressing social and environmental issues. However, the structure we use to allocate resources in the private economy actively precludes using assets in this manner. My article describes a critical structural issue—stockholder primacy—and suggests that a new corporate governance model—the benefit corporation—can help to restructure our system of capital allocation. Benefit corporation statutes, adopted in 31 states including Delaware, require directors and managers to consider the interests of all stakeholders *as a primary concern*, and not merely as a strategy for enhancing stockholder returns.

But reorienting the system for allocating capital in our private markets will require more than an adjustment to governance at the corporate level. The investment channel, from savers at the top, through asset allocators and managers in the middle, to corporations at the bottom, is dominated by Modern Portfolio Theory, which, like stockholder primacy, encourages all participants to focus on "beating the market," but not on managing the market and the systems in which their investments are embedded. Thus, all participants in the system focus on performance differences among different companies and among different portfolios, but ignore the effect of company actions and portfolio behavior on performance of the market as a whole. This creates commons-grazing effects that threaten the health of the planet's ecosystem and the stability of markets and communities. One only need to consider the effects of financial companies chasing returns in the run-up to the Financial Crisis to find a ready example.

To address this problem, everyone along the investment chain, from corporate executives and directors, to fund managers and individual investors, needs to add an ethical component to their decision-making. The article does not propose that investors or managers make decisions from an altruistic or moral framework. What it does propose is that there is a better way to invest for private gain—one that will potentially produce a better outcome for all participants in the economy, including investors. The ethical principle is easy to state: investors and managers should not seek gains by simply extracting as much value as possible from the economy, but instead should seek gains by building and sharing value with all stakeholders in their investments.

In other words, we need to reorient our financial system to encourage the investment of private capital in positive sum opportunities. Stockholder primacy and Modern Portfolio Theory have become identified with a pre-governmental pure "free market." However, there is no free market without rules that are created and enforced by government and social mores, and those rules affect outcomes. The rules in place today pit the interests of investors against those of other stakeholders rather than linking them. This is actually a fairly new construct and not a universal one. Pushing the market in a different direction—one that links the interests of all stakeholders—will return the U.S. to the model of stakeholder capitalism that prevailed after World War II. This model would deliberately allocate capital in order to create value for society as a whole, thereby addressing critical social and environmental issues. It would return U.S. capitalism to a system based on making rather than taking.

Stockholder primacy and Modern Portfolio Theory denies savers the opportunity to build value based on genuine trust and commitment; the rationalization of broad portfolios so that their components are not wasting resources in a negative-sum game; and a portfolio that makes a positive contribution to all aspects of savers' lives, not just their bank accounts. Benefit corporation law is an excellent start to address these concerns, but much more needs to be done. We must have a public discussion that allows us to establish ethical investment principles enforced by laws and custom.

In order to impose the ethical principle suggested by this article, there must be a commitment at the investor level, similar to the management level in a benefit corporation, to seek out stock value only by building real value. Investors and market participants that play by different rules need to be shunned and shamed. Integrating this ethic into the financial system is a beginning, not an end. Corporate and investment managers, as well as investors themselves, will have to do the hard work of figuring out where the value enhancing opportunities are, even though there will be disagreement on the importance and weight of various stakeholder interests. But, in order to at least get all that capital working in the right direction, we have to change the basic rules. Companies and investors must stop competing to take and start competing to create.

The full article is available here.

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Companies Should Maximize Shareholder Welfare Not Market Value

Posted by Oliver D. Hart, Harvard University, on Tuesday, September 5, 2017

Editor's note: Oliver D. Hart is Andrew E. Furer Professor of Economics at Harvard University. This post is based on a recent paper authored by Professor Hart and Luigi Zingales, Robert C. Mccormack Distinguished Service Professor of Entrepreneurship and Finance at University of Chicago Booth School of Business.

There is a big debate in Washington about the attempt in many states to restrict people's ability to vote in political elections. Yet, there is almost complete silence about a more imminent and no less important form of vote suppression: the attempt to limit shareholder votes introduced in the Financial Choice Act, approved by the House in June. As in all forms of vote suppression, it takes a very technical and even benign form: the Financial Choice Act increases from the current level of $2,000 to 1% the ownership threshold for submitting shareholder proposals to be included in corporate ballots. While $2,000 might be too low to filter out purely frivolous proposals, 1% becomes prohibitive for all but a handful of institutional investors: for example, to make a proposal in Apple you would need over $7 billion in holdings.

The House proposal is the intellectual child of a long tradition in economics and finance, often associated with Milton Friedman, that regards maximization of shareholder value as the sole proper objective of a public company. If maximization of long-term share value is the sole objective, any shareholder vote on other issues is a waste of time and corporate resources.

To be sure, many legal scholars have challenged this tradition. But they have generally done so by arguing that directors owe a duty to other stakeholders (be they employees, the community, or the state). While one can discuss whether this might be desirable, Delaware law does not support it, at least according to Judge Leo Strine. Under Delaware law directors are elected by shareholders and by shareholders alone. They are "elected officials in the republic of equity capital" and they owe their loyalty to those who elect them. If corporations should conduct business according to their shareholders' desires, Friedman's conclusion that "the only social responsibility of business is to maximize profits" seems inevitable. Thus, why waste shareholders' time in voting on social proposals? We can happily disenfranchise them for their own good.

While apparently compelling, this argument is based on two weak assumptions. The first is that people care only about money. Many shareholders buy more-expensive electric cars or they pay more for fair-trade coffee because they care about some social objective: why would they not want the companies they invest in to do the same? In fact, Friedman himself recognizes that the shareholders can have other objectives. Nevertheless, he is able to achieve his famous conclusion because he (implicitly) assumes that the social objective is perfectly separable from the money making objective, i.e. making good is completely independent of making money. This

assumption certainly holds in Friedman's leading example: corporate charity. Shareholders' donations are as effective as companies' donations. Therefore, there are no benefits in letting corporate boards allocate profits to charity. It is much better to distribute the profits and let shareholders make this decision. Yet as we argue in our recent paper Companies Should Maximize Shareholder Welfare Not Market Value, this perfect separability assumption is unlikely to hold in general. Consider the recent case, *Trinity Wall Street v. Wal-Mart Stores, Inc.,* where some shareholders wanted to prevent Walmart from selling high-capacity magazines of the sort used in mass killings. If shareholders are concerned about mass killings, transferring profit to shareholders to spend on gun control might not be as efficient as banning the sale of high-capacity magazines in Wall Mart stores in the first place.

Once you drop this separability assumption, then it follows immediately that directors should maximize shareholder *welfare*, not value. One risk of this alternative goal—anticipated by Friedman– is that it can give too much leeway to corporate managers, leaving them free to pursue their own objectives under the guise of shareholder-desired social objectives. To mitigate this problem, in our paper we argue that companies should ask for more, not fewer, votes from their shareholders to find out what they want.

As we know from the social choice literature, voting is not necessarily a perfect method for aggregating individual tastes into social preferences, but it is the best we have. Furthermore, there is no reason to believe that ignoring shareholders' social preferences—as the shareholder value maximization movement would have it—dominates voting, with all its limitations.

One could object that forcing shareholders to vote on many issues would produce cognitive overload. In fact, investors could delegate this job to the mutual finds they invest in, as long as these intermediaries either poll them on their social preferences or segment their offerings depending on how they are going to cast the votes on social issues. Imagine a Vanguard—curb gun sales—S&P 500 fund. It will replicate the S&P 500 index, but it will commit to vote in favor of strategies that curb sales of automatic weapons in America.

In fact, the idea is so simple that one might wonder why we do not observe these funds already. While there are a lot of "ethical" funds, which divest from special sectors, we are not aware of any social purpose funds that do not divest, but engage in particular issues. We suspect that the reason is the reluctance of American corporations to let shareholders vote on social issues, a reluctance that the Financial Choice Act would only enshrine. It would be ironic if an act named "Financial Choice" ended up reducing the little power that shareholders still have in America.

The complete paper is available for download here.

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Shareholder Proposal Developments During the 2017 Proxy Season

Posted by Ronald O. Mueller and Elizabeth Ising, Gibson, Dunn & Crutcher LLP, on Wednesday, July 12, 2017

Editor's note: Ronald O. Mueller and Elizabeth Ising are partners at Gibson, Dunn & Crutcher LLP. This post is based on a Gibson Dunn publication by Mr. Mueller, Ms. Ising, and Lori Zyskowski.

This post provides an overview of shareholder proposals submitted to public companies for 2017 shareholder meetings, including statistics and notable decisions from the staff (the "Staff") of the Securities and Exchange Commission (the "SEC") on no-action requests.

I. Shareholder Proposal Statistics and Voting Results

A. Shareholder Proposals Submitted

1. Overview

For 2017 shareholder meetings, shareholders have submitted approximately 827 proposals, which is significantly less than the 916 proposals submitted for 2016 shareholder meetings and the 943 proposals submitted for 2015 shareholder meetings.

For 2017, across four broad categories of shareholder proposals—governance and shareholder rights; environmental and social issues; executive compensation; and corporate civic engagement—the most frequently submitted were environmental and social proposals (with approximately 345 proposals submitted).

The number of social proposals submitted to companies increased to approximately 201 proposals during the 2017 proxy season (up from 160 in 2016). Thirty-five social proposals submitted in 2017 focused on board diversity (up from 28 in 2016), 34 proposals focused on discrimination or diversity-related issues (up from 16 in 2016), and 19 proposals focused on the gender pay gap (up from 13 in 2016).

Environmental proposals were also popular during the 2017 proxy season, with 144 proposals submitted (up from 139 in 2016). Furthermore, there was an unprecedented level of shareholder support for environmental proposals this proxy season, with three climate change proposals receiving majority support and climate change proposals averaging support of 32.6% of votes cast. This compares to one climate change proposal receiving majority support in 2016 and

climate change proposals averaging support of 24.2% of votes cast. As further discussed below, the success of these proposals is at least in part due to the shift in approach towards environmental proposals by certain institutional investors, including BlackRock, Vanguard and Fidelity.

2. Types of Shareholder Proposals

The most common types of shareholder proposals in 2017, along with the approximate numbers of proposals submitted, were:

- social (201 proposals);
- environmental (144 proposals, including 69 climate change proposals);
- proxy access (112 proposals); and
- political contributions and lobbying disclosure (87 proposals).

By way of comparison, the most common types of shareholder proposals in 2016 were:

- proxy access (201 proposals);
- social (160 proposals);
- environmental (139 proposals, including 63 climate change proposals); and
- political contributions and lobbying disclosure (91 proposals).

3. Proponents

As is typically the case, John Chevedden and shareholders associated with him (including James McRitchie, Kenneth and William Steiner, and Myra Young) submitted by far the highest number of shareholder proposals for 2017 shareholder meetings—approximately 203, which is 24.5% of all shareholder proposals submitted to date in 2017. Other proponents reported to have submitted or co-filed at least 20 proposals each include: As You Sow Foundation (48, largely focused on environmental matters); Trillium Asset Management (42, largely focused on environmental matters); the New York City Comptroller (39, largely focused on governance/shareholder rights and environmental matters); Walden Asset Management (23, largely focused on environmental and political matters); Mercy Investment Services (21, largely focused on environmental and social matters); the New York State Common Retirement Fund (25, largely focused on political matters); and NorthStar Asset Management (20, largely focused on social matters).

II. Key Shareholder Proposal Topics and Trends During the 2017 Proxy Season

A. Environmental Proposals

The total number of environmental proposals increased in 2017, with shareholders submitting approximately 144 environmental proposals for 2017 meetings compared to 139 in 2016. Overall, the 55 environmental proposals voted on received average support of 28.9% of the votes cast, compared to 71 that received average support of 25.1% of votes cast in 2016.

The largest group of environmental proposals related to climate change, with 69 such proposals submitted in 2017 compared to 63 in 2016. The 28 climate change proposals voted on in 2017 averaged support of 32.6% of votes cast. Three climate change proposals received a majority of the votes cast, as further discussed below. Climate change proposals were submitted not just to oil and gas companies, but also to companies in the financial services and technology industries. ISS recommended that shareholders vote "for" 23 of the 28 proposals (or 82.1%) voted on in 2017 and "for" 27 of the 37 proposals (or 73.0%) of the proposals voted on in 2016.

In addition to climate change proposals, environmental proposals submitted in 2017 included:

- 28 proposals related to environmental impacts on the community or supply chains, including impacts of deforestation and pesticides (with 11 such proposals voted on averaging 23.6% support);
- 24 proposals calling for reports on sustainability (with nine such proposals voted on averaging 30.0% support);
- 12 proposals focusing on renewable energy (with four such proposals voted on averaging 18.3% support); and
- Nine proposals focusing on recycling (with three such proposals voted on averaging 24.3% support).

1. Three Climate Change Proposals Receive Majority Support and Pass in 2017

As mentioned above, three climate change proposals received majority support. Various factors may have contributed to the success of these proposals. Most notably, in March, BlackRock announced in its 2017-2018 engagement priorities that it expects boards to have "demonstrable fluency in how climate risk affects the business and management's approach to adapting and mitigating the risk," and that where it has concerns that a board is not "dealing with a material risk appropriately," it may signal that concern through its vote. Vanguard also updated its proxy voting guidelines in 2017 to state that it would evaluate each environmental proposal on the merits and may support those with a demonstrable link to long term shareholder value.

The three climate change proposals that passed specifically called for a report on the impact of climate change policies, including an analysis of the impacts of commitments to limit global temperature change to two degrees Celsius. The three companies where this proposal passed were the following:

- Occidental Petroleum Corp. received the proposal from Wespath Investment Management, the Nathan Cummings Foundation and other investors, including the California Public Employees' Retirement System ("CalPERS"), and it received support of 67.3% of votes cast by the company's shareholders, including BlackRock, a 7.8% owner. In an unprecedented move, BlackRock issued a press release announcing that it had supported the shareholder proposal.
- PPL Corp., a utility holding company, received the proposal from the New York State Common Retirement Fund, and it received support of 56.8% of votes cast by the company's shareholders, including CalPERS and other pension funds.
- Exxon Mobil received the proposal from the New York State Common Retirement Fund, and it received support from about 62.1% of votes cast by the company's shareholders.

These votes reflect the new willingness of institutional investors to support environmental proposals and the effect of increased pressure from their clients to influence companies on environmental issues. In addition, the same proposal was submitted to 18 other companies and voted on at ten companies, where it averaged 45.6% of votes cast.

B. Board Diversity Proposals

Board diversity continues to remain at the forefront of corporate governance discussions as investors and shareholder activists are increasingly pushing for gender diversity on the boards of U.S. public companies. Most recently, BlackRock and State Street Global Advisors announced plans to drive greater gender diversity on boards through active dialogue with companies. These institutional investors have indicated that, if progress is not made within a reasonable time frame, they plan to use their proxy voting power to influence change by voting against certain directors, such as members of nominating and governance committees.

As such, perhaps unsurprisingly, in 2017 the number of board diversity proposals reached an all-time high. Thirty-five proposals calling for the adoption of a policy on board diversity or a report on steps to increase board diversity were submitted in 2017 as compared to 28 proposals submitted in 2016. As in 2016, a substantial number of board diversity proposals were withdrawn, likely due to commitments made by companies to the proponents of these proposals, such as adopting board recruitment policies inclusive of race and/or gender.

Of the 35 proposals submitted in 2017, eight proposals have been voted on and received, on average, 28.3% of votes cast, as compared to six proposals in 2016, which received, on average, 19.1% of votes cast. ISS recommended that shareholders vote "for" all but two of the proposals voted on in 2017 and "for" all but one of the proposals voted on in 2016.

Two board diversity proposals submitted in 2017 received majority support, as compared to one in 2016. One of the successful proposals was submitted by the City of Philadelphia Public Employees Retirement System to Cognex Corp. requesting that the company's board adopt a policy for "improving board diversity [by] requiring that the initial list of candidates from which new management-supported director nominees are chosen . . . by the Nominating and Corporate Governance Committee should include (but need not be limited to) qualified women and minority candidates." Cognex Corp. had no women on its board of directors. The proposal received 62.8% of votes cast. The second proposal asked a different company to prepare a report (at a reasonable expense and omitting proprietary information) on steps the company is taking to foster greater diversity on its board. The proposal received the support of 84.8% of votes cast.

These results, along with the continued investor focus on board composition and board diversity, mean that board diversity will continue to be raised in shareholder engagements, and that shareholder proponents likely will continue to use the Rule 14a-8 shareholder proposals process as a way to push for greater board diversity.

…

IV. Top Take-Aways for 2017 Season

Based on the results of the 2017 proxy season, there are several key take-aways to consider:

- **First, 2017 was the year for both environmental and social proposals to take center stage, and the spotlight on these issues is likely to continue to shine brightly in 2018.**
  - Over 40% of shareholder proposals submitted in 2017 dealt with environmental and social issues, making this the largest category of shareholder proposals for the first time since 2014.
  - The key environmental proposals in 2017 were climate change proposals (69 in 2017, with those voted on averaging 33.8% support); environmental impacts on communities or supply chains (28 in 2017, with those voted on averaging 23.6% support), and reports on sustainability (24 in 2017, with those voted on averaging 30.0% support). The key social proposals to watch are board diversity proposals (35 in 2017, with those voted on averaging 28.3% support); diversity-related proposals (34 in 2017, with those voted on averaging 24.2% support); and gender pay gap proposals (19 in 2017, with those voted on averaging 18.8% support).
  - With the Administration's decision to withdraw from the Paris Climate Accord and decrease federal support for environmental initiatives, the focus on private sector environmental initiatives has increased, including through the submission of shareholder proposals. In this context, engagement on climate-related matters has become more important, as several institutional investors have indicated that company engagement and responsiveness on these issues can sway their votes.
  - With several institutional investors increasingly willing to support environmental proposals, companies should consider whether to take additional actions with respect to their sustainability practices and how these efforts are communicated to investors.
- **Second, in the area of virtual-only annual meetings, the stage is set for increased debate over this hot-button issue.**
  - Companies now have solid no-action request precedent to exclude these shareholder proposals. That being said, certain investors are very vocal about their opposition to virtual-only meetings. Their activism (both leading up to and during the meeting) may discourage some companies from making a move to virtual-only meetings.
  - Companies that are currently holding virtual-only annual meetings may face increasing pressure to either hold hybrid annual meetings or to enhance virtual-only meetings to make them as interactive as possible (*i.e.*, as close to a physical annual meeting as possible). This would include live audio and/or video participation for all shareholder participants, which is something most companies that hold virtual-only annual meetings currently do not accommodate.
- **Third, although the spotlight on proxy access has waned, this has become the latest standard governance practice.**
  - Companies that have not yet adopted proxy access are likely to continue to face shareholder proposals on this topic in the coming years, and these proposals are likely to continue to receive significant support—in 2017, adopt proxy access proposals voted on received average support of 63.2% of votes cast.
  - Accordingly, companies that have not yet adopted proxy access may consider whether to do so—and this may arise either in response to a shareholder proposal or due to the desire to align with majority practice among S&P 500 companies. Likewise, companies that previously adopted proxy access,

particularly those that were early adopters of proxy access, may want to revisit their bylaws and consider whether their provisions align with the terms adopted by the majority of adopters.

- **Lastly, the momentum to amend Rule 14a-8 is growing, albeit slowly.**
    - There is increasing support for amendments to the shareholder proposal rule to update various thresholds in the rule and address some of the ways in which the rule has been abused. Rule 14a-8 was last amended in 2010 to no longer permit the exclusion of proxy access shareholder proposals. However, there have been calls for some time to address other aspects of the rule. Top items on the reform list for Rule 14a-8 include increasing the holding period and ownership requirements for shareholder proponents and increasing the resubmission thresholds for proposals that were voted on in prior years.
    - The CHOICE Act takes a comprehensive approach to amending the rule and aims to address these "top items" on the reform list as well as to prohibit submission of so-called "proposal by proxy" (*i.e.*, ability of a proponent to act as a designee for an actual shareholder with respect to a proposal). Given the scope of the reforms in the CHOICE Act, and with a new Administration and growing support for deregulation, changes to Rule 14a-8 may finally happen. Even without Congressional action, the SEC could take action on its own to amend Rule 14a-8 with its rulemaking authority.

The complete publication, including footnotes, is available here.

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Investor Support Heating Up for Climate Change Proposals

Posted by Lyuba Goltser and Kaitlin Descovich, Weil, Gotshal & Manges LLP, on Monday, July 3, 2017

Editor's note: Lyuba Goltser is a partner and Kaitlin Descovich is an associate at Weil, Gotshal & Manges LLP. This post is based on a Weil publication by Ms. Goltser and Ms. Descovich. Related research from the Program on Corporate Governance includes Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

The biggest headline of the 2017 proxy season was a change in the policies, engagement efforts and voting of institutional investors and asset managers on environmental and climate change issues, which occurred against the backdrop of shifting U.S. policies on these issues. These changes, which resulted in majority-supported proposals at three S&P 500 companies, reflect intensified investor focus on sustainable business practices—a broad category in which environmental and social risks, costs and opportunities of doing business are analyzed alongside conventional economic considerations—as a key factor in long-term financial performance.

The predominant proposals of the season centered on climate change, with a total of 34 companies in the S&P 500 receiving such proposals.[1] In striking contrast with the recent past, when climate change proposals enjoyed little success, this season three proposals—a proposal submitted to Occidental Petroleum by CalPERS and proposals submitted to PPL Corp. and Exxon Mobil Corp. by the New York State Common Retirement Fund—received majority support from shareholders. Moreover, proposals submitted to five companies—Ameren Corporation, Devon Energy Corp., Dominion Energy Inc., DTE Energy Company and The Southern Co.—received over 40% support.

Generally speaking, the proposals received by these companies called for them to issue an annual report assessing the impact of long-term climate change on their asset portfolio and explaining "how capital planning and business strategies incorporate analyses of the short- and long-term financial risks of a lower carbon economy." In particular, the proposals called for the report to outline "the impacts of multiple, fluctuating demand and price scenarios on the company's existing reserves and resource portfolio" and provide a "2 degree scenario analysis" based on the Paris Climate Accord goal of limiting the increase in global temperature to two degrees.

The shareholder victories and near-victories can principally be credited to changes to the voting policies of large institutional investors and asset managers made ahead of the 2017 proxy season. Until this season, Blackrock, Vanguard and Fidelity, for example, had either abstained from voting or voted against such proposals. This year they changed their policies and, for the

[1] See ISS Governance Analytics (June 16, 2017).

first time, supported climate change proposals. Annex A, available here, provides a snapshot of the policies of some of the largest institutional investors and asset managers on climate change and/or environmental-related shareholder proposals.

In explaining its support for the proposal at Exxon, Blackrock noted that it had voted against a similar proposal in 2016 in the expectation of meaningful improvements in Exxon's climate risk reporting.[2] In voting for the proposal this year, Blackrock cited Exxon's failure to "substantially address a 2-degree scenario" notwithstanding improvements in its reporting. Blackrock also noted that its inability to meet with Exxon's independent directors on strategic topics (including but not limited to oversight of climate risk) led it to vote against the election of both the lead independent director and board affairs committee chair. In explaining its support for the proposal at Occidental, BlackRock cited a lack of observed changes in climate-related reporting practices notwithstanding engagement on the topic over two years.[3] In its engagement priorities for 2017-2018, Blackrock emphasized that "as a long-term investor, we are willing to be patient with companies when our engagement affirms they are working to address our concerns. However, our patience is not infinite—when we do not see progress despite ongoing engagement, or companies are insufficiently responsive to our efforts to protect the long-term economic interests of our clients, we will not hesitate to exercise our right to vote against management recommendations."

CalSTRS and CalPERS, two of the largest U.S. pension funds, have committed to corporate engagement on climate change through policy advocacy, engagement with portfolio companies, and investing in climate change solutions. The New York City Comptroller's Office, acting on behalf of the city's five pension funds, has cited the failure of companies to address climate risks as a primary reason for its large and influential campaign to expand "proxy access" and has engaged with many companies on these issues resulting in the settlement and withdrawal of shareholder proposals.

What to Do Now?

The results of the 2017 proxy season leave no doubt about the heightened expectations of major investors for climate change risk disclosure and engagement. To meet these expectations, companies and their boards should consider the following:

- Incorporate material sustainability factors, including climate change, into the formulation and evaluation of business strategy and risk management.
- Take a fresh look at how the board oversees climate change and other sustainability risks, and expressly allocate responsibility to an existing board committee, a new committee or the full board, as appropriate. Memorialize the board's decision in a committee charter or other governance document.
- Understand the policies of significant investors, including how these policies may relate to their investment analysis. Prepare to meet requests by these investors for substantive engagement.
- Recognize that investors expect companies to be proactive in providing enhanced disclosure, such as an annual sustainability or climate change report, as well as insights into how the board oversees the management of material risks posed by climate change.

[2] See BlackRock Voting Bulletin: Exxon Mobil, available here.
[3] See BlackRock Voting Bulletin: Occidental, available here.

Note that investors are looking for such disclosure to address matters that they consider meaningful, such as 2-degree scenario planning.

- Keep abreast of efforts to create standards and benchmarks for reporting on climate change and other sustainability issues, such as those underway by the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB).
- Consider, and discuss with the disclosure committee, how the company addresses existing SEC interpretive guidance about climate change disclosure in its periodic filings (i.e., MD&A, risk factors).[4]
- Understand the disclosures and policies of the company's peers with respect to climate change risks and opportunities.
- Provide periodic updates to the board of directors on industry-specific issues and pressures with respect to climate change to enable directors to thoughtfully consider climate risks and opportunities faced by their companies.
- In connection with reviewing board composition and skills, consider whether the board has the necessary expertise and competency to address environmental and climate issues.

[4] See Securities Act Rel. No. 9106 (Feb. 2, 2010)("2010 Interpretive Release"), available here. For a discussion of the 2010 Interpretive Release, see Climate Change Disclosure: Nothing New Under the Sun (Feb. 24, 2010), available here.

Breaking the Ice: Investors Warm to Climate Change

Posted by Nick Dawson, Proxy Insight, on Friday, June 9, 2017

Editor's note: Nick Dawson is Co-Founder & Managing Director at Proxy Insight. This post is based on a Proxy Insight publication.

With the first ever 2 degrees Celsius campaign proposal recently passing at Occidental Petroleum, this post looks at the increasing success of climate change shareholder proposals alongside Proxy Insight data on the subject.

Warming to climate change

Investors in Occidental Petroleum recently passed a shareholder resolution on climate change reporting. The vote was hailed as historic, marking the first time such a resolution has passed at a major US fossil fuel company, indicating what could be the next hot topic in global corporate governance standards.

A few years ago, climate change was a fringe issue. Ignored by mainstream investors, environmental resolutions were lucky to receive 5 percent support. Now, issuers who try to ignore the associated risks could face serious financial consequences.

The victory of Occidental's shareholders was arguably the result of a perfect storm. Over the past few years, climate change resolutions have become increasingly sophisticated. Where once they tended to be overly prescriptive and confrontational, they now aim to appeal to all parties involved.

Many resolutions exploit investors' fiduciary obligation to act in the best interests of their clients by emphasizing the relevance of the disclosures being requested. Recent climate change proposals also make more of an effort to placate companies. Indeed, by being more general, and in many cases advisory, most current proposals rely on investor support to pressure companies into implementing what they want.

BlackRock's change of heart

One of the main reasons for the success of the climate change resolution at Occidental was the support of BlackRock. The asset manager has a 7.8 percent holding in Occidental, making it the company's largest single shareholder. In an unprecedented move, BlackRock supported the climate change proposal in defiance of management.

In 2016, several institutional investors received shareholder proposals at their annual meetings which questioned their track record on a number of issues. Blackrock was one of those investors, alongside the likes of BNY Mellon, Franklin Templeton and T. Rowe Price.

Climate change was among the issues highlighted by BlackRock's shareholders, who pointed to the gap between the asset manager's voting policy and its record of actual votes cast.

Although the resolution at BlackRock only garnered 5 percent support, it seems to have had an impact. Earlier this year, BlackRock announced that it would be applying new pressure to companies on issues such as climate change and boardroom diversity.

2 degrees Celsius campaign

The resolution at Occidental Petroleum is a classic example of today's more sophisticated climate change proposals. It asks the company to explain how it intends to handle the impact of the Paris Agreement, which seeks to limit global warming to 2 degrees Celsius.

The resolution therefore provides a fiduciary incentive for investors to support it and a clear justification for companies to disclose, as governments may in future impose penalties on high-emission companies. The success of the 2 degrees campaign is reflected by strong investor support. Its resolutions receive an average of 45.7 percent of votes, compared to just 26.0 percent for other climate change proposals.

Strategic Resilience for 2035 and Beyond

A similar, even more successful campaign was Strategic Resilience for 2035 and Beyond. Resolutions for this campaign were submitted to a number of major UK fossil fuel companies last year by the "Aiming for A" coalition.

Through extensive dialogue with boards, every one of these resolutions secured management backing. When it came to a vote, this helped the campaign achieve an average support level of over 98.1 percent across all companies.

The resolutions require that, from 2017 onwards, companies provide additional disclosure in several areas through their annual reporting. This includes more comprehensive information about ongoing operational emissions management, public policy positions on climate change issues and any research and development or investment strategies in low-carbon energy.

Companies are also required to analyze the resilience of asset portfolios to the International Energy Agency's (IEA) scenarios, and to detail relevant strategic key performance indicators (KPIs) and executive incentives that relate to environmental issues.

The campaign's resolutions go on to suggest that this additional information could supplement disclosures that are already made. Either they could be attached to disclosures made to the CDP (formerly the Carbon Disclosure Project), or those contained within companies' Annual Report and Sustainable Development Reports.

As Table 1 illustrates, support for the 2 degrees campaign has been slowly increasing since the signing of the Paris Agreement in April 2016. The average support for 2 degrees resolutions was 40.5 percent in 2016, whereas so far in 2017 such resolutions have received an average of 48.3 percent.

Consequently, as shareholder proposals on climate change continue to garner more support, issuers will have to put more effort into their climate change reporting, lest they risk having their cards revealed by investors.

Issuer	Meeting Date	Proposal Type	For (%)*	Against (%)*	Abstain/ Withheld (%)
AES Corp. (The)	21-Apr-16	Assess Impact of a 2 Degree Scenario [S]	42.2	57.8	14.8
Occidental Petroleum Corp.	29-Apr-16	Assess Impact of a 2 Degree Scenario [S]	49.0	51.0	13.7
Chevron Corp.	25-May-16	Assess Impact of a 2 Degree Scenario [S]	40.8	59.2	5.9
Southern Company (The)	25-May-16	Assess Impact of a 2 Degree Scenario [S]	34.5	65.5	4.0
Devon Energy Corp.	08-Jun-16	Assess Impact of a 2 Degree Scenario [S]	36.1	63.9	3.7
AES Corp. (The)	20-Apr-17	Assess Impact of a 2 Degree Scenario [S]	40.1	59.9	6.5
Marathon Petroleum Corp.	26-Apr-17	Assess Impact of a 2 Degree Scenario [S]	40.9	59.1	3.1
Ameren Corp.	27-Apr-17	Assess Impact of a 2 Degree Scenario [S]	47.5	52.5	6.8
DTE Energy Company	04-May-17	Assess Impact of a 2 Degree Scenario [S]	45.0	55.0	2.1
Duke Energy Corp. - DUKH	04-May-17	Assess Impact of a 2 Degree Scenario [S]	46.4	53.6	2.4
Dominion Resources Inc.	10-May-17	Assess Impact of a 2 Degree Scenario [S]	47.8	52.2	2.2
Occidental Petroleum Corp.	12-May-17	Assess Impact of a 2 Degree Scenario [S]	67.0	32.0	2.1
FirstEnergy Corp.	16-May-17	Assess Impact of a 2 Degree Scenario [S]	43.4	56.6	6.5
PNM Resources Inc.	16-May-17	Assess Impact of a 2 Degree Scenario [S]	49.0	50.0	9.0
PPL Corp.	17-May-17	Assess Impact of a 2 Degree Scenario [S]	56.0	43.0	6.0
BP PLC	16-Apr-15	Approve Strategic Resilience for 2035 and Beyond [S]	98.3	1.7	2.5
Royal Dutch Shell PLC	19-May-15	Approve Strategic Resilience for 2035 and Beyond [S]	98.9	1.1	3.3
Rio Tinto PLC	14-Apr-16	Approve Strategic Resilience for 2035 and Beyond [S]	99.2	0.8	0.8
Anglo American PLC	21-Apr-16	Approve Strategic Resilience for 2035 and Beyond [S]	96.3	3.8	0.4
Glencore Plc	19-May-16	Approve Strategic Resilience for 2035 and Beyond [S]	98.1	1.9	0.5

*Table 1: Voting results for 2 degrees Celsius and Strategic Resilience for 2035 and Beyond shareholder proposals *For (%) and Against (%) columns do not include Abstain/Withheld percentages Source: Proxy Insight*

Shareholder Proposals: Evidence of Private Ordering Supplanting Public Policy?

Posted by John Roe, Institutional Shareholder Services, Inc., on Monday, June 19, 2017

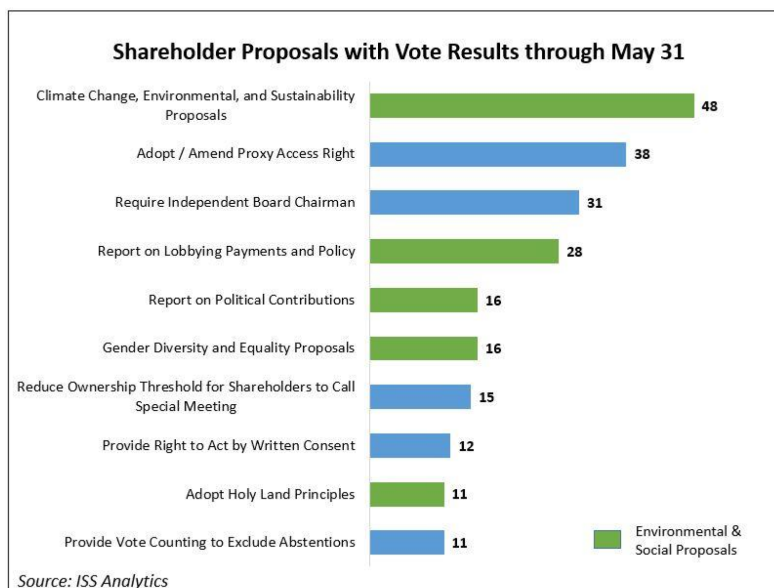
Editor's note: John Roe is Head of ISS Analytics at Institutional Shareholder Services, Inc. This post is based on an ISS publication by Mr. Roe.

Earlier this [month], ExxonMobil released a preliminary tally revealing that 62.3 percent of shareholders supported a non-binding shareholder resolution calling for "an annual assessment of the long-term portfolio impacts of technological advances and global climate change policies, at reasonable cost and omitting proprietary information." A similar proposal filed just last year garnered only 38.1 percent shareholder support—which leads to the question, *what's changed so dramatically in the past year?* We'll get to that in a moment—but first, let's take a look at shareholder proposals voted so far in 2017, and put those into some historical context.

Environmental proposals lead the way in 2017

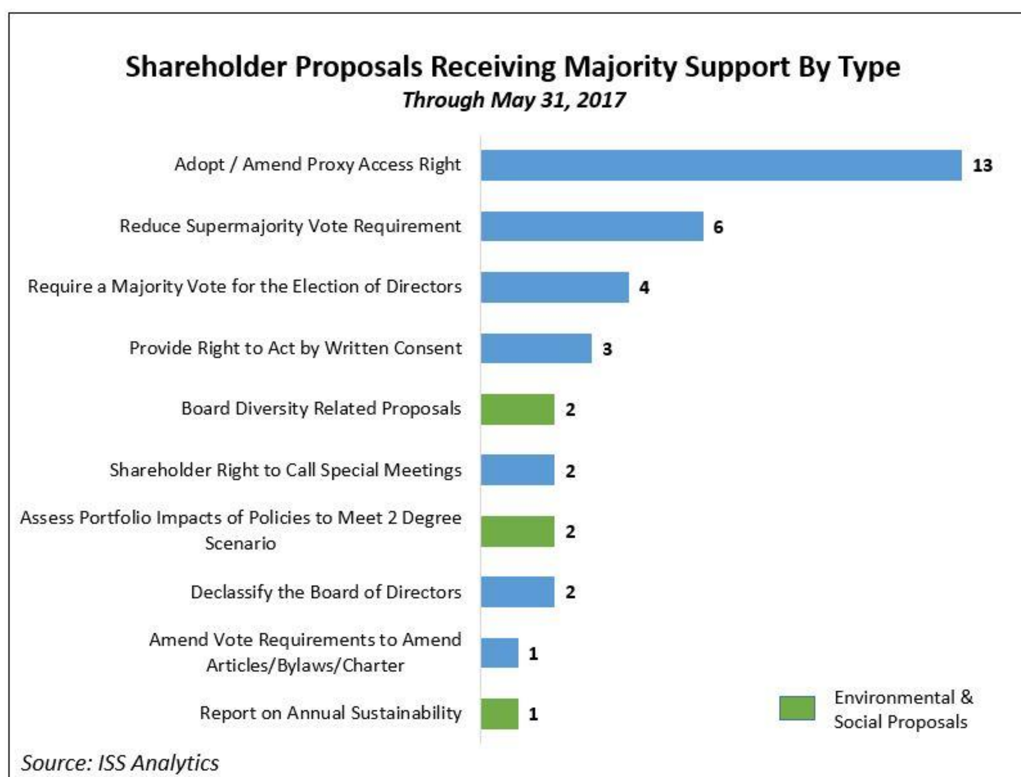
With 330 shareholder proposal results filed by U.S. companies so far this year, we have a good idea of where trends are headed for the full year. 2017 stands out as a year where environmental proposals are emerging more frequently and gaining widespread traction among investors.

On top of these results, more than 80 additional proposals will be voted on this month—and results from proposals voted in May are still being released.



Only eleven percent of voted shareholder proposals earned majority support so far in 2017

Of the 330 shareholder proposals with voting results published through May 31, and excluding proxy contest-related proposals, 36 have received at least 50% shareholder support. Among these, proxy access proposals are leading the way. The next two are more traditional governance-related proposals: voting rights related proposals and proposals requesting shareholders' right to act by written consent. But interestingly, we're beginning to see success with environmental and social proposals this year, much more than ever before. Already, we're seeing shareholders have success with board diversity and climate change proposals—and these are in addition to ExxonMobil's proposals, which had not yet been reported via 8-K as of June 1.



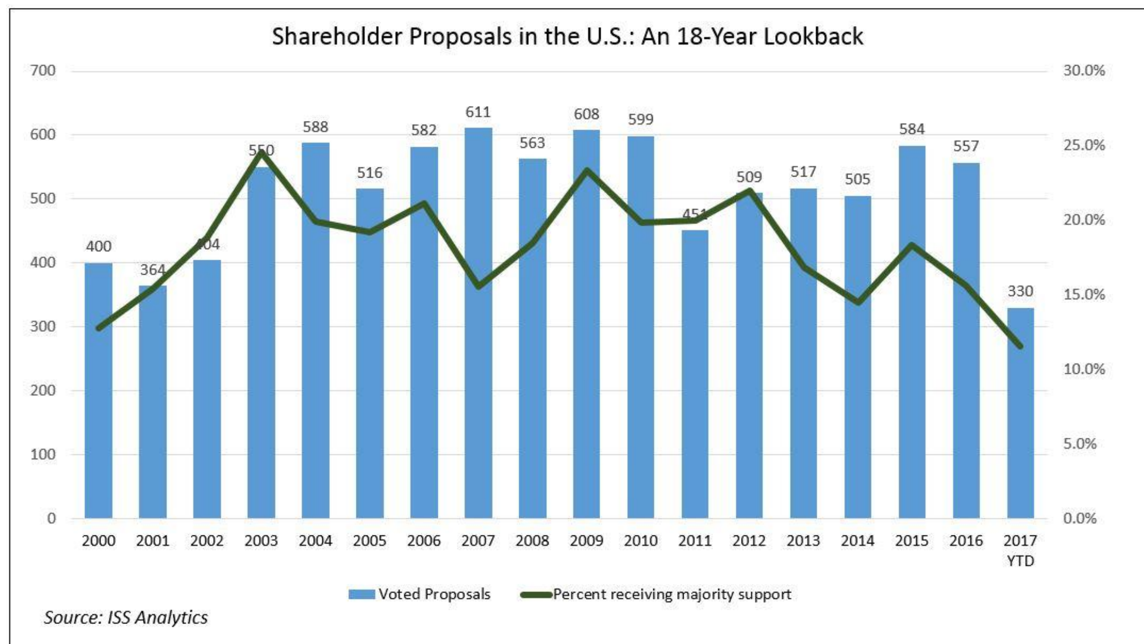
The majority-supported environmental & social shareholder proposals appearing in the list above, while small in number, may signal an important shift in shareholder thinking and willingness to act. In comparison, last year only one climate change proposal was majority-supported, a request for a report on sustainability including greenhouse gas goals at CLARCOR.

Majority support rate lowest in 18 years

Since 2015, much of the shareholder proposal dialogue has been focused on proxy access—but taking a longer view provides some perspective on how today's proposal activity compares to years past. Notably, 2017 is on track to have the lowest percentage of majority-supported proposals in the last 18 years.

Looking across all U.S. companies that ISS covers, we find more than 9,200 shareholder proposals with published vote results filed since 2000. And although much has been made of the proxy access success, the number of proposals making it to the vote over the last few years has not made it back to the 600+ peaks back in 2007 and 2009. The reasons for this are many, and may include:

- Greater proactive focus on governance issues among issuers
- Increased dialogue between companies and shareholders, leading to issues being resolved off the ballot more often
- Fewer opportunities to "clean up" legacy practices such as staggered boards and plurality vote standards among larger companies



At ExxonMobil, same proposals but new results: a sign of the trend reversing?

ExxonMobil provides a glimpse at what may become an increasing trend: old proposals with new results. With a reported vote result increase of 24 percentage points on a substantially similar proposal over the 2016 result, ExxonMobil's outcome begs the question: *Is the change due to new voters casting votes, or is it a "change of heart" among longer-term investors?* While the data is still coming in, it doesn't appear to be a shift in the shareholder base—according to FactSet Research, nine of the top ten shareholders in 2016 were still in the top ten in 2017, as were seventeen of the top twenty holders. In fact, shareholders exiting the top twenty holders list accounted for less than 1.5 percent of all shares outstanding.

The conclusion is, then, that shareholders who voted against the proposal in 2016 changed how they voted in 2017. While N-PX filings for many large institutional holders will be available later in the year to confirm the votes cast, widely-reported statements by large holders such as BlackRockand State Street indicate that they are changing how they look at, and act upon, these issues.

The results of these changes may be two-fold: One, reversing the trend of a smaller percentage of proposals earning majority support, and two, emboldening would-be proponents to file an increasing number of environmental & social proposals.

What's Next? Private ordering a possible replacement for public policy

With the recent announcement that the United States will withdraw from the Paris climate accord, we're beginning to see a groundswell of broad-based investor and issuer support for issues that public policy may be pulling back on. Notably, Goldman Sachs CEO Lloyd Blankfein issued his first tweet ever [on June 1, 2017], using the platform to establish his position on environmental issues.

Other institutional investors, asset owners, and issuers have affirmed their support for emerging and legacy environmental and social issues. It appears that many proxy voters are adjusting their voting policies on related shareholder proposals. As these policies become more widespread, there is the potential for a significant shift in the outcomes of shareholder proposals in general, leaving us with the question: is 2017 the nadir for support of shareholder resolutions? Time will tell.

Social Responsibility Resolutions

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

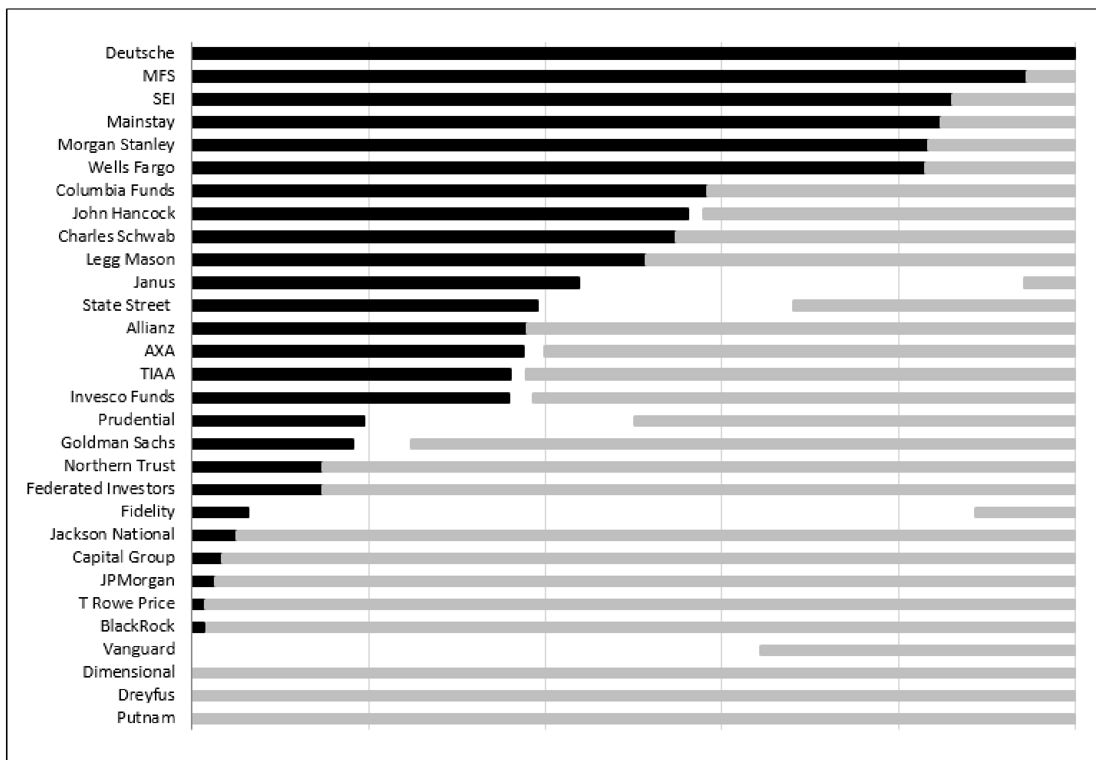
Editor's note: Scott Hirst is a Lecturer on Law at Harvard Law School and Associate Director of the Harvard Law School Program on Corporate Governance. This post is based on a recent article by Dr. Hirst, forthcoming in the *Journal of Corporation Law*.

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 II: Boards of Directors

Independent Directors: New Class of 2016

Posted by EY Center for Board Matters, on Thursday, May 4, 2017

Editor's note: This post is based on a publication from the EY Center for Board Matters.

Today's boards are navigating disruptive changes, a dynamic geopolitical and regulatory environment, shifting consumer and workforce demographics, and shareholder activist activity amid a push by leading investors for a more long-term strategic focus. These demands highlight the critical role boards play in helping companies manage risk and seize strategic opportunities.

To see how boards are keeping current and strategically aligning board composition to company needs, we reviewed the qualifications and characteristics of independent directors who were elected to Fortune 100 boards for the first time in 2016 (Fortune 100 Class of 2016). We also looked at some of the same data for the Russell 3000, and we highlight those findings at the end of this post.

This post highlights five key findings about the Fortune 100 Class of 2016; but first it's worth noting that nearly 60% of Fortune 100 companies added at least one independent director following the company's 2015 annual meeting. These boards added an average of 1.8 directors—and close to one-fifth of these boards added three or more directors.

The Fortune 100 Class of 2016 brings a wide range of strengths into the boardroom

Based on the qualifications highlighted in corporate disclosures, expertise in corporate finance or accounting was most frequently cited. More than half of directors assigned to the audit committee were recognized as financial experts. Companies also highlighted leadership positions in multinational corporations, managing global operations or detailed knowledge of certain markets of particular interest to company strategy. Board experience (public or private) or corporate governance expertise also was commonly cited.

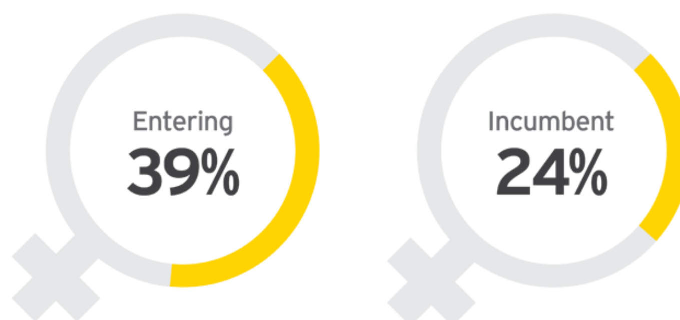
Top 10 skills and expertise of Fortune 100 Class of 2016

1	Corporate finance, accounting
2	International business
3	Board service (public and private), corporate governance experience
4	Industry
5	**Strategy**
6	Marketing or business development
7	**Technology**
8	Risk oversight
9	Government, public policy, regulatory
10	**Transactional finance (M&A, private equity, investment banking)**

The Fortune 100 Class of 2016 enhances gender diversity

Nearly 40% of the Fortune 100 Class of 2016 are women, compared to less than a quarter of incumbents and less than one-fifth of the exiting directors. Newly appointed women directors also are slightly younger than male counterparts (57 compared to 59).

Distribution of Fortune 100 female directorships

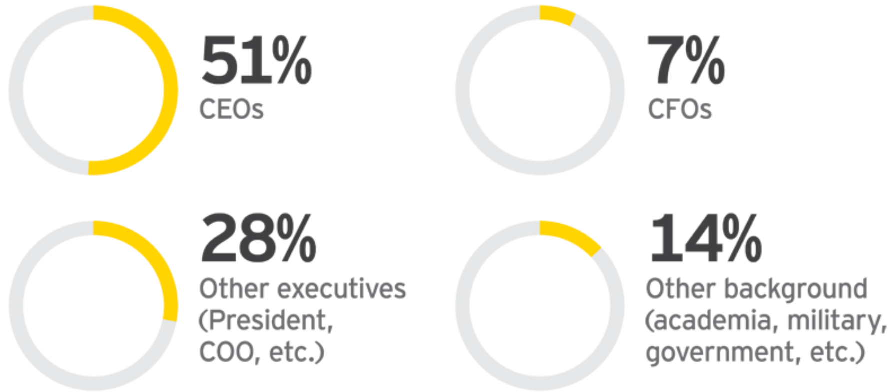


Only about half of the Fortune 100 Class of 2016 are current or former CEOs

While experience as a CEO is often cited as a historical first cut for search firms, about half of the Fortune 100 class of 2016 have non-CEO backgrounds as corporate executives or have non-corporate backgrounds (e.g., scientists, academics and former government officials). Ten percent worked at an institutional investor, an experience which was highlighted to communicate the company's interest in shareholder perspectives. Another 9% were described as bringing

experience in innovation or having the capability to drive innovation. It's also notable that 17% of the entering class appear to be joining a public company board for the first time.

Fortune 100 Class of 2016 director backgrounds (% of directors)



The Fortune 100 Class of 2016 tends to be younger than their director counterparts

The average age of entering directors was 58, compared to 64 for incumbents and 68 for the exiting group. Although most directors are between 50 and 67, nearly 10% of the entering class was under 50 compared to 1% of incumbent directors. Over half of exiting directors were age 68 or older.

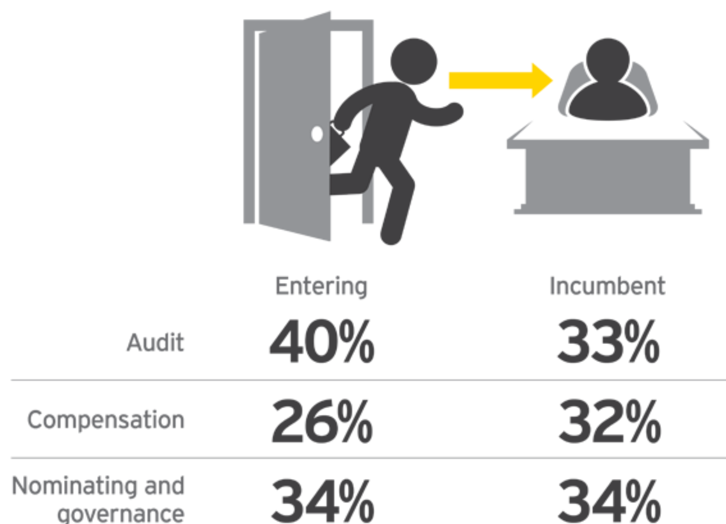
Distribution of Fortune 100 directorships by age

	Entering	Incumbent
68+	2%	31%
60-67	44%	41%
50-59	45%	26%
Under 50	9%	2%

Members of the Fortune 100 Class of 2016 are mainly being added to audit committees

Entering directors are more likely to join the audit committee during their first year on the board. While the committee service of incumbent directors appears to be fairly evenly distributed, the exiting group was most likely to hold positions on the nominating and governance committees.

Distribution of Fortune 100 key committee membership



How does the Russell 3000 Class of 2016 compare?

Significantly fewer Russell 3000 companies added at least one independent director following the company's 2015 annual meeting, and those that did added fewer independent directors. The Russell 3000 Class of 2016 independent directors tend to be slightly younger than the Fortune 100 Class of 2016, and when it comes to key committee membership, they're also most likely to join the audit committee in their first year on the board. Just around a quarter is female, however, showing that smaller company boards have a steeper climb ahead to achieve gender parity.

	Russell 3000	Fortune 100
Boards that added a director last year (% of companies)	**43%**	58%
Average new directors per refreshing board	**1.5**	1.8
Portion of refreshing boards that added three or more directors	**9%**	18%
Gender (% of new female directors)	**26%**	39%
Age group (% of new directors)		
68+	**8%**	2%
60 to 67	**32%**	44%
50 to 59	**44%**	45%
Under 50	**16%**	9%
Key committee membership (% of new directors)		
Audit	**38%**	40%
Compensation	**26%**	26%
Nominating and governance	**26%**	34%

Questions for the nominating and governance committee to consider

- How current and relevant are the skills of incumbent directors to the company's long-term strategy?
- Given increasing attention to director qualifications, including by shareholder activists, do existing company disclosures effectively communicate the strengths of incumbent directors?
- How diverse is the board—defined as including considerations such as age, gender, race, ethnicity, nationality—in addition to skills and expertise?
- How can the board's existing succession planning efforts and approach to considering director candidates be enhanced?

Harvard Law School Forum on
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Balancing Board Experience and Expertise

Posted by John Roe, Institutional Shareholder Services, Inc., on Friday, July 28, 2017

Editor's note: John Roe is Head of ISS Analytics and Managing Director at Institutional Shareholder Services, Inc. This post is based on an ISS publication by Mr. Roe.

One criticism frequently leveled against boards of directors is that, when it comes to filling vacant board seats, they don't cast the net widely enough. The numbers clearly show that boards often fill seats with candidates that have previous board experience—it's even written right into the job description given to search firms in some cases. And, for many boards, that's an understandable request—bringing on a "proven" director can side-step some of the concerns that shareholders and other board members may have.

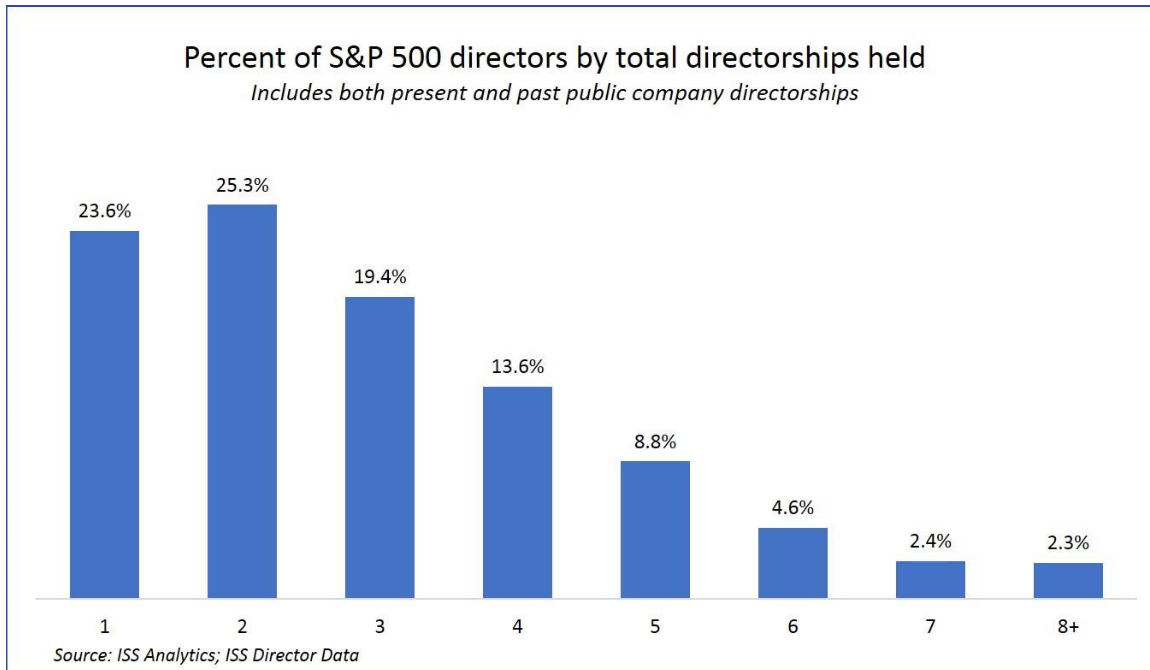
But the flip side of the coin is that the seeming preference for directors with previous board experience may hamper efforts to bring new and diverse views into the boardroom. Some cynics wonder, if companies are simply cycling through the same individuals again and again to fill vacant seats, how many new views are companies actually bringing into the boardroom?

To add some substance to the conversation, we thought it appropriate to see exactly how experienced directors are, starting with S&P 500 companies. Our Director Data database contains information on directors and the public company boards where they currently sit, as well as all directorships the director has held in the past, going back more than thirty years.

For this analysis, when we're talking about experience, we're not talking about how old they are, or how many years they've been working—but rather, how many board seats those directors have held. We count both present directorships held, as well as those held in the past, across all companies that ISS covers. Note, this analysis does not include directorships held at private companies or non-profit organizations.

Fewer than one quarter of S&P 500 directors have held only one directorship

In the U.S., fewer than one in four directors in the S&P 500 has held only one directorship—more than three-quarters have held, or still currently hold, at least one additional board seat. And there are examples of directors that have had more than a dozen board seats over their career. Several of those are directors affiliated with active investors—although there are examples of those who are not, as well.



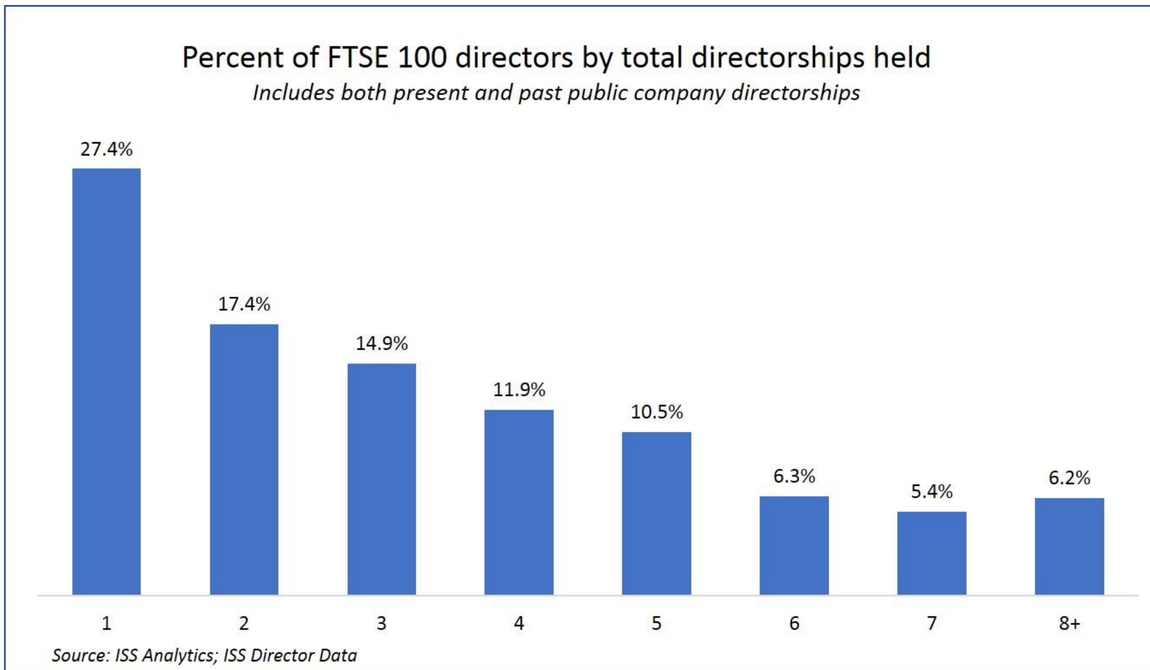
One significant source for these one-directorship directors are sitting CEOs of S&P 500 companies. More than one hundred and fifty CEOs of S&P 500 companies sit only on their own public company board (again, not including private and non-profit organizations). Others are "specialty" role players, such as emerging cyber risk experts—although the numbers suggest that, once identified, these specialists are often asked to join other boards, as well.

S&P 500 companies seem increasingly willing to take on "new" directors

Overall, out of that 23.6 percent of directors with only one directorship, S&P 500 companies have added nearly 200 new individuals to the boardroom in that timespan—and even more, counting those directors who are new to the boardroom since 2015 and have already been seated on multiple boards. Putting that into more tangible terms, about one in three S&P 500 companies has seated new first-time directors since the beginning of 2015. That number is trending up, perhaps in part reflecting the drive to increase diversity and fill critical skill gaps in the boardroom.

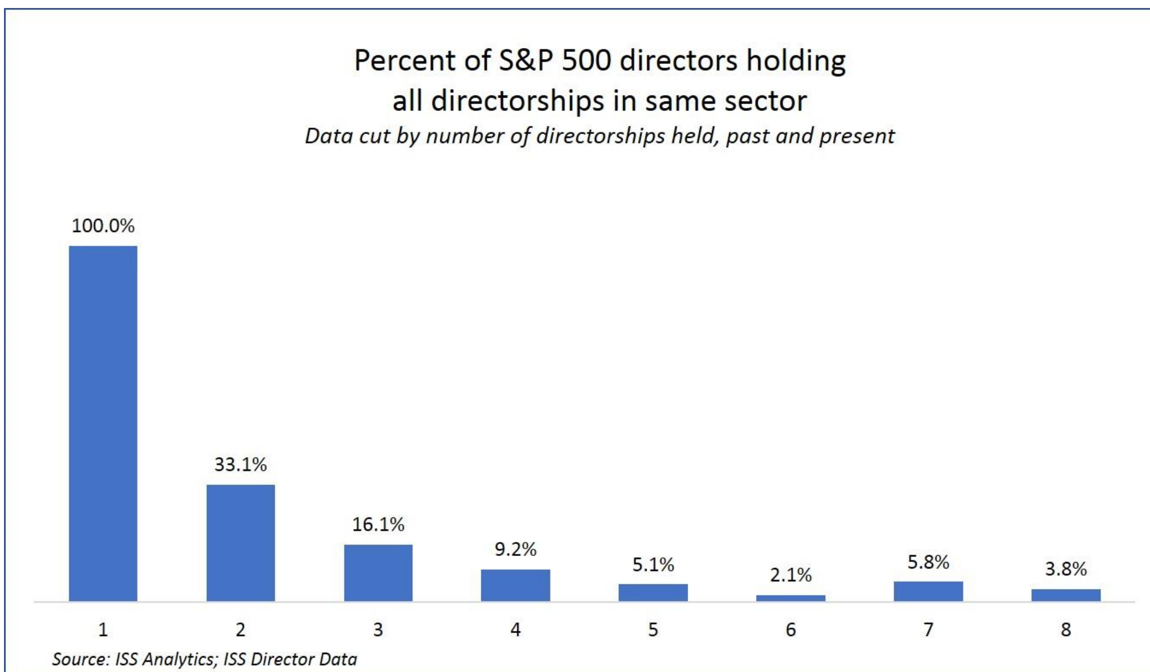
Not just an American phenomenon: FTSE 100 directors roughly the same

Among large-cap UK companies, we see a similar phenomenon, with the difference being that both ends of the distribution are elevated slightly. In other words, there are a slightly higher proportion of single-directorship directors at FTSE 100 companies, as well as a slightly higher proportion of directors that have held at least 8 directorships.



Directors seldom industry-exclusive

A second interesting dimension to the question is around industry concentration for directors that hold multiple directorships. We looked at this through the angle of the two-digit S&P GICS sector, looking to see what percentage of directors with multiple directorships held all of their directorships in a single sector. We cut the analysis by the number of directorships held—clearly, the more directorships held, the likelier a director is to diversify the sectors that they serve.



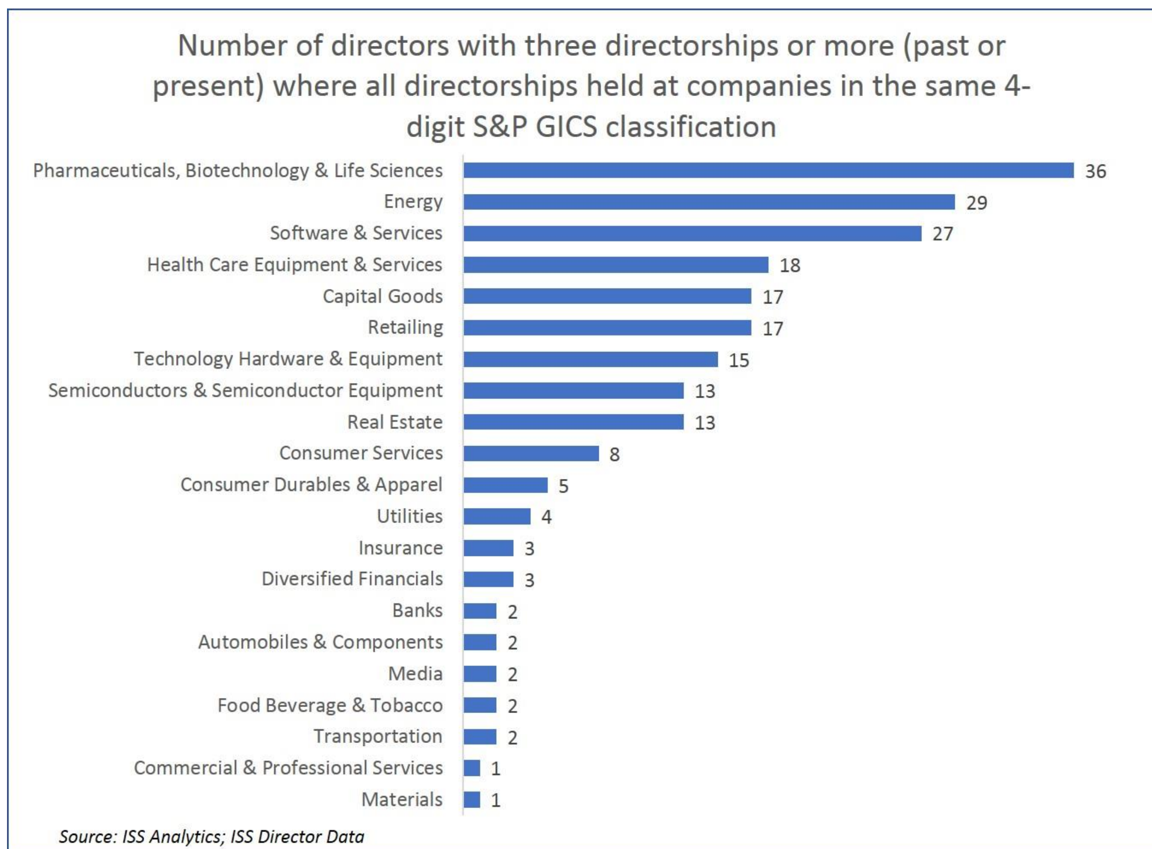
The results show that industry concentration (both past and present) isn't nearly as important for directors as it might be for executives. Of course, some of this may be due to competitiveness issues, particularly for active directorships—companies will often not want their directors to sit on boards of potentially competitive companies.

The focus on skill & expertise breadth, rather than industry depth, is frequently reinforced when boards lay out their director qualification matrices, where they often focus on executive experience, complex and global management responsibilities, and financial acumen over industry-focused knowledge.

On the other hand, most S&P 500 boards do include a number of industry experts, along with a diverse representation of expertise and viewpoints from other industries. This is often seen as healthy and beneficial by most investors.

Some industries show a higher need for "specialty" directors

Among S&P 500 directors, there are approximately 2,200 directors who hold or have held at least three directorships. Among this group, almost exactly ten percent are "specialist" directors—meaning they have held all directorships in one industry (as defined by the four-digit S&P GICS classification). And there is some significant industry concentration among this group.



Pharma, energy, and software & services lead the way for industries where it appears S&P 500 companies are going after experienced industry experts to fill roles on the board—whereas other

industries, such as materials and commercial & professional services, seem less inclined to seek out this expertise.

Finding the right balance

The right combination of directors is different for every company—new versus experienced directors, industry expertise versus broad knowledge, the right level of refreshment, and much more. The only sure thing in all of this analysis is that the level of scrutiny over the selection of directors will only increase.

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On Long-Tenured Independent Directors

Posted by Stefano Bonini, Stevens Institute of Technology, on Monday, June 5, 2017

Editor's note: Stefano Bonini is Assistant Professor of Economics at Stevens Institute of Technology. This post is based on a recent paper by Professor Bonini; Kose John, Charles William Gerstenberg Professor of Banking and Finance at NYU Stern School of Business; and Justin Deng and Mascia Ferrari, both of NYU Stern School of Business.

A growing number of countries, such as UK and France, have adopted tenure-related guidelines or tenure restrictions for independent directors. Most countries adopt a comply-or-explain approach to regulating tenure recommending a maximum tenure for a corporate director between nine and twelve years. In the United States however, where explicit limits are absent, a recent survey by GMI Ratings, the leading independent provider of global corporate governance and research, shows that 24% of independent directors in Russel 3,000 firms have continuously served in the same firm for fifteen years or more.

We argue that long-tenured directors are superiorly skilled individuals who provide tangible value added to their firms. An extension of tenure length allows directors to accumulate information about past events in the firm and about responses to exogenous market shocks that help firms weather crises and discontinuities. In support of the view that the effectiveness of one independent director is also the result of a long build-up process, William George, a Harvard Business School professor and independent director, stated: *"When directors are truly independent of the companies they serve, they generally lack the […] knowledge about the industry or business […]. [O]f the nine boards I served on as an independent director I had industry-specific knowledge in exactly none of them."*

Research on independent directors usually adopts as the main dependent variable the average tenure across independent board members (e.g., Vafeas 2003; Huang 2013). Given that multiple regulation changes have increased the fraction of independent board members that now represent 70% to 80% of the board, average board tenure measures significantly confound the effect of a single long tenure that is diluted by the majority of board members who experience shorter tenures. This view is aligned with best practice recommendations compiled by Institutional Investor Services (ISS, a shareholder activist group) (2017): "While investors in the past have focused on average board tenure, they are beginning to pay attention to individual director tenure as well, particularly for directors serving in board leadership roles like lead director or key committee chairs." Our research focuses on the puzzling phenomenon of extremely long tenures that do not occur board-wide, but are specific to a single director. Switching the focus to individual, abnormal tenures allows us to isolate the strongly beneficial effects on firm performance that increase in the single director tenure and level off after a surprisingly long period. Differently, the average tenure of independent board members does not increase firm

value and in some specifications, appear to have a negative impact on firm performance and firm stability.

The positive effects documented in our paper raise two important questions: first, how do LT directors affect performance? Second, what determines long tenure?

The first question deals with the nature of independent directors, who protect firm stakeholders by monitoring the firm, its management, and the external environment (ICGN 2014). In this respect, the directors' task is crucially related to the quality and amount of information the director can gather and process. Our tests confirm that long-tenured directors can gather and store valuable information that they share with other independent board members, generating a moderate-to-null sensitivity of the firm performance to the opaqueness of the outside information environment. Also, superior information translates into a significantly lower external litigation risk as documented by a set of tests on the likelihood of LT firms to be defendants in security class action lawsuits. This protection effect is robust to alternative specifications of the litigation risk variable.

Addressing the second question requires looking at observable individual factors, but, more importantly, finding proxies for unobservable characteristics. We show that not all board members are equally likely to become long-tenured directors. Personal characteristics and the market perception of traits and skills positively impact the probability of one individual becoming a long-tenured director. Directors with a high-quality education, such as graduate degrees and degrees from Ivy League colleges, are significantly more likely to evolve into LT directors, compared with other independent board members. However, unobservable skills may still explain their long association with a firm. Looking at contemporaneous board directorships at the time of the first appointment in the firm in which a director eventually becomes a LT board member, we show that ex-ante these individuals held a substantially larger number of board appointments than did other directors. This suggests that firms at large recognized these candidates' superior qualities and competed for their services. Consistent with the market's ability to identify skilled directors, we document superior performance of firms in which LT directors hold appointments as independent, but not long-tenured, directors.

Our findings have several normative implications. First, consistent with Katz and McIntosh (2014), we posit that board-wide term limits may be detrimental to the board itself, the company, and the shareholders, in particular if such limits force valuable directors off the board. This is in line with ISS (2017) that states: "*term and age limits, as they have been typically applied, may not be the solutions, because they force the arbitrary retirement of valuable directors.*" Second, our results show that LT directors are disproportionately more likely to be nominated as Lead Independent Directors (LID), a role that has become increasingly relevant in listed companies, following a set of regulation changes in the U.S. stock market. Since firms recognize the value of LT directors and leverage on it by appointing LT directors as LID, an unconditional tenure limit would negatively affect the effectiveness of the LID function and ultimately weaken the governance of companies.

The complete paper is available for download here.

Director Appointments—Is It "Who You Know"?

Posted by Ralph A. Walkling, Drexel University, on Friday, April 7, 2017

Editor's note: Ralph A. Walkling is Christopher and Mary Stratakis Professor in Corporate Governance and Accountability and Founder of the Center of Corporate Governance at Drexel University Lebow College of Business. This post is based on a recent paper by Professor Walkling; Tu Nguyen, Assistant Professor of Finance at University of Waterloo; and Jie Cai, Associate Professor of Finance at Drexel University Lebow College of Business.

> The best way to get on a board, is to be on a board.
> (Old adage)

A pillar of modern corporate governance for U.S. public firms is shareholder representation by the board of directors. Shareholders, however, are generally unable to nominate the directors who will represent them in the boardroom. Instead, the incumbent board nominates new directors, who are almost always subsequently elected. The characteristics of director additions are the foundation of a firm's evolving governance structure, yet we know little about how boards select their new members. In contrast to most other markets where supply and demand meet in marketplaces, the director labor market typically operates in opacity. Companies never advertise vacancies and candidates do not submit their applications, while anecdotal evidence suggests that boards often recruit new members through personal connections.

The appointment of directors already connected to the board is controversial. First, selecting directors through board networks can be efficient. Boards only act as a whole and not as individuals and tend to seek consensus (Bainbridge, 2002). Cooperation and coordination are essential. Appointing unknown directors requires a steeper learning curve as new directors are assimilated into the team. In addition, past association certifies connected directors. Thus, appointing colleagues you trust can reduce uncertainty and lower coordination costs. Further, a potential director appointee will also want to join a board she feels comfortable with and trusts. Having a prior relationship with incumbent directors help to foster such trust for the candidate and the board. The *coordination hypothesis* argues that appointing a connected director increases firm value, particularly in complex situations.

On the other hand, adding a new director with prior connection to the incumbent board can reinforce the homogeneity of the board. McPherson, Smith-Lovin, and Cook (2001) argue that people with similar background and mindset are naturally more likely to form and retain social ties, which they term "homophily." New directors selected from the board network, therefore, are more likely to share a similar view or approach to many issues as the incumbents. Such boards can become blind sighted to certain risks or opportunities. By appointing a connected director, the firm misses an opportunity to bring in fresh perspectives and new skills that the incumbent board lacks or might not even be aware that they need. The *homophily* hypothesis, therefore, argues

that appointing a connected director reduces firm value, in particular for firms in a complex environment.

Finally, the selection process can be influenced by the CEO, the very person the board is supposed to monitor. Even without direct CEO involvement, new members of the board are often appointed by directors coopted by the CEO. Exacerbating the situation is the fact that individuals nominated to the board are almost always elected and thereafter are quite difficult to be involuntarily removed. The *agency hypothesis* argues that board appointment of connected directors, in particular those connected to the CEO or co-opted directors, represents cronyism, perpetuating existing power in the boardroom at the expense of shareholders.

This paper aims to provide comprehensive evidence on the prevalence and consequences of director recruitments from the networks of their board members. Specifically, we examine both direct (first degree) and indirect (second degree) connections in a sample of 9,923 board appointments from 2003 to 2014. Direct connections are people with whom the incumbent board or CEO has worked with in director and/or executive capacity. Indirect connections are those who have worked with or been on the same board with one of the direct connections. That is, they have direct ties to the direct contacts, hence a second degree connection.

Our results indicate a significant and dramatic role for connections in director appointments. Unconditionally, a typical board has a first-degree connection to just over half a percent of all the directors listed in BoardEx, but nearly 30% of all new directors appointed to a board have such a connection.[1] Unconditionally, an average board has a first and second degree connection to about 18% of all directors tracked by BoardEx. In contrast, we find that over 75% of new director appointments are selected from the incumbent boards' first or second degree network. For S&P 500 firms, 94% of the director nominees are selected from the pool of individuals with first or second degree connections to the incumbent board, yet these directors represent only 26% of all directors tracked by BoardEx. To put it differently, only 6% of all S&P 500 director nominees are selected from unconnected directors who represent on average 74% of the potential talent pool.

We also find support for both the agency and coordination hypotheses, but little evidence for the homophily hypothesis. The price reaction to connected appointees is significantly positive in complex firms and firms in competitive industries, where coordination is likely to be most important. Conversely, the price reaction to connected appointees is significantly negative in those situations where agency problems are already indicated. These price reactions to appointments are confirmed by votes for connected directors in the subsequent board elections.

It is conceivable that an appointment of a director with ties to incumbent board is associated with certain governance or firm characteristics of the appointing firm and that shareholders react to the underlying issues rather than the appointment itself. To address this endogeneity issue, we use the deaths of executives or directors in a firm's network as exogenous shocks to the network. Depending on firm needs, companies may seek new directors with certain skills or characteristics. When such skills or characteristics are not available in the network of incumbent directors, the firm has to look outside of the board network. These death events, therefore, represent exogenous shocks to the availability of connected candidates and can lead to appointment of unconnected directors. We then use the network damage caused by these death

[1] A board is connected to an outside individual if at least one member of the board is connected to this individual.

events as an instrument for the firm's subsequent appointment of a connected director. In the analyses of stock market reaction and shareholder votes, we confirm our results using the instrumented likelihood of appointing a connected director as the main independent variable.

Our research contributes to the literature in several ways. First, we provide comprehensive evidence of the importance of social connections in director appointments in a large sample study. This evidence sheds new light on how boards select director nominees and establishes a benchmark against which the importance of other factors influencing director selection can be compared. Second, we illustrate the benefit and harm of appointing a connected director. Connections enhance board coordination, which benefits complex firms and firms facing a more competitive environment, but connections can also help entrenched management to perpetuate their control of boards. Market price reactions and subsequent shareholder votes in director elections are consistent with these arguments and reward or punish such appointments accordingly. These results contribute to the broad literature of social networks and corporate governance, as well as the ongoing debate of shareholder access to director nomination.

The full paper is available for download here.

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Distracted Directors

Posted by Luke C.D. Stein and Hong Zhao, Arizona State University, on Thursday, June 15, 2017

Editor's note: Luke C.D. Stein is Assistant Professor of Finance and Hong Zhao is a PhD candidate in Finance at the Arizona State University W. P. Carey School of Business. This post is based on a recent paper authored by Professor Stein and Mr. Zhao.

A board needs its members to be attentive to effectively fulfill its advisory and monitoring roles, but directors inevitably have outside obligations, which sometimes distract them from their board responsibilities. To minimize the possibility of directors becoming overly distracted, public firms have increasingly imposed restrictions on the outside duties that their directors may assume. In particular, firms may restrict outside board service, but this is likely to represent only a small fraction of the competition for directors' time and attention.

Independent executive directors—i.e., those whose primary job is as an executive at an outside firm—pose a particular concern, not only because they may be especially valuable directors, but also because they are potentially more likely to be distracted, especially by events associated with poor performance at their employing firms. In Distracted Directors: Evidence From Directors' Outside Employment, we study how the time-varying distraction of independent executive directors affects board governance effectiveness using a newly constructed dataset that links independent directors with their employers. We hypothesize that independent executive directors give priority to their jobs, allocating time and effort away from board duties when their primary employer's performance suffers. Indeed, a director with bottom-quintile stock performance at her employer is 30% more likely to miss more than a quarter of board meetings.

In our sample, the average board has 6.8 independent directors and 1.4 independent executive directors, of whom 0.25 are distracted (by events associated with bottom-quintile employer stock returns) in any given fiscal year. We find robust evidence that distraction results in significantly lower firm performance and firm value: the distraction of one executive director is associated with a 31 basis point decrease in ROA (2.5% of sample average) and a 0.03 decrease in Tobin's Q (1.8% of sample average) in preferred specifications.

Beyond overall performance, we also assess a variety of channels through which board distraction could affect the firm. Specifically, we look at CEO compensation, CEO turnover, earnings quality, and acquisition decisions—outcomes associated with boards' effectiveness as monitors and advisors.

We start by considering the effect of board distraction on CEO compensation. As executives hope to extract excess compensation when board monitoring is weak, and distracted directors weaken board monitoring, we expect to observe higher CEO compensation in firms with more distracted directors; empirical evidence supports this hypothesis. All else equal, an additional distracted

director is associated with a 2.2% increase in CEO total compensation, mainly in the form of equity rather than cash compensation. This is consistent with the possibility that designing appropriate equity compensation is more complicated than with cash and requires more effort from directors, so CEOs can extract excess compensation more easily in the form of equity when their board is distracted. It is also possible that additional equity compensation serves as a substitute for board monitoring in aligning executives' incentives. We further find that these effects are more pronounced when distracted directors sit on the compensation committee, consistent with distraction leading to weaker board monitoring.

Our second measure of monitoring effectiveness is CEO turnover. We hypothesize that board distraction leads to lower turnover-performance sensitivity as it impairs the board's ability to monitor the CEO or initiate management changes; we find evidence consistent with this hypothesis. For non-distracted boards, an interquartile decline in firm performance increases the likelihood of a forced CEO turnover by 101%; when one director is distracted, the same performance decline increases turnover likelihood by only 71%.

Another monitoring role of the board is to help ensure the quality of a firm's financial disclosures. Consistent with the hypothesis that director distraction weakens board monitoring effectiveness and thereby encourages earnings manipulation, we find that firms with distracted boards have significantly larger discretionary accruals and more financial restatements due to irregularities. The detrimental effects of director distraction on earnings quality are stronger when distracted directors serve on the audit committee.

Besides monitoring, another important function of the board is advising management. To assess whether director distraction also impairs a board's advisory role, we consider a firm's M&A performance. We find that an additional distracted director is associated with a 28 basis point lower stock return during the five days around deal announcement, driven mainly by the distraction of directors who are M&A "experts"—those who have successful past M&A experience or work in the same industry as the target firm.

To provide further evidence that the relations between board distraction and firm outcomes are causal and to understand how the strength of the distraction effects varies across different environments, we examine heterogeneity with respect to several board structure and director characteristics. Since smaller boards have fewer members to cover the responsibilities of a distracted director, the adverse effects of distraction should perhaps be stronger; we indeed find even lower overall firm performance, more excess CEO compensation, further reduced turnover-performance sensitivity, and even lower M&A announcement returns for firms with small boards. We also investigate a set of director characteristics; empirical results suggest that the distraction effects are stronger for independent executive directors who are less co-opted by the CEO, who are CEOs at their employing firms, and who have shorter director tenure. These results are consistent with the idea that distraction has more adverse effects on a director's board duties if the she serves as a particularly important monitor or advisor, or if she is particularly likely to be distracted by negative events at her employing firm.

In sum, our paper considers whether events at their employing firms distract independent executive directors from board responsibilities and thereby impair board governance effectiveness. Despite the decline in the number of executive directors after Sarbanes-Oxley, active corporate executives are still the most popular source of independent directors. The results

in our paper suggest that independent executive directors indeed play an important governance role, but that their effectiveness can suffer in the face of distracting events at their employing firm.

The complete paper is available for download here.

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Issuers' CEO/Chairman Structure Not Correlated with Firm Performance

Posted by Yafit Cohn, Simpson Thacher & Bartlett LLP, on Monday, July 31, 2017

Editor's note: Yafit Cohn is counsel at Simpson Thacher & Bartlett LLP. This post is based on a Simpson Thacher co-publication with Rivel Research Group, authored by Ms. Cohn; Karen Hsu Kelley, partner at Simpson Thacher; David M. Bobker, Vice President, Corporate Governance & Board Evaluations at Rivel Research; and Brendan Sheehan, Managing Director, Corporate Governance at Rivel Research.

The corporate governance structure of any public company must enable the company to achieve the appropriate balance between the powers of the board of directors, which is typically composed primarily of independent directors, and those of the CEO. The Commission on Public Trust and Private Enterprise, convened in 2002 "to address the causes of declining public and investor trust in companies, their leaders and America's capital markets," concluded at the time that there are three equally valid approaches that issuers can take to strike such a balance:

1. Separate the CEO and chairman roles, with the chairman being an independent director under stock exchange listing standards.
2. Separate the CEO and chairman roles and, where the chairman is not an independent director (often the former CEO), establish a lead director position to be occupied by an independent director.
3. Combine the CEO and chairman roles and establish a lead director position.[1]

In spite of this conclusion, in the years since the publication of the Commission's findings, many have expressed the purported primacy of the first of these structures, and companies have faced increased pressure to require an independent chairman. Since 2012, for example, shareholder proposals requesting the installation of an independent chairman were either the most popular or second in popularity (after proxy access since the proxy access "private ordering" began in 2015) among governance-related proposals. Additionally, whether presented through a shareholder proposal or a management-sponsored proposal resulting from investor pressure, independent chairman proposals and the debate they have stirred at several large cap companies have made headlines in recent years. Moreover, the influential proxy advisory firm Institutional Shareholder Services, Inc. ("ISS") has been supporting more independent chairman proposals than in years past. This year, for example, ISS recommended a vote in favor of 68% of independent chairman proposals for which they issued a recommendation. In contrast, ISS supported 63% of such proposals in 2015 and 48% in 2014.

[1] The Conference Board, Commission on Public Trust and Private Enterprise: Findings and Recommendations (2003) at 2, 19.

Given the passage of time since the issuance of the Commission's report and the increased prominence of the independent chairman issue over this period, we conducted an empirical analysis to determine whether the Commission's conclusions remain valid today from an economic perspective. Specifically, we set out to investigate whether issuers that had a separate CEO/chairman structure outperformed those that had a combined CEO/chairman. As discussed in further detail below, we found that, while there may be legitimate reasons to separate the CEO and chairman positions at certain companies depending on their specific circumstances at any given point in time, from a financial performance perspective the current focus on separating the CEO and chairman positions across public companies appears to be misplaced. In other words, there appears to be little economic evidence to support separating the roles of the CEO and chairman.

Methodology

The objective of our analysis was to determine whether issuers' CEO/chairman structure impacts company valuation. In order to minimize selection bias and time-based anomalies, we included in our analysis all companies in the S&P 500 over three specific time frames—15 years, 3 years and 17 months. Only companies that remained in the S&P 500 index throughout the period under examination were included in the analysis.

Because the purpose of our research was to ascertain the impact on investors, if any, of the CEO/chairman structure, it was determined that dividend adjusted share price was the most appropriate metric to use, as it reflects the total value returned to investors (in the form of stock price appreciation adjusted for cash dividend distributions) over a given period. Prices were adjusted, however, for events such as splits, stock dividends, spin-offs and rights issuances. These events are generally considered to be value neutral and, if not accounted for, could lead to distortions when comparing company valuations over a given time period.

To compare the relative performance over time of companies with different CEO/chairman structures, two custom indices were created for each time period examined: all companies that have a combined CEO/chairman and all of those that have separate CEO/chairman roles. Each company in each index was given equal weighting. Since the objective was to evaluate the relative performance of each pair of custom indices in each period, the value of each index was set to zero at the beginning of each period. The two groups were then compared on the basis of dividend adjusted share price over a 15-year time period, as well as over a 3-year time period.

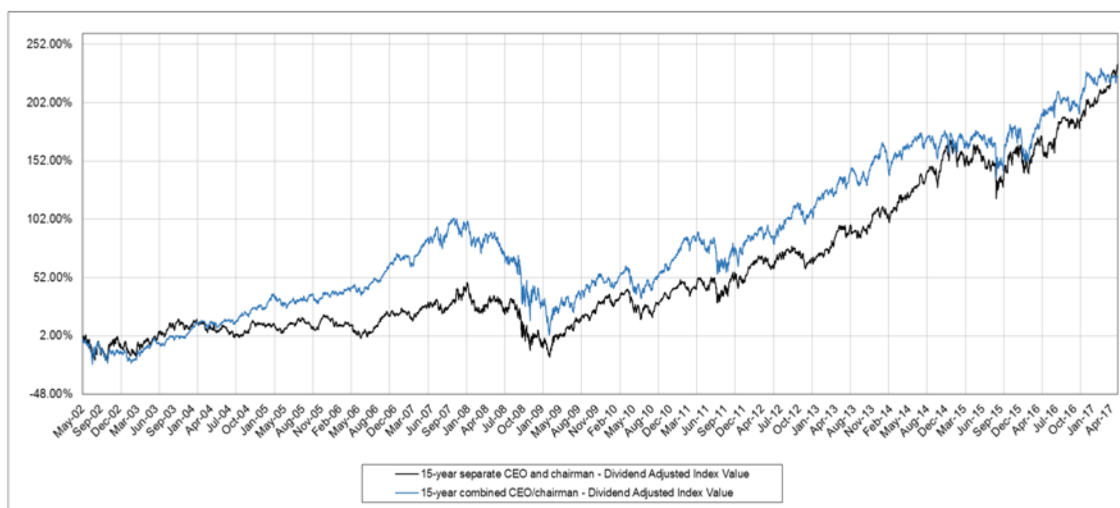
In addition, we examined the dividend adjusted share price of companies that have made a change in their CEO/chairman structure since January 1, 2016, comparing the dividend adjusted index value of companies that have separated the CEO/chairman roles with the index value of those that have combined the roles in the 17 months since January 1, 2016.

It should be noted that, while there may be many factors that impact a company's financial performance, no other financial or operational metrics were taken into account for the purposes of this study. Our report looks solely at CEO/chairman structure and dividend adjusted share price in an effort to test whether there is a correlation between a company's leadership structure and its financial performance.

Findings

Companies that Have Consistently Had Either a Combined CEO/Chairman or Separate CEO and Chairman Roles Over the Past Fifteen Years

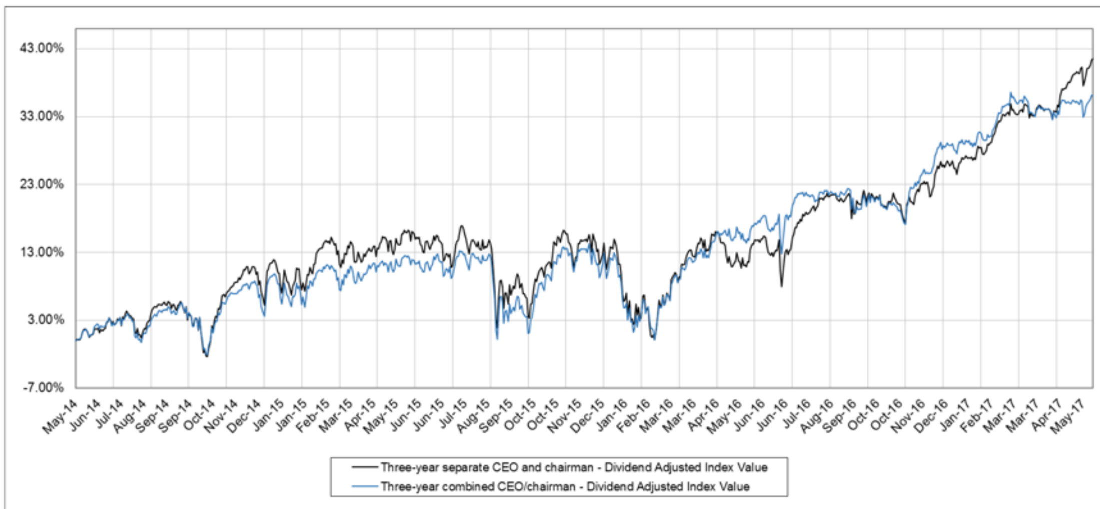
- **There was no statistically significant difference in financial performance between companies that have consistently combined the CEO and chairman roles and those that have consistently separated them since 2002.**
  - As illustrated in the graph below, the 15-year dividend adjusted index change for the "combined" group was 223.68%, while that for the "separate" group was 234.56%. This is a 10.88% difference over 15 years, or a 0.72% difference per year, which is not statistically significant.
  - For much of the past 15 years, the "combined" group outperformed the "separate" group. Indeed, the slight outperformance of the "separate" group is a recent occurrence; in April 2017, the "separate" group began to outperform the "combined" group for the first time in three years. At no point during the 15-year period studied, however, were the differences in performance between the two groups statistically significant.



Companies that Have Consistently Had Either a Combined CEO/Chairman or Separate CEO and Chairman Roles Over the Past Three Years

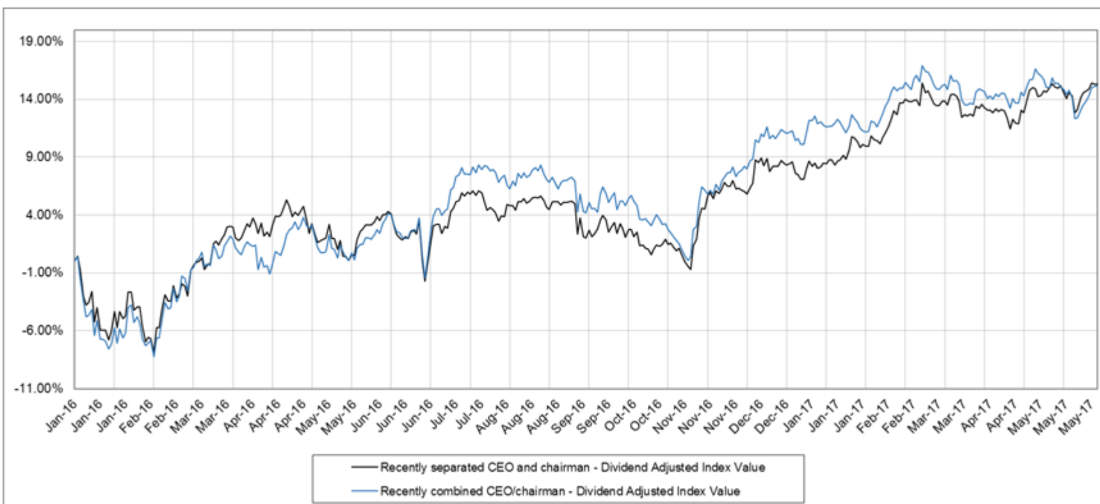
- **There was no statistically significant difference in financial performance between companies that have consistently had a combined CEO/chairman and those that have consistently separated the roles over the past three years.**
  - From May of 2014 through May of 2017, the "separate" group saw a change in dividend adjusted index value of 41.48%, while the "combined" group saw an increase in dividend adjusted index value of 36.15%. From a statistical perspective, this 5.33% difference over three years is not significant.
  - The dividend adjusted share price of the "separate" and "combined" groups have not diverged much over the past three years. When they have, they have always re-converged, rendering their respective rates of change in dividend adjusted index value identical at numerous points throughout the three-year period. While the respective rates of change in index value of the two groups have differed

slightly in the last month of the three-year period studied, it seems, based on historical rates of change, that they will likely re-converge in the near term.



Companies that Have Made a Change to Their Leadership Structure—Either Separating or Combining the Roles of CEO and Chairman—in the Past 17 Months

- **There was no statistically significant difference in financial performance between companies that have combined the CEO and chairman roles and those that have separated the roles since January 1, 2016.**
  - The dividend adjusted index value of those companies that have recently separated the roles of CEO and chairman has increased 15.14% in the 17 months since January 1, 2016, while the index value of those companies that have recently combined the roles has increased 15.32%. This difference is negligible and, from a statistical perspective, not significant.



Conclusion

As is evident by our research, separating the CEO and chairman roles is not correlated with a greater rate of change in dividend adjusted index value (i.e., outperformance). This appears to corroborate the view of the Commission on Public Trust and Private Enterprise that there is no single board leadership structure that is superior in achieving the appropriate balance between the board and CEO functions and providing the oversight that leads to corporate success. Based on our research, therefore, there does not appear to be any compelling economic reason for public companies to adopt any particular CEO/chairman structure. Instead, each company should continue to tailor its leadership structure to its own facts and circumstances at any given point in time.

Independent Directors and Controlling Shareholders

Posted by Lucian Bebchuk, Harvard Law School, and Assaf Hamdani, Hebrew University of Jerusalem, on Wednesday, May 3, 2017

Editor's note: Lucian Bebchuk is the James Barr Ames Professor of Law, Economics, and Finance, and Director of the Program on Corporate Governance, at Harvard Law School. Assaf Hamdani is the Wachtell, Lipton, Rosen & Katz Professor of Corporate Law at Hebrew University of Jerusalem. This post is based on their Article, Independent Directors and Controlling Shareholders, forthcoming in the *University of Pennsylvania Law Review*. The Article is part of the research undertaken by the Controlling Shareholders Project of the Program on Corporate Governance.

Independent directors are an important feature of modern corporate law and courts and lawmakers around the world increasingly rely on these directors to protect investors from controlling shareholder opportunism. In our Article, Independent Directors and Controlling Shareholders, forthcoming in *the University of Pennsylvania Law Review*, we examine this reliance. We show that the existing director-election regime significantly undermines the ability of independent directors to effectively perform their oversight role.

Both the election and retention of independent directors normally depend on the controlling shareholders. As a result, these directors have incentives to go along with controllers' wishes, or, at least, inadequate incentives to protect public investors.

To induce independent directors to perform their oversight role, we argue, some independent directors should be accountable to public investors. This can be achieved by empowering investors to determine or at least substantially influence the election or retention of these directors. These "enhanced-independence" directors should play a key role in vetting "conflicted decisions," where the interests of the controller and public investors substantially diverge, but not have a special role with respect to other corporate issues. Enhancing the independence of some directors would substantially improve the protection of public investors without undermining the ability of the controller to set the firm's strategy.

We explain how the Delaware courts, as well as other lawmakers in the United States and around the world, can introduce or encourage enhanced-independence arrangements. Our analysis offers a framework of director election rules that allows policymakers to produce the precise balance of power between controlling shareholders and public investors that they find appropriate. We also analyze the proper role of enhanced-independence directors as well as respond to objections to their use. Overall, we show that relying on enhanced-independence directors, rather than independent directors whose election fully depend on the controller, can provide a better foundation for investor protection in controlled companies.

We do not argue that independent directors *should* play a key role in protecting public investors at controlled companies. Some may believe that market forces can discourage controller opportunism. Others may find other measures—such as public enforcement or approval by minority shareholders—to be necessary or effective in enhancing investor protection. We take as a given that corporate law has long substantially relied on independent directors in controlled companies to protect public investors in cases of controller conflicts. Given this pervasive reliance on independent directors, our contribution is twofold. First, we show that, by itself, approval by independent directors who serve at the pleasure of the controller cannot serve as an effective device for vetting conflicted decisions. Second, we analyze how to turn independent directors into more effective guardians of the interests of public investors in conflicted decisions.

Below we outline in more detail the analysis of the Article:

In 2012, Google adopted a controversial recapitalization plan that allowed it to issue a new class of nonvoting stock. This plan enabled Google to continue raising capital without weakening its founders' control over the company. To address the concern that the plan would benefit the company's controlling shareholders at the expense of its public investors, Google formed a special committee of independent directors to negotiate and approve the terms of the recapitalization. Furthermore, in the settlement of the litigation over the recapitalization, Google's independent directors were assigned an important ongoing role to enforce certain restrictions on the company's founders.

If a company, like Google, has a controlling shareholder, a main concern of corporate law is to address potential conflicts of interest between the controller and public investors. Corporate law has long relied on oversight by independent directors—directors who have no ties to the controller or the company other than their service on the board—over corporate decisions where the interests of the controller substantially diverge from those of the company or its public investors [hereinafter "conflicted decisions"]. Both courts and lawmakers have sought to use independent directors to safeguard against such controller opportunism.

As we explain in this Article, the existing arrangements for electing directors undermine the effectiveness of independent director oversight. Because these arrangements provide controllers with decisive power to appoint independent directors and decide whether to retain them, independent directors have significant incentives to side with the controller and insufficient countervailing incentives to protect public investors in conflicted decisions. Thus, independent directors currently relied upon to contain controllers' conflicts cannot be expected to be effective guardians of public investors' interests.

We also show how the rules governing the appointment of independent directors could be refined to make their oversight more effective. To improve the effectiveness of independent directors in cases of controllers' conflicts, some directors should be elected in ways that would make them at least somewhat accountable to public investors. These directors, which we call "enhanced-independence directors," should play a key role in approving self-dealing transactions. We develop a framework of alternative legal rules for obtaining enhanced independence without undermining the controller's ability to determine business strategy in non-conflicted decisions. We also explain how courts, regulators, and investors could require or encourage companies to introduce enhanced-independence directors.

Consider again the Google example. Suppose that minority shareholders had the right to elect, or at least veto the appointment of, two independent directors. Such enhanced-independence directors would have had greater incentives to resist a recapitalization plan that benefitted the controller at the expense of public investors. The approval of the plan by such independent directors would have been a more meaningful signal than approval by independent directors who serve only at the controller's will.

The enhanced-independence approach that we put forward can address longstanding dilemmas with which the Delaware courts have been wrestling. In well-known decisions involving freezeout transactions, Delaware courts have recognized the structural problems afflicting independent directors, choosing not to defer to the approval of freezeouts by such directors and, instead, to grant judicial deference only to transactions also approved by a majority vote of minority shareholders. Outside the freezeout context, however, the Delaware courts have not always followed such an approach, and some decisions have granted significant cleansing power to independent director approval in cases of controller conflicts. For example, Delaware courts substantially rely on independent directors to make decisions regarding derivative actions against the controller. Such judicial decisions might be due to concerns about the costs of alternatives. For courts influenced by such concerns, enhanced-independence directors can offer a workable alternative within the existing framework of corporate law doctrine.

Our analysis proceeds as follows. Part I of the Article provides background on controlled companies and independent directors. Controlled companies constitute a sizeable minority of large, publicly traded firms in the United States, including well-known companies such as Facebook, Google, News Corp, and Viacom. Controlled companies are even more prevalent outside the United States, dominating public capital markets in Europe and in most countries around the world.

In widely held firms, the chief governance concern is to prevent professional managers from behaving opportunistically at the expense of investors. In controlled companies, by contrast, controllers have both the incentives and the power to police management, but they may use their power to divert value at the expense of public investors. In these companies, therefore, a primary governance concern is to protect public investors from controller opportunism and value diversion. Corporate law commonly addresses this concern by requiring or encouraging the use of independent directors and relying on such directors to vet self-dealing transactions and other conflicted decisions.

Part II explains the fundamental shortcoming of this approach. Under existing arrangements, controlling shareholders normally play a decisive role in the appointment and retention of independent directors. Even independent directors, therefore, are inherently dependent on the controller for their election and retention as board members. This regime incentivizes independent directors to favor the controller, and it fails to provide them countervailing incentives to protect public investors.

Learning from widely held firms reinforces our critique. The CEOs of such firms once wielded substantial influence over independent directors' appointment. Today, however, there is widespread recognition that, to enable independent directors to monitor the CEO effectively, we should both limit the CEO's influence over their appointment and make these directors accountable to public investors. This recognition underlies the litany of reforms focused on

director elections at widely held firms, including placing director selection in the hands of nominating committees composed solely of independent directors, providing for majority voting, and enabling proxy access. If CEOs' informal influence over the selection of independent directors compromises their ability to contain CEO opportunism, controlling shareholders' absolute control over the appointment and retention of independent directors is all the more problematic.

Part II concludes by introducing our proposed approach for making independent directors more effective guardians of the interests of public investors in controlled companies. Such companies, we argue, should have some directors who (i) lack the incentives produced by the controller's decisive influence over the directors' appointment and retention and (ii) have some incentives that flow from making the directors accountable to public investors. A regime of such *enhanced-independence* directors requires measures that will limit controllers' power over the appointment of these directors while providing public investors with some degree of influence over this appointment. Such measures, we show, are not an ivory-tower idea without real-world precedent. The American Stock Exchange (AMEX) required them for dual-class companies that went public during a certain period, and they have been recently introduced in the United Kingdom, Italy, and Israel.

Part III develops a framework for designing enhanced-independence rules with the desired balance between enhancing independence to limit controller opportunism and controllers' legitimate interests in making business decisions. Public investors may participate in three stages of director elections: initial appointment, reelection, and termination. For each stage, we identify different degrees of public investors' input rights and evaluate the impact of these rights on investor protection. Public investors, we argue, should at least have veto rights over the initial appointment, reelection, and termination of enhanced-independence directors. We also explain, however, that there are good reasons to consider going beyond veto rights—for example, by empowering public investors to determine whether enhanced-independence directors are reelected and terminated.

Part IV focuses on the strategies for implementing an enhanced-independence approach. Regimes based on judge-made law, such as in Delaware, can encourage the use of enhanced-independence directors by according significant cleansing powers only to the approval of conflicted decisions by such directors. By contrast, regimes based on legislative or regulatory mandates can require the appointment of some enhanced-independence directors and the approval of certain conflicted decisions by such directors.

We also discuss the desirable number and role of enhanced-independence directors. To protect public investors, these directors should play a dominant role in—and only in—vetting self-dealing transactions and other conflicted decisions. To preserve controllers' ability to set the company's business strategy, however, such directors should not play a dominant role in other corporate affairs, and they should therefore not constitute a substantial fraction of the members of the board.

Part V considers potential objections to an enhanced-independence approach. We address claims that enhanced-independence directors would be harmful by interfering with the controller's ability to run the company, undermining the board's collegiality and cohesiveness, or facilitating abuse by some opportunistic minority shareholders. We also consider claims that such directors

would not add significantly to the protection of public investors. We show that these objections do not undermine the case for enhanced-independence directors.

While we use the terms “minority shareholders” or “public investors” to refer to shareholders other than the controller, we note that these shareholders sometimes hold a majority of the equity capital. This is likely to be the case when a dual-class structure, or another aspect of the corporate structure, separates voting rights from cash flow rights and enables the controller to retain a lock on control while holding a minority, even a small minority, of the company’s equity. A substantial body of evidence suggests that the risk of value diversion increases when controllers use dual-class or other ownership structures for separating cash flow rights from votes. Thus, even those who would not support enhanced-independence directors for controlled companies in general should consider using them for dual-class companies and other structures that separate voting and cash flow rights.

Our Article is available here.

One Take on the Report of the Independent Directors of Wells Fargo: Vote the Bums Out

Posted by Howell E. Jackson, Harvard Law School, on Saturday, April 22, 2017

Editor's note: Howell E. Jackson is James S. Reid, Jr., Professor of Law at Harvard Law School. Professor Jackson is the co-author of *Financial Regulation: Law and Policy* (Foundation Press 2016) and has served as an expert witness for the plaintiff class in *In re Wells Fargo Residential Mortgage Lending Discrimination*, No. C 08-1930 MMC (JL) (N.D.Cali.). Additional information on Professor Jackson's outside interests and activities is available here. The views expressed in this blog posting are those of Professor Jackson and are not necessarily those of organizations, institutions or individuals with which he is associated.

Next Tuesday, the 25th of April, the shareholders of Wells Fargo will meet for the first time since the news of the massive Wells Fargo mis-selling scandal broke last September when the firm was hit with penalties of $185 million for opening 1.5 million bank accounts and issuing 565,000 credit cards for customers without their consent.[1] In recent weeks, the two leading proxy advisory firms have recommended negative votes for many of the directors serving on the Wells Fargo Board at the time the fines were announced, with Glass Lewis advocating negative votes on six of twelve continuing directors and ISS recommending the ouster of all twelve.

Just two weeks before the meeting date, the independent directors of Wells Fargo released a 110 page "Sales Practice Investigation Report," prepared with the assistance of the law firm Shearman & Sterling under the direction of four independent trustees: Duke, Hernandez, James, and Sanger, all four of whom have received negative vote recommendations from ISS and one of whom (Hernandez) has received a negative recommendation from Glass Lewis.[2] The Shearman & Sterling Report—and I call it that because the document has all the hallmarks of a carefully and cautiously drafted legal document—is illustrative of an increasingly common practice in the aftermath of financial scandal: the preparation and distribution of a nominally "independent" but "in-house" analysis of corporate practices that have resulted in widespread violations of law.

These reports share a common structure. First, there is an element of shock and awe: Attorneys from Shearman & Sterling declare that they received and searched thirty-five million documents, reviewed 1,000 investigations, conducted 100 interviews, and retained an outside expert on forensic consulting and data analysis. Then there is the identification of serious wrong-doing—but, conveniently, only by already departed personnel, in this case former Wells Fargo CEO John Stumpf and disgraced head of the Wells Fargo Community Bank Carrie Tolstedt, both of whom suffered additional clawbacks of compensation timed to coincide with the Report's release to

[1] https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-fines-wells-fargo-100-million-widespread-illegal-practice-secretly-opening-unauthorized-accounts/. For illustrative press coverage at the time, see The High Cost of Wells Fargo's Sales Practices, Financial Times, Sept. 13, 2016.

[2] https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf.

facilitate wide-spread press coverage. Finally, reports of this sort are wont to conclude with a brief acknowledgment, explored in their final pages, of modest process failures on the part of key constituents—here, the Wells Fargo continuing directors—set out with an appearance of candor yet avoiding concessions that might give rise to subsequent litigation or enforcement actions. In the case of Wells Fargo, "the Board should have been more forceful in pushing Stumpf to change leadership [that is, fire Tolstedt sooner] so that the Community Bank could move forward more quickly." (p.17) If you have a taste for the genre, the Shearman & Sterling Report is nicely executed. But if you are trying to figure out whether the Wells Fargo directors should be elected to another term of service, the Report needs to be unpacked with a more careful eye.

The Self-Serving and Silly

Let me start with aspects of the Report that are simultaneously self-serving and silly. On its first page, the Report asserts that "The Board only learned approximately 5,300 employees had been terminated for sales practice violations" with the public announcement of the fines in September 2016. The 5,300 figure is an eye popping one as it represents nearly two percent of the entire Wells Fargo workforce. And it may technically be true that the Board did not have that particular number until September of 2016 when the firm's $185 million penalty was made public. But what this factoid obscures is that the Board, earlier in the spring of 2016, had been informed that 2,000 to 3,000 firings—roughly one percent of the workforce—were due to sales violations. And that a full year before that, in the Spring of 2015, internal Wells Fargo investigations had already identified thousands of employee firings for sale misconduct but the Board apparently failed to corner the right personnel early on to get a realistic assessment of employee turnover rates. They simply took note of several hundred reported firings without digging further to find the full scope of the problem. To the extent that the directors did not discover the true scope of employee firings until so late in the process, one wonders whether this Board was doing its job.

Also in the silly category are implications sprinkled throughout the Report that John Stumpf's sunny disposition explains why sales abuse problems were not detected or corrected sooner: "Stumpf was by nature an optimistic executive who refused to believe that the sales model was seriously impaired." (p. 10) Apparently, the independent directors—many of whom had served on the Board with Stumpf for a full decade—were unable to resist their CEO's predilection to accentuate the positive. While interpersonal solicitude of this sort may be a good way to make friends at your country club, it is a poor standard for supervising the chief executive officer of a systemically important financial institution. If Stumpf had an optimistic disposition that hampered effective management, then the Board had a responsibility to account for that in their oversight of his leadership. The "sunny disposition" excuse may explain why the Board failed; it does not excuse the Board's failure.

One False Narrative: Mis-selling as a Byproduct of Customer Service

Moving from silly to serious, consider the larger narrative arch of the Shearman & Sterling Report. The root cause of the Wells Fargo selling abuses, according to the account, was the delegation of too much managerial responsibility to operating units like Tolstedt's Community Bank. "Run it like you own it" (p. 19) was apparently a corporate shibboleth and is repeated in the Sherman & Sterling Report as if to suggest that any problems in the retail banking unit were simply a byproduct of trying to be attentive to customer needs. The word "decentralized" and variants thereon appear twenty-three times in the Report, and many more times if one adds in synonyms.

In practice, what this down-streaming of authority apparently meant at Wells Fargo was that both operational discretion and risk oversight were delegated to operating units. And when internal problems began to be detected—for instance from reports from the Community bank's own risk officers or critical letters from bank examiners—Tolstedt was seemingly empowered to suppress their elevation to higher-ups in the firm. While plans were afoot to shift towards more centralized risk management (as modern best practices dictate),[3] the risk oversight structure actually in place was inadequate, as the Shearman & Sterling Report candidly acknowledges:

[A]s problems with sales practices in the Community Bank became more apparent in 2013-2015, Corporate Risk was still a work in progress and the [Enterprise-wide] Chief Risk Officer had limited authority with respect to the Community Bank. As events were unfolding, his visibility into risk issues at the Community Bank was hampered by his dependence on its group risk officer and he was essentially confined to attempting to cajole and persuade Tolstedt and the Community Bank to be more responsive to sales practice-related risks (p. 12).

Reading through these sections of the Report, one almost starts to feel sorry for the Wells Fargo Board, betrayed by a decentralized management team and ill-served by a corporate risk team not yet prepared for major league action. Still, one might reasonably ask why the Board did not examine its decentralization more expertly and reviewed its risk team's competence more appropriately. There are people who think that's exactly what corporate boards are supposed to do.

From a shareholder perspective, the failures of Wells Fargo's risk management function is made all the more galling because they'd suggested quite a different arrangement in prior SEC filings. For example, in the firm's 2013 annual report—the annual report outstanding when the mis-selling scandal was first picked up in *Los Angeles Times* reporting—the Board had assured shareholders that at Wells Fargo risk management was controlled at the top:

Our risk culture also depends on the "tone at the top" set by our Board, CEO, and Operating Committee members. Through oversight of the three lines of defense, the Board and the Operating Committee are the starting point for establishing and reinforcing our risk culture and have overall and ultimate responsibility for oversight of our risks, which they carry out through committees with specific risk management functions.[4]

So back in 2013, the Board of Directors was ready to assume "ultimate responsibility" for the oversight of risk. But in the Shearman & Sterling Report of 2017, the Board has become an innocent victim of a risk management function that somehow failed to stand up on its own. As the Shearman & Sterling Report wistfully admits, "Wells Fargo should have moved toward the centralization of the risk function earlier than it did." This admission makes good sense, but needs the missing conclusion: that the failure to do so clearly falls at the feet of the firm's directors.

[3] "[Among the] primary responsibilities [of a board of a financial institution] … (a) reaching agreement on a strategy and risk appetite with management, (b) choosing a CEO capable of executing the strategy, … [and] (d) obtaining reasonable assurance of compliance with regulatory, legal, and ethical rules and guidelines and *that appropriate and necessary risk control processes are in place*." Group of Thirty, Toward Effective Governance of Financial Institutions 20 (April 2012) (emphasis added) (http://group30.org/publications/detail/155).

[4] https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2013-annual-report.pdf (excerpt from page 51).

(Incidentally, current Wells Fargo CEO Timothy Sloan, whom the Shearman & Sterling Report exonerates as having limited managerial responsibilities with respect to Tolstedt—"[Before November 2015,] Sloan had little contact with sales practice matters" (p.11)—was a member of the Operating Committee identified in the 2013 Annual Report as being responsible for establishing and overseeing risk management; so clearly his responsibilities with respect to Tolstedt and her malfeasance were not nearly as circumscribed as the Report would have readers think).

A Second False Narrative: Vigorous and Effective Board Action After 2013

A second theme of the Shearman & Sterling Report is that the Board of Directors actually detected deficiencies in Tolstedt's management of the Community Bank well before public disclosures in September of 2016 and should be credited for their aggressive efforts in taking corrective action, suggesting that they had the matter just about wrapped up when news of the scandal broke publicly last September. According to the Shearman & Sterling Report, the Board began to focus attention on sales practices in the Community Bank shortly after a December 21, 2013, *Los Angeles Times* article on the subject. In advance of an April 2014 Board Risk Committee meeting, directors apparently indicated that they "wanted to hear from Tolstedt whether 'the pressure of cross sell goals cause bad behavior,'" but "Tolstedt's presentation was removed from the agenda when she was summoned to jury duty." (p. 68) Apparently, it was a long trial, because Tolstedt does not make it back to the Risk Committee on this issue—at least in the Shearman & Sterling account of Board actions—until a year later in April 2015. Reportedly, the Committee members found her presentation wanting: "too superficial and optimistic." (p. 103) The next month, following the filing of a lawsuit against Wells Fargo by the City of Los Angeles that alleged illegal sales practices, the Board further ramped up its attention to the problem of mis-selling, resulting in another Tolstedt presentation to the Risk Committee, of which the directors were "highly critical." (p. 105) Many more meetings followed later in the year, with outside experts starting to be called in and evidence mounting that the directors variously "felt blindsided," (p. 105) had "vigorously questioned" management representatives, (p. 106), and, by December 2015, coming to the "view that Tolstedt could no longer effectively lead the Community Bank." (p. 107)

So far, so good, one thinks, reading through this section of the Report. But, suddenly—at the top of page 108 (of a 110 page document), the plot takes an unexpected turn. On February 23, 2016, when the Board's Human Resources Committee meets to determine compensation for top executives, including Tolstedt, it turns out "the reaction of the Board members to Tolstedt is a complicated one"! Concerns about Tolstedt, apparently, are limited to members of the Risk Committee (chaired by Hernandez, who was also on the committee overseeing the Shearman & Sterling Report). "Most other directors, while believing that she had been overly optimistic and minimized problems, were not yet that critical," and were willing to allow her to stay in her leadership position at least several more months while her performance could be assessed. So, in the spring of 2016, as the Board was receiving detailed accounts of thousands of sales force firings, and more than two years after the Risk Committee began to focus on the problem of wide-spread inappropriate sales practices, Wells Fargo shareholders were informed that Carrie Tolstedt would be the third-highest paid employee at the firm.[5] So much for Board oversight.

[5] https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2016-proxy-statement.pdf (reporting Tolstedt's 2015 total compensation at $9,050,000, tied for third highest senior executive along

And One Great Big Whopper

One final and egregious misstatement in the Shearman & Sterling Report concerns the point of time at which the Wells Fargo directors became aware of mis-selling problems within the organization. On its second page, the Report asserts "Sales practices were not identified to the Board as a noteworthy risk until 2014," and then back on page 97, the assertion is repeated: "Prior to 2014, sales practice or sales integrity issues were not flagged as noteworthy risks either to the Board of Directors as a whole or to any Board committee." If one parses carefully the discussion that follows, the basis for this assertion is the content of internal reports circulated to the Board's Risk Committee, which classified risks in various categories, such as high or medium. Mis-selling practices apparently did not get placed into the high category until after the *Los Angeles Times* story appeared in December 2013. So, the fine lawyers at Shearman & Sterling apparently reasoned that the Board must not have been on notice of these problems until 2014 and hence the report proceeds under the assumption that the Board had no responsibility to investigate the matter before then.

This is an outrageous position but one that the Wells Fargo Board has adopted in accepting the Shearman & Sterling Report.

And, here's how you can tell it's outrageous. Just google the phrase "Wells Fargo retail banking sales practices" with a time restriction of before 2014. (If you don't know how to do this, just ask anyone under 30.) On the first page of results, you'll see accounts of a July 20, 2011, consent order against Wells Fargo by the Federal Reserve Board imposing an $85 million civil penalty based on allegations that internal compensation arrangements would encourage Wells Fargo sales personnel to steer borrowers that qualified for prime mortgage into subprime products that were more profitable for Wells Fargo.[6] In other words, Wells Fargo paid a substantial fine in 2011 based on allegations of incentive-based mis-selling to customers.

For readers willing to forgive the Wells Fargo Board for failing to recall a monetary sanction that only ran to eight digits, the next year—that is in 2012—in what was widely reported to be the federal government's second largest fair lending enforcement action to date, Wells Fargo entered into a settlement with the Justice Department requiring Wells Fargo to pay $184.3 million in compensation to qualified minority borrowers who were steered into subprime loans. (The total monetary amounts involved in this action were actually higher than in Wells Fargo's September 2016 settlement). A Justice Department press release accompanying the announcement of the settlement explained:

The United States' complaint … alleges that, as a result of Wells Fargo's policies and practices, qualified African-American and Hispanic wholesale borrowers were placed in subprime loans rather than prime loans even when similarly-qualified non-Hispanic white borrowers were placed in prime loans. The discriminatory placement of wholesale borrowers in subprime loans, also known as "steering," occurred because it was the bank's business practice to allow mortgage

with three others, a slight improving in Tolstedt's ranking from 2014 when she was the fourth highest paid executive). See also https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2015-proxy-statement.pdf.

[6] https://www.federalreserve.gov/newsevents/pressreleases/enforcement20110720a.htm.

brokers and employees to place a loan applicant in a subprime loan even when the applicant qualified for a prime loan.[7]

No doubt, CEO Stumpf with his ever optimistic demeanor emphasized to the Board that the firm had entered into the settlement without admitting liability and perhaps even chided the government for relying on statistical evidence to support its claims, but the Wells Fargo Board of directors were most certainly on notice of serious allegations of sales misconduct at the firm well before 2014.

Perhaps the most charitable interpretation of the Shearman & Sterling Report's statement about the directors' knowledge prior to 2014 is that they had no idea before then that Wells Fargo was also mis-selling its retail banking services to white folks.

* * *

The Shearman & Sterling Report makes many excuses for the Board not having done its job. But read with care, the Report can and should be understood as a devastating critique of the Board's work. Deconstructed, the Shearman & Sterling Report reveals a Board that failed to follow up on serious and widespread wrong-doing at Wells Fargo. This Board let their organization and their shareholders down. Were I a shareholder of Wells Fargo, I would definitely vote the bums out.

[7] https://www.justice.gov/opa/pr/justice-department-reaches-settlement-wells-fargo-resulting-more-175-million-relief.

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With the Benefit of Hindsight: The Wells Fargo Sales Practices Investigation Report

Posted by Arthur H. Kohn and Pamela L. Marcogliese, Cleary Gottlieb Steen & Hamilton LLP, on Tuesday, May 16, 2017

Editor's note: Arthur H. Kohn and Pamela L. Marcogliese are partners at Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb publication by Mr. Kohn, Ms. Marcogliese, Louise M. Parent and Elizabeth K. Bieber. Additional posts on Wells Fargo are available here.

On April 10, 2017 Wells Fargo released the independent directors' report on sales practices at its community bank. While the report covers familiar elements of the widely-publicized accounts-creation problems at the bank, it also takes an inside look at the organization to determine what caused the problems in the first place and what allowed them to persist for years before last fall's regulatory enforcement actions. The report cites the following as principal causes:

- a distortion of the sales culture and performance management and incentive compensation system combined with aggressive sales management and too much autonomy of business unit leaders from corporate executives;
- a former CEO who relied excessively on decades of past success and positive customer survey results and was too slow in addressing the problem and perceiving the substantial reputational risk;
- control functions that were decentralized, reported and deferred to the business and missed the opportunities to analyze, size and escalate the problem; and
- incomplete and inaccurate reporting to the board so that the board did not know that 5300 employees had been terminated for sales practice violations until the information was made public.

In light of the significant disclosures in the report, there is an opportunity for management teams and boards to reflect on their own situations. The report contains lessons for companies in all industries, not just financial services. For those who use the release of the investigation report as the catalyst to explore their own processes and procedures, the following questions for management and the board may be helpful.

For Management Teams

- Organizational Design
    - Do we have the appropriate internal reporting structure for functions like risk, human resources and legal and a process to report any material issues to the board?

- Regardless of our structure, do we have a free flow of feedback so that problems are surfaced and solved quickly?
    - Do we resist sharing complete information with "corporate" functions or massage the information that is shared?
- Tone at the Top
    - As everyone realizes, value statements and guidelines alone do not create an ethical culture. Have we allowed strong financial results to cloud our view of poor leadership?
    - Do we rely on a single metric, like the employee survey, or do we look at multiple metrics to determine how well a good "tone at the top" permeates our company?
    - What metrics have we chosen as indicators of "tone at the top"?
    - Are we appreciative when employees describe problems and concerns or do we discount them, explain them away or delay making changes?
    - How do we know that our whistleblower process is an effective method for surfacing issues?
    - How well do we train managers at all levels for setting an appropriate "tone at the top"?
    - Is there an actual or perceived punitive repercussion to sharing negative information?
- Reputational Risk
    - Do we see defects in our processes from our customers' point of view?
    - Is the language we use to describe a problem the same language our customers or the press would use, or do we use softer language that might result in our de-prioritizing a problem?
    - Is a one percent error rate acceptable when it means that a very large number of customers have been affected?
    - Do we accept a financially immaterial defect without considering the reputational harm to us?
- Connecting the Dots
    - Do we address a specific problem as a stand-alone, or do we look to see if there are broader trends, root causes or similar situations elsewhere in the organization?
    - Do we have the systems and data to see the problems and recognize patterns over time?
    - Whose responsibility is it to gather and make use of that trend information on a regular basis?
    - Do we know how frequently we act on it?
- Fixing Problems
    - Once we've identified a problem, how quickly do we fix it or create a remediation plan?
    - Does line management sponsor the remediation and fund the necessary efforts?
    - Are there some issues that linger because only a small number of customers or employees complain and the costs to fix the defect are perceived to be greater than the benefit?
    - Do our executives have meaningful compliance/control goals?
    - Are the compliance incentives built into our compensation programs adequate?
- Sales Incentives
    - Do we utilize specific sales incentives too broadly?

- Are we satisfied with the percentage of an employee's compensation that is a sales incentive?
- Do we review what percentage of employees and groups meets their incentive goals?
- Have we received information from employees that sales incentives are unachievable?
- How would we respond to information that only half of employees meet their sales incentive goals?
- Do we have effective ways to get feedback on whether goals are incenting the wrong behavior?
- Do we know how many employees are disciplined or terminated for "gaming" the sales incentive system?
- To whom is information regarding employee discipline and termination elevated?
- Is our scorecard balanced to consider customer impacts as well as revenue?

For Boards of Directors

A board might begin by asking for management's assessment and recommendations coming out of the Wells Fargo investigation report. In addition to reviewing and discussing those responses, the board might raise additional topics in executive sessions of the full board or the relevant committees or as part of the annual evaluation process. Board chairs and heads of committees might consider leading the discussions themselves or may wish to use a moderated discussion facilitated by an executive such as the general counsel, the chief risk officer, or the head of human resources. What's important is selecting an approach that fits the board culture and creates an atmosphere of candor and self-reflection. Here are a few topics that might be relevant:

- Separate Board Chair
    - Is there a separate board chair? If not, should there be a change?[1]
- Clear Responsibility
    - Who has responsibility for ethics and integrity?
    - Is it a committee or the whole board?
    - Does the Board have sufficient information on customer relationships, including customer complaints?
    - Do the Audit Committee and the Board get enough information on hotline calls and whistleblower investigations?
    - How should the Board assess and monitor the company's compliance culture?
    - Does it make sense to have risk oversight as part of the Audit Committee charter or is there a need for a separate risk committee?
    - If there is a separate risk committee, how is risk oversight allocated and information shared between the committees?
- Management Accountability
    - Who reports to the board on compliance and risk issues?
    - Is it the control groups or the business leaders?
    - Are the reports to the board and the relevant committees detailed enough for the board to assess the scope and pace of the company's efforts and track whether timelines and milestones are being met?

[1] For reference, according to the Spencer Stuart Board Index, 27% of S&P 500 boards had an independent chair in 2016, up from 21% in 2011, but a 2% decline from 2015.

    - If the board believes that compliance projects are languishing, how successful has it been in getting management to accelerate progress?
- Leadership
    - Does the board get enough information on whether the CEO or direct reports are strong ethical leaders?
    - Does the board get sufficient information about the business?
    - How and when is this information provided?
    - If the board is dissatisfied with a leader's performance, how receptive is the CEO to the board's feedback?
- Compensation
    - Is there enough "teeth" in the compliance and leadership goals of the senior executives?
    - Is the oversight of compliance risk management below the senior executives sufficiently rigorous?
    - Would information on reasons for employee terminations and employee turnover be useful to that oversight?
    - Will any compensation clawback apply in cases where executive actions cause substantial reputational harm?

A company's commitment to an ethical culture and a board's commitment to strong risk management oversight are complementary and mutually reinforcing. No single exercise or effort by either management or the board will be sufficient in itself. However, a willingness to self-assess and enhance before problems surface will undoubtedly advance both culture and oversight.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:

Do Independent Directors Curb Financial Fraud? The Evidence and Proposals for Further Reform

Posted by Cindy A. Schipani, University of Michigan, on Sunday, April 16, 2017

Editor's note: Cindy A. Schipani is Merwin H. Waterman Collegiate Professor of Business Administration and Professor of Business law at the University of Michigan Ross School of Business. This post is based on a recent article, forthcoming in the *Indiana Law Journal*, by Professor Schipani; H. Nejat Seyhun, Jerome B. & Eilene M. York Professor of Business Administration and Professor of Finance at University of Michigan Ross School of Business; and Sureyya Burcu Avci, University of Michigan Ross School of Business.

Around the turn of the millennium, a slew of corporate scandals involving outright fraud, including those at Enron, WorldCom, Global Crossing, and Adelphia Communications, among others,[1] plagued capital markets and shook investor confidence to the core. Faced with this runaway corporate malfeasance by managers of large firms around the turn of the millennium, Congress decided to discipline the managers by increasing the supervisory role of the board of directors. The Sarbanes-Oxley Act of 2002 ("SOX" or the "Act"),[2] was passed by Congress in an effort "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[3]

This was not of course the only option for Congress. Congress could have also increased the direct supervisory role of the shareholders themselves. This alternative, Congress decided not to pursue. We are now nearly fifteen years down the road from the corporate scandals of the early 2000s, and we are now in a position to observe how well Congress' choices have been working so far.

The actions Congress decided to take not only included increasing the potential criminal and civil fines and sentences for securities fraud, SOX also attempted to rectify perceived corporate governance failures by legislating rules that shifted the power from management to corporate boards, including the requirement that certain board members be independent[4] and competent audit committees be established.[5] For example, SOX demanded that the audit committee be

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[1] *See* Scott Green, *A Look at the Causes, Impact and Future of the Sarbanes-Oxley Act*, 3 J. Int'l. Bus. & L. 33 (2004).

[2] The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

[3] *Id.* Preamble

[4] *Id.* at 46.

[5] *Id.* at 38.

comprised of entirely independent directors[6] and include at least one financial expert.[7] In addition, SOX included rules requiring outside auditors be independent.[8]

One would have hoped these SOX-created independent watchdogs would reduce the incidents of securities fraud and result in better governance. Yet, our analysis of the number of class action settlements for claims of financial fraud for settlements greater than $10 million shows no significant decrease since the adoption of SOX. We presume that settlements of over $10 million indicate serious concern of the board evidencing the viability of the suit.[9] The dollar amount for analysis was chosen to reduce the incidence of strike suits in our data. Thus, the lack of a significant decrease in these claims seems to indicate that it may have been unreasonable to expect independent directors —who almost by definition are not privy to the day-to-day affairs of the firm—to have enough incentives or information to ferret out complex, and likely hidden, fraud.

Moreover, and perhaps even more troubling, our data also shows that independent directors themselves are not necessarily immune from the temptations of financial fraud, particularly with the gains to be had from backdating stock options. SOX's reliance on them may simply have transferred oversight responsibilities from compromised executives to compromised and ill-informed board members.

An alternative approach to the SOX mandates would have been to empower the shareholders directly and enable them to exercise a greater degree of direct oversight over the managers. First, it does not make logical sense for the shareholders to cede some of their supervisory role to the managers, the very same people that they are trying to supervise. This is a nonstarter. But this is exactly what happens when the managers vote shareholders' proxy as they see fit. Second, the system of tracking the shareholders and registering all ownership of the security in the name of the shareholders is a long-ignored reform that puts the U.S. even behind most developing countries. It was now been more than eight years following the Madoff scandal and the U.S still does not register securities directly in shareholders' names. This simple reform would put an end to all future Madoff-like scandals. Finally, the cost to shareholders from directly exercising their supervisory role and communicating with managers would be minimal in this electronic age. Companies could set up secure websites to allow the shareholders to review corporate issues and vote their choices.

We recommend that Congress take another look at this issue. Granted, some shareholders are not privy to the day-to-day affairs and unless their holding is substantial, may be rationally stay ignorant, there are also shareholders with substantial holdings who could be further empowered to provide an effective check on both the managers and the board of directors. To this extent, we thus propose that shareholder resolutions bind management (subject to minimum participation levels), one share to be required to have one vote, as well as for shareholders to have the ability to directly nominate and/or actively vote against board members.

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[6] *Id.* at 38.

[7] Sarbanes-Oxley Act of 2002, *supra* note 1, at §407.

[8] *Id.* at §404.

[9] To exclude strike suits, we require a minimum settlement amount of $10 million. The years 2001-2002 appear to be anomalous due to the recession and cratering stock market. We find that between 1996 and 2000; 42.4 lawsuits per year for an average annual total of $3.3 billion were settled for $10 million or more, while the corresponding numbers between 2003 and 2008 are 42.4 lawsuits per year and average annual total of $3.1 billion. While there are no on-going cases from the pre-SOX period, the post-SOX numbers exclude a total of 13 on-going cases.

We find that the outsider directors have failed with everyone else on the board to monitor the management. In this regard, we investigate the timing and backdating of executive compensation options between 1996 and 2015. In this study, we find that outside directors receive manipulated their option grants like the top executives do. Similar to options given to the top managements, outside directors use dating and timing techniques to manipulate stock options granted. Our evidence shows that they employ back-dating, spring-loading and bullet dodging games to increase the value of their options. Back-dating among other techniques provides remarkable profits to outside directors. Application of these techniques for late reported grants increase outside directors' compensation by substantial amounts. Specifically, management received extra compensation amounts of 9.2%, 14.9% and 4.1% for the 1996-2002 period, 2003-2006 period; and the 2007-2014 period, respectively. For outside directors, the comparable numbers are 7.0%, 10.3%, and 7.5%, respectively. For large late reported option grants, abnormal returns increase even further.

Our evidence strongly suggests that outside directors are not fulfilling the monitoring responsibility placed on the by SOX. We recommend that the solution lies not in strengthening the board of directors, but by strengthening the power of the shareholders. We make three specific recommendations: First, we recommend that multi-class voting structures should be eliminated. The multi-class voting structures exacerbate the conflict between shareholders and the management and lead to inferior outcomes. Our second recommendation is to make the shareholder resolutions binding on the board of directors. Currently, management typically ignores the non-binding shareholder resolutions. Finally, we recommend that plurality voting be eliminated and replaced by majority voting for the board of directors. Majority voting shifts the relative power to elect the directors away from the management to the shareholders themselves.

The complete article is available for download here.

Harvard Law School Forum on
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“Captured Boards”: The Rise of “Super Directors” and the Case for a Board Suite

Posted by Kobi Kastiel, Harvard Law School, and Yaron Nili, University of Wisconsin, on Tuesday, June 27, 2017

Editor’s note: Kobi Kastiel is a Research Director of The Project on Controlling Shareholders at the Harvard Law School Program on Corporate Governance, and Yaron Nili is Assistant Professor at University of Wisconsin Law School. This post is based on their recent article, published in the *Wisconsin Law Review.*

In October 1972, former Supreme Court Justice Arthur Goldberg resigned from his seat as a director of Trans World Airlines. In a *New York Times* article published afterward, he expressed his frustration, stating that: “[t]he outside director is simply unable to gather enough independent information to act as a watchdog or sometimes even to ask good questions. When presented with the agenda of the board meeting, the director is not basically equipped to provide any serious input into the decision. Realistically, it has already been made by management.”

The composition of U.S. boardrooms, however, has seen a dramatic shift since Justice Goldberg left the Trans World Airlines board. Over the last few decades, boardrooms that were historically controlled by company executives have been replaced with boardrooms that are dominated by independent directors which in many cases consist of the CEO as the lone executive in the room. Motivated by the belief that independent directors are better equipped to detect fraud, protect shareholders’ interests, and monitor managerial abuses of authority, shareholder pressure and regulatory reforms have forced public firms to populate their boards and committees with independent directors. But is it the case that independent directors now have the proper tools to perform their monitoring function?

While academic literature has focused on the impact director independence may have on the board’s *advisory* role and company performance, little attention has been given to the impact of the current independent board structure on the board’s ability to effectively carry out its *monitoring* role—the main goal for which director independence was sought.

In an Article recently published in the *Wisconsin Law Review*, we sought to address this gap in the literature by analyzing how board independence may have actually diminished the board’s ability to monitor management effectively. Specifically, independent board members suffer from what we term as “informational capture”. As part-time employees who often sit on multiple boards, independent directors lack the time, adequate resources, and the industry-specific knowledge to obtain, digest and analyze properly the extensive and complex information that modern boards are tasked with evaluating. Consequently, these directors are too dependent on that information which management chooses to provide or conceal, as well as on the manner management presents it to them.

A recent survey that covers 783 public company directors further highlights this informational capture problem, revealing that when it comes to the quality of information that directors receive from management, "[t]here is a lot of room for improvement." The survey finds that two-thirds of the polled directors wish "their materials better highlighted risks"; more than half of directors wish "the materials were shorter and more summarized"; forty-six percent wish "they were provided with more lead time"; and nearly half of them wish "the dialogue with management was less scripted or controlled."

These institutional constraints faced by directors have led to the following paradox: shareholders, courts, and regulators expect the board to be independent in order to ensure its ability to monitor management. But at the same time, the current composition of the boardroom, dominated by "outside" independent directors, severely limits the ability of the board to obtain independent, complete, and unfiltered information regarding the company, *a prerequisite* to the board's ability to perform its monitoring role properly. Therefore, the board often oversees management's actions while wearing "filtered glasses" that are provided by the same executives the board is tasked to monitor.

This informational capture can also explain the increasing tendency of activist shareholders to request board representation in their target companies. Activist hedge funds, we argue, identified this informational gap, and have attempted to mitigate it through what is commonly termed as "super directors"; directors who, due to the backing and resources of the activist fund that appointed them, can transcend the limitations from which "ordinary" directors have suffered due to their part-time role at their respective companies and their limited access to information. Activist super directors, who enjoy the full resources and analytical strength of the hedge funds that appointed them, have the ability to collect, process, analyze, and edit voluminous information in a timely fashion, independently of management. The activists' working product is then provided to the entire board, through its director nominee, allowing other independent board members to base their decision-making on a more balanced and complete picture. Further, contrary to many who cast the rise of activist super directors in a negative light, we show that the presence of a director with informational advantages in the boardroom is not a new phenomenon, is not limited to activist nominees, and, most importantly, these super directors serve as a key channel for mitigating informational capture of their fellow directors.

However, while the rise of activist super directors indeed underscores the importance of addressing the informational capture of boards, we argue that the current model of activist directors provides only a *partial* remedy to such a fundamental, structural problem. Activist interventions are limited to a small number of companies per year, the activist-appointed directors usually serve on boards for up to three years, and the interventions do not promote the creation of institutional knowledge within the boardrooms. Therefore, as a structural matter, a board that is comprised of part-time outside directors is doomed to suffer from these information deficiencies. This acute problem, in our view, can no longer be ignored.

Addressing the issue at its core, thus, requires a rethinking of the current board structure and how this structure correlates with the board's role as a monitor. Because the independence of directors has become a key governance feature of the U.S. boardroom, and as boards have shifted into a monitoring role, the board as an institution must provide independent directors with the tools necessary to monitor management comprehensively. To achieve this goal, we call for the creation of a new institution within the board—the "Board Suite". Such suite is a dedicated

office within the board, consisting of a full time special counsel to the board (and supporting staff) that would serve as information facilitators. The suite would request information and collect outside sources, analyzing and editing the received information, and providing it to the board in a simple, clear, and efficient with a critical eye on management's actions. This office would become the institutional knowledge base of the board—unmoved by the personnel changes the boardroom experiences—and is likely to alleviate the informational capture from which boards currently suffer.

Finally, we address potential objections to our proposed solution and highlight its doctrinal implications on Delaware case law. First, we show that this positive informational role performed by the activist super directors carries an important doctrinal implication for the way Delaware Courts should treat information sharing between board members and the activist investors that nominated them. Second, acknowledging board informational capture could potentially lead Delaware Courts to conclude that a board, which refrains from independently gathering the needed information and blindly relies on management, may not be afforded the protections from personal monetary liability provided by Sections 141(e) and 102(b)(7) of the Delaware Code.

The complete Article is available for download here.

Harvard Law School Forum on
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NYC Pension Funds Boardroom Accountability Project Version 2.0

Posted by CamberView Partners, on Tuesday, September 19, 2017

Editor's note: The following post is based on a publication from CamberView Partners, authored by Abe M. Friedman, Erica K. Lukoski, Bob McCormick, and Eric Sumberg.

On Friday, September 8, New York City Comptroller Scott M. Stringer sent a letter to 151 companies seeking engagement around a range of disclosures regarding the race and gender of company directors, the creation of a standardized director skills matrix and details of those companies' director evaluation and succession plans. The letter, sent on behalf of the New York City Pension Funds (NYC Funds), is also intended to put pressure on companies to engage on the topic of pursuing diverse independent board candidates. The request was packaged as part of the launch of the second phase of the NYC Funds' Boardroom Accountability Project, which in its first phase focused on achieving widespread adoption of proxy access.

The NYC Funds have a track record of coordinating among investors to run shareholder proposal campaigns and other initiatives that have received widespread support. In our view, NYC Funds are among the most likely investors to attempt to use the proxy access right. Accordingly, issuers should think carefully about how they manage their response to this outreach.

Proxy Access Campaign

In 2014, Comptroller Stringer filed 75 shareholder resolutions requesting the right for "proxy access," the ability for shareholders to nominate directors using the company's ballot. The Comptroller's office approach was intended to help set a market-standard around the terms of proxy access bylaws. The NYC Funds filed resolutions at companies that fit within three categories that were likely to gain the support of traditional institutional investors: carbon-intensive energy companies significantly impacted by climate change, companies at which executive compensation was misaligned with company performance and companies with limited or no board diversity (in addition to filing at some of its largest holdings).

At the start of the campaign in 2014, just six U.S.-based companies had enacted proxy access bylaws. Today, more than 440 companies have a bylaw in place, including 60% of the S&P 500 and 80% of the S&P 100. The NYC Funds' proxy access proposals routinely receive majority support and a significant number of issuers now preemptively adopt a proxy access bylaw to avoid a vote on the shareholder proposal.

Boardroom Accountability Project Campaign—Version 2.0

The next phase of Comptroller Stringer's Boardroom Accountability Project seeks to "ratchet up the pressure on some of the biggest companies in the world to make their boards more diverse, independent, and climate-competent, so that they are in a position to deliver better long-term returns for investors." The 151 U.S. companies that received the letter include those that enacted proxy access after receiving a shareholder resolution from the NYC Funds and companies at which an NYC Funds- sponsored proxy access proposal received majority support in 2017. The letter requests that companies disclose the demographic background, skills and experience of directors in a standardized "matrix" format and enter into a dialogue regarding their board refreshment process.

The Comptroller's letter also outlined four sample engagement topics that representatives from the NYC Funds would like to discuss with a member of each recipient's Nomination/Governance committee, including:

1. The matrix currently used by the board to help them and investors understand the range of skills and experiences the board considers most critical and how current directors and potential board candidates best serve the Company's long-term business strategy, executive succession planning process and risk oversight responsibilities.
2. Understanding how the company evaluates individual directors on an ongoing basis, to assess whether and how directors continue to contribute to the above board responsibilities and to changing responsibilities over time. This would also include discussing what processes are in place for companies to discuss board transitions in cases where a particular director no longer is able to contribute in this way.
3. How to establish a process whereby director search firms that a company may retain, would regularly reach out to significant shareowners for suggestions for the names of both potential board candidates and other organizations that specialize in sourcing potential diverse board candidates.
4. How to establish a normalized and structured process, pursuant to which the NYC Funds and other significant shareowners may provide to Nominating/Governance Committees the names of potential board candidates, on an ongoing basis.

Of these four topics, the Comptroller's letter focuses most of its attention on the board skills matrix. According to the letter, disclosure of a matrix allows investors to assess how well-suited individual director nominees are for the company, identify any gaps in skills, experience or other characteristics, and to more fully exercise shareholder voting rights. The NYC Funds also published a sample matrix, displayed below, that outlines the skills and experience of individual directors as well as their tenure, sexual orientation, gender, age and race/ethnicity.

[Insert Your Organization Name]

Board Matrix

This sample matrix can help boards and investors assess the level of experience each company director/nominee has in various areas, as well as in the areas of gender, sexual orientation and racial/ethnic diversity, age and tenure.

	Board of Directors							
	Name 1	Name 2	Name 3	Name 4	Name 5	Name 6	Name 7	Name 8
Skills & Experience								
Board of Directors Experience	X			X				
[Specific] Industry Experience		X					X	
CEO/Business Head	X			X				
International	X					X	X	
Human Capital Management/Compensation			X				X	
Finance/Capital Allocation		X			X		X	
Financial literacy/Accounting (Audit Committee Financial Expert or "ACFE")			X			X		
Government/Public Policy	X			X				
Marketing/Sales			X		X			
Environmental Science/Policy/Regulation						X		
Academia/Education								
Risk Management				X				
Corporate Governance		X						X
Technology/Systems					X			X
Business Ethics			X			X		X
Real Estate		X			X			X
[Custom 1]								
Demographic Background								
Board Tenure								
Years	15	15	10	8	7	7	4	1
Sexual Orientation (voluntary)								
LGBTQ	X							
Gender								
Male		X	X	X	X	X		X
Female	X						X	
Non-Binary								
Age								
Years old	60	63	65	62	60	67	55	47
Race/Ethnicity								
African American/Black	X							
Asian, Hawaiian, or Pacific Islander								
White/Caucasian		X	X	X		X	X	X
Hispanic/Latino					X			
Native American								
Other								

Takeaways for Issuers

Certain themes in this phase of the Boardroom Accountability Project, such as boardroom diversity and climate risk, are likely to resonate with the investor community. However, much of the NYC Funds' request is forward-leaning and some investors may consider it overly prescriptive or not necessary for all companies. It is not clear that investors would broadly support shareholder proposals on these topics unless they were fairly high-level and focused on the overall objective of boardroom diversity. However, this phase of the campaign may be a

precursor to identifying companies at which the NYC Funds may seek to run a proxy access campaign in the future.

Companies that received the letter and have risk on topics where a shareholder proposal might receive broad-based support should consider engaging with their investors to assess what, if anything, investors would like to see them do around the issues outlined in the NYC Funds letter. Given the deliberate approach being taken toward engagement by the NYC Funds, all issuers may want to begin evaluating their practices against industry standards and conducting analyses of their board diversity and composition, as well as their board's processes for evaluation and regular refreshment. In addition, issuers should review and consider whether enhancements to their governance-oriented engagement on these topics is appropriate.

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Congressional Lawmakers Push SEC Chairman to Focus on Board Diversity Disclosure

Posted by Ning Chiu, Davis Polk & Wardwell LLP, on Thursday, July 6, 2017

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

Two letters from members of the House of Representatives directed Chairman Clayton to continue his predecessor's efforts toward requiring companies to provide more information on the diversity composition of their boards.

Citing research that found that only half of S&P 100 companies referenced gender when disclosing their board diversity, Representatives Carolyn Maloney (D-NY) and Donald Beyer (D-VA) asked Clayton to consider the SEC staff's review of the existing rule previously ordered by former SEC Chair White. In March, Representative Maloney reintroduced a bill on board gender diversity that would require the SEC to establish a group to study and make recommendations on ways to increase gender diversity on boards. Companies must also disclose the gender composition of their boards.

Representative Gregory Meeks (D-NY), along with 28 other House Democrats, requested that Clayton go further, and to work on a rule proposal. That letter also asked the SEC to share with Congress the status of the SEC staff's review.

Earlier this year, the SEC Advisory Committee on Small and Emerging Companies recommended to Acting Chairman Piwowar that the Commission amend the SEC regulations to require companies to describe the extent to which their boards are diverse, and to include in that disclosure information regarding the race, gender and ethnicity of each member.

In Chairman Clayton's questionnaire pertaining to his nomination, he was asked specifically for his views on the effectiveness of the SEC's board diversity rule, and whether he would commit to working to update the rule to provide investors with information on the racial, ethnic and gender composition of boards as well as any efforts to improve board diversity.

In his response, Clayton stated his belief in the value of diversity and his understanding that companies and their investors are continuing to engage on the issue, and that "disclosure practices are evolving as a result." Then he indicated that he will work with his fellow commissioners, the SEC staff (including the Office of Minority and Women Inclusion) and the SEC's Advisory Committee on Small and Emerging Companies to "monitor this issue."

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Institutional Investors Lead Push for Gender-Diverse Boards

Posted by Anthony Goodman & Rusty O'Kelley, Russell Reynolds Associates, on Tuesday, April 25, 2017

Editor's note: Anthony Goodman is a member of the Board Effectiveness Practice and Rusty O'Kelley is a member of the CEO and Board Services Practice at Russell Reynolds Associates. This post is based on a Russell Reynolds publication by Mr. Goodman and Mr. O'Kelley.

Despite decades of companies' commitments to improve gender diversity at all levels of senior leadership, female representation on US corporate boards remains low: according to State Street Global Advisors (SSGA), one out of every four Russell 3000 companies do not have a single woman on their board and nearly 60% have fewer than 15%. Women held 18.8% of the board seats of companies in the Fortune 1000 in 2016. Frustrated by the slow pace of change, the world's largest institutional investors are now taking the campaign directly to their investees, arguing that gender diversity at the board level is material to a company's financial performance.

SSGA and BlackRock recently announced their renewed commitment to holding boards to account, each warning that they are prepared to vote against directors when boards fail to make progress in improving diversity. Boards with minimal female representation (defined by SSGA as fewer than 15% of directors) must therefore meaningfully address their diversity issues. This note will help boards better understand the imperative for gender diversity and the steps that should be taken in the near term to avoid being targeted by disgruntled institutional investors.

SSGA: Running Out of Patience?

Though gender diversity has been a thematic engagement area for SSGA since 2015, their March 2017 guidance note is the most explicit to date in making the link between female board representation and financial performance. Whereas advocacy campaigns elsewhere have often treated gender diversity as peripheral to broader performance analysis or viewed it as an end in itself, SSGA has placed the issue firmly within the mainstream by positioning gender diversity as a means to effective board leadership, which it views as *"foundational to good governance and positive investment outcomes."* The guidance note advises that SSGA will engage directly with companies to encourage the addition of more female directors and are prepared to vote against nominating committee chairs of boards that fail to do so.

Clients may be aware that SSGA previously focused its engagement efforts on the issue of average board tenure and in 2015 voted against or withheld votes for long-tenured board members at 380 companies. By 2016, an estimated 32% of companies targeted had added at least one new director.

BlackRock: Diverse Boards Make Better Decisions

BlackRock used its annual publication of engagement priorities in March 2017 to underscore the importance of diversity of all kinds, with a specific focus on improving gender balance in the boardroom. Like SSGA, BlackRock explicitly ties diversity to board effectiveness and performance, echoing the recent Commonsense Corporate Governance Principles (discussed on the Forum here) pronouncement that *"diverse boards make better decisions."* The world's largest asset manager will engage with companies in order to better understand their progress on improving gender diversity, but warns that that it will hold nominating and/or governance committees accountable if a company does not make progress on diversity initiatives *"within a reasonable time frame."*

Our Perspective on What Boards Should Do Next

Based on our discussions with leading investment management firms and pension funds, it is clear that concern for gender diversity at the board level is not unique to SSGA or BlackRock. Rather, it is now a recognized priority for most institutional investors, as evidenced by the Investor Stewardship Group's February 2017 Principles of Corporate Governance (discussed on the Forum here), which state that *"a well-composed board should also embody and encourage diversity, including diversity of thought and background."*

Boards that fail to meet SSGA's suggested 15% threshold should therefore expect increasing pressure from institutional investors to, in the near-term, communicate plans and targets for improving gender diversity to investors and, in the longer-term, demonstrate results. To this end, we believe clients should consider the following actions:

1. **Broaden the approach for evaluating director candidates:** Many companies cite a limited pool of suitable female director candidates as the primary obstacle to improving gender diversity. This is often the result of a narrow definition of criteria for the role that inherently disadvantages female candidates. For example, requiring that director nominees have public company P&L ownership experience above a certain size (e.g., $10B) immediately reduces the number of eligible women, without necessarily improving the quality of the pool. Broadening the criteria to include divisional CEOs with significant P&L responsibility (above $3B) widens the pool of eligible female candidates. Boards should screen for the types of skills and competencies required by the company's strategic context and be open to leaders in staff functions such as finance, marketing or operations to increase the talent pool of diverse candidates generally.
2. **Take a longer-term approach to board succession:** If each board search is treated as an individual event, there will be a tendency to develop criteria for the role that exclude potential candidates. If boards instead consider the next 2-3 vacancies that will occur over a few years, and develop a set of specifications to meet their emerging strategy, it is easier to ensure a pool of diverse candidates.
3. **Expand networks for sourcing director candidates:** In its guidance note, SSGA identifies "excessive *reliance on existing director networks and connections [as] the primary source for identifying director candidates"* as a key barrier to improving a board/s gender diversity. As such, boards should make every effort to source new directors via a diverse mix of channels rather than relying on existing networks.

4. **Communicate your plan to investors:** Investors understand that sourcing qualified directors takes time, but they also want to see evidence that boards are making this a priority and taking steps in the right direction. It is important that boards clearly communicate their plans and policies on gender diversity to investors. Details on the steps being taken and results achieved to date should be readily available, ideally in the proxy or on the company website.

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Declassified Boards Are More Likely to Be Diverse

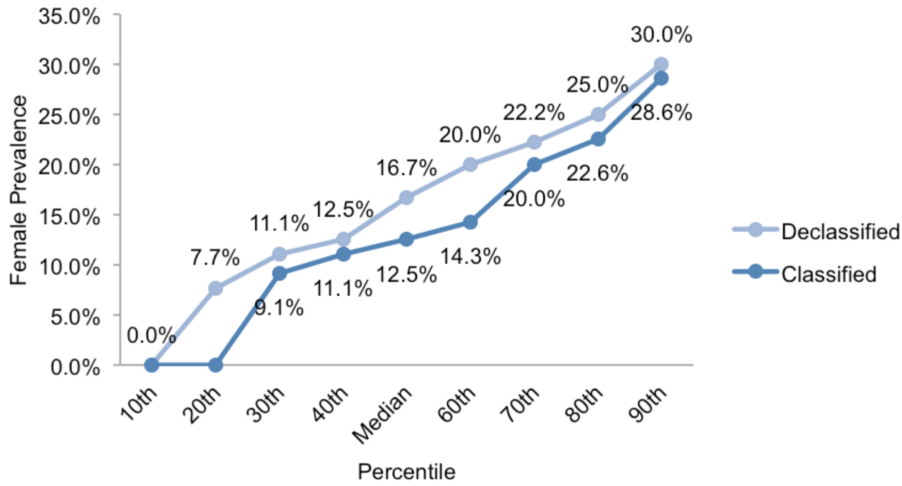
Posted by Grant Bremer, Equilar Inc., on Tuesday, August 15, 2017

Editor's note: Grant Bremer is a research analyst at Equilar Inc. This post is based on an Equilar publication by Mr. Bremer. Related research from the Program on Corporate Governance includes The Costs of Entrenched Boards by Lucian Bebchuk and Alma Cohen; How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment by Alma Cohen and Charles C. Y. Wang; and Staggered Boards and Shareholder Value: A Reply to Amihud and Stoyanov, also by Alma Cohen and Charles C. Y. Wang (discussed on the Forum here).

The Equilar Gender Diversity Index (GDI) has reported that, at the current pace of growth in female representation on public company boards of directors, gender parity would not be reached until Q4 2055 for the Russell 3000. However, annually elected boards may already have an edge against their classified counterparts.

Classified boards, also colloquially known as staggered boards, create separate "classes" of directors who are elected for multiple-year terms, with one "class" coming up for re-election each year. Proponents of classified boards say they strengthen a company's long-term strategy by increasing focus and dedication. Classification may also reduce stress on a board by creating job stability and preventing hostile corporate takeovers. On the other hand, advocates of declassified boards highlight how annual elections can increase accountability and responsiveness to shareholders. Over the past five years, corporations have seen a strong migration away from classified boards to annually elected boards with no director classes. Indeed, almost 90% of large-cap companies now have declassified boards, up from about two-thirds in 2011.

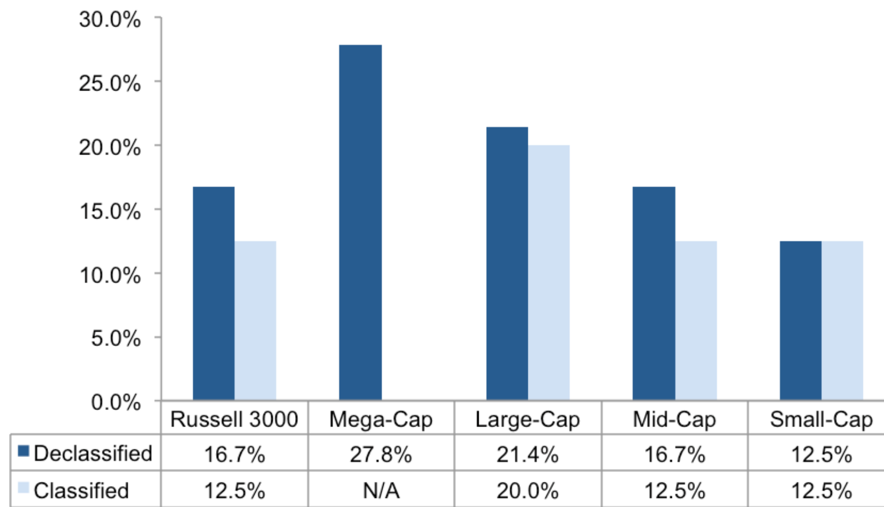
In the Russell 3000, boards are more evenly split. According to a recent Equilar study, more than 40% of boards were classified. Further analysis using data from the forthcoming Equilar GDI—which will publish August 2—elucidates a discrepancy between classified and declassified boards. For the Russell 3000, median prevalence of female directors for Q2 2017 in the Gender Diversity Index was 14.3% overall. However, when split into categories according to whether or not the board is classified, median prevalence differs notably—classified boards had 12.5% female directors at the median vs. 16.7% for declassified boards. The most recent data has shown that declassified boards have consistently outpaced their classified peers in female prevalence across all percentiles.



Separating companies by market capitalization provides another look into how market value may affect gender diversity. Size doesn't mean everything, but when it comes to gender diversity company size it clearly correlates to higher female prevalence on boards overall.

Companies that fall under the mega-cap and large-cap distinctions (greater than $200 billion and between $10 and $200 billion in market cap, respectively) are both ahead of the Russell 3000 median for both classified and declassified boards. Mega-cap companies reached 27.8% female prevalence in declassified boards—notably, there were no classified boards among this group of companies. Meanwhile, large-cap companies beat the index median by 7.5 and 4.7 percentage points for classified and declassified boards, respectively, and declassified boards edged out their counterparts with 21.4% women on boards at the median.

Classified and declassified boards at mid-cap companies have the same median prevalence of gender diversity as the median index overall. Declassified boards for small-cap companies were the only group that dipped below the index median in their category, with a difference of 4.2 percentage points.



	Russell 3000	Mega-Cap	Large-Cap	Mid-Cap	Small-Cap
Declassified	16.7%	27.8%	21.4%	16.7%	12.5%
Classified	12.5%	N/A	20.0%	12.5%	12.5%

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Activism and Board Diversity

Posted by David A. Katz & Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, on Friday, September 29, 2017

Editor's note: David A. Katz is partner and Laura A. McIntosh is consulting attorney at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton publication by Mr. Katz and Ms. McIntosh which originally appeared in the *New York Law Journal*.

Activism at public companies can reduce board diversity, or it can increase it, depending on the circumstances. In recent years, activist hedge funds have installed dissident nominees who collectively have trailed the S&P 1500 index significantly in terms of gender and racial diversity. In contrast, institutional shareholders and asset managers are promoting board diversity to an unprecedented extent, with concerted public efforts already producing results. Several institutional investor initiatives, announced earlier this year, and the New York Comptroller's Boardroom Accountability Project 2.0, announced earlier this month, may be game-changing initiatives on the path to greater board diversity.

Hedge Fund Activism

Since the early 2000s, a number of studies have demonstrated that companies with women on their boards consistently experience a wide range of benefits, including higher average returns on equity, higher net income growth, lower stock volatility, and higher returns on invested capital. Whether because of improved group dynamics, a shift in risk management, increased ability to consider alternatives to current strategies, or a focus on governance generally, board gender diversity produces stronger boards. While the argument for gender diversity may have begun from notions of equality, experience has shown a compelling financial rationale.

With the evidence for board diversity very much in the public domain, the behavior of hedge fund activists seeking board representation has been somewhat puzzling. Hedge fund activism has been notably counterproductive in terms of gender diversity on public boards. A 2016 Bloomberg analysis of the years 2011 through 2015 found that women represented only five percent of the candidates successfully placed on boards by activist funds, a significant finding during a period in which women represented about 19 percent of S&P 500 directors and in which female candidates were nominated to fill 26 percent of open seats at S&P 500 companies. At companies targeted by hedge funds during the same years, the proportion of all-male boards increased from 13 percent to 17 percent, while in the S&P 1500 that proportion significantly declined.

An August 2017 study investigated the reasons that hedge fund activists seemingly ignore the evidence for gender-diverse boards in their choices for director nominees and disproportionately target female chief executive officers. The authors suggest that hedge funds may be subconsciously biased against women leaders due to perceptions, cultural attitudes, and beliefs

about the attributes of leaders in our society. Activists may tend to view female CEOs as weaker and may be more willing to second-guess and criticize the corporate strategic plans put forth by women leaders. Indeed, one academic study found that the persistent mention of a female CEO in media coverage leads to a 96 percent probability that her company will be targeted by activists.

Boardroom Accountability 2.0

In marked contrast to hedge fund activists, significant institutional investors and asset managers are engaging in deliberate, proactive, and effective campaigns for increased diversity on public company boards. BlackRock, State Street Global Advisors, and Vanguard all have taken public steps this year to promote and advocate for greater board diversity. For example, State Street Global Advisors' "preferred approach is to drive greater board diversity through an active dialogue and engagement with company and board leadership." Using the carrot and stick approach, State Street notes that "[i]n the event that companies fail to take action to increase the number of women on their boards, despite our best efforts to actively engage with them, [State Street] will use [its] proxy voting power to effect change—voting against the Chair of the board's nominating and/or governance committee if necessary." BlackRock has noted that "over the coming year, we will engage companies to better understand their progress on improving gender balance in the boardroom." Vanguard, in an open letter, noted that one of the four pillars it will use to evaluate a public company's corporate governance is whether there is "[a] high-functioning, well-composed, independent, diverse, and experienced board with effective ongoing evaluation practices."

Earlier this month, the New York City Comptroller and the New York City Pension Funds announced the "Boardroom Accountability Project 2.0," a three-pronged initiative focusing on board diversity, director independence, and climate expertise. With regard to board diversity, the project calls for the boards of 151 U.S. companies to release "board matrix" disclosure indicating the race, gender, and skill sets of their board members, on the theory that standardized disclosure will increase transparency, accountability, and incentives for diversification. The project aims to combat a "persistent lack of diversity" on public company boards by encouraging boards to seek director candidates more broadly. The New York City Comptroller recently sent letters to the targeted companies asking them to provide the requested information.

The new project could well be successful as the NYC Comptroller's original Boardroom Accountability Project. The goal of the original project was to make proxy access a standard feature of corporate governance. Since the 2014 launch of the initial project, proxy access has indeed become widespread, with over 400 U.S. companies (and over 60 percent of the S&P 500) having adopted some form of proxy access. Boardroom Accountability 2.0 is the sequel, in that nearly all of the targeted companies recently adopted proxy access, and the current project aims to empower shareholders to use this tool more effectively with the information contained in the proposed standardized matrix disclosure.

Even if companies choose not to directly respond to the information requested by the NYC Comptroller, the combination of the Boardroom Accountability Project 2.0 and institutional investors' focus on the issue of diversity is likely to push public companies to reassess their approaches to board diversity generally and gender diversity specifically. We are already seeing changes in the way boards of directors are approaching director succession in response to these pressures. Public companies should consider using the opportunity presented by the Boardroom Accountability Project 2.0 to communicate their approaches to board diversity generally, and

gender diversity specifically, to their larger institutional investors and engage in a dialogue that will present their approach in the best possible light.

The concerted efforts of some of the largest and most influential investors and asset managers toward increasing board diversity are likely to be effective. Their support for shareholder proposals, their ongoing engagement with companies, and their consistent public advocacy for independent and diverse boards are powerful factors that will change the corporate governance landscape. Meanwhile, the advantages of diverse boards are becoming more widely understood and have been demonstrated through convincing evidence, making the business case for board diversity stronger than ever.

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Tab III: Departures from One-Share One-Vote

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Swimming Against the Current

Posted by Nick Dawson, Proxy Insight, on Monday, August 14, 2017

Editor's note: Nick Dawson is Co-Founder and Managing Director of Proxy Insight. This post is based on a Proxy Insight publication by Mr. Dawson.

Dual stock structures have been cropping up quite a lot in the news recently. The resurgence of this long-standing debate can be traced back to Snap Inc's listing earlier this year. The tech company's IPO took the unprecedented step of offering no voting rights for its common stock.

This led the Council of Institutional Investors (CII) and some asset managers to reiterate the call for indices to ban non-voting shares. Picking up the debate, this post will look at the arguments surrounding this controversial issue alongside Proxy Insight data.

Although most investors agree with CII that dual stock structures represent poor corporate governance, rivalry between exchanges means that the council is likely fighting a losing battle.

A number of countries around the world already permit non-voting shares such as the US, Canada, France, Italy and Switzerland. With competition for tech company listings heating up, the likes of London, Hong Kong and Singapore have considered allowing them as well.

It used to be mostly family-owned companies like Ford Motor Co. and News Corp. that had these structures. However, since Google dual listed in 2004, it has been common for tech companies such as Facebook to adopt dual stock structures in order to allow their founders to retain control.

Earlier this year, Facebook announced it would be creating a new class of non-voting shares. At the time, CEO and Founder Mark Zuckerberg cited a number of reasons why this was a good thing, including Facebook's controversial $1 billion purchase of Instagram, which has since proved fruitful.

Zuckerberg argued that, had he been answerable to the board and shareholders this, and a number of other key decisions, may not have been made. Critics counter this by arguing that a dual stock structure undermines the fundamental principle that those who provide the capital should get a say in how the company is run.

Large institutional investors have more cause than most to object because a lot of them manage index funds. This means they have no choice but to buy shares in these dual stock companies and then have no way to effect change. Table 1 shows the policies of the top 10 investors on dual stock structures, all of which say they are opposed to the concept.

It seems that the investors are choosing to back up their words with actions. Table 1 also illustrates the percentage of times the top 10 investors decided to support these proposals. Average support among them was 91%, which is incredibly high for a shareholder proposal.

Investors	Dual Stock Structure Policy	(%) For US
BlackRock	BlackRock supports the concept of equal voting rights for all shareholders. They oppose differential voting power as it may have the effect of denying shareholders the opportunity to vote on matters of critical economic importance to them. When a management or shareholder proposal requests to eliminate an existing dual-class voting structure, BlackRock seek to determine whether the cost of restructuring will have a clear economic benefit to their clients' portfolio(s). BlackRock evaluate these proposals on a case-by-case basis, and we consider the level and nature of control associated with the dual-class voting structure as well as the company's history of responsiveness to shareholders in determining whether support of such a measure is appropriate.	77.3
Vanguard	Vanguard are opposed to dual-class capitalisation structures that provide disparate voting rights to different groups of shareholders with similar economic investments. They will oppose the creation of separate classes with different voting rights and will support the dissolution of such classes.	91.7
State Street Global Advisors	SSgA will not support proposals authorising the creation of new classes of common stock with superior voting rights. SSgA will support capitalization changes that eliminate other classes of stock and/or unequal voting rights.	100
Fidelity Management & Research	FMR will generally vote in favor of proposals to recapitalize multi-class share structures into structures that provide equal voting rights for all shareholders, and will generally vote against proposals to introduce or increase classes of stock with differential voting rights. However, FMR will evaluate all such proposals in the context of their likelihood to enhance long-term economic returns or maximize long-term shareholder value.	87.1
BNY Mellon	BNY Mellon support proposals to eliminate a class of common stock with voting rights greater than the class held in client accounts.	100
J.P. Morgan Asset Management	JPMAM generally, vote against dual-class recapitalisations as they offer an effective way for a firm to thwart hostile takeovers by concentrating voting power in the hands of management or other insiders. JPMAM vote for dual-class recapitalisations when the structure is designed to protect economic interests of investors.	85.3
Goldman Sachs	GSAM vote for resolutions that seek to maintain or convert to a one-share, one-vote capital structure and vote against requests for the creation or continuation of dual-class capital structures or the creation of new or additional super voting shares.	80.6
Legal & General	LGIM supports the "one share one vote" policy and favours a share structure where all shares have equal voting rights. LGIM does not support the issue of shares with enhanced or impaired voting rights. In some markets, however, differential voting rights is a long-standing structure and where this exists the structure should be transparently disclosed.	100
Wellington Management Company	WMC believe that shareholders' voting power should be reflected by their economic stake in a company.	90.3
Northern Trust	Northern Trust generally votes against dual-class exchange offers. Northern Trust generally votes against dual-class recapitalizations.	100

Table 1: Top 10 largest investors' approaches to dual stock structures as written in their voting policies, as well as their average support for one share, one vote shareholder proposals, 2012-2017

Source: Proxy Insight

The data in Table 2 certainly seems to show a consensus among the investor community that dual stock structures are bad practice. Taking all shareholder resolutions asking to abolish dual stock structures in 2017 and excluding the founders' voting rights reveals that, without their influence, the majority of these resolutions would have passed. Average support without founder influence was 69%, compared to just 29% when the founder votes were included.

Issuer	Meeting Date	% For	% Against	% For Without Founder	Founder
Alphabet Inc	07-Jun-17	29	71	71	Larry Page, Sergey Brin
Facebook Inc.	01-Jun-17	20	80	79	Mark Zuckerberg
Ford Motor Company	11-May-17	36	64	46	The Ford Family
Ingles Markets, Incorporated	14-Feb-17	12	88	100	Robert P. Ingle, II
Lennar Corporation	18-Apr-17	35	65	45	Leonard Miller
Swift Transportation Company	24-May-17	35	65	85	Jerry Moyes
Telephone and Data Systems Inc.	25-May-17	36	64	76	LeRoy T. Carlson Jr.
Vishay Precision Group Inc.	25-May-17	32	68	46	Zandman Family Trust

Table 2: Voting data for one share, one vote shareholder proposals in 2017, including the name of the company's founder/founder trust and the support that the proposals would have received had their shares been removed from the equation

Source: Proxy Insight

Despite a consensus among investors over the harmful nature of dual stock structures, and growing concerns over their increased adoption by companies, Table 3 shows that the number of shareholder proposals seeking to adopt a one share, one vote policy has not increased.

Neither has the level of support for those resolutions. The quantity of shareholder proposals and levels of support peaked in 2015, but there have already been 8 this year so there may be more proposals to come.

It may be that ordinary investors have conceded that there is little they can do on this issue. While they put up a united front when a shareholder proposal is put forward, as Table 2 shows, there is little they can do without the support of those who hold founder shares. Indeed, it seems that such investors are stuck in a catch-22, as their efforts to overthrow their companies' dual class structures are undermined by those very structures.

Date	# of proposals	Av % Support
2012	5	32.7
2013	7	26.6
2014	9	23.4
2015	10	32.8
2016	8	30.1
2017	8	29.4

Table 3: No. of one share, one vote shareholder proposals per annum and their average support

Source: Proxy Insight

Harvard Law School Forum on
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The Untenable Case for Perpetual Dual-Class Stock

Posted by Lucian Bebchuk and Kobi Kastiel, Harvard Law School, on Monday, April 24, 2017

Editor's note: Lucian Bebchuk is the James Barr Ames Professor of Law, Economics, and Finance, and Director of the Program on Corporate Governance, at Harvard Law School. Kobi Kastiel is the Research Director of the Project on Controlling Shareholders of the Program. This post is based on their Article, The Untenable Case for Perpetual Dual-Class Stock, forthcoming in the *University of Virginia Law Review*. The Article is part of the research undertaken by the Project on Controlling Shareholders.

We recently placed on SSRN our study, The Untenable Case for Perpetual Dual-Class Stock. The study, which will be published by the *University of Virginia Law Review* in June 2017, analyzes the substantial costs and governance risks posed by companies that go public with a long-term dual-class structure.

The long-standing debate on dual-class structure has focused on whether dual-class stock is an efficient capital structure that should be permitted at the time of initial public offering ("IPO"). By contrast, we focus on how the passage of time since the IPO can be expected to affect the efficiency of such a structure.

Our analysis demonstrates that the potential advantages of dual-class structures (such as those resulting from founders' superior leadership skills) tend to recede, and the potential costs tend to rise, as time passes from the IPO. Furthermore, we show that controllers have perverse incentives to retain dual-class structures even when those structures become inefficient over time. Accordingly, even those who believe that dual-class structures are in many cases efficient at the time of the IPO should recognize the substantial risk that their efficiency may decline and disappear over time. Going forward, the debate should focus on the permissibility of finite-term dual-class structures—that is, structures that sunset after a fixed period of time (such as ten or fifteen years) unless their extension is approved by shareholders unaffiliated with the controller.

We provide a framework for designing dual-class sunsets and address potential objections to their use. We also discuss the significant implications of our analysis for public officials, institutional investors, and researchers.

Below is a more detailed summary of our analysis:

1990, Viacom Inc., a prominent media company, adopted a dual-class capital structure, consisting of two classes of shares with differential voting rights. This structure enabled Viacom's controlling shareholder, Sumner Redstone, to maintain full control over the company while holding only a small fraction of its equity capital. At the time, Redstone was already one of the most powerful and successful figures in Hollywood. Indeed, three years earlier, he had bought

Viacom in a hostile takeover, exhibiting the kind of savvy and daring business maneuvers that subsequently helped him transform Viacom into a $40 billion entertainment empire that encompasses the Paramount movie studio and the CBS, MTV, and Showtime television networks. Investors during the 1990s could have reasonably been expected to be content with having Redstone safely at the helm.

Fast-forward twenty-six years to 2016: Ninety-three-year-old Redstone faced a lawsuit, brought by Viacom's former CEO and a long-time company director, alleging that Redstone suffered from "profound physical and mental illness"; "has not been seen publicly for nearly a year[;] can no longer stand, walk, read, write or speak coherently; … cannot swallow[;] and requires a feeding tube to eat and drink." Indeed, in a deposition, Redstone did not respond when asked his original family birth name. Some observers expressed concerns that "the company has been operating in limbo since the controversy erupted." However, public investors, who own approximately ninety percent of Viacom's equity capital, remained powerless and without influence over the company or the battle for its control.

Eventually, in August 2016, the parties reached a settlement agreement that ended their messy legal battles, providing Viacom's former CEO with significant private benefits and leaving control in the hands of Redstone. Notably, despite the allegation and the evidence that surfaced, the settlement prevented a court ruling on whether Redstone was legally competent. Note that even a finding of legal competency would have hardly reassured public investors: Legal competence does not by itself qualify a person to make key decisions for a major company. Moreover, once Redstone passes away or is declared to be legally incompetent, legal arrangements in place would require the control stake to remain for decades in an irrevocable trust that would be managed by a group of trustees, most of whom have no proven business experience in leading large public companies. Thus, even assuming that Viacom's governance structure was fully acceptable to public investors two decades ago, this structure has clearly become highly problematic for them.

Let us now turn from Viacom to Snap Inc. The company responsible for the popular disappearing-message application Snapchat has recently gone public with a multiple-class structure that would enable the company's co-founders, Evan Spiegel and Robert Murphy, to have lifetime control over Snap. Given that they are now only twenty-six and twenty-eight years old, respectively, the co-founders can be expected to remain in control for a period that may last fifty or more years.

Public investors may be content with having Spiegel and Murphy securely at the helm in the years following Snap's initial public offering. After all, Spiegel and Murphy might be viewed by investors as responsible for the creation and success of a company that went public at a valuation of nearly $24 billion. However, even if the Snap co-founders have unique talents and vision that make them by far the best individuals to lead the company in 2017 and the subsequent several years, it is hardly certain that they would continue to be fitting leaders down the road. The tech environment is highly dynamic, with disruptive innovations and a quick pace of change, and once-successful founders could well lose their golden touch after many years of leading their companies. Thus, an individual who is an excellent leader in 2017 might become an ill-fitting or even disastrous choice for making key decisions in 2037, 2047, or 2057. Accordingly, as the time since Snap's IPO grows, so does the risk that Snap's capital structure, and the co-founders' resulting lock on control, will generate costly governance problems.

The examples of Viacom and Snap highlight an important dimension—the passage of time since a company's IPO—that has thus far received insufficient attention. This Article seeks to provide a comprehensive, systematic analysis of how the potential costs and benefits of a dual-class structure—and thus the overall efficiency of such a structure—change over time. Our analysis demonstrates that, as time passes, the potential costs of a dual-class structure tend to increase and the potential benefits tend to erode. As a result, even if the structure were efficient at the time of the IPO, there would be a substantial risk that it would not remain so many years later, and this risk would keep increasing as time passes. Furthermore, we show that controllers have strong incentives to retain a dual-class structure even when that structure becomes inefficient over time. Thus, even those who believe that a dual-class structure is often efficient at the time of the IPO should recognize the perils of providing founders with perpetual or even lifetime control.

The debate going forward should focus on the assessment and permissibility of dual-class structures with a finite term—that is, structures that sunset after a fixed period of time (such as ten or fifteen years) unless their extension is approved by shareholders unaffiliated with the controller. We examine how sunsets could be designed, address potential objections to their use, and explain the implications of our analysis for public officials, institutional investors, and corporate governance researchers.

The analysis of our Article is organized as follows. Part I explains the substantial stakes in the policy debate that we seek to reframe. We begin by discussing the importance of dual-class companies in the United States and around the world. A significant number of U.S. public companies, including such well-known companies as CBS, Comcast, Facebook, Ford, Google, News Corp., and Nike, have dual-class structures. Furthermore, since Google decided to use a dual-class structure for its 2004 IPO, a significant number of "hot" tech companies have followed its lead.

Part I also discusses the long-standing debate over the desirability of dual-class structures. The New York Stock Exchange ("NYSE") prohibited dual-class structures for approximately sixty years, until the mid-1980s, and they are still prohibited or rare in some jurisdictions, such as the United Kingdom and Hong Kong. However, the rules now prevailing in the United States, as well as in some other jurisdictions around the world, permit the use of dual-class stock. Moreover, the debate on the subject is still ongoing—both in jurisdictions that prohibit dual-class structures and those that permit them.

In this debate, which has thus far focused on whether and when it is desirable for companies to go public with a dual-class structure, we side with those who are skeptical of the value of dual-class IPOs. In this Article, however, we seek to reorient the debate by focusing on the mid-stream desirability of dual-class structures in long-standing public companies. Showing that dual-class structures are likely to become inefficient over time even if they happen to be efficient at the time of the IPO, we suggest taking one option—a perpetual dual-class structure—off the table. Going forward, the debate should focus on whether companies should be allowed to go public with finite-life dual-class structures—that is, structures with a sunset clause. Perpetual dual-class stock, without any time limitation, should not be part of the menu of options.

Part II analyzes how the potential costs of dual-class structures change over time. These costs tend to increase for two major reasons. To begin, in a dynamic business environment, even a founder who was the fittest leader at the time of the IPO might eventually become an inferior

leader due to aging or changes in the business environment, and this risk increases the expected costs of providing the founder with a lifetime lock on control. Indeed, the expected costs of a lifetime lock on control are likely to be especially large when the founder is young or even middle-aged at the time of the IPO. Concerns about the emergence of inferior leadership over time are further aggravated when the dual-class structure enables a transfer of the founder's lock on control to an heir who might be unfit to lead the company.

Furthermore, many dual-class structures enable controllers to substantially reduce their fraction of equity capital over time without relinquishing control, and controllers often do so to diversify their holdings or finance other investments or assets. When the wedge between the interests of the controller and those of the public investors grows over time, the agency costs of a dual-class structure can also be expected to increase.

Part III then analyzes how the potential benefits of a dual-class structure can be expected to change over time. Dual-class structures are often justified on the grounds that the founder of a company going public has skills, abilities, or vision that makes her uniquely fit to be at the helm. Many years later, however, the founder's superiority as the company's leader, and with it the expected value of having the founder retain a lock on control, could erode or disappear altogether. Another potential benefit often ascribed to dual-class structures is that they insulate management from short-term market pressures. However, the expected benefit from such insulation is likely to be larger when the controller is a fitting leader for the company and likely to decline when the passage of time makes the controller ill fitting for the leadership role. Finally, it might be suggested that insulation from market forces might be beneficial to companies that are new to the public market, but any such potential benefit is again expected to decline and eventually disappear as time passes from the IPO.

Part IV explains why public officials and investors cannot rely on private ordering to eliminate dual-class structures that become inefficient with time. We show that controlling shareholders, especially those who hold a small fraction of equity capital, have significant perverse incentives to retain a dual-class structure that has become inefficient, even when dismantling it—via a conversion to a one-share-one-vote structure or a sale of the company—would produce substantial efficiency gains. The reason is that the controller would capture only a fraction of the efficiency gains, which would be shared by all shareholders, but would fully bear the cost of forgoing the private benefits of control associated with the dual-class structure.

To address the distorted incentives of controllers to retain dual-class structures even when those structures become substantially inefficient, IPO dual-class structures can include sunset provisions stipulating the structures' expiration after a fixed period of time, such as ten or fifteen years. Part V discusses the merits and design of such sunset provisions. To enable the retention of structures that remain efficient, we explain that the initially specified duration of the dual-class structure could be extended if such extension is approved by a majority of the shareholders unaffiliated with the controller. We also address potential objections to arrangements that preclude or discourage perpetual dual-class structures. In particular, we respond to objections that (1) perpetual dual-class structures should be presumed efficient if they are chosen by market participants and (2) allowing perpetual structures is necessary to induce founders to go public.

Finally, Part VI discusses the implications of our analysis for policymaking, investors, and corporate-governance research. Public officials and institutional investors should consider

precluding or discouraging IPOs that set a perpetual dual-class structure. They should also be attentive to the aggravated agency problems that are posed by companies that went public with perpetual dual-class structures a long time ago. Researchers should take the time dimension into account in their analyses of dual-class structure and should test several empirical predictions that Part VI puts forward. We hope that future assessments of dual-class structures will be informed by the problems that we identify in this Article and the framework of analysis that we put forth.

The Article is available for download here.

Dual-Class Stock and Private Ordering: A System That Works

Posted by David J. Berger, Wilson Sonsini Goodrich & Rosati, on Wednesday, May 24, 2017

Editor's note: David J. Berger is Partner at Wilson Sonsini Goodrich & Rosati. This post is based on a Wilson Sonsini publication by Mr. Berger, Steven E. Bochner, and Larry Sonsini. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).

Dual-class stock has become the target of heightened attention, particularly in light of Snap's recent IPO. While the structure remains popular for companies trying to respond to the short-term outlook of public markets—including companies in the technology and media sectors, as well as companies in more traditional industries ranging from shipping and transportation to oil and gas, and everything in between—dual-class stock continues to be the subject of considerable attack by various investor groups and some academics. Further, while a majority of dual-class companies are not technology companies, young technology companies continue to be the primary focus of governance activists.[1]

Despite the controversy over dual-class stock, we believe that the present system of private ordering with respect to dual-class stock will—*and should*—continue. Private ordering allows boards, investors, and other corporate stakeholders to determine the most appropriate capital structure for a particular company, given its specific needs. So long as the company makes appropriate disclosure of its capital structure, including the implications of this structure to its investors, we believe there is no need for further regulation on this issue.

The benefits of a system of private ordering have become increasingly apparent in the U.S. and across the globe. For example, both Nasdaq and the NYSE continue to actively solicit and list companies with multi-classes of stock. According to a recent Council of Institutional Investors (CII) study, about 10 percent of publicly listed companies have multi-class structures. This includes not just newly public and/or prominent technology companies such as Alphabet (formerly Google), Facebook, and Snap, or even numerous media companies such as CBS, Liberty Media, Sinclair Broadcast Group, Scripps, and Viacom, but also companies in every industry ranging from financial services (Berkshire Hathaway, Evercore, Houlihan Lokey, etc.) to consumer products (Constellation Brands, Coca-Cola Bottling Co., Nike, Panera Bread, etc.) to transportation and industrial companies (Swift Transportation, TerraForm, Quaker Chemical, Nacco Industries, etc.).

[1] The Council of Institutional Investors recently published a list of dual-class companies in the Russell 3000. The list can be found here: http://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf.

As the companies identified above demonstrate, many of the dual- or multi-class companies listed by the NYSE and Nasdaq continue to be among the most successful in the world—both financially and from a governance perspective. The success and prominence of these companies make it unlikely that there will be a broad effort among the exchanges to require them to change their governance structure.

The success of many dual-class companies has also led both Nasdaq and the NYSE to continue to support dual-class listings. For example, Nasdaq recently released a report (discussed on the Forum here) that included an endorsement of dual-class stock, including laying out the arguments why companies with dual-class stock should continue to be listed.[2] Among the reasons cited by Nasdaq was the recognition that encouraging entrepreneurship and innovation in the U.S. economy is best done by "establishing multiple paths entrepreneurs can take to public markets." Because of this, each "publicly traded company should have flexibility to determine a class structure that is most appropriate and beneficial for them, so long as this structure is transparent and disclosed up front so that investors have complete visibility into the company. Dual-class structures allow investors to invest side-by-side with innovators and high-growth companies, enjoying the financial benefits of these companies' success.[3]" While the NYSE has not recently issued any public statements on multi-class stock, it continues to actively seek to list companies with multi-class stock, including Alibaba, which chose to list on the NYSE after the Hong Kong stock exchange raised significant questions about its governance structure.

The trend towards private ordering on dual-class shares can also be seen globally. For example, less than two years ago, Hong Kong's stock exchange rejected a proposal to allow companies with dual-class stock to list on its exchange. However, the Hong Kong Securities and Futures Commission (SFC) recently announced a new study to determine whether to permit dual-class listings (including possibly creating a separate exchange for companies listing dual-class stock). While the SFC's decision includes consideration of a new trading exchange in Hong Kong for companies with multi-class structures, its actions have been widely interpreted as essentially reversing its prior decision. Additionally, the SFC's chairman recently announced that the SFC "supports the consultation to allow the public to share their views on the dual-shareholding structure," and he made it clear that the SFC was "open minded" about the possibility of listing dual-class companies.

Singapore appears to be going through a similar transition. Singapore also historically did not allow listings of dual-class companies, but in February 2017, the country released a paper titled "Possible Listing Framework for Dual-Class Share Structures." The proposal has been the subject of considerable debate, with many large institutional investors (including those based in the U.S.) opposed to allowing any type of dual-class listing. At the same time, the head of Singapore's Investors Association, which represents more than 70,000 retail investors and is the largest organized investor group in Asia, has become an outspoken advocate of dual-class stock, arguing that "retail investors are not idiots" and that any "capital market that is aspiring to be leading" should offer this alternative.

The trend can also be seen in Europe. In 2007, the EU considered imposing a one-share/one-vote requirement on publicly traded companies, but abandoned the idea at the time of the 2008

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[2] A copy of Nasdaq's Blueprint for Market Reform can be found here: http://business.nasdaq.com/media/Nasdaq%20Blueprint%20to%20Revitalize%20Capital%20Markets_tcm5044-43175.pdf, discussed on the Forum here.

[3] *Id.* at 16.

financial crisis. Now many EU countries are adopting some form of “time-based voting” shares, to encourage long-term investors by giving more votes to shareholders who own their shares for longer periods.[4] For example, France has adopted the “Florange Act,” which generally provides that shareholders who own their shares for two years will receive two votes per share. Italy has also considered loyalty shares, while in many of the Nordic countries companies with shares with multiple voting rights are common.[5]

At the same time, critics of dual-class stock in the U.S., especially within the institutional investor community, remain quite vocal. For example, the Securities and Exchange Commission’s (SEC’s) Investor Advisory Committee recently held a hearing on dual-class stock, where its use was sharply criticized by Commissioner Stein (whose term ends in June), as well as a representative from CII.[6] During the meeting, representatives from CII and other institutional investors urged the SEC to use its regulatory authority over the exchanges to limit the ability of companies to have dual-class structures, while also calling upon the companies that create the benchmark indexes to exclude companies with non-voting stock from these indexes (ironically, many of the same companies that create these indexes are CII members and among the world’s largest institutional investors).

More recently, two of the country’s leading academics, Harvard Law School professors Lucian Bebchuk and Kobi Kastiel, published an article (discussed on the Forum here) calling for a mandatory sunset provision on all dual-class stock for public companies.[7] The Bebchuk and Kastiel piece argues that “public officials and investors cannot rely on private ordering to eliminate dual-class structures that become inefficient with time,” and for that reason “[p]ublic officials and institutional investors should consider precluding or discouraging IPOs that set a perpetual dual-class structure.” Bebchuk and Kastiel conclude that “[p]erpetual dual-class stock, without any time limitation, should not be part of the menu of options” for public companies.

We disagree with Bebchuk and Kastiel on the need for additional regulation in this area and, further, do not believe that the SEC will adopt the Bebchuk and Kastiel proposal. While the SEC has not recently taken a formal position on dual-class stock, its new leadership is certainly familiar with the issue. For example, while Chairman Clayton was a partner at Sullivan & Cromwell, he represented many companies with dual-class share structures, and William Hinman, the SEC’s new Director of Corporate Finance, represented Alibaba in its IPO. Mr. Hinman, who was based in Silicon Valley before taking his new position at the SEC, was also involved in a number of other IPOs where companies have dual-class stock. While it is impossible to predict the future positions of the SEC, Chairman Clayton has emphasized that one of his top priorities is to reverse the decline in U.S. public companies that has occurred over the last 20 years. As Nasdaq recognized, one way to foster increased numbers of IPOs (as well as

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[4] For a lengthier discussion on time-based voting and its possibilities in the U.S., *see* David J. Berger, Steven Davidoff Solomon, and Aaron Jedidiah Benjamin, “Tenure Voting and the U.S. Public Company,” 72 *Business Lawyer* 295 (2017).

[5] According to ISS, 64 percent of Swedish companies have two share classes with unequal votes, while 54 percent of French companies have shares entitled to double-voting rights. *See* “ISS Analysis: Differentiated Voting Rights in Europe” (2017), available at https://www.issgovernance.com/analysis-differentiated-voting-rights-in-europe/.

[6] WSGR partner David J. Berger was also a panelist at this forum, and explained why companies and investors may support dual-class shares (or at least allow for private ordering on this issue). A copy of Mr. Berger’s remarks can be found here: https://www.sec.gov/spotlight/investor-advisory-committee-2012/berger-remarks-iac-030917.pdf.

[7] *See* Lucian Bebchuk and Kobi Kastiel, “The Untenable Case for Perpetual Dual-Class Stock,” available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954630 (discussed on the Forum here).

companies staying public rather than going private) is by allowing companies (and entrepreneurs) the option of dual-class shares and other alternative capital structures.

We agree with Nasdaq and believe that dual-class stock is an issue that is best left to private ordering. For some companies, dual-class stock is both necessary and appropriate to respond to the corporate governance misalignment that exists in our capital markets today. In particular, many of the rules governing our capital markets have the practical impact of favoring short-term investors. When responding to this governance misalignment it is understandable that some companies may choose dual-class (or multi-class) stock. While multiple classes of stock are obviously not the right model for all companies (and it must be noted that there are many different types of capital structures even within the multi-class framework), there is no single capital structure that is right for all companies. Given the dynamics of our capital markets and the ever-changing needs of entrepreneurs and companies, a company's capital structure is best left to a company's investors and a system of private ordering based upon full disclosure.

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Snap Decision: Leading Index Providers Nix Multi-Class Shares

Posted by Joseph A. Hall and Michael Kaplan, Davis Polk & Wardwell LLP, on Wednesday, August 2, 2017

Editor's note: Joseph A. Hall and Michael Kaplan are partners at Davis Polk & Wardwell LLP. This post is based on a Davis Polk publication by Mr. Hall, Mr. Kaplan, Alan F. Denenberg,Sophia Hudson, Byron B. Rooney, and Richard D. Truesdell, Jr. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).

Changes Respond to Snap Controversy But Would Hit Many Other Public Companies

The Snap, Inc. IPO in March 2017 was the first in which only non-voting shares were offered to the public. In response, the Council of Institutional Investors and others lobbied the major index providers to bar non-voting shares from their indices, arguing that absent this change passive investors such as index funds would be forced to invest in non-voting shares that erode public company governance. In turn, global index providers S&P Dow Jones Indices, MSCI and FTSE Russell initiated market consultations to determine whether to revise their policies. S&P Dow Jones and FTSE Russell recently announced plans to revise their index eligibility rules. MSCI's consultation remains open until August 31, 2017.

S&P Dow Jones

On July 31, S&P Dow Jones announced that, effective immediately, companies with multiple share classes will no longer be eligible for inclusion in the indices comprising the S&P Composite 1500, including the S&P 500, S&P MidCap 400 and S&P SmallCap 600. The change will not affect existing S&P Composite 1500 index constituents, who will be grandfathered. S&P Dow Jones also stated that the S&P Global BMI Indices, S&P Total Market Index and other S&P and Dow Jones-branded indices will not be affected.

Importantly, a newly public company spun off from a current S&P Composite 1500 index constituent would not need to meet the criteria for new additions to the index, and so would effectively benefit from its parent's grandfathering. S&P Dow Jones believes this helps the index meet the objective of minimizing turnover.

FTSE Russell

On July 26, FTSE Russell announced a proposal to require more than 5% of a company's voting rights (aggregated across all equity securities, including shares that are not listed or traded) to be

held by non-restricted (or “free float”) shareholders, as defined by FTSE Russell, in order to be eligible for inclusion in FTSE Russell indices, including the broad-market Russell 3000 index and the small-cap Russell 2000 index. Subject to modification based on public reaction to the proposal, the policy would apply to new index constituents in FTSE Russell’s upcoming September 2017 index review, but would not apply to current constituents until September 2022—at which point grandfathering would end. FTSE Russell has indicated that it intends to review the voting rights threshold on an annual basis and that it may adjust requirements in the future.

According to FTSE Russell, its market consultation indicated broad support for the inclusion of a 5% voting-rights hurdle. Nonetheless, a significant minority of survey responders did not support voting-rights eligibility criteria, taking the position that an index provider should provide a comprehensive representation of the investable universe. FTSE Russell also noted concerns that a voting-rights hurdle would incentivize some companies in the tech sector to stay private and deprive investors of the opportunity to participate in that sector’s growth. While FTSE Russell acknowledged these views, its prevailing concern appears to have been responding to Snap’s corporate governance structure.

The policy would apply to all of a company’s equity securities and would not be limited to non-voting securities. Accordingly, for a company with a relatively customary 10-to-1 high-vote stock where the free float is low-vote stock, there must be a free float equal to slightly more than 33% of all the shares before the 5% voting threshold will be satisfied. Given that newly public companies often float only 5-20% of their outstanding stock, many of these companies would be excluded from FTSE Russell indices.

An indicative analysis performed by FTSE Russell shows that 37 current index companies would not meet the 5% hurdle. Under FTSE Russell’s grandfathering rule, these companies would have five years to increase the voting power of their free float or reduce the voting power of their high-vote stock to avoid index expulsion.

Implications

To meet FTSE Russell’s eligibility criteria, newly public companies with dual-class stock would need either to reduce the voting power of high-vote stock (which could lead to fewer acquisitions with stock as consideration issued to target shareholders and fewer equity offerings as founders seek to retain control) or include a formulaic voting provision in their charters guaranteeing their low-vote stock will hold just above 5% of the vote.

The change to the S&P 1500 Composite—which applies to all “multiple share class structures”—is far more sweeping and at a minimum will exclude any company with differential common-share classes, without regard to the voting power held by the public. This change not only precludes index eligibility for many newly public companies that are controlled using a dual-class structure, but also may impact newly public companies with “Up-C” structures, even when there is no differential voting, because public holders have a class of stock with economic and voting rights, while pre-IPO holders have a separate class of stock with just voting rights as they hold their economics in a separate subsidiary. At the moment it is not clear how S&P Dow Jones will interpret the phrase “multiple share class structures,” perhaps creating uncertainty for companies with tracking or other preferred shares outstanding.

While the index providers are taking different approaches to address concerns over limited-vote public offerings, the impact in each case will likely deny index eligibility to fairly common high-vote/low vote structures that have met widespread market acceptance. With Congress and the SEC working hard to encourage companies to go public in the face of a long-term decline in IPOs, it is disappointing that these measures may discourage founders and other controlling shareholders from taking their companies public in a manner conducive to long-term management perspectives, which can give critical breathing room to companies otherwise facing the short-term demands of activists and analysts. These index provider moves also seem likely to reduce opportunities for retail investors to access mutual funds that reflect the broader U.S. market—in particular depriving them of investment exposure to some of the most innovative companies in the U.S. economy.

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Index Eligibility as Governance Battlefield: Why the System is Not Broken and We Can Live With Dual Class Issuers

Posted by Ethan A. Klingsberg, Cleary Gottlieb Steen & Hamilton LLP, on Wednesday, July 5, 2017

Editor's note: Ethan A. Klingsberg is a partner in the New York office of Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb publication by Mr. Klingsberg. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).

As passive investing via funds that track market indices continues to grow, the terrain where investors are fighting battles over governance reform is now expanding beyond contested stockholder meetings and into debates over the criteria for eligibility of issuers for inclusion in these indices. Indeed, in this era of index fund investing, a company focused on the future trading price of its shares should be much more concerned about gaining entry into and maintaining eligibility for indices than whether there will be a withhold vote recommendation on the members of its governance committee. If this direction continues to gain traction, we could end up with a market dominated by passive strategy investing where the current importance of familiarity with the hot button governance concerns of proxy advisory firms and institutional investors becomes subsidiary to understanding how to navigate new, governance-related eligibility requirements of major equity indices.

The recently launched campaign by the Council of Institutional Investors, among others, to block Snap Inc.'s eligibility for S&P Dow Jones and other indices, as a result of Snap's dual class share structure, may be looked back on as a turning point in this expansion of the governance battlefield. Significantly, CII's public position is to exclude from the indices not only all new classes of "no vote" shares, but also all "low vote" shares in new dual class issuers absent a strict five-year sunset or ratification by the low vote holders.[1] We may well see future campaigns by CII and others to enshrine other corporate governance practices into eligibility criteria for indices. Recent developments in the realm of dual class issuers sheds light on whether this potential movement of governance matters into index eligibility criteria is sensible.

One argument against inclusion of dual class issuers with controlling stockholders in an index is that these issuers merit "controlled company" discounts due to the risk of non-alignment between their controlling stockholders and the public stockholders and therefore these issuers are fundamentally different than the other issuers in the index. But, of course, not all controlled companies are the same as there are many variables beyond capital structure and the presence

[1] http://cii.org/files/issues_and_advocacy/correspondence/2017/20170426%20CII%20comment.pdf

of a controlling stockholder that feed into a company's trading multiple[2] and therefore the major indices have not historically excluded issuers strictly on the basis of a dual class structure or the presence of a controlling stockholder.

Hence, the current debate over dual class structures tends to focus less on any automatic, empirically-based link between performance metrics and dual class structures and more on concepts, such as "the promotion of accountability" (by the opponents of dual class) vs. "insulation from the forces of short-termism" (by the proponents of dual class). Ironically, both the opponents and the proponents argue that our current "system is broken" and that is why we need bright line rules either to prohibit dual class structures—otherwise investors will be left naked and vulnerable to the costs of entrenched control groups—or to enshrine dual classes—otherwise boards will be at risk of being voted out for sacrificing near-term results to permit the pursuit of extraordinary, long-term achievements. Fortunately, the "system" is not broken and there is a well-worn path to a market solution to this debate and that is where the focus should be, rather than on creating barriers such as eligibility requirements for market indices.

Even if the growth of passive-strategy investing continues, there will always be a place for the active manager and, indeed, even for the activist. Thanks to the active manager class, there will, from time to time, be a trading discount attributable to the entrenchment of control by holders of high-vote shares that becomes sufficiently glaring such that it will become feasible to negotiate a collapse of the dual class structure through a reclassification transaction that is a win for both the public shareholders and for the control group. In the reclassification, all the high vote shares are converted into low vote shares at a premium to the exchange ratio that would otherwise apply, while the premium is low enough to preserve room for a multiple bump in the trading price attributable to the elimination of the control group and their entrenchment via the dual class structure. Should boards miss these scenarios where unwinding the dual class makes sense for both the control group and the public, observant activists should be able to pick out these scenarios on their screens and bring them to the attention of boards.

Arguably this is what happened over the last year at Forest City, a dual class company that had been founded and controlled by the same extended family since its IPO in the 1960s. The family, through its ownership of high-vote stock, controlled the election of 75% of the board seats (the other 25% were set aside by the charter to be elected by the low vote shares) while owning just 10% of the economics. The largest public shareholders, as is typical for a multi-billion dollar market cap issuer, included not only passive funds managed by Vanguard and Blackrock, but also active managers like Fidelity and Senator. In June 2016, Scopia, an activist fund, filed a Schedule 13D revealing a 7% interest and a desire to push for the collapse of the dual class structure. At the heart of Scopia's thesis was that Forest City was trading at a steep discount to where its financial metrics indicated it should be trading, which left the entrenchment of control through the dual class structure as the culprit. The board, dominated by family members, accepted the recommendation of Scopia to explore reclassification and appointed directors, who

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[2] In addition to the readily available anecdotal evidence of high performing controlled companies with dual class structures, the compilations of financial and market data, collected and cited by even the critics of dual class structures, shows that many controlled, dual class issuers out-perform the market under a spectrum of metrics. See, e.g., the latest IRRC/ISS study strongly opposing the entrenchment of control via dual class structures, but providing a series of charts that show numerous categories (three-year and five-year average shareholder return, five-year and ten-year average EBITDA growth, average return on equity, five-year and ten-year return on invested capital, five-year and ten-year return on assets, and current assets to current liabilities ratio) where the results for controlled multi-class issuers are superior to or statistically indistinguishable from those of non-controlled issuers, at https://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf.

were elected by the low-vote shares and unaffiliated with the family, to a special committee to negotiate with the family a collapse of the dual class structure. Within less than six months, a deal was cut that provided for the conversion of all the high vote shares into low votes at a 1:1.31 ratio (a 31% conversion premium over the 1:1 ratio otherwise available under the charter) and Scopia agreed to support the transaction, which was conditioned on approval by a majority of the low vote shares voting as a separate class. Decades of dual class-based control were set to be unwound based on arm's-length negotiations focused on economic rationality. On June 12, 2017, just about one year from the date of Scopia's initial Schedule 13D, both classes of shares formally adopted the reclassification to eliminate the dual class. The transaction was a win for both the controllers (who received a 31% premium for their high vote shares) and the public (the low vote shares traded up over 10% on the announcement).

Among the factors that will make an issuer more or less ripe for a reclassification transaction and that merit taking into account in any negotiation or consideration of such a transaction is the magnitude of the equity position (disregarding voting power) represented by the holdings of the control group. The smaller the equity position, the easier it may be to provide the control group with a generous exchange ratio that still leaves lots of room for all the low vote shares to benefit from a multiple expansion triggered by the reclassification's elimination of the overhang of control. This conclusion is contrary to that reached in the leading "anti-dual class" paper, most recently revised in May 2017, by Harvard's Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).[3] Their paper incorrectly assumes that a reclassification transaction would not occur, due to deterrents under applicable corporate law, if the exchange ratio were to result in the receipt by the control group of a portion of the overall increase in the company's market capitalization attributable to the reclassification disproportionate to the control group's pro rata ownership on a per share basis. But, while there are procedural hurdles for any related party transaction with a controlling holder such as a reclassification, these hurdles are far from insurmountable. In fact, the roadmap for transactions between a company and its control group, laid out in the Delaware Supreme Court's *MFW* decision[4] and generally followed by Forest City (although Forest City is organized under Maryland law), actually greatly facilitates the ability to enter into a reclassification transaction. The requirement is not strict allocation of the benefits pro rata between the low vote and high vote, but terms negotiated by a committee of independent directors, conditioned on approval by a majority of the disinterested (i.e., non-control group) shareholders and reasonably characterized by the committee in good faith as being at least fair to and in the best interests of the non-control group stockholders.

Factors that may make a dual class company less ripe for a reclassification transaction include:

- Minority protections under the dual class structure, such as the reservation of board seats and other matters for class votes of the low vote holders
- Sunset provisions for the dual class structure (e.g., as a result of the death of the members of the control group or a near-term date)
- Failure of the dual class to entrench control of the company by any group—e.g., if the high vote shares are freely tradeable and are increasingly held by entities and individuals who do not act in concert

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[3] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954630, (discussed on the Forum here).

[4] http://www.clearymawatch.com/2016/10/delaware-chancery-applies-mfw-dismiss-challenge-going-private-transaction-clarifies-obligations-controlling-stockholders/ (discussed on the Forum here).

Dual class is necessarily neither a vice nor a virtue. The lesson of Forest City is that, when a dual class structure ceases to be economically rational, a relatively easy escape valve exists and, most importantly, incentives for the control group to head for that exit become palpable.[5] The system is not broken. Before market indices start serving as gatekeepers for corporate governance "best practices," they should undertake a similar analysis of whether the system really needs fixing.

[5] There are numerous other examples of recapitalization transactions that collapse dual class structures, see. e.g., those cited in the descriptions of the financial analyses by the financial advisors on the Forest City transaction at https://www.sec.gov/Archives/edgar/data/1647509/000119312517124689/d289676ds4a.htm

Harvard Law School Forum on Corporate Governance and Financial Regulation

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Decreasing Patience for IPOs with Poor Shareholder Rights

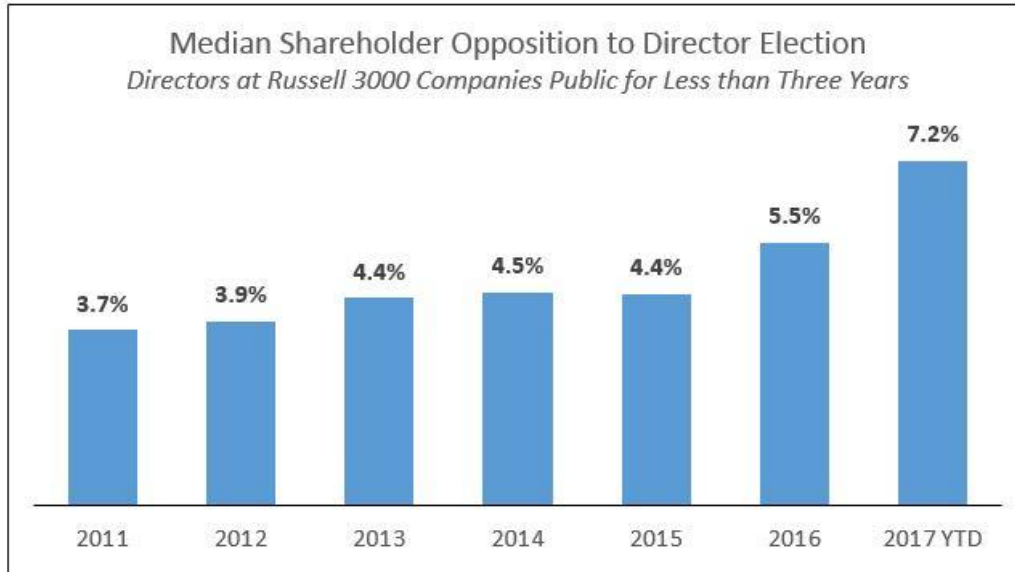
Posted by Robert Kalb, Institutional Shareholder Services, Inc., on Friday, June 2, 2017

Editor's note: Robert Kalb is a Senior Associate at Institutional Shareholder Services, Inc. This post is based on an ISS publication by Mr. Kalb. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).

For many years, companies have often held their initial public offerings (IPOs) while maintaining potentially shareholder-unfriendly features, such as multi-class share structures, restrictions on shareholders' ability to amend bylaws, supermajority vote requirements, and classified boards. Arguments for those practices include giving management room to maneuver during its initial public years, protecting certain shareholder classes, and more. Recently, however, shareholder tolerance for these features has waned, with proxy advisers following suit as reflected in their voting policies and recommendations.

Shareholders Increasingly, But Still Tentatively, Expressing Frustration Through Votes

Shareholders are starting to express their views at the proxy ballot box. We focus our attention on director elections at new companies—defined as director elections held less than three years from a company's IPO date. Among this group, the proportion of directors receiving less than 80 percent shareholder support has increased from 1.5 percent in 2011 to 6.5 percent in 2016. Four directors among this group failed to earn majority support in 2016—up from zero in 2011. Looking more broadly at support for directors at these newly-public companies, we also find new trends. Median opposition for directors at these newly-public companies has doubled since 2011 (although voting data for 2017 is still relatively limited, with peak meeting day in the U.S. occurring next week).



Source: ISS Analytics

ISS Policy Shifts to Hold IPO Companies Increasingly Accountable

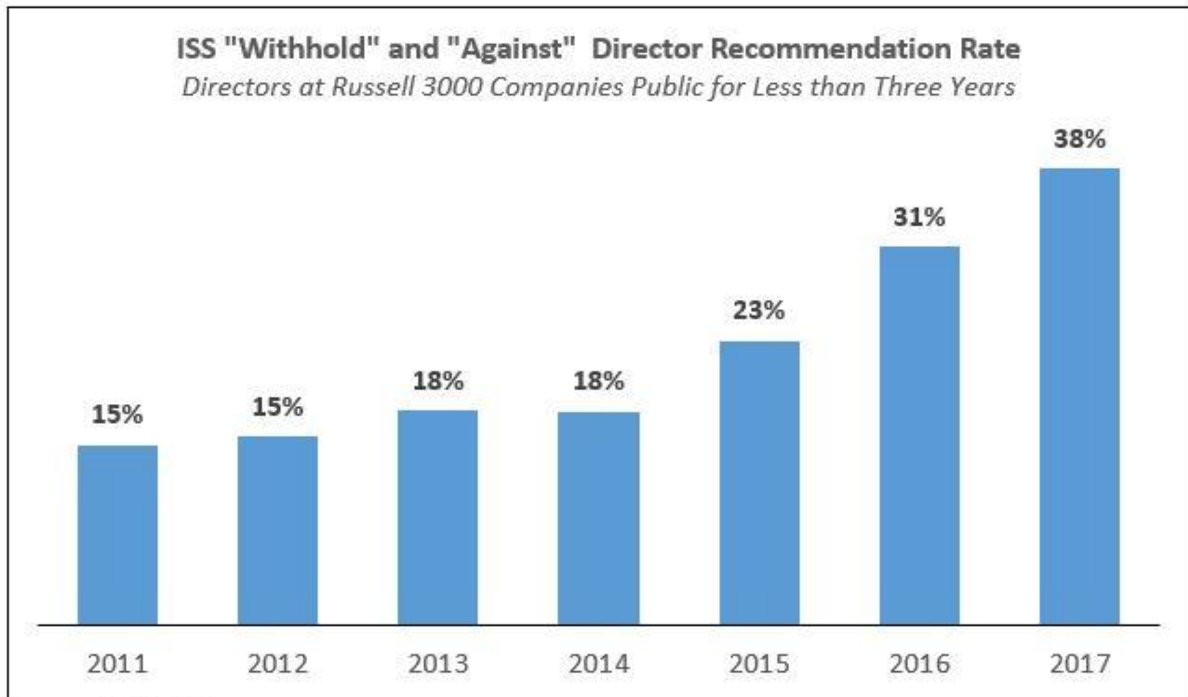
Over the past several years, ISS has had many conversations with institutional investors regarding shareholder rights issues at newly-public companies. For example, last year, ISS' annual Global Policy Survey addressed one of these points, asking market participants "Should ISS policy also consider recommending voting against the directors if the company, when it goes public or emerges from bankruptcy, has a structure that includes multiple classes of stock with unequal voting rights?" Fifty-seven percent of investor respondents agreed, with another 24 percent expressing that support for the director should be contingent upon a sunset provision on the unequal voting rights.

In response, ISS clarified and updated its policy on director elections in late 2015, and again in late 2016, most recently saying:

> For newly-public companies, generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if, prior to or in connection with the company's public offering, the company or its board adopted bylaw or charter provisions materially adverse to shareholder rights, or implemented a multi-class capital structure in which the classes have unequal voting rights considering the following factors:
>
> - The level of impairment of shareholders' rights;
> - The disclosed rationale;
> - The ability to change the governance structure (e.g., limitations on shareholders' right to amend the bylaws or charter, or supermajority vote requirements to amend the bylaws or charter);
> - The ability of shareholders to hold directors accountable through annual director elections, or whether the company has a classified board structure;

- Any reasonable sunset provision; and
- Other relevant factors.

The impact of this updated policy has been pronounced. Today, ISS' adverse vote recommendation rate on directors at companies within the Russell 3000 and public for less than three years is 23 percentage points higher than it was in 2011.



Source: ISS Analytics

New IPO Companies Beginning to Introduce More Favorable Shareholder Rights

Notably, companies are responding as evidenced by movement on the issues at newly-IPO companies. For instance, when Valvoline, Inc. completed its spinoff from Ashland, Inc. in September 2016 it retained an 80 percent supermajority vote requirement to amend its bylaws and certain sections of the charter. At its first annual meeting on Jan. 24 certain members of the nominating and governance committee received vote support of less than 95 percent, significantly below the median of all director elections across the Russell 3000 (including non-IPO companies). Valvoline subsequently called a special meeting on April 26 for the sole purpose of requesting shareholders approve an amendment to the charter and bylaws to phase out the supermajority requirement in favor of a simple majority over a period of three years. This proposal was overwhelmingly supported.

Several other newly-public companies have publicly committed to put proposals to reverse these adverse provisions on the ballot at their 2018 annual meeting. Exterran Corp and California Resources Corporation shareholders will see 2018 management proposals to reduce supermajority vote requirements, while Babcock & Wilcox Enterprises and SPX Flow, Inc.

shareholders will see shareholder proposals to both declassify the board and reduce supermajority vote requirements.

With the exception of Valvoline, where Ashland currently retains a controlling stake, each of the other mentioned newly-public companies were spun off from their former parents. As a result, from the start of their trading the shareholder bases were diversified with significant institutional shareholder ownership.

More Mature Companies Making Shareholder Rights Improvements, Too

It’s not just IPO companies that are feeling the pressure. Anthem Inc. and Columbia Property Trust, Inc. placed management proposals on the ballot this year to amend governing documents to provide shareholders the right to amend the bylaws. While Anthem shareholders will convene on May 18, Columbia Property shareholders overwhelmingly passed this amendment on May 2.

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Tenure Voting and the U.S. Public Company

Posted by David J. Berger, Wilson Sonsini Goodrich & Rosati, on Monday, March 7, 2016

Editor's note: David J. Berger is a partner at Wilson Sonsini Goodrich & Rosati. This post is based on a recent white paper authored by Mr. Berger, Steven Davidoff Solomon, and Aaron Jedidiah Benjamin.

In today's capital markets the principle of one share, one vote is increasingly under scrutiny. The rise of high-vote and no-vote stock has created a popular alternative for companies at the initial public offering stage. According to Dealogic, approximately 14% of IPOs in the past year used some form of dual-class stock, compared to only 1% in 2005. Prominent companies with a separate class of high-vote stock include Alibaba, Facebook, Ford, Google (now Alphabet), and Square.

In the paper Tenure Voting and the U.S. Public Company, co-authored with U.C. Berkeley Law Professor Steven Davidoff Solomon and my colleague Aaron Jedidiah Benjamin, we examine "tenure voting" as an alternative to the prevailing one share, one vote and dual-class models. Tenure voting is the award of an additional number of votes to shareholders depending upon the duration of their ownership.

The rise of dual-class stock has created a culture of "haves" and "have-nots." Companies with dual-class stock may be more insulated from shareholder activism and other shareholder demands than companies with a single class of stock. Supporters of these types of structures often claim that such structures provide companies greater ability to plan and act over the "long-term," taking into account shareholder considerations but also avoiding short-term actions that can be taken just to boost short-term stock prices while being detrimental to creating long-term value.

In contrast, many public companies with one share, one vote assert that they are unable to shield themselves from shareholder pressure to increase their stock price. They complain that this forces them to take short-term actions and engage in financial engineering that may limit the company's ability to grow and innovate for the long term.

The purpose of this white paper is not to resolve or take sides in the debate over long and short-termism, though we recognize that the debate is reshaping the field of corporate governance. Rather, the purpose is to examine an innovative response to the rise of dual-class stock: the use of tenure voting by U.S. public companies. There are a variety of different models of tenure voting, but the core principles driving consideration of and support for tenure voting are: (1) giving long-term shareholders increased voting power over corporate decisions, and (2) incentivizing shareholders to be long-term investors. Tenure voting has gained support in many countries in recent years.

Tenure voting has the potential to be a more palatable alternative to high-vote and no-vote shares while also addressing current arguments about long- and short-termism in U.S. markets. By design, tenure voting rewards all shareholders who hold their shares for an extended period. This could better align incentives for all shareholders, since all shareholders who wish to take action for the long term will have greater influence in those decisions, while shareholders less interested in voting and more interested in trading will still have a vote as well as the ability to freely trade their shares.

This paper is designed to be a roadmap of the issues and considerations for companies and market participants contemplating tenure voting under current market conditions and regulations. In particular, we conclude that companies which are currently listed on the New York Stock Exchange and Nasdaq can adopt tenure voting under current interpretations of each stock exchanges' rules. While we do not propose tenure voting as a "one-size-fits-all" model, we conclude that, after examining the current voting landscape and perceived problems of short-termism, tenure voting offers a middle option that should be considered.

The full paper is available for download here.

Tab IV: Institutional Investors Stewardship

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:

Investment Stewardship 2017 Annual Report

Posted by F. William McNabb III and Glenn Booraem, Vanguard, on Monday, September 18, 2017

Editor's note: F. William McNabb III is Chairman and CEO of Vanguard; Glenn Booraem is the head of Investment Stewardship and a principal at Vanguard. This post is based on an excerpt from a recent Vanguard publication by Mr. Booraem, and an open letter to directors of public companies worldwide by Mr. McNabb.

An open letter to directors of public companies worldwide

Thank you for your role in overseeing the Vanguard funds' sizable investment in your company. We depend on you to represent our funds' ownership interests on behalf of our more than 20 million investors worldwide. Our investors depend on Vanguard to be a responsible steward of their assets, and we promote principles of corporate governance that we believe will enhance the long-term value of their investments.

At Vanguard, a long-term perspective informs every aspect of our investment approach, from the way we manage our funds to the advice we give our investors. Our index funds are *structurally* long-term, holding their investments almost indefinitely. And our active equity managers—who invest nearly $500 billion on our clients' behalf—are *behaviorally* long-term, with most holding their positions longer than peer averages. The typical dollar invested with Vanguard stays for more than ten years.

A long-term perspective also underpins our Investment Stewardship program. We believe that well-governed companies are more likely to perform well over the long run. To this end, we consider four pillars when we evaluate corporate governance practices:

1. *The board:* A high-functioning, well-composed, independent, diverse, and experienced board with effective ongoing evaluation practices.
2. *Governance structures:* Provisions and structures that empower shareholders and protect their rights.
3. *Appropriate compensation:* Pay that incentivizes relative outperformance over the long term.
4. *Risk oversight*: Effective, integrated, and ongoing oversight of relevant industry- and company-specific risks.

These pillars guide our proxy voting and engagement activity, and we hope that by sharing this framework with you, you'll have a better perspective on our approach to stewardship.

I'd like to highlight a few key themes that are increasingly important in our stewardship efforts:

Good governance starts with a great board.

We believe that when a company has a great board of directors, good results are more likely to follow.

We view the board as one of a company's most critical strategic assets. When the board contributes the right mix of skill, expertise, thought, tenure, and personal characteristics, sustainable economic value becomes much easier to achieve. A thoughtfully composed, diverse board more objectively oversees how management navigates challenges and opportunities critical to shareholders' interests. And a company's strategic needs for the future inform effectively planned evolution of the board.

Gender diversity is one element of board composition that we will continue to focus on over the coming years. We expect boards to focus on it as well, and their demonstration of meaningful progress over time will inform our engagement and voting going forward. There is compelling evidence that boards with a critical mass of women have outperformed those that are less diverse. Diverse boards also more effectively demonstrate governance best practices that we believe lead to long-term shareholder value. Our stance on this issue is therefore an economic imperative, not an ideological choice. This is among the reasons why we recently joined the 30% Club, a global organization that advocates for greater representation of women in boardrooms and leadership roles. The club's mission to enhance opportunities for women from "schoolroom to boardroom" is one that we think bodes well for broadening the pipeline of great directors.

Directors are shareholders' eyes and ears on risk.

Risk and opportunity shape every business. Shareholders rely on a strong board to oversee the strategy for realizing opportunities and mitigating risks. Thorough disclosure of relevant and material risks—a key board responsibility—enables share prices to fully reflect all significant known (and reasonably foreseeable) risks and opportunities. Given our extensive indexed investments, which rely on the price-setting mechanism of the market, that market efficiency is critical to Vanguard and our clients.

Climate risk is an example of a slowly developing and highly uncertain risk—the kind that tests the strength of a board's oversight and risk governance. Our evolving position on climate risk (much like our stance on gender diversity) is based on the economic bottom line for Vanguard investors. As significant long-term owners of many companies in industries vulnerable to climate risk, Vanguard investors have substantial value at stake.

Although there is no one-size-fits-all approach, market solutions to climate risk and other evolving disclosure practices can be valuable when they reflect the shared priorities of issuers and investors. Our participation in the Investor Advisory Group to the Sustainability Accounting Standards Board (SASB) reflects our belief that materiality-driven, sector-specific disclosures will better illuminate risks in a way that aids market efficiency and price discovery. We believe it is incumbent on all market participants—investors, boards, and management alike—to embrace the disclosure of sustainability risks that bear on a company's long-term value creation prospects.

Engagement builds mutual understanding and a basis for progress.

Timely and substantive dialogue with companies is core to our investment stewardship approach. We see engagement as mutually beneficial: We convey Vanguard's views and we hear companies' perspectives, which adds context to our analysis.

Our funds' votes on ballot measures—171,000 discrete items in the past year alone—are an outcome of this process, not the starting point. As we analyze ballot items, particularly controversial ones, we often invite direct and open-ended dialogue with the company. We seek management's and the board's perspectives on the issues at hand, and we evaluate them against our principles and leading practices. To understand the full picture, we often also engage with other investors, including activists and shareholder proponents. Our goal is that a fund's ultimate voting decision does not come as a surprise. Our ability to make informed decisions depends on maintaining an ongoing exchange of ideas in a setting in which we can cover the intention and strategy behind the issues.

Yet our engagement activities are not solely focused on the ballot. Because our funds will hold most of their portfolio companies practically permanently, it's important for us to build relationships with boards and management teams that transcend a transactional focus on any specific issue or vote. Engagement is a process, not an event, whose value only grows over time. A CEO we engaged with once said, "You can't wait to build a relationship until you need it," and that couldn't be more true.

The opportunity to articulate our perspectives and understand a board's thinking on a range of topics—anchored at the intersection of the firm's strategy and its enabling governance practices—is a crucial part of our stewardship obligations. Although ballot items are reduced to a series of binary choices—yes or no, for or against—engagement beyond the ballot enables us to deal in nuance and in dialogue that drives meaningful progress over time.

There is a growing role for independent directors in engagement, both on issues over which they hold exclusive purview (such as CEO compensation and board composition/succession) and on deepening investors' understanding of the alignment between a company's strategy and governance practices. Our interest in engaging with directors is by no means intended to interfere with management's ownership of the message on corporate strategy and performance. Rather, we believe it's appropriate for directors to periodically hear directly from and be heard by the shareowners on whose behalf they serve.

* * *

Our focus on corporate governance and investment stewardship has been and will continue to be a deliberate manifestation of Vanguard's core purpose: "To take a stand for all investors, to treat them fairly, and to give them the best chance for investment success." Our four pillars and our increased focus on climate risk and gender diversity are not fleeting priorities for Vanguard. As essentially permanent owners of the companies you lead, we have a special obligation to be engaged stewards actively focused on the long term. Our Investment Stewardship team—available at InvestmentStewardship@vanguard.com—stands ready to engage with you and your leadership teams on matters of mutual importance to our respective stakeholders. Thank you for valuing our perspective and being our partner in stewardship.

Sincerely,

William McNabb III
Chairman and Chief Executive Officer
The Vanguard Group, Inc.

* * *

Investment Stewardship 2017 Annual Report

Our values and beliefs

> "To take a stand for all investors, to treat them fairly, and to give them the best chance for investment success."
>
> —Vanguard's core purpose

Vanguard's core values of focus, integrity, and stewardship are reflected every day in the way that we engage with our clients, our crew (what we call our employees), and our community. We view our Investment Stewardship program as a natural extension of these values and of Vanguard's core purpose. Our clients depend on us to be good stewards of their assets, and we depend on corporate boards to prudently oversee the companies in which our funds invest. That is why we believe we have a unique mission *to advocate for a world in which the actions and values of public companies and of investors are aligned to create value for Vanguard fund shareholders over the long term.*

We believe well-governed companies will perform better over the long term.

Effective corporate governance is more than the collection of a company's formal provisions and bylaws. A board of directors serves on behalf of all shareholders and is critical in establishing trust and transparency and ensuring the health of a company—and of the capital markets—over time. This board-centric view is the foundation of Vanguard's approach to investment stewardship. It guides our discussions with company directors and management, as well as our voting of proxies on the funds' behalf at shareholder meetings around the globe. Great governance starts with a board of directors that is capable of selecting the right management team, holding that team accountable through appropriate incentives, and overseeing relevant risks that are material to the business. We believe that effective corporate governance is an important ingredient for the long-term success of companies and their investors. And when portfolio companies perform well, so do our clients' investments.

We value long-term progress over short-term gain.

Because our funds typically own the stock of companies for long periods (and, in the case of index funds, are structurally permanent holders of companies), our emphasis on investment outcomes over the long term is unwavering. That's why we deliberately focus on enduring themes and topics that drive long-term value, rather than solely short-term results. We believe that companies and boards should similarly be focused on long-term shareholder value—both through

the sustainability of their strategy and operations, and by managing the risks most material to their long-term success.

Our approach

Vanguard's Investment Stewardship team comprises an experienced group of senior leaders and analysts who are responsible for representing Vanguard shareholders' interests through industry advocacy, company engagement, and proxy voting on behalf of the Vanguard funds. The team also houses an internal research and communications function that is active in developing Vanguard's views, policies, and ongoing approach to investment stewardship. Our data and technology group supports every aspect of our Investment Stewardship program.

We take a thoughtful and deliberate approach to investment stewardship.

Our team supports effective corporate governance practices in three ways:

Advocating for policies that we believe will enhance the sustainable, long-term value of our clients' investments. We promote good corporate governance and responsible investment through thoughtful participation in industry events and discussions where we can expand our advocacy and enhance our understanding of investment issues.

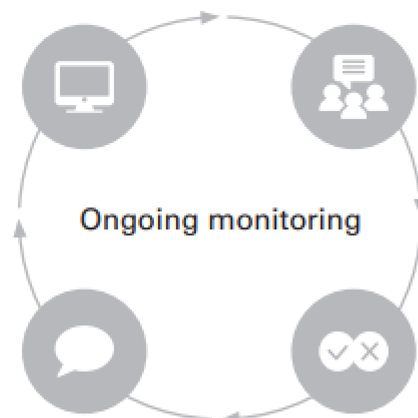
Engaging with portfolio company executives and directors to share our corporate governance principles and learn about portfolio companies' corporate governance practices. We characterize our approach as "quiet diplomacy focused on results"—providing constructive input that will, in our view, better position companies to deliver sustainable value over the long term for all investors.

Voting proxies at company shareholder meetings across each of our portfolios and around the globe. Because of our ongoing advocacy and engagement efforts, companies should be aware of our governance principles and positions by the time we cast our funds' votes.

Our process is iterative and ongoing

Research and analyze company performance, governance practices, and ballot proposals.

Engage with companies and other stakeholders to inform our perspective on issues. Consult with our fund managers, where appropriate, to gain additional context.



Communicate key activities (e.g., engagement activities and voting results) to clients, regulators, and other stakeholders.

Vote on proposals at shareholder meetings in the best long-term interests of each portfolio.

Our four pillars

Board

Good governance begins with a great board of directors. Our primary interest is to ensure that the individuals who represent the interests of all shareholders are independent (both in mindset and freedom from conflicts), capable (across the range of relevant skills for the company and industry), and appropriately experienced (so as to bring valuable perspective to their roles). We also believe that diversity of thought, background, and experience, as well as of personal characteristics (such as gender, race, and age), meaningfully contributes to the board's ability to serve as effective, engaged stewards of shareholders' interests. If a company has a well-composed, high-functioning board, good results are more likely to follow.

Structure

We believe in the importance of governance structures that empower shareholders and ensure accountability of the board and management. We believe that shareholders should be able to hold directors accountable as needed through certain governance and bylaw provisions. Among these preferred provisions are that directors must stand for election by shareholders annually and must secure a majority of the votes in order to join or remain on the board. In instances where the board appears resistant to shareholder input, we also support the right of shareholders to call special meetings and to place director nominees on the company's ballot.

Compensation

We believe that performance-linked compensation policies and practices are fundamental drivers of the sustainable, long-term value for a company's investors. The board plays a central role in determining appropriate executive pay that incentivizes performance relative to peers and competitors. Providing effective disclosure of these practices, their alignment with company performance, and their outcomes is crucial to giving shareholders confidence in the link between incentives and rewards and the creation of value over the long term.

Risk

Boards are responsible for effective oversight and governance of the risks most relevant and material to each company in the context of its industry and region. We believe that boards should take a thorough, integrated, and thoughtful approach to identifying, understanding, quantifying, overseeing, and—where appropriate—disclosing risks that have the potential to affect shareholder value over the long term. Importantly, boards should communicate their approach to risk oversight to shareholders through their normal course of business.

By the numbers: Voting and engagement

Engagement and voting trends

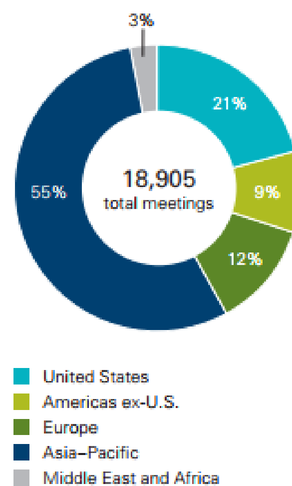
	2015 proxy season	2016 proxy season	2017 proxy season
Company engagements	685	817	954
Companies voted	10,560	11,564	12,974
Meetings voted	12,785	16,740	18,905
Proposals voted	124,230	157,506	171,385
Countries voted in*	70	70	68

* The number of countries can vary each year. In certain markets, some companies do not hold shareholder meetings annually.
Note: The annual proxy season is from July 1 to June 30.

Our voting

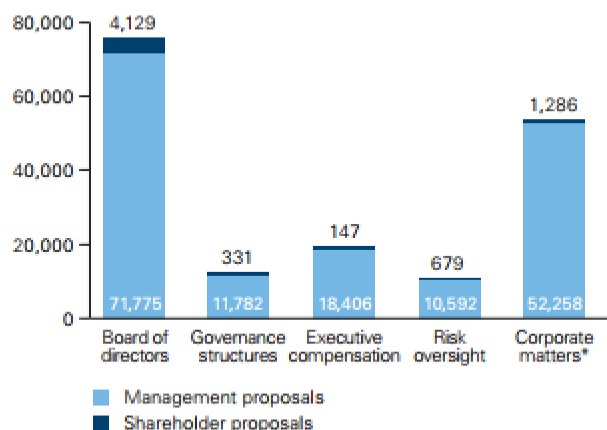
Proxy voting reflects our governance pillars worldwide.

Meetings voted by region



Note: Data pertains to voting activity from July 1, 2016, through June 30, 2017

Global voting activity



* Includes more than 26,000 proposals related to capitalization; 8,000 proposals related to mergers and acquisitions; 16,000 routine business proposals; and 1,000 other shareholder proposals.
Note: Data pertains to voting activity from July 1, 2016, through June 30, 2017.

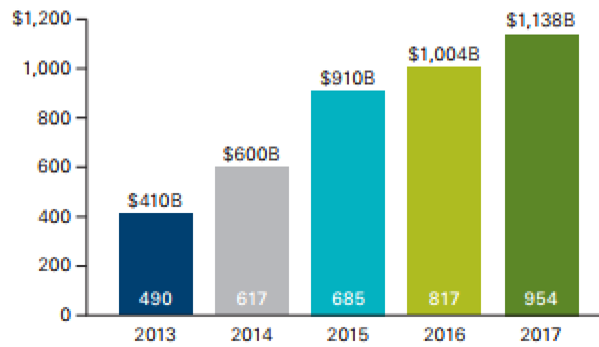
Our engagement

We engage with companies of all sizes.

Market Capitalization	% of 2017 proxy season engagements
Under $1 billion	19%
$1 billion–under $10 billion	44%
$10 billion–under $50 billion	24%
$50 billion and over	13%

Our engagement with portfolio companies has grown significantly over time.

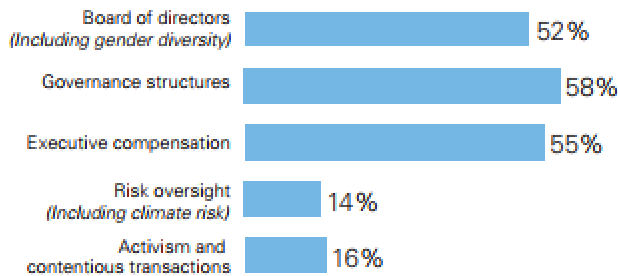
Number of engagements and assets represented



Note: Dollar figures represent the market value of Vanguard fund investments in companies with which we engaged as of June 30, 2017.

We engage on a range of topics aligned with our four pillars

Frequency of topics discussed during Vanguard engagements (%)



Note: Figures do not total 100%, as individual engagements often span multiple topics.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:

The Investor Stewardship Group: An Inflection Point in U.S. Corporate Governance?

Posted by John C. Wilcox, Morrow Sodali, on Thursday, March 30, 2017

Editor's note: John C. Wilcox is Chairman of Morrow Sodali. This post is based on a Morrow Sodali publication by Mr. Wilcox. Additional posts on the Investor Stewardship Code are available here.

A potentially influential new organization of institutional investors has made its presence known in the U.S. corporate governance scene. On January 31, 2017, the Investor Stewardship Group (ISG), a "collective" of some of the largest U.S. and international investors, announced the launch of an ambitious program to establish a set of basic corporate governance principles for U.S. listed companies and a parallel set of stewardship principles for U.S. institutional investors (discussed on the Forum here). This unprecedented event could be a turning point in the evolution of U.S. governance practice.

Here are some of the reasons why the ISG and its principles could have a significant impact on U.S. companies:

1. The formation of the ISG is noteworthy not just because of the group's size, global reach and financial clout ($17 trillion in assets under management). W hat is unusual is that ISG's members are the individuals within financial institutions who manage their day-to-day governance responsibilities—setting policies, engaging with portfolio companies and voting proxies. The ISG opens a door to this important but sometimes hard-to-reach audience of decision-makers whose policies companies need to understand and with whom companies should try to establish a relationship of trust through constructive dialogue and engagement. These are the individuals companies want to reach when they conduct governance road shows.

2. The ISG introduces into the U.S. a framework for the type of principles-based corporate governance that is the norm in virtually all countries outside the U.S. It is a voluntary system that relies on a "comply-or-explain" accountability mechanism rather than the rules-based, strict-compliance, liability-based governance system found in the U.S. Voluntary, principles-based governance should be welcomed by U.S. issuers because it encourages a flexible, case-by-case approach in which business strategy and financial goals are given priority over compliance with external governance standards. As the governance spotlight focuses more deeply on boardroom transparency and implementation of ESG policies rather than just a check list of best practices, the advantages of principles-based, comply-or-explain governance will become increasingly apparent to U.S. companies and investors alike.

3. The simultaneous launch of governance principles and stewardship principles conveys an implicit message that companies and institutional investors share responsibility for the economic

success of portfolio companies. The idea that providers of capital and managers of business enterprises should work together for a common economic goal may seem like common- sense capitalism, but it is often forgotten in the adversarial, fight-first-ask-questions-later attitude that at times has colored relations between companies and shareholders. This is the case particularly in the U.S., where the legal system establishes formal structures for confrontation—in particular, SEC Rule 14a-8 governing shareholder proposals—and is seen as presenting obstacles to dialogue or disclosure outside regulatory guidelines.

4. The ISG initiative is focused exclusively on U.S. companies and investors. This can be taken as a sign that ISG members, all of which have portfolios of both U.S. and global stocks and are familiar with global governance practices, believe that the U.S. is where their attention is most needed. The ISG governance proposal does have roots in the U.S.—the need for a uniform U.S. governance code has been discussed intermittently for more than a decade, but consensus has not been reached largely because of two obstacles: corporate governance is deemed to be outside the remit of the SEC and a single national code seemed impractical in light of 50 separate state corporate law statutes. As ISG members clearly understand, national codes play a central role in the governance systems of countries outside the U.S. By introducing a national code of principles applicable to all U.S. listed companies, the ISG's goal, in the words of Anne Sheehan, Director of Corporate Governance at CalSTRS, "is to codify the *fundamentals* of good corporate governance and establish *baseline expectations* for U.S. corporations and their institutional shareholders." By contrast, the ISG's stewardship initiative is rooted in global practice. National stewardship codes have been adopted in the UK, Canada, Italy, Japan, Malaysia, the Netherlands, South Africa, Switzerland and Taiwan and endorsed by the International Corporate Governance Network. The European Commission's recent amendments to the Shareholders' Rights Directive also strengthen provisions relating to engagement and stewardship. It is noteworthy that "stewardship," rather than "fiduciary," is the concept promoted by the ISG, suggesting a focus on oversight of portfolio companies in the broadest sense, including ESG and non-financial factors rather than simply financial performance and legal compliance.

5. The ISG's six governance and six engagement principles are brief, clear and succinct, drafted in general terms that allow room for flexibility in their interpretation and application. They contain no surprises, are within established guidelines, are not overly prescriptive and do not expand shareholder rights or create new obligations for either companies or institutional investors. They are designed to function as guiding principles rather than a list of do's and don'ts. The principles "reflect the common corporate governance beliefs that are embedded in each member's proxy voting and engagement guidelines" and they avoid conflict with existing legal structures and regulatory requirements. They also reflect commonplace governance standards that have already been adopted by many companies in the U.S. and abroad. The ISG framework can therefore be seen as posing no additional compliance burdens on either companies or investors.

6. ISG's condensed governance principles offer a counterpoint to proxy advisory firms' more detailed governance standards and voting guidelines based on proprietary models. Although the ISG's stated intention is not to replace or reduce the importance of proxy advisory firms, its principles-based approach reflects the continuing evolution of governance away from external standards and compliance check lists. Fundamental principles of the type proposed by the ISG are easier to apply contextually, allowing more room for substantive dialogue between companies and investors and encouraging a case-by-case approach that integrates business strategy and ESG decision-making.

7. Because the ISG governance and stewardship principles will not take effect until January 2018, the year of lead time will enable the ISG, which describes itself as a "sustained initiative," to recruit additional members, increase its public profile and answer a number of important questions that will determine its effectiveness over the long term: the group's leadership and governance; its plans for enforcing its principles; its relationship with existing governance organizations and NGOs; and, most important, the relationship of ISG's members to the leadership and investment arms of their own institutions. A number of ISG member firms' CEOs are signatories to the Commonsense Principles of Corporate Governance, published in July 2016. Are these activities coordinated or expected to achieve a common goal?

The ISG's promulgation of a governance code and stewardship principles for the United States represents a private sector initiative that has the potential to fundamentally change the relationship between U.S. companies and institutional investors and to align U.S. corporate governance more closely with global practice. The next year will tell whether this potential will be realized. In the meantime, companies and investors alike should pay attention to developments at the Investor Stewardship Group.

Appendix

ISG Corporate Governance Principles

- 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.

ISG Stewardship Principles

- 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.

Proxy Voting Conflicts—Asset Manager Conflicts of Interest in the Energy and Utility Industries

Posted by Edward Kamonjoh, The 50/50 Climate Project, on Tuesday, May 2, 2017

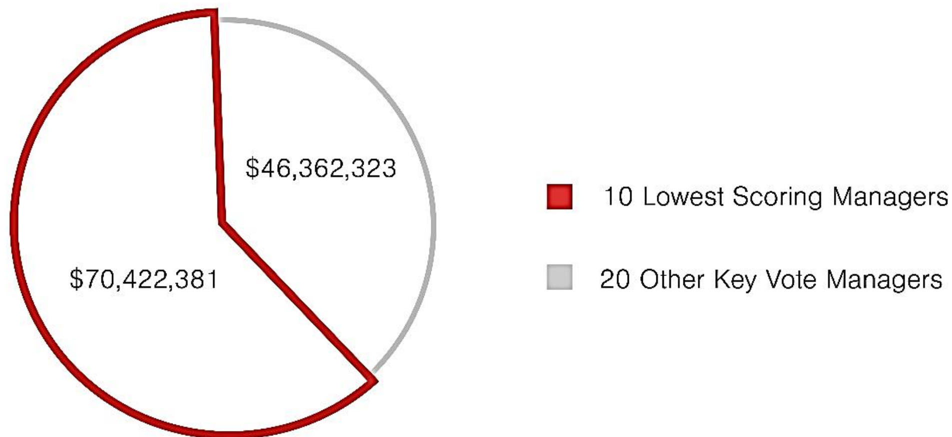
Editor's note: Edward Kamonjoh is Executive Director of The 50/50 Climate Project. This post is based on a 50/50 Climate Project publication by Mr. Kamonjoh.

While shareholder resolutions calling on companies to proactively address the risks to investors from climate change received unprecedented levels of support last year, despite their mainstream acceptance by investors, asset managers including JP Morgan, Fidelity, Vanguard, BlackRock, and BNY Mellon frequently voted in favor of management and failed to support the resolutions.

In a new report (available here), the 50/50 Climate Project, a non-profit shareholder resource and action center, finds that the managers who tended to vote in favor of management received more in fees and stewarded more assets than all other managers combined, and that their voting practices were even more management friendly at companies with which they had business relationships. The asset managers examined manage assets worth billions of dollars for the retirement plans sponsored by the portfolio companies at which they voted. The managers also receive millions of dollars in fees for managing such plans.

The report examines the conflicts of interest that large asset managers encounter when casting proxy votes on climate-related shareholder resolutions. It analyzes data from Form 5500 filings submitted to the Department of Labor by retirement plans sponsored by energy and utility companies, and compares this data to the publicly disclosed vote records of the top 30 managers by assets under management and how well the asset managers scored on the 50/50 Climate Project's 2016 survey of shareholder votes on key climate-oriented proposals ("Key Vote Proposals"). Ten fund managers that supported 25 percent or fewer of the Key Vote Proposals are referred to as the "Low Scoring Managers."

Figure 1: Low Scoring Managers Received the Most Fees from Key Vote Companies in 2015



50/50
Climate Project

By quantifying, in dollar terms, the sizeable magnitude of business ties between managers and their portfolio companies, this report shines new light on competing and potentially conflicting interests. It provides a practical framework that investors can use to engage asset managers on mitigating conflicts of interest.

A summary of the report's findings include:

- Pension and welfare plans sponsored by the top energy and utility companies paid over $116 million in fees to the 30 largest asset managers in 2015. Asset managers who scored poorly on the 2016 survey of key climate shareholder votes captured the majority of these fees, receiving over $70 million. Low scoring managers also managed at least $17 billion in assets for these plans, more than all the other top asset managers in the study combined. **Fidelity**, **BlackRock**, and **Vanguard** alone managed over $13 billion in assets for these plans and earned over $18 million in fees in 2015.
- When these low scoring asset managers had business ties with energy and utility company pension and welfare plans, **they voted against key climate shareholder proposals even more frequently.**
- The voting actions of potentially conflicted asset managers affected the outcome of close shareholder votes:
    - **BNY Mellon** was both a service provider and a fund manager for **Occidental Petroleum's** retirement plans, and also held 2 percent of the company's stock. In 2016, an unprecedented 49 percent of Occidental Petroleum shares were voted in favor of a resolution calling on the company to disclose the portfolio impact of global action to limit global warming to 2 degrees Celsius. BNY Mellon voted against the resolution, which would have received majority support if BNY Mellon had voted its stake in favor of it.

- **BlackRock** managed nearly $3 billion for **BP's** retirement plans in 2015, and received over $2 million in fees. BP posted a $6.5 billion net loss for its FY 2015, including a $10 billion charge for its liabilities from the Deepwater Horizon disaster. However, BP's proposed executive compensation plan for 2016 would have awarded the CEO a 20 percent pay increase, which one major shareholder called "unreasonable and insensitive." While a majority of BP's shares were voted against this plan, BlackRock voted in favor of it.
- **Vanguard** was paid $3.8 million in fees by **Chevron** in 2015, and managed at least $863 million for the oil giant as well. Vanguard was also Chevron's largest shareholder during the 2016 proxy season, controlling 6.2 percent of shares outstanding. While 46 percent of Chevron shares were voted against the company's compensation plan, Vanguard voted to approve it, ensuring it received majority support. Vanguard also voted against a resolution calling on Chevron to disclose the portfolio impact of scenarios in which global warming is restricted to a 2° C increase. 41 percent of shares cast voted to support the proposal.
- **Wells Fargo** funds showed a pattern of voting in favor of climate-change proposals in support of 2° C scenario planning in 2016, but this pattern reversed at **Chevron**, where former scandal-plagued Wells Fargo CEO John Stumpf sat on the board until he was ousted later in the year. Wells Fargo funds also voted in favor of approving Chevron's "Say on Pay" program, even though 46 percent of Chevron's voting shareholders opposed it. Mr. Stumpf sat on Chevron's compensation committee.

Table 1: Voting Performance Decreased when Asset Managers had Conflicts

Asset Manager	Performance on 2016 Key Vote Survey	Performance at Companies with Business Ties	Fees Earned from Key Vote Company Plans	Assets Managed for Key Vote Company Plans
Capital Group	9%	↓ **0%**	$1,384,340	$516,198,560
Fidelity	11%	↑ 13%	$11,848,471	$936,389,016
Blackrock	12%	12%	$6,172,830	$9,313,123,290
Invesco	12%	↓ **0%**	$3,905,921	$1,536,622,044
JP Morgan	16%	↓ 13%	$17,675,558	$727,133,051
Prudential	16%	↑ 21%	$14,708,845	$38,658,791
BNY Mellon	21%	↓ 19%	$8,056,299	$1,199,560,075
Franklin Templeton	22%	↓ **0%**	$485,843	$ -
Vanguard	22%	↓ **0%**	$5,111,532	$2,697,693,864
Allianz	25%	↓ **0%**	$1,072,742	$ -
TOTAL	**17%**	↓ **12%**	**$70,422,381**	**$16,965,378,691**

The report recommends that asset managers adopt the following best practices to effectively address potential conflicts of interest when making proxy voting decisions:

1. Disclose any existing business and contractual relationships when casting votes at portfolio companies
2. Delegate votes that may involve conflicting interests to a neutral third party
3. Describe all voting policies in sufficient detail and make them clearly transparent to investors.
4. Discuss existing policies with and solicit input from underlying clients when formulating or updating proxy voting policies

The complete publication is available here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:

The Increasing Evidence that Horizontal Shareholding Is Distorting Our Economy

Posted by Einer Elhauge, Harvard Law School, on Thursday, June 29, 2017

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

Horizontal shareholding exists when major shareholders own stock in horizontal competitors. A year ago, I argued that such horizontal shareholding can have worrisome anticompetitive effects that help explain various puzzles about our economy (this article was discussed on the Forum here). In a new article, I show that new evidence both confirms my earlier conclusions and indicates the problem of horizontal shareholding is getting worse.

This new data reveals that horizontal shareholding levels have grown sharply in recent years. From 1999 to 2014, the odds that two competitors have a common shareholder with more than 5% of the stock of each of them rose from 16% to 90%. In other word, take any two random competitors, and the odds are now 90% that they each have a common major shareholder whose profits will suffer if the firms compete with each other for market share.

This sharp rise in horizontal shareholding since 1999 helps explain many economic puzzles. First, why is executive compensation based in large part on industry performance, even though Holmström's Nobel prizewinning work has long proven it would be efficient to filter out industry performance and base incentive compensation only on the performance of the executive's firm relative to other firms? Horizontal shareholding explains this puzzle, because basing executive compensation in part on industry performance maximizes the profits of horizontal shareholders who have shares across the industry.

I previously pointed out that the horizontal shareholding explanation best fits the empirical evidence showing that: (1) in less competitive markets, executive compensation is based more on industry performance and less on firm performance; (2) executive compensation has become increasingly based on market performance since the 1990s, which coincides with the dramatic rise in horizontal shareholding since then; and (3) large institutional investors voted against proposals to make executive compensation based more on individual corporate performance.

Now we also have direct empirical proof that the problem is linked to horizontal shareholding, with new regression analysis showing that, in markets with higher horizontal shareholding levels, firms compensate executives "less for their own firm's performance and more for their rival's performance." The statistical confidence level of this finding is over 99 percent. This empirical finding precisely fits what a new proof shows would maximize the interests of shareholders who are partly horizontal. It also provides a clear mechanism for how horizontal shareholders influence corporate management.

Second, why has corporate investment has been so low in recent years despite high corporate profits? Another Nobel prizewinner, Paul Krugman, argued that the likely explanation was increased market power, but that begged the question: what was causing this increase in market power that was going unpoliced by current antitrust law? I argued that rising horizontal shareholding could help explain this phenomenon, because horizontal shareholding would increase profits by reducing output, and lowering output requires less corporate investment.

New empirical strongly supports this conclusion. To begin with, it confirms that the historically high gap between corporate investment and profits started in 2000, just when the recent sharp rise in horizontal shareholding started. More important, a new regression directly shows that the investment-profit gap is driven by the level of horizontal shareholding in concentrated markets. This new empirical evidence now affirmatively establishes a link between anticompetitive horizontal shareholding and the economy-wide lack of corporate investment that has contributed to low economic growth in recent decades. This new evidence also indicates that the driving cause cannot be general macroeconomic, technological or policy trends, such as recessions, increased automation, decreased productivity, a slowdown in technological innovation, or changes in government spending, taxes or labor law. If such general trends were the cause, they should result in a profit-investment gap across the economy; they cannot explain why the gap is instead driven by concentrated markets with high horizontal shareholdings.

Third, why has economic inequality increased in recent years? Nobel prizewinners like Joseph Stiglitz and Paul Krugman have suggested that part of the explanation is increased anticompetitive practices, but again that begs the question: what is causing this increase in anticompetitive practices despite our antitrust laws? I suggested that horizontal shareholding could help explain the phenomenon because it was rising and was the one anticompetitive problem we were literally doing nothing about.

New evidence again supports my conclusion. During the same 1999-2014 period when the probability that two competitors had a large common shareholder went from 16 percent to 90 percent, we have had the highest growth in corporate profits and greatest decline in labor's share of national income since World War II. Further, the empirical study showing that horizontal shareholding in concentrated markets has driven the gap between high corporate profits and low corporate investment also confirms a connection to economic inequality. The reason is that those high corporate profits go to shareholders who are disproportionately wealthy and reflect high prices that are disproportionately borne by the non-wealthy, and the lack of corporate investment depresses employment and wages in a way that also disproportionately harms the non-wealthy.

New empirical evidence also validates two important industry studies that have confirmed horizontal shareholding increased prices in the airline and banking industries. These studies have been subject to various critiques, many funded by institutional investors with large horizontal shareholdings, which helpfully assures that there has been a well-funded and strongly motivated effort to uncover any flaws in those studies. As I detail in my new paper, those critiques are either misguided in theory or, when taken into account, actually indicate the anticompetitive effects are even stronger than previously found.

The cross-industry regressions showing that horizontal shareholding explains our inefficient methods of executive compensation and high investment-profits gap also provides important evidence that the problem with horizontal shareholding generalizes beyond the two industries in

which anticompetitive effects have been directly proven. And all these empirical studies just confirm what economics would predict given the structural incentives created by high levels of horizontal shareholding.

Luckily, the problem of horizontal shareholding has a straightforward solution. The Clayton Act already bans any stock acquisition that substantially lessens competition. When horizontal shareholding creates anticompetitive effects, the stock acquisitions that created those horizontal shareholdings substantially lessen competition and thus violate the plain meaning of the Clayton Act. The solely-for-investment “exception” is not to the contrary because: (1) it requires a lack of influence that institutional investors typically do not satisfy; and (2) it is not actually an exception, but rather provides that investor passivity triggers a requirement to show that the substantial lessening of competition was intended or actually occurred (whereas without investor passivity, it suffices to show such anticompetitive effects “may” occur).

In short, new evidence not only confirms the problem of horizontal shareholding, but shows the problem is growing and central to major economic concerns facing our nation. Horizontal shareholding clearly remains the biggest anticompetitive problem we are doing nothing about. But it has a straightforward solution. All we need is the will to enforce the antitrust laws we already have on the books.

The complete article is available for download here.

Harvard Law School Forum on
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Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance

Posted by Edward B. Rock, New York University School of Law, and Daniel L. Rubinfeld, NYU School of Law, on Monday, March 13, 2017

Editor's note: Edward B. Rock is Professor of Law at New York University School of Law; andDaniel L. Rubinfeld is Professor of Law at NYU School of Law and Robert L. Bridges Professor of Law Emeritus and Professor of Economics Emeritus at the University of California, Berkeley. This post is based on recent paper by Professor Rock and Professor Rubinfeld.

For the past thirty years, regulatory reform efforts have focused on encouraging diversified institutional investor involvement in corporate governance. Now, some recent economic research threatens to chill these developments. In Azar, Schmalz and Tecu (working paper 2015) and Azar, Raina and Schmalz (working paper 2016), the authors argue that concentration among shareholdings by institutional investors has led to higher prices in two relatively concentrated industries: airlines and banking. Based on this research, Einer Elhauge (2016) has argued that current ownership patterns by diversified institutional investors violate Section 7 of the Clayton Act. Following on Elhauge's piece, Posner, Scott Morton and Weyl (working paper 2016) propose a "solution" in which diversified investors would be limited to acquiring one firm in any oligopolistic industry.

In this paper, we critique the economic evidence, focusing on the airline industry. We then challenge Elhauge's legal analysis and critically examine the proposals of Posner et al. Although we are unconvinced by the provocative claims of this new literature, we agree that an open discussion of the antitrust implications of common ownership by large institutional investors is appropriate and timely. We meet this challenge by sketching out and defending proposed "Antitrust Guidelines," including a safe harbor, in an effort to prevent possible anticompetitive effects, while continuing to encourage institutional investor involvement in corporate governance.

The economic analyses are implausible theoretically and unconvincing empirically. The core claim is that managers of airlines, in choosing their business strategies, take into account the effect of those strategies on the value of the stock portfolios held by their investors. Because, as we show, the airlines' shareholders have very different portfolios—some own all the major airlines, others only some, and some only one—we do not see how managers could do this. Other than maximizing the value of their own company, no other strategy could command the approval of investors with heterogeneous and often changing portfolios. Although "soft competition" might be in the economic interests of some of their shareholders, it will be against the economic interest of others. We also find implausible the claim that shareholders would be able to influence managers to "soften" competition so as to maximize portfolio value. How would they do so when directors do not run on a "competition" platform, and when shareholders vote on few other issues of importance?

Turning to the empirical analysis, we raise a variety of questions, focusing primarily on the claim that the modified Herfindahl-Hirschman index or HHI (the MHHI) is commensurate with the familiar HHI. Moreover, we are unconvinced by the efforts of Azar et al to control for the endogeneity of *both* the HHI and the MHHI. With regard to the claimed channel of influence—executive compensation—we are likewise unconvinced. Azar et al rely on a related paper that argues that the channel of influence is the (relative) absence of "Relative Performance Evaluation" in management compensation in concentrated industries. The idea is that without RPE, managers will care more about the profits of other firms in the same industry. Examining airlines, we show that contrary to the Azar et al assumption, RPE is pervasive in the airline industry, as one would expect given the pressure from leading shareholders and Institutional Shareholder Services ("ISS") to utilize relative performance measures in structuring compensation.

We then provide a comprehensive analysis of the legal framework, starting with Clayton Act Section 7 and the 1957 Supreme Court case *of U.S. v. DuPont (GM).* The key legal issues are (a) whether there is evidence that the holdings are anti-competitive and (b) the scope of the "solely for investment" exemption. Contra Elhauge's analysis, we conclude that existing ownership patterns do not violate Section 7, a position that is consistent with decades of DOJ/FTC enforcement policy.

Turning to Posner et al, we reject their proposal that index funds should be forced to abandon their highly successful business model and limit themselves to buying one firm in any concentrated industry. A much more likely response to antitrust risk, we argue, would be for funds to become entirely passive in governance matters, essentially "putting their shares in a drawer." Although this strategy would satisfy the "solely for investment" exemption, the cost to corporate governance would be high, and any theory of antitrust liability that would induce this conduct should be viewed skeptically.

The final section takes seriously the core issue raised by this provocative line of research raises, namely, the intersection between the increased concentration of shareholdings and antitrust. Although we reject the claims that existing ownership patterns have anti-competitive effects, we agree that common ownership can be anti-competitive. We sketch out and defend proposed "Antitrust Guidelines," including a safe harbor for investment below 15%, with no board representation and only "normal" corporate governance activities. This, we argue, complies with current law and will preserve institutional investors' involvement in corporate governance. We also explore scenarios that *would* raise serious issues under Clayton Act Section 7 and Sherman Act Section 1, including the acquisition of large (30%+) holdings in competing airlines, and portfolio managers who act as "Cartel Ringmasters."

The key takeaway is clear: although the current structure of institutional investor ownership does not violate the antitrust laws, institutional investors, like industrial companies, must be conscious of antitrust risk and should train their professionals accordingly.

The complete paper is available for download here.

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Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?

Posted by Rüdiger Fahlenbrach, Ecole Polytechnique Federale & Cornelius Schmidt, Norwegian School of Economics, on Saturday, May 20, 2017

Editor's note: Rüdiger Fahlenbrach is Associate Professor at Ecole Polytechnique Federale and Swiss Finance Institute. Cornelius Schmidt is Adjunct Associate Professor at the Department of Finance, Norwegian School of Economics (NHH Bergen) and is an Economist with the European Commission (DG Competition—Chief Economist Team). This post is based on a recent article by Professor Fahlenbrach and Professor Schmidt, forthcoming in the Journal of Financial Economics. The views expressed in this article are personal, and do not necessarily represent those of DG Competition or of the European Commission.

In our article, Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?, which was recently accepted for publication in the *Journal of Financial Economics*, we examine whether the increase in passively managed institutional ownership changes the governance of corporations to the detriment of shareholders, or whether index-tracking institutions participate in governance as much as more active institutions. We concentrate on two corporate governance areas which executives may rapidly influence after a change in the balance of power in corporations—the board of directors and their relative power in the organization measured by an accumulation of titles. We also examine whether passive institutional investors use their main governance device, shareholder proposals, more actively. We study announcement returns to mergers and acquisitions to test whether agency costs are higher and whether managers can reap personal gains from empire building after increases in passive ownership.

From 2007 through 2013, U.S. index domestic equity mutual funds and exchange-traded funds (ETFs) received $795 billion in cumulative net new cash and reinvested dividends, and at the end of 2013, index mutual funds and large cap ETFs held $1.2 trillion and $450 billion in assets, respectively. Actively managed domestic equity mutual funds had outflows of $575 billion (Investment Company Institute, 2014). The dramatic increase in ownership of U.S. corporations by passively managed funds raises important issues for the corporate governance of firms because it is uncertain to what extent passively managed funds have the capacity and interest to monitor corporations.

The academic governance literature proposes two main channels through which large institutional investors can affect corporate governance decisions: Voice and exit (the "Wall Street walk"). Both channels, however, appear ill-suited for index-tracking institutions. The voice channel, in which institutional investors actively interact with management to voice their preferences, seems

expensive for low-cost and low-overhead passive institutional investors that cover thousands of stocks. The exit channel is not available to institutional investors who track indexes and are often paid by tracking error. Passive institutional investors insist that they have a fiduciary duty to exercise governance and do so, for example, through informal meetings with management and through voting at annual general meetings. It is not clear, however, how active they really are in corporate governance. Organizations such as Institutional Shareholder Services (ISS) that give vote recommendations to institutional investors at annual general meetings have rapidly grown and there exists evidence that many institutional investors mechanically follow their advice so that they can prove to have complied with their fiduciary duties.

One challenge for our analysis is the endogenous nature of a company's shareholder structure. It is plausible to expect that a firm's shareholder structure is influenced by firm characteristics that also drive changes in governance. One of the contributions of our paper is therefore to use—in addition to the standard ordinary least squares (OLS) approach—plausibly exogenous changes in a firm's shareholder structure. The exogenous change is driven by the annual reconstitution of the Russell 1000 and the Russell 2000 indexes, following Chang, Hong, and Liskovich (2015).

Using a sample of U.S. stocks from 1993–2010, we find evidence suggesting that corporate executives use the (index-reconstitution-driven) exogenous change in the shareholder base to influence corporate governance to advance their personal interests. We find that the power of CEOs increases in firms with more passive owners. The likelihood to become chairman or president increases significantly. While the fraction of independent board members does not change, we find that in firms with more passive investors, independent board turnover decreases so that directors serve longer terms. Interestingly, the incidence of a broad basket of governance-related shareholder proposals does not change following changes in the shareholder base.

Are the observed changes in governance good or bad for shareholders? The answer is not obvious. For example, more powerful CEOs may be able to have more influence on the firm and help the firm succeed but are also more entrenched and may be able to carry out actions that are to their personal benefit but to the detriment of shareholders. To answer this question, we examine the announcement returns to two governance changes—the accumulation of titles and new director appointments. We find evidence that shareholders react more negatively to the accumulation of titles and the appointment of new directors in firms with more passive owners, consistent with these governance changes being value-decreasing.

Finally, we examine whether firms undertake more value-decreasing mergers and acquisitions (M&A), after exogenous increases in passive ownership. Jensen (1986) emphasizes that value-destroying M&A activity is one of the main mechanisms for extracting private benefits in public corporations. Masulis, Wang, and Xie (2007) empirically show that managers of firms with less effective corporate governance indeed engage in more value-destroying acquisitions. We find strong evidence that the cumulative announcement returns to mergers and acquisitions decrease after exogenous increases in passive ownership and that the reduction of shareholder value is economically meaningful in dollar terms. In additional tests, we show that the same firms make worse M&A decisions after they experience an exogenous increase in passive ownership.

Our article complements the work by Appel, Gormley, and Keim (2016), discussed on the Forum here. They also analyze how passive investors impact corporate governance and employ the Russell index reconstitution to establish causality. Appel, Gormley, and Keim (2016) examine

basic corporate governance characteristics such as removal of poison pills, establishment of equal voting rights, or an increase in board independence. They choose these characteristics because the largest passive institutional investors themselves describe them as important in public speeches or publications. Appel, Gormley, and Keim (2016) argue that these characteristics are targeted because they require a relatively low level of costly monitoring. They find that several governance mechanisms improve with more passive ownership and that voting behavior at annual general meetings changes. Overall, Appel, Gormley, and Keim (2016) therefore draw conclusions that appear more positive with respect to the role of passive institutional investors than ours. We believe that the results of Appel, Gormley, and Keim (2016) and our results are not inconsistent with each other. Much of our evidence on value-reducing actions of managers after increases in passive ownership comes from an analysis of announcement returns to board appointments and mergers and acquisitions which are much more costly to monitor for passive institutions than basic corporate governance characteristics. Hence, it could be that the role of passive institutional investors for corporate governance is more complex than originally thought. More passive ownership affects corporate governance positively when it comes to *low-cost* governance activities such as consistently voting according to a pre-defined program at annual meetings or endorsing removal of poison pills and staggered boards. However, more passive ownership affects corporate governance negatively and reduces shareholder value when it comes to *high-cost* governance activities such as monitoring of mergers and acquisitions, the choice of board members, or the accumulation of titles that often happen outside of annual general meetings and require continuous monitoring.

The complete article is available for download here.

Tab V: Executive Compensation

Is Executive Pay Broken?

Posted by Rupal Patel and David Ellis, EY, on Friday, April 14, 2017

Editor's note: Rupal Patel and David Ellis are partners at EY. This post is based on an EY publication by Ms. Patel and Mr. Ellis. Related research from the Program on Corporate Governance includes: Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here) and The Growth of Executive Pay by Lucian Bebchuk and Yaniv Grinstein.

In recent months executive pay has received an unprecedented level of attention from a wide range of stakeholders. While Remuneration Committees, executives and investors in many businesses may feel that current pay structures are working well and fit for purpose, the intensity of noise we are experiencing tells us that it is no longer reasonable for any organisation to assume that there is nothing it needs to be concerned about.

First indications from the 2017 AGM season show that in many cases the noise in the system is now turning into real opposition. Many would seek to explain away this opposition as being specific to a business, or focussed on a discrete issue. We at EY believe that this is now wishful thinking.

Much of the noise in the system derives from the view held by some that executive pay is simply too high. A suggested solution is to regulate pay by imposing a cap on the amount an individual may receive. Whilst capping executive pay would be relatively straightforward to execute, we believe that it will not fix the root problem and could create considerable complexity in itself.

That is not to say that change in the executive pay arena would not be welcome. There is work to be done in several areas including governance, communication and alignment of interest. However, one aspect on which stakeholders appear to be agreed is the need for the simplification of executive pay.

EY's view is that this simplification agenda cannot be addressed by tweaking aspects of the traditional package. This is not about the number of performance measures used or the length of deferral applied. It is about acknowledging that a desire for simplification requires agreement on what is core to an executive pay strategy and to focus on that exclusively.

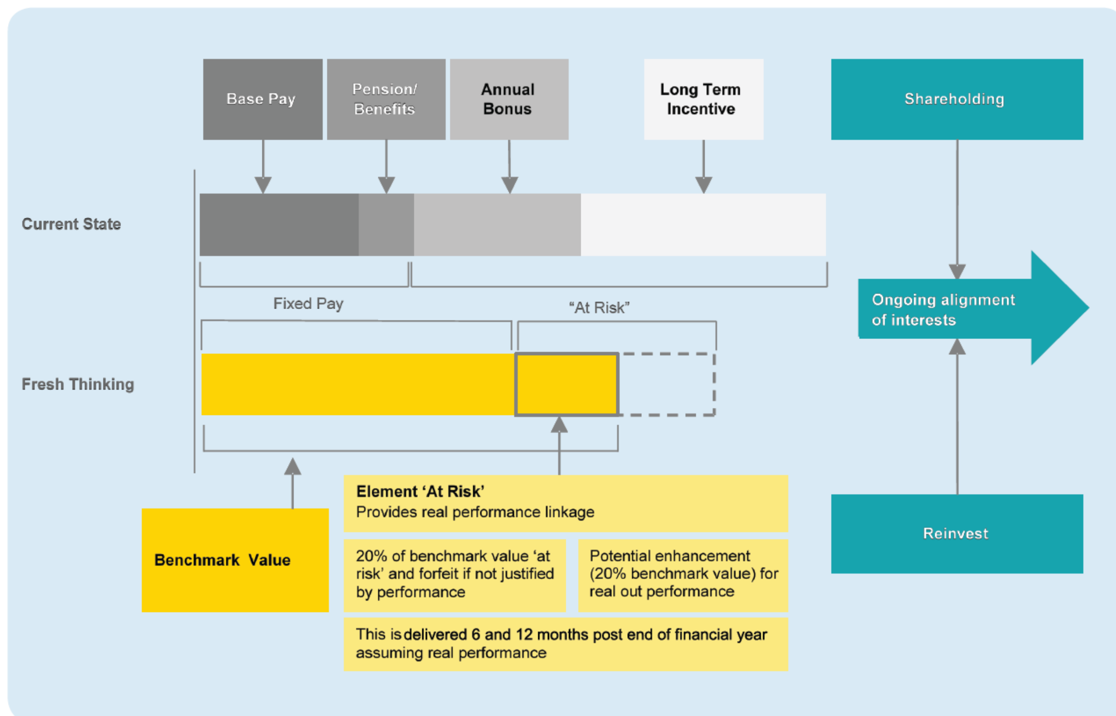
EY feels that many aspects of the today's pay structures, which have been viewed as integral to the traditional model, may not be the most efficient way to deliver remuneration or may simply be no longer relevant.

Whilst there are any number of alternative structures and possible approaches to improve the status quo, EY believe the current challenges cannot be addressed by existing remuneration models. Accordingly we have designed a new model, the One Element Pay Model.

Under such a model, companies:

- Pay executives for the work they do.
- Pay them a bit more if they generate better than expected outcomes.
- Pay them a bit less if they undershoot expectations.
- Require that they buy shares every year with a meaningful portion of their remuneration.

EY believe the One Element Pay Model for executives can offer advantages not only to businesses of many shapes and sizes, but also the diverse group of stakeholders in the executive pay debate.



Harvard Law School Forum on
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The 200 Highest-Paid CEOs in 2016

Posted by Dan Marcec, Equilar, Inc., on Monday, June 12, 2017

Editor's note: Dan Marcec is Director of Content at Equilar, Inc. This post is based on an Equilar publication by Mr. Marcec which was originally published in the Equilar Knowledge Center. Related research from the Program on Corporate Governance includes The Growth of Executive Pay by Lucian Bebchuk and Yaniv Grinstein, and Executive Compensation in Controlled Companies by Kobi Kastiel (discussed on the Forum here).

The *New York Times* recently published its coverage of the annual Equilar 200 study, which analyzes the largest pay packages awarded to CEOs at U.S. public companies. The 2017 Equilar 200 marks the 11th consecutive year of a partnership with The *New York Times* to analyze data on pay awards for these high-profile executives.

The introductory page of this feature shows the Top 10 CEOs who were awarded the largest pay packages in 2016, as reported in the summary compensation table of the proxy statement filed to the SEC. (Read more about the study's methodology.)

Below the Top 10 table, there is a link to the full list of the 200 CEOs in an interactive chart that allows you to sort by pay, change in compensation year over year, change in company revenue and total shareholder return (TSR) to see how pay aligns with company performance and shareholder return.

Because compensation is reported to the SEC including the full value of stock and options awards on the day they were granted, "total compensation" in this study does not reflect what CEOs actually put in their pocket each year, but rather what they were awarded in both cash and equity during the fiscal year reported. Therefore, these numbers reflect what CEOs earn for both short-term gains and what they are being provided to incentivize long-term performance.

The Top 10 Largest CEO Pay Packages in 2016

	Chief Executive	Total Comp.	Change in Pay*	TSR**
1.	**Thomas M. Rutledge** Charter Communications (CHTR)	$98,012,344	499%	n/a
2.	**Leslie Moonves** CBS (CBS)	$68,594,646	22%	36%
3.	**David O'Connor** Madison Square Garden (MSG)	$54,044,394	n/a	n/a
4.	**Fabrizio Freda** Estee Lauder (EL)	$47,691,779	196%	6%
5.	**Mark G. Parker** Nike (NKE)	$47,615,302	183%	10%
6.	**Mark V. Hurd** Oracle (ORCL)	$41,121,896	n/a	-6%
7.	**Robert A. Iger** Walt Disney (DIS)	$40,988,618	-6%	-8%
8.	**Safra A. Catz** Oracle (ORCL)	$40,943,812	n/a	-6%
9.	**David M. Zaslav** Discovery Communications (DISCA)	$37,192,354	15%	3%
10.	**Robert A. Kotick** Activision Blizzard (ATVI)	$33,065,560	358%	-6%

*n/a = Executive did not serve two full fiscal years as CEO
**n/a = Company not publicly traded for a full fiscal year
The full list of CEOs is available here in an interactive table.

Key Trends and Takeaways

Pay packages on the whole were higher than ever before.

The 200th CEO on this year's list was awarded more than $13 million for the first time in the history of the Equilar 200 study. In the past, the low-end cut off has typically been approximately $12 million. On the 2015 list, for example, the 200th CEO was awarded $12.2 million, and 18 CEOs who made the list last year received pay packages less than $13 million.

Median pay for Equilar 200 CEOs was $16.9 million in fiscal year 2016, and the CEOs on this list saw a 9% pay increase at the median. CEOs on last year's Equilar 200 list were awarded 5%

more than in 2014 at the median. Average pay for the Equilar 200 in 2016 was $19.7 million, compared to $19.3 million for the CEOs on the 2015 list.

Media and entertainment companies dominate the top 10 and were awarded more than any other sector overall.

Tom Rutledge, the CEO of Charter Communications, had the highest chief executive pay package in 2016, bolstered by an options award valued at $78.0 million that will he will receive if he meets performance goals over the next five years.

Other more familiar faces at the top of the Equilar 200 list include Les Moonves of CBS, Robert Iger of Walt Disney and David Zaslav of Discovery Communications, who each consistently appear in the top 10 for this annual study. Along with Rutledge, newcomers to the top rung of the Equilar 200 ladder who lead companies in the media and entertainment business included David O'Connor of Madison Square Garden and Robert Kotick of Activision Blizzard.

Overall, CEOs in the "services" sector, which includes each of these executives, were awarded a median pay package of $20.1 million, more than any other sector. Because it is so wide-ranging, the services sector also boasts the most CEOs on the list. Interestingly, CEOs from the services sector represented in the recent Equilar 100 study—which looked at CEO pay among the 100 largest companies by revenue to file proxy statements before April 1, 2017—were awarded the lowest median.

Though few in number, top female CEOs outpace the field.

Sixteen CEOs on the Equilar 200 list are female, one more than on the previous year's list. These women were awarded $17.6 million at the median, down from $18.6 million for the 15 women on last year's list.

Once again, however, the female CEOs on the list outpaced males with an average pay package of $20.9 million vs. $19.5 million. Safra Catz of Oracle earned the largest pay package of any female CEO at $40.9 million—eighth on the list. She was the only woman in the top 10 for the second year in a row.

The largest cash award goes to…

Les Moonves of CBS received a $32 million cash bonus in 2016. Jeff Immelt of GE earned the largest salary in the study at $3.8 million. Moonves was a close second with $3.5 million in base salary, and along with the value of his benefits and perks, his total cash compensation for the year came in at $36.6 million. By comparison, Immelt's total cash compensation was $10.9 million.

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Say-on-Pay: Is Anybody Listening?

Posted by Dan Palmon, Rutgers Business School, on Friday, August 4, 2017

Editor's note: Dan Palmon is William J. von Minden Chair in Accounting at the Rutgers Business School. This post is based on a recent article by Professor Palmon; Stephani A. Mason, Assistant Professor of Accounting at the DePaul University Driehaus College of Business; and Ann F. Medinets, Assistant Professor of Accounting at Rutgers Business School. Related research from the Program on Corporate Governance includes: Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

Populist anger in the U.S., Europe, and Australia has triggered an ongoing debate about whether executives receive excessive compensation, and if so, how to control it. Several countries have instituted say-on-pay rules (shareholders' right to vote on executive compensation) aimed at reducing excessive compensation. Determining the effectiveness of say-on-pay is difficult because its tenets vary by country due to political, institutional, cultural, economic, and social factors that have shaped local governance and compensation practices. Policy issues like say-on-pay are complex and lack the necessary foundation of definitive assumptions and theories. Existing say-on-pay research is inconclusive, since some studies find no change in CEO compensation around its adoption, whereas other studies show that say-on-pay lowers CEO pay or changes its composition. A major factor that hinders the effectiveness of say-on-pay research is the many forms in which it comes. It can be implemented by shareholder proposals or through legislation, and the effect of say-on-pay measures can be binding or non-binding, depending on regulatory requirements or internal corporate policy.

The purpose of this study is to chronicle the history of say-on-pay in the Organisation for Economic Co-operation and Development (OECD) countries, to compare its implementation by groups, such as shareholder-initiated or legislated adoption and binding or advisory votes, to identify the issues associated with say-on-pay, and to explore the sources and possible remedies for observed deficiencies. We frame our discussion using the public interest theory of regulation because it has primarily been enacted in response to market failures in order to improve public good. That is, governments have mandated say-on-pay to correct excessive executive compensation. We provide a historical framework of say-on-pay around the world. Although the U.K. was the first to legislate say-on-pay in 2002, its origins are in the U.S. proxy rules. In 1992, the Securities and Exchange Commission (SEC) expanded the scope of allowable topics for shareholder proxy proposals to include executive compensation issues. In the years since, the Netherlands, Sweden, Norway, Denmark, Australia, US, South Africa, Spain, Belgium, Germany, Italy, Israel, Switzerland, and France have legislated some form of say-on-pay; the EU Shareholder Rights Directive approved a say-on-pay vote every three years on compensation policies; and Canada and Ireland allow shareholder proposals for say-on-pay. Our study also provides a literature review of the academic literature on say-on-pay, grouping papers into those that study 1) Advisory shareholder-initiated say-on-pay proposals, 2) Binding shareholder votes on equity compensation plans, 3) Implementing say-on-pay in OECD countries, 4) Factors

affecting say-on-pay voting outcomes, 5) Theoretical and behavioral studies of say-on-pay, 6) Market reaction to say-on-pay, and 7) Say-on-pay and the market for executives.

Successful shareholder proposals result in periodic advisory votes to accept or reject the Board's proposed executive compensation package. Mandated say-on-pay could include separate binding or advisory votes on compensation, or it might be part of the annual report with the votes applying to compensation packages, incentive plans, or other components, such as severance arrangements, non-completion clauses, pension agreements, option grants, or approval of capital authorizations required to meet obligations under share-based incentive plans. Votes can occur annually or on some other basis, may cover compensation policy, a compensation report, compensation of individual executives/directors, or specific elements of the compensation package, such as share-based compensation. They can also look forward at compensation to be set in the future or backward at compensation as executed in the past.

The empirical evidence is mixed on whether say-on-pay reduces the level or growth rate of executive compensation, although evidence shows that the composition shifts toward a larger equity component and more sensitivity of CEO pay to poor performance. Increased disclosure and shareholder engagement are two key non-quantifiable benefits of say-on-pay. Although the goal of say-on-pay has always been to give shareholders a voice in setting executive compensation, it also has created some unintended consequences, such as a movement to "one size fits all" executive compensation programs and a reduction on the impact of economic value creation, since there seems to be no material difference between the voting outcomes for firms that create economic value and those that destroy value. A number of studies do find a movement towards equity compensation and greater pay-performance sensitivity, but some of this shift has been attributed to scrutiny by proxy advisory firms. Based on say-on-pay data and research in the U.S. and U.K., say-on-pay votes have little effect on reducing CEO compensation levels. However, the votes do affect pay-performance sensitivity; CEOs of firms with negative votes face a greater penalty for poor performance than other CEOs. Despite government intervention on behalf of the public interest, perhaps shareholders never agreed that executives are overpaid.

Say-on-pay can be considered an ill-structured problem because various parties disagree about the problem that needs to be resolved and propose vastly different resolutions. There is no clear goal, set of operations, end states, or constraints, and there is uncertainty about the preferred outcome of shareholder votes on executive compensation. In order to determine the effectiveness of say-on-pay, there must be some consensus on the nature of the problem and the desired outcome. There also has to be some consensus on what led to say-on-pay. Moreover, say-on-pay cannot be understood in a vacuum. Instead, it must be analyzed as a part of corporate governance. As long as the corporate governance system as a whole does not serve shareholders' interests properly, there is little that say-on-pay can achieve. A major limitation of this paper is its inability to assess the deterrent effect of say-on-pay. Without the threat of say-on-pay, excess executive compensation might have been even higher, but that is impossible to measure.

This complete article is available here.

Harvard Law School Forum on
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SEC's Latest Guidance on Pay Ratio Rule

Posted by Davis Polk & Wardwell LLP, on Monday, September 25, 2017

Editor's note: The following post is based on a publication from Davis Polk & Wardwell LLP.

On September 21, 2017, the SEC issued guidance to assist companies in their efforts to comply with the pay ratio disclosure requirement mandated by the Dodd-Frank Act. Overall, the guidance should come as a relief to many companies. It came in three parts:

- The Commission's interpretative guidance that clarifies:
  - A basis for excluding independent contractors, by allowing companies to use a widely recognized test that they otherwise use under other laws and regulations to determine whether their workers are "employees;"
  - The ability to use appropriate existing internal records, such as tax or payroll records, in identifying the median employee and in determinations about the inclusion of non-U.S. employees; and
  - The significant flexibility in methodologies available to identify a company's median employee and in calculating his or her annual compensation.
- Staff guidance that includes detailed examples illustrating how reasonable estimates and statistical methodologies may be used; and
- Updated Compliance and Disclosure Interpretations (C&DIs), which, among other things, withdraws the prior C&DI on independent contractors.

The issuance of this guidance underscores the need for calendar-year companies to continue their preparations to comply with the pay ratio rule during the 2018 proxy season.

Background

Section 953(b) of the Dodd-Frank Act directed the SEC to amend Item 402 of Regulation S-K to require each company, with limited exceptions,[1] to disclose:

- the median of the annual total compensation of all employees of the company, except the chief executive officer (or any equivalent position) of the company determined in accordance with Item 402(c) of Regulation S-K;
- the annual total compensation of the chief executive officer (or any equivalent position) of the company; and
- the ratio of these two amounts.

[1] Under the final rule, emerging growth companies, smaller reporting companies, foreign private issuers (even those filing on Form 10-K), MJDS filers and registered investment companies are exempt from the pay ratio disclosure requirement.

In August 2015, the SEC adopted its final rule implementing the Dodd-Frank provision by adding a new Item 402(u). Under the final rule, companies are required to disclose their pay ratio in proxy statements or Form 10-Ks filed starting in 2018.[2]

In February 2017, then-Acting SEC Chairman, Michael S. Piwowar issued a request for public comments on the implementation of the pay ratio rule in response to "unanticipated compliance difficulties" encountered by some companies "that may hinder them in meeting the reporting deadline." In response to Mr. Piwowar's request, the SEC received a number of comment letters[3] that addressed, among other things, the rule's expansion of the definition of "employee" to capture independent contractors and the resulting administrative burdens and complexities.

On September 15, 2017, at a meeting of the American Bar Association, William Hinman, Director of the SEC Division of Corporation Finance, indicated that the implementation of the pay ratio rule would not be delayed. However, he further indicated that the SEC would issue additional guidance to provide flexibility and to reduce the cost of compliance.

Below, we have set forth the SEC's guidance in Q&A format.

Independent Contractors

Q: May a company apply a widely recognized test under another area of law that it otherwise uses to determine whether its workers are "employees?"

A: Yes.

In what may be perceived as a major shift for the SEC, the SEC stressed that Item 402(u) makes clear that an "employee" is an individual employed by the company. The exception from employee status for workers who are employed, and whose compensation is determined, by an unaffiliated third party was intended only to describe one category of workers who are excluded from the definition of "employee," but was not intended to serve as an exclusive basis for exemption.

The SEC's latest guidance clarifies that a company may apply a widely recognized test under another area of law that the company otherwise uses to determine whether its workers are employees. In furtherance of this, the SEC withdrew old C&DI 128C.05, which previously provided that, in determining when a worker is an "employee," a company "must consider the composition of its workforce and its overall employment and compensation practices" and that a company "should include those workers whose compensation it … determines regardless of whether these workers would be considered 'employees" for tax or employment law purposes or under other definitions of that term."

Q: Did the SEC provide any examples as to what such a widely recognized test might be?

A: Yes.

[2] For our client memorandum regarding the final rule, please see here.
[3] For our comment letter in response to Mr. Piwowar's request, please see here.

While the SEC did not specifically bless any particular test, it suggested that such a test might, for example, be drawn from guidance published by the Internal Revenue Service with respect to independent contractors. A company may also rely upon another widely recognized test that it already uses to determine whether a worker is an employee or independent contractor in other legal and regulatory contexts, such as for employment law or tax purposes.

Significant Flexibility

Q: What level of flexibility is afforded to companies in determining appropriate methodologies to identify the median employee and in calculating the median employee's annual compensation?

A: Significant flexibility.

The Commission's interpretative guidance makes clear that companies have "significant" flexibility in this regard. Required disclosure may be based upon a company's reasonable belief; use of reasonable estimates, assumptions and methodologies; and reasonable efforts to prepare its disclosure. Specifically, the pay ratio rule:

- Permits companies to use reasonable estimates to identify the median employee, including by using statistical sampling and a consistently applied compensation measure (such as payroll or tax records);
- Permits companies to use reasonable estimates in calculating the annual total compensation or any elements of annual total compensation for employees; and
- Provides that, after a company's first disclosure, it may change its methodology or its material assumptions, adjustments or estimates, as long as the company briefly describes the change and the reasons for the change if its effects are significant.

Q: May a company describe its pay ratio as an "estimate"?

A: Yes.

New C&DI 128C.06 specifically provides that, "due to the use of estimates, assumptions, adjustments, and statistical sampling permitted by the rule, pay ratio disclosures may involve a degree of imprecision. Therefore, the staff would not object if a [company] states in any required disclosure that the pay ratio is a reasonable estimate calculated in a manner consistent with Item 402(u)."

Median Employee

Q: Is the use of existing internal records appropriate in identifying a company's median employee?

A: Yes, in most circumstances.

Instruction 4 to Item 402(u) permits a company to identify its median employee using a consistently applied compensation measure (CACM), such as information derived from the

company's tax or payroll records. The SEC has clarified that a company may use internal records that reasonably reflect annual compensation to identify the median employee, even if those records do not include every element of compensation, such as equity awards widely distributed to employees.

In this connection, the SEC revised C&DI 128C.01 by deleting references that previously provided that total cash compensation might not be an adequate CACM for a company that distributed annual equity awards widely among its employees and that withheld Social Security taxes would likely not be an appropriate CACM unless all employees earned less than the Social Security wage base.

Q: Once a median employee is identified, if the company then determines that his or her actual total compensation has anomalous characteristics that have an impact on the pay ratio, can the company replace the median employee with a another median employee?

A: Yes, the company may substitute another employee with substantially similar compensation to the original identified median employee.

In such a circumstance, instead of concluding that the CACM that the company used was unsuitable to identify its median employee, the company may substitute another employee with substantially similar compensation to the original identified median employee based on the CACM it used to select the median employee. This means that if, for example, the original identified median employee earns a higher or lower than typical bonus, the company can select a new median employee, as long as he or she has substantially similar compensation to the original employee based on the CACM it used to select the median employee.

Non-U.S. Employees

Q: Can a company use existing internal records, such as tax or payroll records, in determining whether the 5% *de minimis* exemption is available in connection with its non-U.S. employees?

A: Yes.

The pay ratio rule permits a company to exempt non-U.S. employees where these employees account for 5% or less of its total U.S. and non-U.S. employees, with certain limitations (often referred to as the "*de minimis* exception"). In the guidance, the SEC has clarified that a company may use appropriate existing internal records, such as tax or payroll records, in determining whether the *de minimis* exemption is available.

Use of Reasonable Estimates, Assumptions and Methodologies, and Statistical Sampling

Q: May companies combine the use of reasonable estimates with the use of statistical sampling or other reasonable methodologies? For instance, is a company with multinational operations or multiple business lines permitted to use sampling for some geographic/business units and a combination of other methodologies and reasonable estimates for other geographic/business units?

A: Yes.

The Staff guidance specifically points out that Instruction 4.2 to Item 402(u) provides that "[i]n determining the employees from which the median employee is identified, a [company] may use its employee population or statistical sampling and/or other reasonable methods." Focusing on the use of the "and/or," the Staff guidance indicates that a company is permitted to use statistical sampling, other reasonable methods or a combination of statistical sampling and other reasonable methods. Further, the Staff guidance notes that the SEC deliberately did not specify "other reasonable methods" that may be appropriate to allow each company the flexibility to determine the method that best suits its own facts and circumstances.

Q: Are companies permitted to use a combination of *sampling methods*?

A: Yes.

The Staff guidance points out that Instruction 4 to Item 402(u) does not set forth specific limitations regarding the methods of sampling that are permissible and that, rather, it provides that companies must use reasonable methods and make reasonable estimates. For example, "reasonable estimates of the median for [companies] with multiple business lines or geographical units may be determined using more than one statistical sampling approach. Additionally, all statistical sampling approaches should draw observations from each business or geographical unit with a reasonable assumption on each unit's compensation distribution and infer the [company's] overall median based on the observations drawn."

Q: What are some examples of sampling methods that companies may use?

A: The Staff guidance provides a non-exhaustive list of sampling methods that could be appropriate to use (alone or in combination), depending on the company's particular facts and circumstances.

These sampling methods include:

- simple random sampling (drawing at random a certain number or proportion of employees from the entire employee population);
- stratified sampling (dividing the employee population into segments, e.g., based on location, business unit, type of employee, collective bargaining agreement, or functional role and sampling within each segment);
- cluster sampling (dividing the employee population into clusters based on some criterion, drawing a subset of clusters, and sampling observations within appropriately selected clusters; cluster sampling may be conducted in one stage or multiple stages); and
- systematic sampling (the sample is drawn according to a random starting point and a fixed sampling interval, every nth employee is drawn from a listing of employees sorted on the basis of some criterion).

Q: What are some examples of situations where companies may use *reasonable estimates*?

A: Per Instruction 4.1 to Item 402(u), reasonable estimates may be used both in the methodology used to identify the median employee and in calculating the annual total compensation or any elements of total compensation for employees other than the principal executive officer.

The Staff guidance provides a non-exhaustive list of examples of situations where companies may use reasonable estimates under the appropriate facts and circumstances:

- analyzing the composition of the company's workforce (by geographic unit, business unit, employee type);
- characterizing the statistical distribution of compensation of the company's employees and its parameters (e.g., a lognormal, beta, gamma or another distribution, or a mixture of distributions—for example a mixture of two normal or lognormal distributions yielding a bimodal distribution);
- calculating a CACM and annual total compensation or elements of the annual total compensation of the median employee;
- evaluating the likelihood of significant changes in employee compensation from year to year;
- identifying the median employee;
- identifying multiple employees around the middle of the compensation spectrum; and
- using the mid-point of a compensation range to estimate compensation.

Q: May companies use a combination of other *reasonable methodologies*?

A: Yes.

The Staff guidance notes that Item 402(u) does not specify any required methodology and permits companies flexibility to choose a method or combination of methods based on their facts and circumstances. Any method or combination of methods used would need to be reasonable.

Q: What are some examples of other reasonable methodologies that companies may use?

A: The Staff guidance provides a non-exhaustive list of examples of common statistical techniques and methodologies that companies may consider.

These techniques and methodologies include:

- making one or more distributional assumptions, such as assuming a lognormal or another distribution, provided that the company has determined that the use of the assumption is appropriate given its own compensation distributions;
- reasonable methods of imputing or correcting missing values; and
- reasonable methods of addressing extreme observations, such as outliers.

Q: Does the SEC provide hypothetical examples of the use of reasonable estimates, statistical sampling and other reasonable methods?

A: Yes, the Staff guidance provides of examples of three hypothetical scenarios:

- A company that has a global workforce with employees concentrated in the following geographic units: North America, China, Europe and Latin America; and 21 geographic units, covered by multiple payroll systems;
- A company that has employees in the United States and Asia.

The Staff's examples are intended to illustrate the principles that a company may consider when using reasonable estimates, statistical sampling and other reasonable methods to identify its median employee. The Staff guidance also states that the application of the principles should be tailored to a specific company's facts and circumstances and that, in addition, the use of estimates, statistical sampling and other methods must be reasonable. The Staff guidance notes that some of the techniques referenced in the examples may be more suitable for larger companies with more complex workforces, and also reminds companies that the examples are not meant to suggest that they follow any particular approach and that, in many cases, simpler approaches may be appropriate in determining the pay ratio.

Enforcement

Q: Under what circumstances might the SEC bring an enforcement action with respect to a company's pay ratio disclosure?

A: If the company does not have a reasonable basis for the disclosure or the disclosure was provided other than in good faith.

The SEC acknowledges that, in light of the use of estimates, assumptions, adjustments and statistical sampling permitted by the pay ratio rule, disclosures may involve "a degree of imprecision." In its view, if a company uses reasonable estimates, assumptions or methodologies, then the pay ratio and related disclosure that results from such use would not provide the basis for the SEC to bring an enforcement action, unless the disclosure was made or reaffirmed "without a reasonable basis or was provided other than in good faith."

Implications and Observations

The SEC repeatedly reiterated the significant flexibility afforded by the pay ratio disclosure rule in this most recent guidance from the Commission and the Staff. This latest guidance, such as the clarification related to independent contractors, should alleviate some compliance costs and administrative burdens of companies.

That said, the core rule remains in place and, at this point, there is little chance that it will go away altogether, unless Congress intervenes (which seems highly unlikely in the short term, at least). The benefit of this disclosure to shareholders may be questionable at best and the costs may be high. In addition to the administrative costs of compliance, companies may have to deal with employee relations issues and broader scrutiny and criticism from the public and the media as a result of their disclosure. Aside from the pay ratio number itself, the disclosure of the methodology chosen to determine the median employee and any material assumptions, adjustments or estimates may also be subject to scrutiny and questions.

Given this, companies are advised to carefully think through the methodology they employ to identify the median employee and how they will calculate the pay ratio, how this information will be disclosed in their proxy statement and what communications, if any, they will want to prepare to address the concerns that their shareholders and broader stakeholders may have.

2017 Proxy Season Review: Compensation

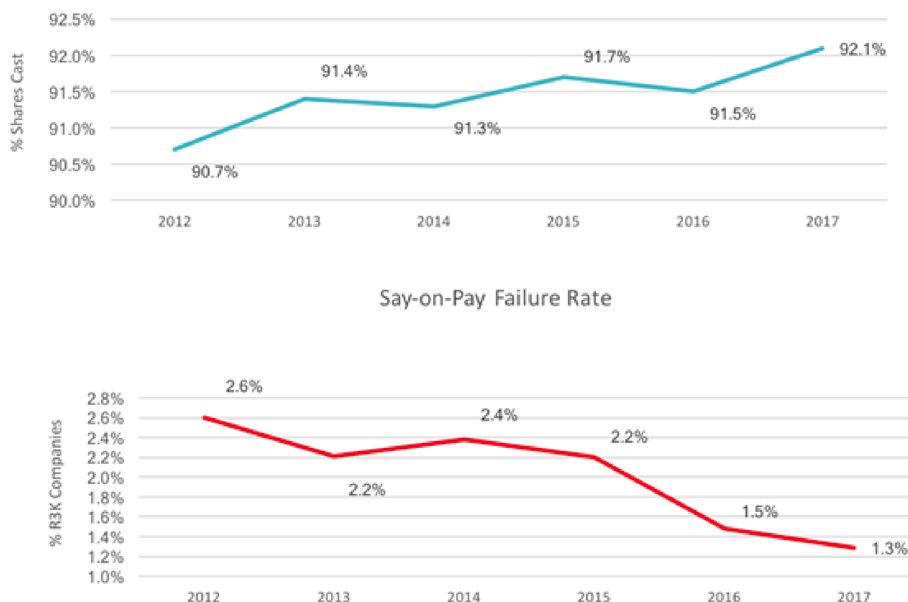
Posted by Subodh Mishra, Institutional Shareholder Services, Inc., on Friday, October 6, 2017

Editor's note: Subodh Mishra is Executive Director at Institutional Shareholder Services, Inc. This post is based on an ISS publication.

In early September, ISS published its annual post-season report on compensation vote results and practices, which revealed a continuation of many trends identified last year. Shareholder support for management say-on-pay remains stronger than ever, while failures are exceedingly rare; average support for equity plan proposals was consistent with prior years. While CEO pay at larger companies has increased, the composition of CEO pay packages has trended towards more strongly performance based incentives. Interestingly, median golden parachute payments rose considerably, while golden parachute vote rates dropped and failure rates more than doubled. Shareholder proposals on compensation topics remained on the decline, and for the second consecutive proxy season no proposals received majority support.

Say-on-Pay Votes

Say-on-pay support reached its highest levels. Since the introduction of say-on-pay, average support levels have remained consistently high. The 2017 proxy season was no exception, with average vote support of 92.1 percent, the highest to date. Failed votes remained a rare occurrence and the failure rate of 1.3 percent for 2017 was the lowest yet.

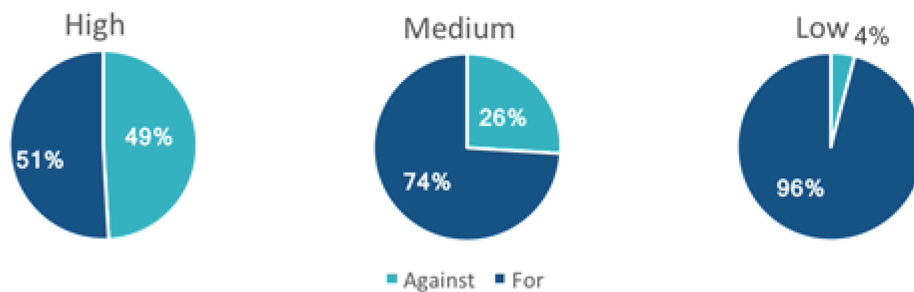


Votes Cast For / Votes Cast For + Against. Unless otherwise indicated, charts represent companies in the Russell 3000 Index (R3K), inclusive of the S&P 500 Index (S&P 500), with annual meetings held between January 1 and June 30.

ISS Recommendation Trends

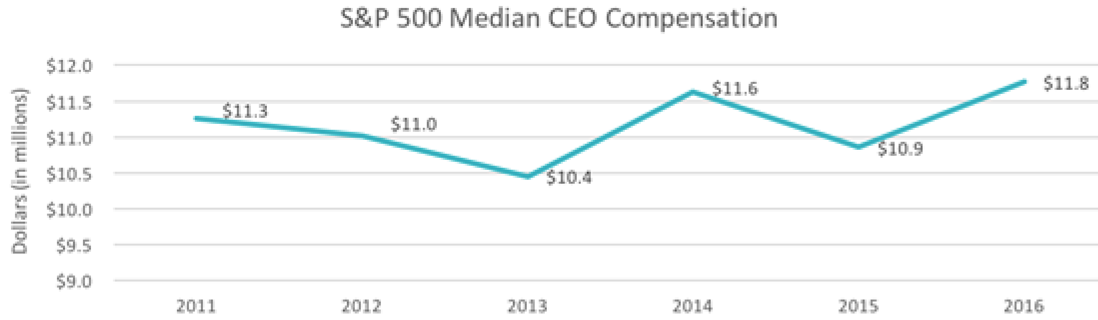
The severity of pay-for-performance misalignment correlates with ISS vote recommendations. During the first half of 2017, ISS recommended "against" votes for nearly half of the companies where there was a "High" quantitative concern, which indicates a severe misalignment between pay and performance. ISS recommended against slightly more than one-quarter of companies with a "Medium" concern level. Only 4 percent of companies that yielded a "Low" quantitative concern level (indicating quantitative alignment) received "Against" recommendations, usually as a result of problematic contractual provisions or poor board responsiveness. The initial screens identify quantitative outliers, while the ultimate say-on-pay vote recommendation is based on an in-depth qualitative assessment of pay programs and practices.

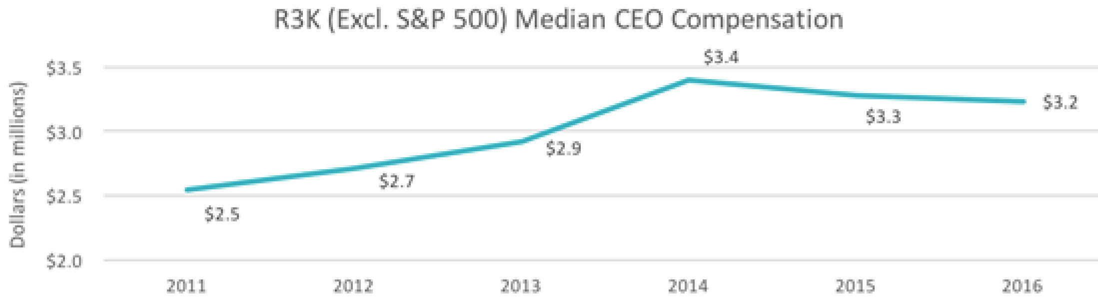
ISS' Say-on-Pay Recommendations by Quantitative Concern Level 2017



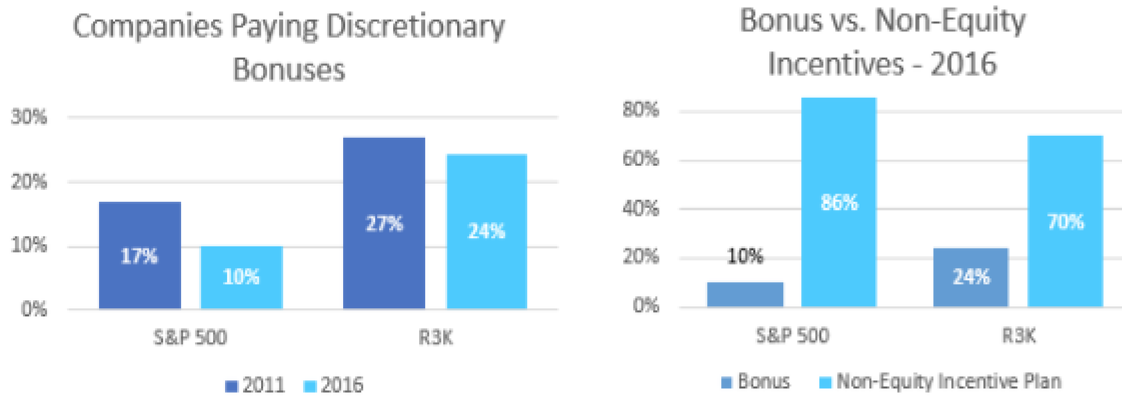
CEO Pay Trends

Median S&P 500 CEO pay reached its highest point since the say-on-pay rule took effect in 2011, pay at smaller companies was flat. Median CEO compensation in the S&P 500 grew nearly 8 percent over 2015 (including the impact of cash, stock awards, pensions, and other compensation), driven primarily by increases in stock compensation. Median CEO pay in the Russell 3000 (exclusive of the S&P 500) declined slightly from $3.28 million to $3.24 million. For these smaller companies, CEO total pay has remained relatively steady over the past three years.

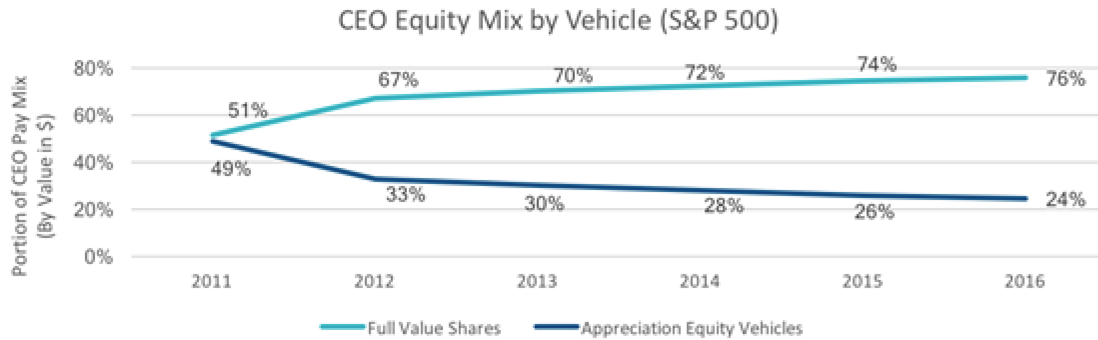




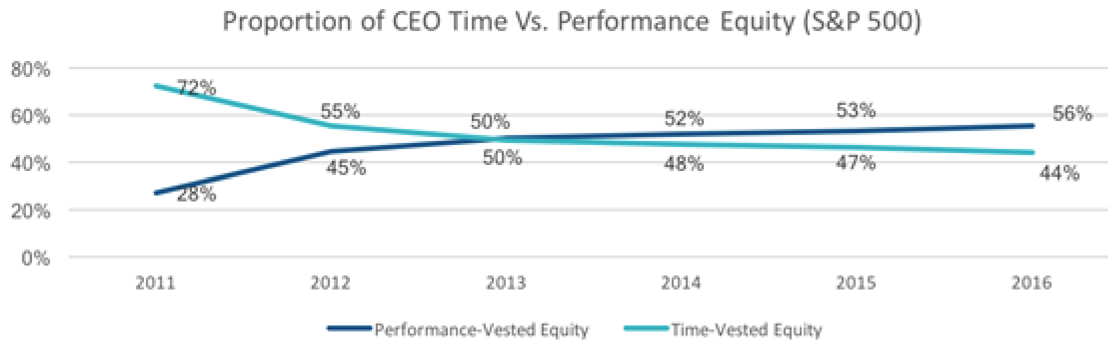
Discretionary bonuses continued to decline. Companies paying discretionary cash bonuses to the CEO (as disclosed in the "Bonus" column of the Summary Compensation Table) made up an even smaller minority in both the S&P 500 and the Russell 3000. In 2016, just 10 percent of the S&P 500 and less than a quarter of R3K companies paid discretionary cash bonuses. Concurrently, more companies are moving to formulaic non-equity incentive programs. In 2016, 86 percent of the S&P 500 and 70 percent of the R3K reported payments to the CEO through non-equity incentive plans.



Appreciation awards continue to decline in popularity. The use of appreciation awards (options and SARs) for CEOs in the S&P 500 continued to decline in 2016, and these were increasingly replaced with full value share awards (restricted stock and RSUs, both time- and performance-vested).

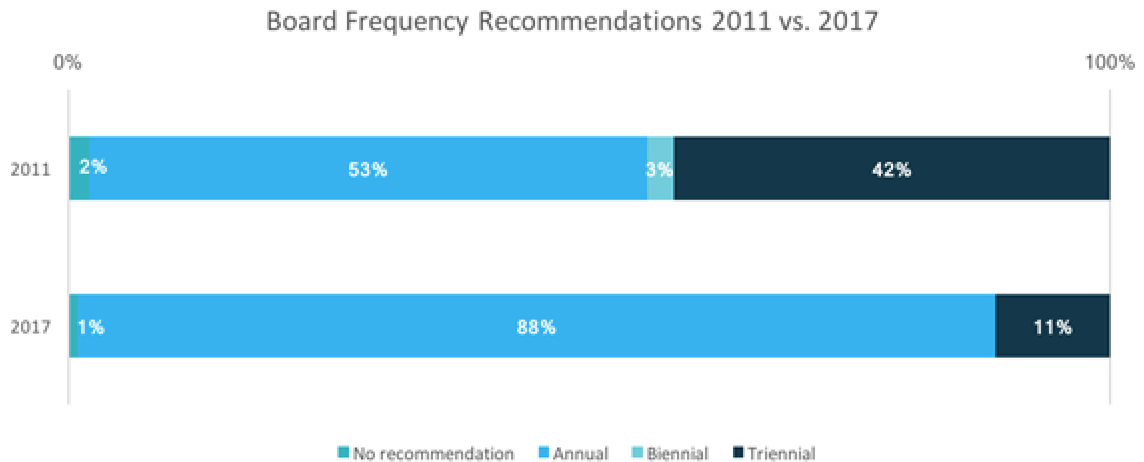


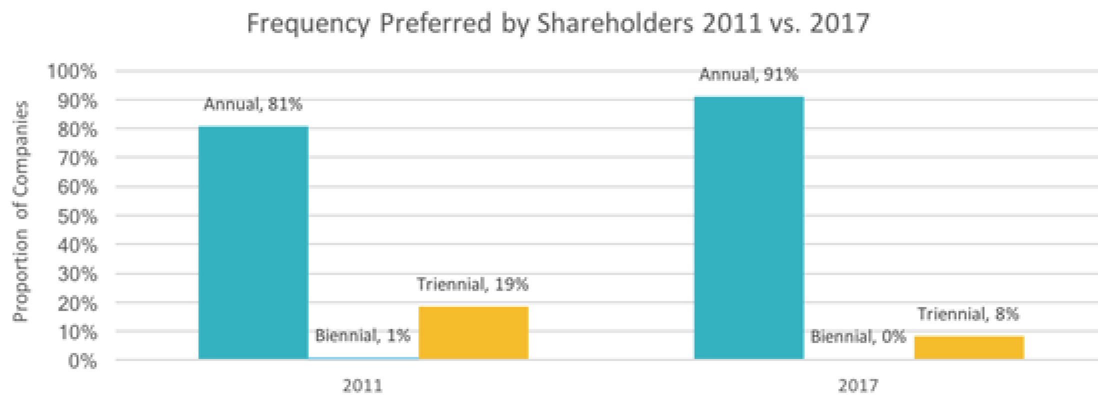
Performance-conditioned equity is the prevailing practice. Among the S&P 500, most companies deliver the majority of CEO equity awards in performance-conditioned vehicles. The percentage of CEO performance equity increased further in 2016 to an all-time high of 56 percent.



Say-on-Frequency Votes

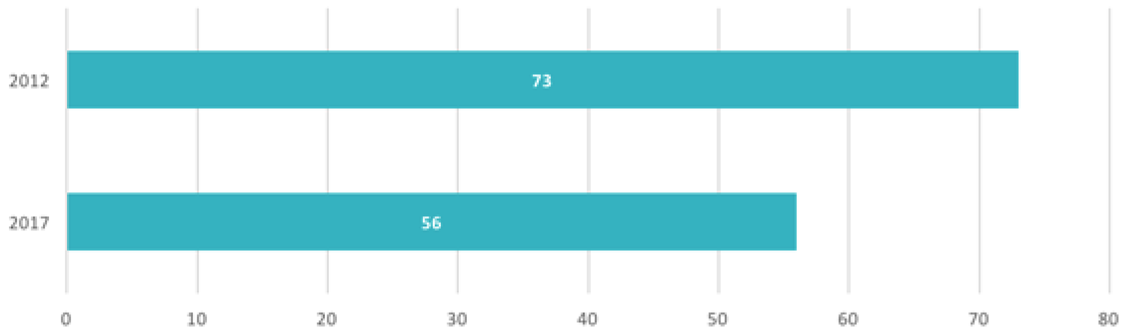
Say-on-pay frequency votes returned; annual frequency favored by boards and investors. Say-on-pay frequency votes are required at least once every six years, and most companies held their second say-on-pay frequency vote during the 2017 proxy season. In this second wave of frequency votes, significantly more boards supported an annual frequency. During the 2017 proxy season, 88 percent of boards recommended annual votes, compared to 53 percent in 2011. Shareholders' strong preference for an annual frequency was even more pronounced in 2017, as they endorsed an annual frequency at 91 percent of companies in 2017, compared to 81 percent in 2011.





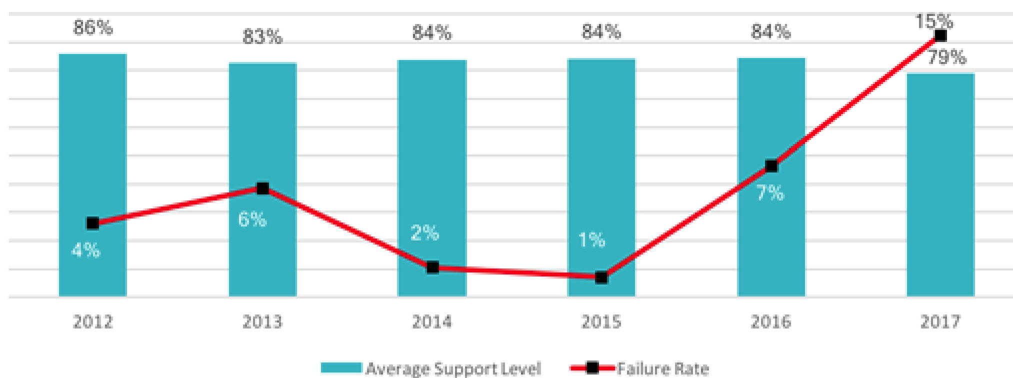
Problematic Pay Practices

Problematic pay practices are generally declining. The number of problematic severance and change-in-control provisions (per ISS policy) that were included in new or materially amended executive agreements has declined each year, as illustrated below. However, the decline has recently slowed: this year 56 companies included such provisions in new or amended agreements, compared to 58 in 2016. Excise tax gross ups were the exception to this trend, and actually grew more prevalent in 2017.



Say-on-Golden Parachute Votes

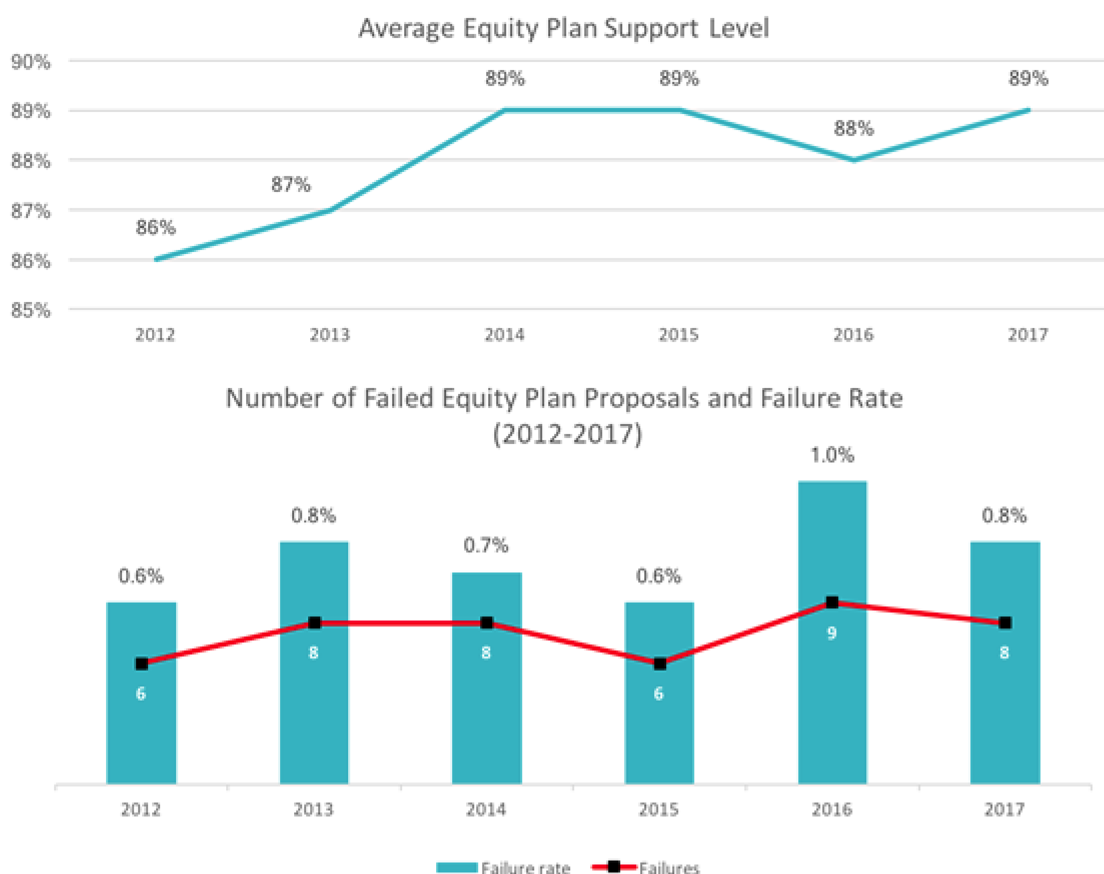
Golden parachute failure rate doubled as average shareholder support fell. Shareholder support for golden parachute proposals has typically trended lower than say-on-pay support. Average support for golden parachute proposals fell to an all-time low of 79 percent in 2017. The number of failed proposals doubled from six proposals in the first half of 2016 (7 percent of all proposals) to 12 proposals (15 percent) in 2017. As companies continue to incorporate performance equity awards, ISS and shareholders are more closely scrutinizing vesting treatment upon a change in control, particularly for recent grants. Moreover, the median CEO golden parachute payment rose by close to 75 percent, from $5.2 million in 2016 to $9 million in 2017.



Equity Plan Proposals

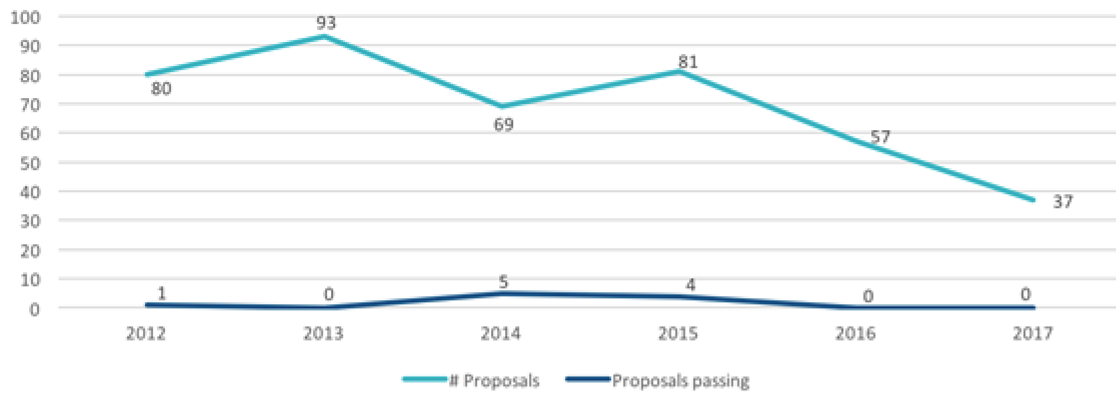
Equity plan support levels were essentially flat. For the 2017 proxy season, average equity plan support was 89 percent, consistent with recent years. ISS supported 70 percent of the equity plan proposals analyzed under U.S. policy in 2017, a slight increase from 68 percent in 2016. Eight equity plan proposals failed, just below the five-year high of nine failures seen in the 2016

season. While there was no single common factor resulting in the failed proposals, many of the evaluated plans showed a relatively high shareholder value transfer (plan cost).



Shareholder Proposals on Compensation

The number of shareholder proposals on compensation plummeted. Shareholders voted on 37 compensation-related proposals during the 2017 proxy season, the lowest number since the first full year of say-on-pay. Compensation shareholder proposals rarely receive majority support and, similar to last year, none did during the 2017 proxy season. The steadily declining number of compensation-related shareholder proposals is likely impacted by the introduction of say-on-pay, which provides shareholders an alternative channel to voice their concerns.


Shareholder Compensation Proposals (2012-2017)
100
90
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2012
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2014
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2017
Proposals
Proposals passing

S&P 500 CEO Compensation Increase Trends

Posted by Aubrey E. Bout and Brian Wilby, Pay Governance LLC, on Saturday, October 7, 2017

Editor's note: Aubrey E. Bout is Managing Partner and Brian Wilby is a Consultant at Pay Governance LLC. This post is based on a Pay Governance publication by Mr. Bout, Mr. Wilby, andPerla Cruz.

CEO pay continues to be a widely debated topic in the media, in the boardroom, and among investors and proxy advisors. As the U.S. was in the heart of the 2008-2009 financial crisis, CEO total direct compensation (TDC; base salary + actual bonus paid + value of long-term incentives [LTI]) dropped for 2 consecutive years. As the U.S. stock market sharply rebounded and the economy started to slowly grow again, CEO pay also rebounded. Large pay increases occurred in 2010, primarily in the form of larger LTI grants. Since then, year-over-year increases have been fairly moderate—in the 2% to 6% range for 2011-2016.

We expect that 2017 CEO TDC will likely be up in the mid-single digits (at the upper end of the recent range or slightly higher) based on past pay trends, accelerated earnings growth projections, a relatively stable global economic environment, and preliminary signs of a growing U.S. economy. Executives in industries with favorable economic conditions and higher growth will more likely see bigger pay increases than those in slow-growth industries.

Executive Summary

- Annual CEO pay among S&P 500 companies has been increasing by the low- to mid-single digits over the last 6 years.
- Historical CEO pay increases have been supported by total shareholder return (TSR)—in fact, annualized pay increases have been 9 percentage points lower than TSR performance.
- We expect that current year (2017) CEO pay will be up in the mid-single digits, given expected revenue and earnings growth achievements and strong TSR performance among S&P 500 companies (year-to-date TSR through September 15 was 13%)
- We expect CEO pay to continue to be a closely monitored topic with the likely implementation of the CEO pay ratio, while we expect that institutional investors will continue to support current pay models at the vast majority of companies despite continued proxy advisor scrutiny.

Historical Trend in CEO Pay and LTI Vehicles

CEO pay rebounded 31% in 2010 after 2 consecutive years of -9% and -13% decreases during the financial crisis of 2008 and 2009, respectively (source: Equilar CEO Pay Trends annual

reports). Since then, year-over-year pay increases have been fairly moderate—in the 2% to 6% range (Figure 1).

It is not surprising that CEO pay has slowed recently, given that S&P 500 revenue and earnings growth has been anemic in recent years—in 2016, CEO pay increased 4% while S&P 500 Index revenue and earnings before interest, taxes, depreciation, and amortization (EBITDA) growth were 1.8% and 0.9% in 2016, respectively. The lack of robust earnings growth has translated to lower actual bonuses, partly offset by slightly higher salaries and LTI grant values.

Over the last several years, LTI vehicle usage has shifted away from stock options, mostly in favor of performance-based plans that pay based on performance versus goals. From 2009-2016, performance share prevalence increased from 50% to 88%, stock options decreased from 70% to

59%, and restricted stock increased from 46% to 59% (Figure 2). The rise in performance-based plans can largely be attributed to proxy advisors and some shareholders considering performance share plans, and not stock options, as performance-based.

Figure 1:

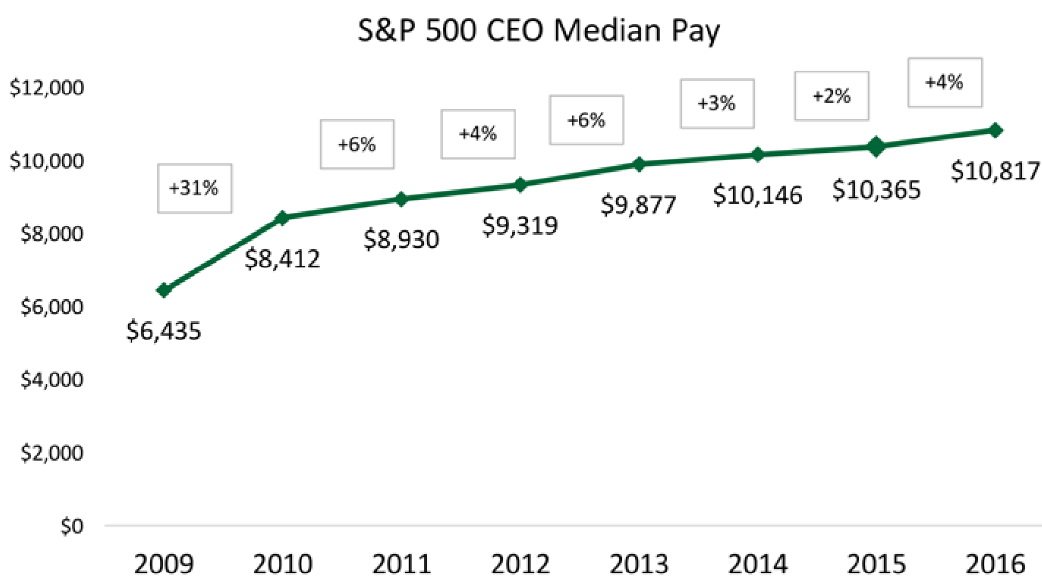


Figure 2:

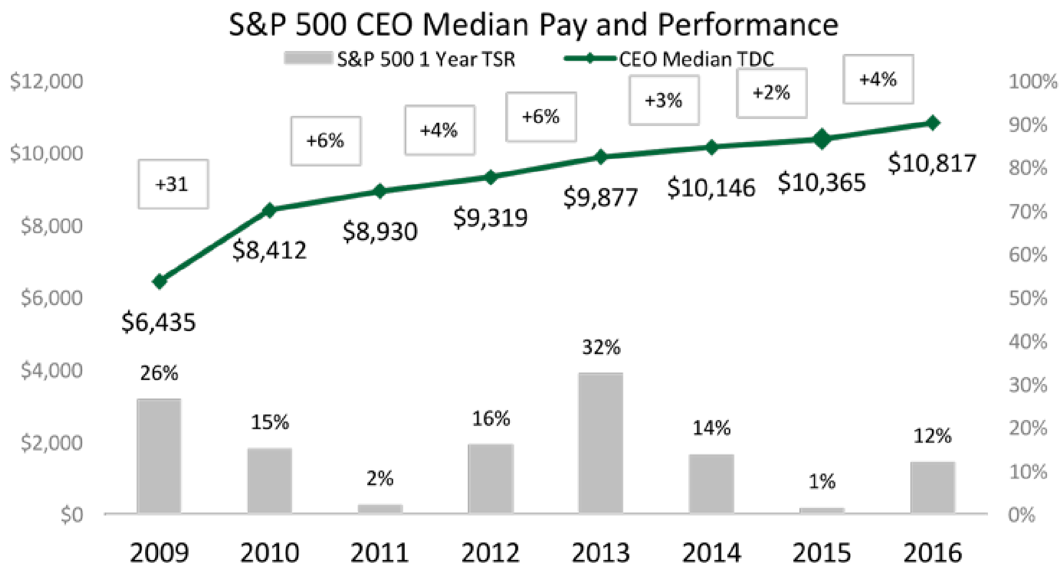
Year	LTI Vehicle Prevalence for S&P 500		
	Performance Plan	Stock Options	Restricted Stock
2009	50%	70%	46%
2012	71%	61%	51%
2016	88%	59%	59%

Trend in CEO Pay versus S&P 500 Index Performance

CEO pay increases have been supported by strong total shareholder return (TSR)—in fact, pay increases over the last 7 years have trailed TSR performance by ~9% based on the Compound Annual Growth Rate. Figure 3 demonstrates that in every year that TSR increased, CEO pay increased. The increases were not always proportionate: in each of the last 6 years (2011-2016), annual pay increases were ≤6%, while the S&P 500 total return ranged from 1% in 2015 to 32% in 2013.

There is clear positive correlation between share price performance and CEO pay. In a positive stock price environment, Compensation Committees are often more supportive of CEO pay increases, typically delivered in the form of larger LTI grants. CEO base salaries sometimes only periodically increase (i.e., less than an annual basis) and typically only make up a small portion of the executive pay package. Annual actual bonuses, though not as large as the LTI portion, can have a meaningful impact on whether year-over-year pay increases. When a company is having a good year and exceeding budget goals and investor analyst expectations, the CEO bonus often pays above target and increases year-over-year (often, the share price also increases as company performance is strong). That said, there will be some years where a CEO's bonus pays above target as the company exceeded its budgeted goals, while the share price goes down due to stock market volatility or correction and sector rotation. The opposite also can happen: goals are not met, resulting in lower bonuses, while the stock market goes up.

Figure 3



CEO Pay Projections

1. We expect overall 2017 CEO TDC to increase by the mid-single digits for many executives in most industries, assuming 2017 profits increase as projected in the low-double-digit range in aggregate.
    a. Our research suggests that CEO pay increases have been lower in recent years (Figure 1); however, if companies deliver on strong 2017 earnings forecasts, we could see a marked increase in CEO pay.
    b. Aggregate S&P 500 Index year-over-year revenue and EBITDA for 2017 are forecasted to increase by 7-9% and 14-18%, respectively (based on data sourced from S&P Capital IQ). The energy sector and profitability rebound contributed to higher forecasted growth rates overall.
    c. EPS forecasts for 2017 are currently showing major growth over 2016, suggesting that significant macroeconomic and political expectations are included in current equity valuations.
    d. While strong earnings growth may support higher executive pay increases, the media, CEO pay ratio implementation, and proxy advisor scrutiny will continue to exert negative pressure.
    e. Although voluntary CEO turnover is very low, the increasingly tight labor market and luring away of high-profile sitting CEOs (e.g., Dara Khosrowshahi from Expedia to Uber) might make some Board members nervous about losing their current strong performing CEO; this may translate to larger pay increases in the future.
2. In certain industries, such as biotechnology or information technology, executives may experience continued faster growth in total compensation this year, while executives in slow-growth industries might see smaller increases.
3. We expect general industry executive target pay TDC levels to up in the mid-single digits in 2017 and 2018 due to meaningful earnings increases expected for 2017 supported by strong TSR performance. The exception would be for executives who outperform their peers and exceed company goals—those CEOs might see larger pay increases than the norm.

The above pay projections do not account for any potential market setbacks (e.g., nervousness about geopolitical uncertainty, dramatic changes in the economic environment, unexpected changes in the Federal Reserve's interest rate policies, or significant drops in the overall stock market).

Methodology

The CEO pay analysis consists of S&P 500 companies that have CEOs with a ≥3-year tenure. Pay data includes base salaries and bonuses paid for each year as well as the reported grant date fair value of LTI awards. Our analysis of consistent incumbent CEOs was designed to highlight true changes in CEO compensation (as opposed to pay changes driven by the new hiring or internal promotion of CEOs, which typically involves ramped-up pay over a period of 2-3 years).

Note on Realizable Pay

It is important to note that our methodology used year-over-year CEO pay and was based on the accounting value of LTI as reported in proxy summary compensation tables. These amounts are more akin to pay opportunity and are quite different from realizable pay, which includes in-the-money value of stock options, ending period value of restricted stock, and estimated value of performance shares. Pay Governance's past research has shown there is a very strong correlation between realizable pay and TSR performance. While we have shown there is a positive correlation between CEO annual pay increases and TSR performance, we are confident the correlation is not as high as that between realizable pay and TSR increases.

Executive Compensation: A Survey of Theory and Evidence

Posted by Alex Edmans, London Business School; Xavier Gabaix, Harvard University; and Dirk Jenter, London School of Economics, on Wednesday, September 6, 2017

Editor's note: Alex Edmans is Professor of Finance at London Business School; Xavier Gabaix is Pershing Square Professor of Economics and Finance at Harvard University; and Dirk Jenter is Associate Professor of Finance at London School of Economics.This post is based on their recent paper. This post is based on their recent paper. Related research from the Program on Corporate Governance about CEO pay includes Paying for Long-Term Performance (discussed on the Forum here) and the book Pay without Performance: The Unfulfilled Promise of Executive Compensation, both by Lucian Bebchuk and Jesse Fried.

Executive compensation is a rich, complex, and controversial topic. In addition to there being an intense debate among academics on its drivers, the efficiency of current practices, and the case for reform, few topics have sparked as much interest among the general public. Politicians, regulators, investors, and executives themselves have all taken strong positions on whether and how to reform pay.

This paper sheds light on this debate by surveying the theoretical and empirical literature on executive compensation. We start in Section 2 by presenting the stylized facts, starting with U.S. data on public firms going back to 1936. We show that, while the level of pay has generally increased over time, this trend has been neither constant nor uniform, contrary to popular belief. We next decompose total pay into its components, illustrating in particular the rise and fall of option compensation, and discuss the increasing use or disclosure of other forms of pay, such as performance-based equity, (multi-year) bonus plans, pensions, perquisites ("perks"), and severance pay. We then present evidence on the level and composition of pay in non-U.S. countries, and survey recent findings on pay in U.S. private firms.

There is considerable debate among both academics and practitioners on what causes the observed trends in pay. There are three broad perspectives. One is the "shareholder value" view, which argues that compensation contracts are chosen to maximize value for shareholders, taking into account the competitive market for executives and the need to provide adequate incentives. Section 3 presents a simple unifying model of the level and sensitivity of pay, in both a static and dynamic setting, under shareholder value maximization. We discuss its empirical implications and the extent to which a shareholder value view can explain the stylized facts. We also address the optimality of relative performance evaluation and debt-based pay, and whether incentives should be provided using stock or options. Section 4 discusses the "rent extraction" view, which argues that contracts are set by executives themselves to maximize their own rents. Since the theoretical development of this view is more limited, we focus on presenting empirical findings suggestive of rent extraction, such as pay for non-performance, hidden pay, and the association of certain

practices with poor corporate governance. A third perspective, which we discuss in Section 5, is that pay is shaped by institutional forces, such as regulation, tax, and accounting policies.

While Sections 3-5 explore the determinants of executive pay, Section 6 summarizes evidence on its effects. Such evidence is relatively scarce, since compensation contracts are endogenous and causal identification is difficult, but we discuss some promising approaches. Section 7 tackles policy interventions that have been proposed, and in some cases enacted, and critically evaluates them using both theory and evidence. Section 8 suggests directions for future research, and Section 9 concludes. We also include an Appendix that provides an overview of institutional detail, such as legislation, disclosure requirements, accounting treatments, and tax treatments, focusing on the U.S. but also discussing the U.K. and Europe. We hope this overview will be particularly useful to those new to the literature.

In addition to the specific conclusions of each chapter, we make the following broader points.

- Observed compensation arrangements result from a combination of potentially conflicting forces—shareholders' desire to maximize firm value, executives' desire to maximize their rents, and the influence of legislation, taxation, accounting policies, and social pressures. No one perspective can explain all of the evidence, and a narrow attachment to one perspective will distort rather than inform our view of executive pay.
- Recent theoretical contributions make clear that shareholder value models can be consistent with a wide range of observed compensation patterns and practices, including the large increase in executive pay since the 1970s. The challenge is now to confront these new models more rigorously with the data, explore their limitations, and contrast them with (mostly yet-to-be-written) rent extraction models.
- Theories of executive pay must take into account the specific features of executives' jobs; models of the general principal-agent problem are not automatically applicable to executives. For example, the skills of executives may be particularly scarce, and CEOs have a much larger impact on firm value than rank-and-file employees, which can fundamentally change the nature of the optimal contract.
- Theorists should consider very carefully their modeling choices. Seemingly innocuous features of the modeling setup, often made for tractability or convenience (such as the choice between additive or multiplicative utility and production functions, or between binary and continuous actions) can lead to large differences in the model's implications—and thus conclusions as to whether observed practices are consistent with theory.
- Compensation contracts have evolved over time. For example, the U.S. has seen a shift in the largest component of CEO pay from cash in the 1970s to options in the 1980s and 1990s and to performance-based stock in the 2000s. The reasons for this evolution are not fully understood. Likely drivers include boards learning over time how to improve pay practices as well as regulatory and institutional changes.
- Attempts to improve CEO pay should focus on the incentives created, and especially on the sensitivity of CEO wealth to long-term performance. The level of pay receives the most criticism, but usually amounts to only a small fraction of firm value. Badly structured incentives, on the other hand, can easily cause value losses that are orders of magnitudes larger.
- Any high-powered incentive contract creates incentives to manipulate the performance measure(s) it relies upon. However, finding that a pay practice, such as equity-linked pay,

is associated with manipulation does not imply that incentive contracts are worse than no incentive contract.

- Most of what we know about executive pay concerns CEOs of U.S. public firms. We need more research on top executives other than CEOs, countries outside the U.S., and private firms.
- Identifying the causal effect of compensation contracts on any interesting outcome variable is extraordinarily difficult. These contracts are endogenous—executives, directors, and compensation consultants spend time and effort designing them, taking into account unobservable firm, industry, and executive characteristics. As a result, compensation contracts are inevitably correlated with these unobservable characteristics, which in turn affect firm behavior, performance, and value.
- There are almost no instrumental variables or natural experiments that create as-good-as-random variation in compensation contracts. The few exceptions have significantly advanced our understanding of the causal effects of executive pay, and we strongly welcome any additions to this short list. On the other hand, insistence on clean identification frequently results in the use of bogus "instruments" that almost certainly violate the exclusion restriction, a focus on narrow questions, or the avoidance of research on executive pay altogether. Much can be learned from papers that do not attempt to identify causal effects, and instead carefully study how firms endogenously choose compensation contracts in different settings.

The complete paper is available for download here.

Tab VI: Mandatory Arbitration and Forum Selection Bylaws

You Want Mandatory Arbitration in your Charter? Hey, Just Ask!

Posted by Cydney Posner, Cooley LLP, on Sunday, August 6, 2017

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

This is the opening paragraph from Tuesday's column by Alison Frankel, one of my favorite legal columnists/bloggers:

> This could be the start of something huge: Securities and Exchange Commissioner Michael Piwowar said in a speech Monday to the Heritage Foundation that the SEC is open to the idea of allowing companies contemplating initial public offerings to include mandatory shareholder arbitration provisions in corporate charters. If Piwowar's statements…mark a new SEC policy on mandatory arbitration, they could be the beginning of the end of securities fraud class actions.

As she continues, the concept of mandatory arbitration of shareholder claims has been run up the flagpole a few times in the past. The idea took hold in the late 1980s, when SCOTUS concluded that stock brokers could enforce mandatory arbitration agreements with customers. However, in subsequent encounters, the SEC has not been particularly receptive to the idea. When a private equity fund sought to go public in 2012 with a provision in its partnership agreement requiring mandatory individual arbitration of any disputes, including disputes under the federal securities laws, Corp Fin advised that it would not accelerate effectiveness of its registration statement, and the provision was withdrawn. Then, in an interesting turn of events, binding shareholder proposals were submitted at several companies seeking to amend their bylaws to *include* mandatory shareholder arbitration provisions. (If this seems a bit curious, the argument submitted by the proponent was that the costs of frivolous class action litigation were ultimately borne by the shareholders, and preventing these suits would therefore benefit shareholders.) Some of these companies, attempting to *exclude*the proposals from their proxy statements, contended that it should be excludable under Rule 14-8(i)(2)— on the basis that implementation would cause the company to violate applicable law—because implementation would violate Section 29(a) of the Exchange Act. Section 29(a) declares void any provision "binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder…." Since the bylaw prohibited claims subject to arbitration from being brought in a representative capacity, that is, in class actions, the company argued, the provision effectively waived shareholders' abilities to bring claims under Rule 10b-5. The SEC allowed exclusion of the shareholder proposal, agreeing that there was some basis for the view that implementation of the proposed bylaw amendment would cause the company to violate the federal securities laws.

As reported, Piwowar "encouraged" companies undertaking IPOs to "come to us to ask for relief to put in mandatory arbitration into their charters." So Piwowar's comments appear to signal the possibility of a shift in the SEC's position, although, as Frankel observes, it's unclear whether new SEC Chair Jay Clayton necessarily agrees with that position. Frankel "talked to six securities law professors on Tuesday about the implications of mandatory shareholder arbitration provisions. Most said a pro-arbitration Supreme Court would likely uphold the legality of such provisions," and at least one also indicated that federal law would likely preempt attempts at the state level to preclude adoption of provisions of this type. And, as Frankel suggests, if "the SEC allows companies going public for the first time to require shareholder arbitration, companies that are already public won't be far behind in imposing the requirement. And that, the profs agreed, will hamper shareholder class actions in state and federal court. If businesses can avoid securities class actions, they will."

SideBar

Note that Piwowar's encouragement is limited to the IPO context; whether the offer would be extended to companies that are already public is not entirely certain. In addition, to include an arbitration provision in a company's charter would require a shareholder vote, which, for an already-public company, could be an obstacle depending on what the charter provides. Of course, companies can usually amend their bylaws without a shareholder vote, but then bylaw changes can typically be more easily undone than charter provisions.

SideBar

And what's up with these invitations to appeal for special exceptions? In this PubCo post of July 12, I wrote about a speech by Jay Clayton in which he reminded companies about the availability of Rule 3-13 of Reg S-X. That rule permits companies to request modifications to their financial reporting obligations where they believe that the required disclosures are burdensome but not material to the total mix of information available to investors. Like Piwowar above, as noted in the post, Clayton encouraged companies to consider submitting these requests "in connection with their capital raising activities," and stressed that the "SEC staff is placing a high priority on responding with timely guidance." Rule 3-13 was also mentioned in the announcement extending the confidentiality provisions, which seems to imply that they really mean it. (See this PubCo post.) This latest request for requests seems to underline that these commissioners may really be willing to entertain providing relief through a series of one-offs. But it remains to be seen how much flexibility the staff will really be willing to provide.

How the markets will feel about mandatory arbitration might be a different story however. Frankel quotes Columbia law professor John Coffee, who "predicted that the combination of non-voting shares and mandatory arbitration clauses would have a price impact on companies going public." Note, however, that the proponents of the shareholder proposals discussed above seemed to think otherwise, viewing mandatory arbitration as cost-saving and therefore shareholder favorable. In addition, as a policy matter, the article asks, without the threat of shareholder class actions, will companies still be deterred from committing securities fraud? Opinions appear to be split. Some commentators suggested in the article that, so long as big institutions don't balk altogether at investing in companies with the charter provision, they will have sufficient interest and adequate funds to continue to pursue—and thus deter—fraudsters. However, others expressed concern for small holders, who would essentially be "left in the cold"—not that they

usually reap great rewards from class actions anyway—and questioned whether, in the absence of public trials and related publicity, individual private arbitrations would adequately deter fraud.

SideBar

Interestingly, the CFPB has recently adopted a new rule that would prohibit mandatory individual arbitration provisions in agreements related to bank accounts and credit cards. However, as reported in The Hill, a group of Republican Senators has introduced a bill to repeal the rule, with several House members to follow suit. Under the Congressional Review Act, Congress can jettison agency rules adopted within the preceding 60 days by simple majority vote and a presidential signature, avoiding a Senate filibuster. You may recall that the CRA was used to repeal the SEC's resource extraction disclosure rules. (See this PubCo post.)

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Delaware's Fall: The Arbitration Bylaws Scenario

Posted by Lynn M. LoPucki, UCLA Law School, on Friday, May 19, 2017

Editor's note: Lynn M. LoPucki is Security Pacific Bank Distinguished Professor of Law at the UCLA Law School. This post is based on a recent article by Professor LoPucki, forthcoming in *Delaware's Dominance in Corporate Law* (Stephen Bainbridge, ed., Cambridge University Press 2018). This post is part of the Delaware law series; links to other posts in the series are available here.

Until recently, Delaware's dominance in the competition to sell corporation charters was considered so great as to be irreversible. Scholars assumed that if another state were to discover a method to compete effectively, Delaware could simply copy it. But the current threat to Delaware's dominance comes not from another state, but from arbitration bylaws. Delaware cannot solve the problem by copying because the U.S. Constitution prohibits states from offering secret arbitration.

For Delaware, loss of its cases to arbitration would a crippling blow. Delaware dominates the charter competition by leveraging its unique Chancery Court. Unlike the courts of other states, the Chancery Court is significantly specialized in corporate law, publishes its opinions, has a large body of precedent, tries cases without juries, and has the resources and motivation to provide quick hearings. Other states cannot copy Delaware because they do not incorporate sufficient numbers of companies to generate sufficient litigation to support a court specialized in corporate law, because their governments are not dependent upon, and so not fully supportive of, their efforts to compete for charter sales, and because their constitutions guarantee the right to trial by jury.

Delaware has leveraged its unique judicial advantage by encouraging its judiciary to make corporate law on a case by case basis. To provide that encouragement, Delaware has made its corporation law vague, complex, and indeterminate. The advantage to Delaware was that it became possible for Delaware judges to resolve cases based largely on the interests of managers and Delaware. The litigation provided work for Delaware lawyers and enabled them to develop corporate expertise. Because they had that expertise, Delaware gave its lawyers control over the legislative process with respect to corporate law.

Delaware's highly successful judicial strategy now appears to be unraveling. Beginning in 2001, Delaware Chancery Court cuts to the fees of plaintiffs' attorneys began making it difficult for that Court to attract cases. In 2010, the Court changed strategies by encouraging corporations to adopt "forum selection" bylaws. Delaware corporations adopted them, but have treated the bylaws as merely options to take cases to Delaware when the Delaware courts offered strategic advantage. The effect is to pressure the Delaware courts to favor managers even more flagrantly in litigation. If the Delaware courts give in, Delaware's and the charter competition's legitimacy

may be impaired. If they don't, Delaware will continue to lose its cases. Either way, Delaware is at risk.

Arbitration bylaws may be Delaware's *coup de grace*. Corporations have already begun adopting them, and they have been upheld in a few cases decided under Maryland law. The U.S. Supreme Court has held that the states cannot refuse to enforce contracts that provide for arbitration. The Delaware courts have held that certificates of incorporation and bylaws are contracts. It would seem to follow that Delaware cannot refuse to enforce bylaws that provide for the arbitration of shareholder litigation.

Delaware's corporations are likely to prefer arbitration for five reasons. First, arbitrations could be secret, thus sparing the companies and their managers the embarrassment of litigating in public. Second, arbitration bylaws need not provide for class representation or fee awards to plaintiffs' attorneys. The effect would be to prevent many, if not most, claims from being brought at all. Third, arbitrations could occur in locations convenient to the parties and their attorneys—including cyberspace. Because the arbitrations would not be in the Delaware courts, the parties could employ the counsel of their choice; they would not need to be represented by members of the Delaware bar. Fourth, the companies and their managers could write their own procedures and tailor them to different kinds of cases. Small cases could be heard by a single arbitrator without the possibility of appeal, while bet-the-company cases were heard by three arbitrators with the possibility of appeal. If shareholders objected to the procedures, the companies and their managers could negotiate the objections. Lastly, cases filed anywhere other than in the designated arbitration tribunal could be immediately dismissed, eliminating the problem of multi-district litigation.

From 2009 to 2013, Delaware attempted to provide secret arbitration through its Chancery court. The attempt was rebuffed in a 2-1 decision of the Third Circuit in 2013. After the Supreme Court denied certiorari, Delaware abandoned the strategy and prohibited arbitration bylaws.

Arbitration bylaws would not merely move the same cases to different forums. Arbitration bylaws would bar plaintiffs from proceeding in representative capacities and bar arbitrators from providing fee awards to successful plaintiffs. Because most plaintiffs who bring shareholder litigation do not individually have enough money at stake to warrant even the cost of arbitration, a shift to arbitration would sharply reduce the numbers of cases brought.

Without enough cases, Delaware's judicial strategy would fail, leaving that state with little advantage over competing states. Competing states may seize the opportunity by adopting statutes that allow certificate of incorporation and bylaw provisions to displace *all* provisions of their corporation laws—to the full extent of the internal affairs doctrine. Because states need no corporate law expertise to enact such a statute and their courts need no corporate law expertise to enforce arbitration awards, Delaware's history, familiarity, networks, and precedent would count for little. Corporate charter competition might turn solely on price and the quality of the states' websites. No state could gain significant revenues in so competitive an environment. Delaware would be out of business, but charter competition could continue to provide a forum in which the states could demonstrate their business-friendliness, and by doing so attract economically significant business activity.

The complete article is available for download here.

Op-ed: Shareholders Deserve Right to Choose Mandatory Arbitration

AUGUST 21, 2017

Originally published by the CLS Blue Sky Blog on August 21, 2017

On July 17, SEC Commissioner Michael Piwowar extended an important invitation to U.S. public companies. "For shareholder lawsuits," Piwowar offered, "companies can come to [the SEC] to ask for relief to put… mandatory arbitration into their charters." To some, this idea may be unfamiliar or even controversial. But, as someone who has studied the U.S. securities class action system and its impact on our capital markets extensively, I know this policy is a sound one that serves U.S. investors and markets well.

Indeed, the Committee on Capital Markets Regulation, which I direct, first introduced the idea of corporation-stockholder non-class arbitration in 2006, and I have long supported shareholders' right to opt out of the costly and ineffective system of securities class action litigation and into a system of mandatory arbitration to resolve issuer-stockholder disputes. Such arbitration provisions may be included in a company's charter, as Commissioner Piwowar suggests, or adopted through a shareholder proposal to amend a company's by-laws.

Commissioner Piwowar's offer is an important one, because it should be up to shareholders to decide whether they wish to resolve securities law disputes through arbitration or class actions. And preserving shareholder choice on this matter is especially critical because of the demonstrated problems that securities class actions create for U.S. investors and markets.

The U.S. system of securities class action litigation is anomalous and extreme—the U.S. is the only developed country where public company stockholders can form a class and sue their own company for securities law violations (typically disclosure failures). Going public in the U.S. exposes companies to litigation risk that can cost them billions of dollars—the mere filing of such a suit can reduce a company's market value by 10 percent, and public companies have paid $55.6 billion in securities class action settlements in the last 10 years.

Troublingly, these suits are being filed at record rates. In the first half of 2017, 226 federal securities fraud class actions were filed, 135 percent above the semiannual average during the 1997-2016 period. And if filings against U.S. exchange-listed companies continue at their current 2017 pace, these suits will target one in 11 of such firms this year, the highest rate since 1997.

This is a serious problem for U.S. markets, because it discourages U.S. companies from going public and foreign companies from doing so in the United States. These suits also create problems for the shareholders they are supposed to protect, because

they fail to accomplish their two major goals: compensating harmed investors and deterring bad behavior.

U.S. securities class actions do a poor job of compensating investors because shareholders themselves bear the costs of these lawsuits. As former SEC Commissioner Paul Atkins explains, “the costs of defending and settling these suits are borne by the company’s shareholders, leading to an absurd situation in which money is merely shifted from one group of innocent investors to another, with plaintiff and defense attorneys siphoning off billions of dollars in the process.”

The data on lawyers’ fees and investor recoveries speak for themselves. Last year, securities class action plaintiffs’ attorneys brought home roughly $1.27 billion in fees and expenses—a healthy chunk out of the $6.4 billion in aggregate U.S. settlements. For smaller settlements, lawyers take an even bigger piece of the pie: For settlements below $10 million, plaintiffs’ attorneys generally walk away with about 30 percent of the value. Of course, because institutional investors effectively sue themselves in these suits, their net recoveries are negative. Potential shareholder recoveries are in fact so small that CCMR found that holders of only 40-60 percent of potentially eligible shares bother to submit a claim.

These shareholder suits also achieve little in the way of deterrence. Securities law violations are committed by individual actors, but it is a company’s shareholders that shoulder the costs of lawsuits seeking corporate damages. In fact, a company’s directors and officers rarely contribute to these payments themselves.

Furthermore, the need for private class actions to deter securities fraud is questionable in light of the country’s robust public system of enforcement. Government agencies like the SEC and Department of Justice are strong enforcers of the securities laws and have ramped up their efforts since the financial crisis. In fiscal 2016, for example, the SEC brought 33 percent more enforcement actions against public company defendants and obtained 68 percent more in monetary penalties and disgorgements from public company defendants than they did in fiscal 2010. And while plaintiffs’ lawyers invariably sue corporations in search of the largest and most likely payout, public enforcement agencies consider cases on the merits, including whether it is appropriate to pursue specific individuals instead of the company, enhancing their ability to deter fraud.

Given the high costs and uncertain benefits of these suits, shareholders may view individual arbitration as a more appropriate mechanism to resolve issuer-stockholder disputes. For example, non-class arbitration involves higher levels of shareholder engagement due to their direct involvement (versus their passive role in class litigation led by lawyers), and this can lead to better investor compensation on an individual basis. The data on disputes involving consumers of financial services and products are illustrative. Consumers who are successful in arbitration receive an

average of $5,389 and generally obtain relief within two months; those who receive class action cash payments recover about $32, and these lawsuits usually take years. In any event, Commissioner Piwowar's policy rightfully puts the ball in the shareholders' court.

The SEC need not itself take any position on the desirability of securities class actions, it need only permit shareholders to decide on whether they want to permit them.

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Forum-Selection Provisions in Corporate "Contracts"

Posted by Helen Hershkoff and Marcel Kahan, New York University School of Law, on Monday, September 11, 2017

Editor's note: Helen Hershkoff is the Herbert M. and Svetlana Wachtell Professor of Constitutional Law and Civil Liberties at the New York University School of Law. Marcel Kahan is the George T. Lowy Professor of Law at the New York University School of Law. This post is based on a recent paper by Professor Hershkoff and Professor Kahan.

In our paper, we consider the emergent practice of including clauses in corporate certificates of incorporation or bylaws that specify an exclusive judicial forum for lawsuits. So far, state and lower federal courts that have considered whether such clauses are valid or enforceable have applied a contractual approach that mimics judicial treatment of forum-terms in ordinary contracts.

It is old news that parties to a contract are allowed to do things that the state cannot. The U.S. Supreme Court has upheld the validity of contractual forum-selection terms on the view that it is efficient and fair to let the parties decide to choose where and how to litigate. Under the corporation-as-contract conception, permitting a corporate charter or bylaw—the constitutive documents of a corporation—to specify where shareholders can sue the company would seem the logical next doctrinal step.

We say: not so fast. Treating corporate charter and bylaw forum-terms as a matter of ordinary contract doctrine is neither logical nor justified. While there is a family resemblance, a corporation's charter and bylaws are no ordinary contracts. Rather, they are hybrid legal structures that provide a mechanism for collective choice in the context of substantial state regulation and straddle the public-private divide in ways that make them quite dissimilar from ordinary contracts.

Indeed, their unusual features make applying a contractual paradigm to corporate forum-terms vulnerable to two significant challenges. First, charters and bylaws involve a type of consent that often is only distantly related to contract principles. Even academic proponents of the corporation-as-contract model admit that terms added after a company has issued its stock are contractually suspect. These so-called "mid-stream" amendments do not bear a hallmark of consent equivalent to ordinary contracts.

Second, charters and bylaws involve the state in ways that are at odds with private-ordering principles. To be sure, state judicial decisions routinely call the state a party to the corporate "contract" of a domestic corporation. But the state reserves rights that typically are not a part of an ordinary contract—above all, the unilateral right to enact laws that retroactively modify or render invalid aspects of the corporate-governance structure.

States, however, operate under legal constraints that do not apply to private actors. These constraints are particularly pronounced in the context of laws that restrict access to the courts or disfavor the interests of other states. Thus, the Constitution generally does not permit a state to adopt a "forum-selection" statute that eliminates a party's right to sue in the courts of a sister state or in federal court. Should the notionally private corporate "contract" be subject to these constraints imposed on the state because the state is considered to be a party to the contract? Conversely, should the intermediary of the "corporate contract" permit the state to achieve indirectly goals that it could not achieve directly because of constitutional limits on state government power?

These questions have current importance. Several states, including Delaware, recently amended their laws to authorize companies to designate the courts of the state of incorporation as exclusive fora for corporate litigation via a charter or bylaw provision. Corporations, in increasing numbers, have adopted such provisions. The propriety of such terms goes to core matters of judicial federalism and corporate governance.

Moreover, even if corporate forum-terms can be justified, corporations have started to use the contractual paradigm to adopt provisions that have farther reaching effects on jurisdictional doctrine. In particular, corporations have begun to adopt bylaw provisions that postulate that a shareholder who bought stock after the term was added shall be "deemed" to have "consented" to personal jurisdiction in the selected-forum court to enforce the forum-selection term if that shareholder were to file an action in a different court. A state could not mandate such a result, but it is a result that very quickly could become entrenched through the reflexive—and, in our view, inappropriate—application of the contractual approach.

Although the contractual paradigm is not a sufficient basis for the blanket enforcement of corporate forum-terms, enforcement may often be desirable. Arguably, the emergence of corporate forum-terms is attributable to a strategy to curb abuses in representative litigation, with the Delaware judiciary as chief designer of that strategy. Delaware judges recently have announced a crackdown on settlements in merger-related corporate disputes that provide for minimal recovery to shareholders, high fees to plaintiffs' attorneys, and broad releases of claims. These settlements are doubly problematic as they both induce plaintiffs' attorneys to bring low-merit "strike" suits and, by releasing occasional meritorious claims without investigation, undermine incentives to comply with the law. Centralizing representative merger-related litigation involving Delaware corporations in Delaware—as is achieved through corporate forum-terms—may be necessary to assure that Delaware's strategy is not undermined by other courts. The benefits from this strategy may be lost if party consent is the sole touchstone for the enforceability of corporate forum-terms turns.

We argue that the type of consent provided, the state's role in corporate law, principles of federalism, and the implications of a forum-term for the efficiency of litigation and the ability to vindicate private rights should all bear on the enforceability of these provisions. Because the relevant plaintiffs have provided no meaningful consent, corporate forum-terms that purport to encompass claims by non-shareholders that are not derivative should not be enforced. Likewise, forum-terms that divest federal courts of diversity jurisdiction should only be enforced against shareholders who affirmatively consented to the term (such as by voting in favor).

In other situations, courts should consider, before enforcing a corporate forum-term, whether adjudicating the entire dispute in the designated forum would be efficient (e.g., whether the court has subject matter jurisdiction over all claims) or fair (e.g., whether the procedural rules, including the limitations period, of the designated forum are substantially more advantageous to the defendants than those of the state that supplies the substantive law). One implication of this approach is that forum-terms that select the courts of the state of incorporation for "internal affairs" disputes should generally be enforceable, but that forum-terms that select an alternate forum should receive greater scrutiny. Similarly, in the context of representative suits, the limited form of "consent" by class members to these suits and the benefits of avoiding the pathologies of multi-forum litigation militate in favor of enforceability of forum-terms. By the same token, however, any decision by the corporation to waive a forum-term in a representative suit needs to receive careful judicial scrutiny.

Moving beyond adjudicative practice, we also assess the likely impact of corporate forum-terms upon interstate competition for incorporation and for corporate litigation. As the quality of the Delaware courts is generally seen as a significant factor in inducing corporations to incorporate in Delaware, permitting Delaware companies to select a forum-term choosing its courts will increase Delaware's competitive edge in the market for incorporations. But requiring that a lawsuit be filed in a certain jurisdiction also benefits the bar in that jurisdiction. To the extent that the statutes adopted in some of the several states, permitting only the designation of that state's courts as exclusive fora, but barring companies from selecting another state's courts, were meant to promote the self-interest of the local bar, the Commerce Clause may provide grounds for sister states to refuse to enforce the forum-terms.

The complete paper is available for download here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Forum-Selection Bylaws—Another Attack Rebuffed

Posted by Eric M. Roth and Eric S. Robinson, Wachtell, Lipton, Rosen & Katz, on Thursday, December 15, 2016

Editor's note: Eric M. Roth and Eric S. Robinson are of counsel at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton publication by Mr. Roth, Mr. Robinson, and Aneil Kovvali. The memorandum discusses the continued judicial acceptance of exclusive forum bylaws, which were put forward by Wachtell Lipton partner Theodore N. Mirvis and discussed by him on the Forum here, here, and here. This post is part of the Delaware law series; links to other posts in the series are available here.

In previous posts (available here and here), we have tracked the increasing judicial acceptance of forum selection bylaws adopted by Delaware corporations in the wake of the 2013 Court of Chancery decision in *Chevron* and the 2015 enactment of Section 115 of the Delaware General Corporation Law. Some plaintiff's law firms nevertheless continue to file breach of fiduciary duty claims in other states against Delaware companies that have adopted forum selection bylaws, in apparent response to the Court of Chancery's recent crackdown on disclosure-only settlements. [On December 12, 2016], a Missouri state court rejected the most recent attempt to circumvent a Delaware forum bylaw, amplifying the trend toward enforcement of such bylaws adopted in anticipation of, or in connection with, a potential corporate transaction.

Monsanto Company is a Delaware corporation headquartered in Missouri. In the weeks leading up to its approval of a $66 billion merger agreement with Bayer AG, the Monsanto board adopted a bylaw requiring that any fiduciary duty litigation against the company or its directors be brought in the Delaware courts.

After Monsanto mailed its proxy statement for the merger, a shareholder plaintiff sued Monsanto, Monsanto's board and financial advisors, and Bayer in Missouri state court, alleging that Monsanto's directors breached their fiduciary duties in negotiating the merger and issuing a misleading proxy statement, and that the financial advisors and Bayer aided and abetted that purported breach. In response to the defendants' motions to dismiss the action, plaintiff argued that enforcement of Monsanto's forum selection bylaw would infringe his federal and state constitutional rights because jury trials are unavailable in the Delaware Court of Chancery. The Missouri court rejected plaintiff's arguments and dismissed the action.

This result is consistent with federal appellate precedents that have enforced forum selection clauses in bilateral contracts even when the designated forum would not provide a jury trial. In light of this decision and other recent precedents confirming the validity and enforceability of forum selection bylaws, Delaware companies should continue to consider the adoption of state-of-the-art bylaws to manage opportunistic shareholder litigation brought in forums other than Delaware.