Harvard Roundtable on Shareholder Engagement

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Part I: The Continuing Debate Over Dual-Class Stock

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.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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The Life-Cycle of Dual Class Firms

Posted by Martijn Cremers (University of Notre Dame and ECGI), Beni Lauterbach (Bar Ilan University and ECGI), and Anete Pajuste (Stockholm School of Economics and ECGI), on Tuesday, May 1, 2018

Editor's note: Martijn Cremers is Bernard J. Hank Professor of Finance at University of Notre Dame Mendoza College of Business, and an ECGI research member; Beni Lauterbach is a Professor of Finance and the Raymond Ackerman Family Chair in Corporate Governance at Bar Ilan University Graduate School of Business Administration, and an ECGI research member; Anete Pajuste is an Associate Professor of Finance and Head of Accounting and Finance Department at the Stockholm School of Economics, and an ECGI research member. This post is based on their recent paper.

Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock (discussed on the Forum here) and The Perils of Small-Minority Controllers (discussed on the Forum here), both by Lucian Bebchuk and Kobi Kastiel.

In our paper, The Life-Cycle of Dual Class Firms, we consider the market valuation of dual class firms over their life cycle. Dual class financing is on the rise in recent years, particularly among high-tech firms, following Google's seminal 2004 dual-class IPO structure. This financing choice leaves control of the firms in the hands of entrepreneurs, giving outside investors with inferior-vote shares no direct mechanism to influence the board or management. Rather, public investors buying inferior vote shares at the IPO are betting that granting the entrepreneurs such control allows them to better implement their unique vision.

However, as dual class firms mature and their vision is largely accomplished, entrepreneurs' leadership may no longer be needed, and entrepreneurs may start self-serving behavior. Public investors' resentment may then develop, accusing dual class firms' controlling shareholders for wanting their money without any accountability. Such public pressure arguably recently led MSCI to issue a proposal to reduce the weight of inferior-vote shares in MSCI indices by multiplying the regular weight by the shares fractional voting power. Notably, the same MSCI also issued a report a few months ago stating that "[o]ur research shows that unequal voting stocks in aggregate *outperformed* the market over the period from November 2007 to August 2017, and that excluding them from market indexes would have reduced the indexes' total returns by approximately 30 basis points per year over our sample period." Obviously, confusion reigns over the merits of dual class financing.

Bebchuk and Kastiel (2017) (The Untenable Case for Perpetual Dual-Class Stock, *Virginia Law Review*) argue that any initial benefits of dual class structures decay with firm age, while the potential agency costs associated with dual class structures increase with time. Thus, Professors Bebchuk and Kastiel advocate sunset clauses to dual class financing. The sunset clauses would require the "non-interested" public shareholders of the firm to vote on whether or not to extend the dual class structure, some pre-determined number of years after the IPO. If the extension proposal is declined, firms would unify the low- and high-vote shares, i.e., convert all shares into a single class of shares with "one share one vote".

In our paper, we empirically investigate the desirability of sunset provisions by examining the life-cycle of dual class firms. Using an extensive sample of all single-and dual-class firm IPOs in the U.S. during 1980-2015, and relying on comparing dual class firms to similar single class firms, we document several novel phenomena in the life cycle of dual class firms.

First, the difference in firm valuation between dual and single class firms strongly varies over the corporate life cycle. At the IPO, dual class firms tend to have *higher* valuations, as at the IPO year-end the market valuation of dual class firms is, on average, 11% higher than that of matched single class firms. This initial valuation premium of dual class firms dissipates in the years after the IPO, and on average it becomes insignificantly negative about six to nine years after the IPO. We also find that the difference between the voting and equity stakes of the controlling shareholders of dual class firms (the "wedge") tends to increase as the firm ages. According to one of our estimates, the mean wedge increases from 16% one year after the IPO to 22% five years after the IPO, and to 26% nine years after the IPO. The widening of the wedge is typically associated with more severe valuation reducing agency problems—see Masulis et al. (2009) (Agency Costs and Dual-Class Companies, *Journal of Finance*). Bebchuk and Kastiel (2018)(The Perils of Small-Minority Controllers, forthcoming *Georgetown Law Review*) analyze the perils of the widening wedges and advocate informing the public and capping it.

Second, we document interesting differences between dual class firms with a valuation premium (relative to their matched single class firms) at the IPO and dual class firms with a valuation discount at the IPO. Dual class firms with a valuation premium at the end of their IPO year gradually tend to lose this premium, until their valuations become very similar to those of their single class counterparts about six to nine years after the IPO. In contrast, we find no evidence for a life cycle in the relative valuation of initially discounted dual class firms, as their valuation discount persists from the time of their IPO to when they are mature dual class firms as well. The behavior of the subsample of dual class firms with a valuation premium at the IPO suggests that for some firms the dual class structure does not harm valuations, at least in the first decade after the IPO. On the other hand, the behavior of the subsample of dual class firms with an initial valuation discount, which we find is highly persistent, suggests that a mandatory sunset provision may be useful for these firms.

Third, a natural solution to possible dual class inefficiency is a voluntary firm-initiated dual class share unification, in which all share classes are transformed into "one share one vote". We find that only about 20% of dual class firms unify their shares within 9 years after the IPO. Furthermore, voluntary unifications become rare after six years following the IPO. Most of the mature dual class firms elect to retain a dual class structure, perhaps because unification is against the interests of their controlling shareholders. This implies that some inefficient dual class structures may persist.

Our findings suggest that some sort of a sunset provision might be useful, especially for firms that trade at a valuation discount. Further, regarding the set-in time of any sunset provision, our study suggests to wait at least six years after the IPO. Regulators should also be worried about some potential negative consequences of any sunset regulation. First, some founders may be more reluctant to issue publicly traded shares if their reign over the firm is likely to be more limited in time. Public may lose the opportunity to invest in some breakthrough firms. Second, controlling shareholders may intensify their private benefits extraction in the period before their extra power expires. Third, it is possible that shareholders may elect to abolish dual class structures even when they are (still) beneficial.

Finally, our paper also documents several other interesting life cycle phenomena of dual class firms such as their higher survival rates, similar stock returns and lower likelihoods of being taken over, compared to matched single class firms. We conclude that unequal vote structures are viable financing tools.

The complete paper is available for download here.

The Perils of Small-Minority Controllers

Posted by Lucian A. Bebchuk, Harvard Law School and Kobi Kastiel, Harvard Law School, on Monday, February 26, 2018

Editor's note: Lucian Bebchuk is James Barr Ames Professor of Law, Economics and Finance, and Director of the Corporate Governance Program, at Harvard Law School. Kobi Kastiel is Research Director of the Program's Project on Controlling Shareholders and Assistant Professor at Tel-Aviv University Faculty of Law. This post is based on their recent study, available here.

Dropbox filed IPO documents last week, and our analysis of these documents reveals considerable risk that the company's co-founders would hold lifetime control even if they would retain only a tiny minority of the company's equity capital. In a study that we just placed on SSRN, The Perils of Small-Minority Controllers, we seek to place a spotlight on a significant set of dual-class companies whose structures raise especially severe governance concerns: those with controllers holding a small minority of the company's equity capital.

We analyze the perils of small-minority controllers, explaining how they generate considerable governance costs and risks and showing how these costs can be expected to escalate as the controller's stake decreases. We also identify the mechanisms that enable such controllers to retain their power despite holding a small or even a tiny minority of the company's equity capital. Based on a hand-collected analysis of governance documents of these companies, we present novel empirical evidence on the current incidence and potential growth of small-minority and tiny-minority controllers. Among other things, we show that governance arrangements at a substantial majority of dual-class companies enable the controller to reduce his equity stake to below 10% and still retain a lock on control, and a sizable fraction of such companies enable retaining control with less than a 5% stake.

Finally, we examine the considerable policy implications that arise from recognizing the perils of small-minority controllers. We first discuss disclosures necessary to make transparent to investors the extent to which arrangements enable controllers to reduce their stake without forgoing control. We then identify and examine measures that public officials or institutional investors could take to ensure that controllers maintain a minimum fraction of equity capital; to provide public investors with extra protections in the presence of small-minority controllers; or to screen midstream changes that can introduce or increase the costs of small-minority controllers.

Below we provide a more detailed account of our analysis:

Snap, the owner of the disappearing-message application Snapchat, went public last March at a valuation exceeding $20 billion. The company used a multiple-class structure that would enable its young co-founders, Evan Spiegel and Bobby Murphy, to have lifetime control of the company.

Following the initial public offering, Spiegel and Murphy owned a substantial fraction of Snap's equity capital—about 18% each. Our analysis of Snap's IPO structure indicates that it would enable the co-founders to unload an overwhelming majority of their shares—lowering their economic stakes to less than 1% of the company's equity capital—and still retain control. Notably, however, Snap's offering documents omitted this crucial fact.

Similarly, Facebook, Snap's larger and older rival, went public in 2012 with a dual-class structure that placed significant limits on the ability of its founder, Mark Zuckerberg, to reduce his fraction of equity capital without relinquishing control. In April 2016, however, Facebook passed a reclassification plan, approved by Zuckerberg's majority voting power, that would have enabled Zuckerberg to sell two-thirds of his Facebook shares—reducing his stake of equity capital to about 4% and possibly less—without losing his controlling voting power. In September 2017, however, Facebook announced its decision not to proceed with the reclassification plan for the time being, and Zuckerberg currently continues to face significant limits on his freedom to unload shares without losing his control.

In our paper, we focus on such situations — dual-class structures that enable controllers to have a lock on control with only a small or even a tiny fraction of the company's equity capital. In the long-standing debate on dual-class structures, both proponents and opponents have often lumped all dual-class structures together into one category. By contrast, we seek to reorient the debate by stressing certain key differences among dual-class structures.

Dual-class structures generally enable a shareholder to retain a lock on control with less than a majority ownership stake. Dual-class structures thus commonly enable what the literature labels as a "controlling minority shareholder" (Bebchuk-Kraakman-Triantis (2000)). In our paper, however, we focus on the subset of controlling minority shareholders whose stake is not merely a minority stake, but rather a "small-minority" stake (defined as below 15% of equity capital), a "very-small-minority" stake (below 10%) or even a "tiny-minority" stake (below 5%). Controllers holding such stakes pose enhanced governance risks relative to other controlling minority shareholders, and therefore they deserve the close attention of public officials and institutional investors.

The analysis of our paper is organized as follows. Part II begins by discussing the long-standing and heated debate over dual-class structures and how we aim at contributing to it and reorienting it. We then turn to explain why structures with small-minority controllers can be expected to produce considerable governance risks and costs. In companies that are widely held, the market for corporate control and the threat of replacement incentivizes corporate insiders to serve the interests of public investors. In companies with a majority owner, the disciplinary force of the control market does not operate, but the controller's ownership stake forces the controller to bear the majority of the effect of his choices on total market capitalization, and thus provides strong ownership incentives that align the controller's interests with those of public investors. By contrast, a company with a small-minority controller lacks both the discipline of the control market and the incentives generated by having to bear a majority of any effect on total market capitalization.

We show how the decisions made by small-minority controllers can be expected to be distorted across a wide range of corporate choices—including allocation of opportunities and talents, decisions whether to remain as the CEO, choices of strategy and company scale, related-partytransactions, and responses to acquisition offers. In each of these contexts, we show, there is a substantial risk that the choices of small-minority controllers would be significantly distorted.

Part III of our paper identifies and explains the operation of mechanisms that are used to enable shareholders to retain control despite owning only a small minority of the company's equity capital. Furthermore, using a hand-collected dataset of governance arrangements in dual-class companies, we provide empirical evidence about the incidence and use of these mechanisms.

The mechanisms that Part III analyzes include (i) "hardwiring" provisions granting the controller the ability to elect a majority of board members, or to cast a fixed fraction of votes, regardless of how small the controller's equity stake might become; (ii) a large difference between the voting power of high-vote and low-vote shares; (iii) nonvoting shares, which represent an extreme case of infinitely high ratio between the voting power of high-vote and low-vote shares; (iv) arrangements aimed at limiting the consequences that stock sales by the controller could have for the controller's lock on power; and (v) arrangements aimed at constraining the consequences that high-voting shares held by third parties could have on the controller's lock on power.

Part III also analyzes midstream changes, such as nonvoting stock reclassifications, that can be used to amend existing governance arrangements to enhance the controller's ability to unload shares without relinquishing control. We show that the future use of such nonvoting stock reclassification could enable controllers to reduce their ownership stakes to negligible levels without weakening their grip on control.

Part IV presents novel empirical evidence, based on our hand-collected dataset of governance provisions in dual-class structures, on the incidence of small-minority, very-small-minority, and tiny-minority controllers. Importantly, we analyze not only current equity stakes but also the extent to which controllers would be able to reduce their equity stakes in the future without relinquishing control. Existing governance provisions plant the seeds for future increases in the separation between control and ownership stake, so we also analyze the minimum equity stake that the controller at each company would need to hold to retain control.

We find that, in a *sizable fraction* of cases, the governance provisions in place would enable the controller to hold less than 5% of the equity capital (and thus be a "tiny-minority controller") and still retain control. Furthermore, in a *substantial majority* of cases, the governance provisions in place would enable the controller to hold less than 10% of the equity capital (and thus be a "very-small-minority") and still retain control. Finally, in an *overwhelming majority*, the governance provisions in place would enable the controller to hold less than 15% of the equity capital (and thus be a "small-minority controller") and still retain control.

Part V discusses the implications of our analysis for future policymaking and capital market practices. To begin, public officials and institutional investors should recognize the substantial governance risks associated with small-minority controllers. The extent to which governance arrangements can be used to expand the "wedge" ¾ the gap between the controller's fraction of voting rights and his fraction of equity capital ¾ is commonly not transparent to investors. Thus, disclosure rules should require companies to provide such information. In assessing the extent to which dual-class companies pose governance risks, public officials and institutional investors should play close attention to the existing and potential level of the wedge.

Furthermore, we identify and discuss arrangements that could be used to address the current and future presence of small-minority controllers. Institutional investors could press for or encourage the introduction of such measures, and public officials could consider using their legal and regulatory tools to ensure a uniform adoption of such measures. Here we discuss three types of arrangements: (i) arrangements aimed at limiting the extent to which controllers can lower their ownership stake without weakening their lock on control; (ii) arrangements aimed at providing additional protections to public investors in situations where small-minority controllers would remain in control; and (iii) arrangements aimed at preventing midstream changes, such as nonvoting stock reclassifications, that would introduce or exacerbate the governance costs of small-minority controllers.

Before proceeding, we should note that some corporate law scholars oppose any limits on the structures that companies going public may offer to investors. The debate on contractual freedom in corporate law is long-standing and raises general questions that go beyond the scope of this paper. While we subscribe to the view that it is desirable to place some constrain on IPO choices, as existing corporate and securities law do, this paper does not seek to repeat the arguments for this view or otherwise to contribute to the debate on contractual freedom. However, because we recognize that some readers could well support in principle allowing companies to go public with any structures they choose, we wish to stress that our analysis should be of interest even to such readers.

To be sure, such readers would not support requiring dual-class companies to adopt governance provisions that place any limit on the size of the stake that controllers would be required to have to retain control. However, the main contribution of our paper, and one which should be of interest even to such readers, is to provide an understanding of the governance risks posed by small-minority controllers. To the extent that such risks are significant, even such readers should recognize the benefits to public officials and institutional investors of understanding these risks. Obtaining such an understanding would be essential for facilitating the introduction of private-ordering arrangements that would serve the interests of public investors; for judicial application of an appropriate level of scrutiny to controller actions; and for the development of disclosures that would provide adequate transparency of the risks posed to public investors and would help IPO investors to price these arrangements accurately.

Our paper 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

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

[3] *Id*. at 16.

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

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

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

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

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

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

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

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

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

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

Mutualism: Reimagining the Role of Shareholders in Modern Corporate Governance

Posted by Kara M. Stein, U.S. Securities and Exchange Commission, on Thursday, February 15, 2018

Editor's note: Kara M. Stein is a Commissioner at the U.S. Securities and Exchange Commission. The following post is based on Commissioner Stein's recent remarks at Stanford University, available here. The views expressed in the post are those of Commissioner Stein and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

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Tonight [Feb. 13, 2018], I want to talk to you about something that has been vigorously debated in recent years: What is, and what should be, the role of the corporate shareholder? In the spirit of being in California, this debate could be summarized as follows: Are shareholders merely extras in the corporate movie? Or are they lead actors that need to be empowered so that they can successfully play their roles? However, as most people in this room know, it is actually much more complicated than that. It is not, and should not be conceptualized as, a binary choice. Rather, I would posit that the entire corporate ecosystem's success actually rests on effective communication and collaboration between corporations and their shareholders. When a company, its management, its shareholders, and its employees work together, companies tend to be more resilient and prosperous. In turn, this benefits companies, their corporate stakeholders, and the economy as a whole.

Today's corporations influence and impact our society in a multitude of ways. Corporations help grow our economy, provide well-paying jobs, and provide earnings to investors saving for retirement, college, or a new home. Many companies, whether small or large, are helping to drive our society forward, developing new technologies that are raising our living standards, improving our environment, and lengthening our life span. Corporations hold some of our most precious assets, such as medical histories, consumer bank account information, addresses, and other sensitive information. They also are central players in some of our most immediate problems, such as global warming.

Corporations have shaped, and will continue to shape, our society, our identities, and our relationships with one other. This week's series seeks to promote a discussion of the interrelationship and interdependency between corporations and our society. Pretty heady stuff, to be sure, but extremely important. Not only from an academic point of view, but from a practical and policy point of view, as well.

So, I thought I would start off our discussion tonight by talking a bit about the science of "mutualism." For those of you not familiar with the concept, mutualism is a symbiotic relationship between individuals of different species in which both benefit from the association. One example of mutualism is the relationship between bees and flowers. Bees fly from flower to flower gathering nectar to make food. By flying from flower to flower, bees pollinate the plants on which they land. Bees get to eat, and the flowering plants get to reproduce. Bees help plants grow, thus supporting other animals, including us humans. The bee-flower relationship is integral to our entire food chain, and our larger ecosystem.

The relationship between a company and its shareholders is rooted in a similar form of mutualism. Shareholders invest their savings or capital in a company. The company then deploys the capital to fund its operations. This allows the corporation and its shareholders' investments to grow. This corporation-shareholder relationship is likewise part of a larger ecosystem. When all goes well, more employees and managers get hired, and the company produces more products or provides more services, all of which benefits the entire economy.

Unfortunately, the relationship between corporations and their shareholders may be moving away from its origins and becoming less mutualistic. This, I believe, may harm companies and their shareholders, as well as those who depend on the health of the corporation-shareholder relationship.

So, how do we restore mutualism in the relationship upon which our corporate ecosystem is based?

Mutualism and the Corporation-Shareholder Relationship

Brief History

I recently remarked upon the history of the American corporate form, and I would like to start my talk tonight there, as well. Don't worry, I won't go as far back as the Dutch East India Company and its *participanten,* or the tulip bulb market. Rather, I will quickly touch upon the history of the corporation-shareholder relationship in the United States to inform the rest of our discussion.

From the late-1700s to the mid-1800s, corporations started to flourish in the United States. American companies typically operated within a single state or community. The shareholders of a corporation were often members of the same community in which the corporation was located. As a result, they were able to engage and monitor the company's business affairs in a more direct manner than we currently see today. A corporation also met with its shareholders more frequently, whether in the form of shareholders' meeting or otherwise.

Beginning in the mid-1800s, however, companies started growing larger and the corporate form changed. Companies began hiring managers—who often had no ownership interest in the companies—to run their affairs. While this transition created certain efficiencies, it also in many cases separated the ownership of the company from the management of the company. This had the effect of reducing shareholders' ability to directly influence the company's business.

Mutualism and the Corporation-Shareholder Relationship in Recent Years

A lot has happened since the mid-1800s, and we are now at a tipping point. Instead of being in the midst of an industrial revolution, we are in the midst of a digital revolution. This new revolution comes with many benefits—speed, efficiency, and innovation, to name only a few. Coupled with these benefits, however, are also some risks. I think if we focus on the strengths of the American corporate form, we can successfully reimagine the corporation-shareholder relationship for the Digital Age.

I would like to discuss a few examples of how, in modern corporate governance, the concept of mutualism can help us think through the path forward for corporations, their shareholders, and the larger corporate ecosystem.

Cyberthreats

As we all know, the digital transformation is providing both companies and shareholders with tremendous opportunities. However, one of the biggest challenges facing corporations and their shareholders, their employees and consumers, and our economy as a whole, is cybersecurity. As we have learned, cyberattacks can affect millions of people at once and potentially compromise our most sensitive personal information.

Shareholders have been out front advocating for more information on company practices relating to cybersecurity. The number of shareholder proposals regarding cybersecurity has increased in recent years. But good information remains scarce. Unfortunately, corporate disclosures are far from robust and largely consist of boilerplate language that fails to provide meaningful information for investors.

While companies and shareholders agree that cybersecurity is one of the most prominent corporate issues of our time, it is unclear why companies are not doing more to implement robust cybersecurity frameworks and to provide meaningful disclosures regarding the risks of data loss.

Companies and their intermediaries tend to view cyberthreats as a technology problem instead of, more appropriately, a business risk. As we have seen time and time again, cybersecurity, and the related threats of unintentional loss of data, is a governance challenge for all of us, and it requires a change in culture and approach. Many shareholders seem to understand this and have been urging, and continue to urge, companies to engage.

Regulators are certainly not immune from facing these challenges. In August 2017, I learned for the first time that the Commission's official record system was breached in 2016, and that this breach may have provided the basis for illicit gains through trading. Clearly, the Commission's enterprise risk management processes failed to adequately address appropriate escalation protocols. Once he was informed, Chairman Clayton immediately launched an investigation into the breach and has focused the Commission and the staff on improving our risk management framework.

Companies, their managers, their boards, as well as their regulators, all need to do a better job in recognizing and addressing the significant risks that can result from the loss of data. Breaches of security measures can result in theft, reputational harm, or the loss of intellectual property. Simply put, the unintentional loss of data may have material effects on companies. Slowly, regulators around the globe are stepping up to the challenge of issuing data protection laws and regulations. The approach to these issues continues to evolve with the changing landscape. For example, the European Union's General Data Protection Regulation is set to go into effect in May 2018. China has begun enforcing regulations concerning “critical information infrastructure.” Last March, the New York Department of Financial Services required that regulated firms name a chief information security officer (or CISO). These CISOs must provide an annual report on cybersecurity to the firm’s board. Last year, a bipartisan bill was introduced in the Senate to require publicly traded companies to disclose whether any members of their board have cybersecurity expertise.

We at the Commission have not yet adequately pressed forward. While the Commission’s staff has released disclosure guidance for public companies to consider when dealing with cyberrisks and breaches, the Commission can and should do more. I believe the Commission should consider rules to require disclosure of a firm’s enterprise-wide consideration of cyberrisks. I also believe that we should develop rules to ensure that market intermediaries, including broker-dealers and investment advisers, develop and implement policies and procedures to protect investors’ personal information.

The security and integrity of a corporation’s assets, like the SEC’s, is a great responsibility. As I said earlier, cybersecurity has been viewed by many as simply an “IT” problem, hoisted on the shoulders of a company’s chief information officer. Too often, this has led to a failure to integrate cybersecurity into a firm’s enterprise risk management framework. To be sure, some companies are focused on cyberthreats and recognize their potential economic threat. But companies need to do more than simply recognize the problem. They need to heed the calls of their shareholders and treat cyberthreats as a business risk. Corporations and shareholders will both benefit from greater transparency and focus on the risks related to unintended data loss and the collateral consequences.

Board Composition

The composition of corporate boards provides another example of how the concept of mutualism is informative. Boards can and should be a bridge to investors, but too often they are a wall. Board composition is vitally important as directors play a meaningful role in helping companies make productive investments and good decisions going forward. However, boards remain far from diverse or reflective of shareholders’ views despite evidence pointing to the value of such diversity in their composition.

Gender diversity on boards provides a notable example. This is not about making people feel good—it is about dollars and cents. Studies suggest that women may be better monitors of executives, a central function of boards of directors. Research has also shown that companies with strong female leadership generated higher returns on equity compared to those without. This may be because having a diverse board helps the company better understand purchasing and usage decisions by its clients or customers. Studies have found, after all, that women drive 70% to 80% of purchasing in the United States. As I have remarked in the past, diverse boards also appear to deter “groupthink” and help reduce instances of fraud, forms of corruption, and shareholder contests. The Commission and regulators across the globe have also echoed the importance of gender diversity on boards.

Despite all of this, gender diversity on boards remains elusive. The percentage of women on boards is currently at approximately 20%, an increase of only 5% since 2011. This is striking when you consider that women make up 50.5% of the U.S. population and approximately 47% of the U.S. labor force. Indeed, the United States lags behind many advanced economies in terms of women's representation on corporate boards.

More striking still, it is not just academics and think tanks that support gender diversity on boards. Shareholders, too, expect the companies they own to have diverse board membership. For example, State Street Global Advisors and BlackRock have adopted policies or guidance with respect to increasing gender diversity on boards, and indicated their willingness to use their voting power to effect change, if necessary.

Yet, despite the documented benefit of diverse boards, many board members do not believe that board diversity enhances company performance. Further, more than half of directors believe that their boards are already sufficiently diverse.

It is one thing for boards to ignore scholarly research, but it is quite another for boards to ignore their companies' shareholders or owners. Especially when it can affect everyone's bottom line. Although we have come a long way since the 18^{th} Century, we still have a long way to go. How can technology help this process? Can it be used to better connect a company and its board with its shareholders? How can a corporation capitalize on mutualism and benefit from the best ideas of its shareholders for the benefit of all?

Shareholder Activism

Changes in the corporation-shareholder relationship are perhaps most apparent when looking at efforts to curtail shareholders' information and rights. As owners of a company, shareholders actually care about corporate practices of all types and how they affect the bottom line—from strategic plans to employee relations to executive compensation, and much more. So-called shareholder activism can provide a necessary check on a company's leaders. Or it can be a needless expense for a company ultimately producing no benefit. Whatever your opinion, shareholder activism seems to be here to stay, with 39% of directors believing that there will be an increase in shareholder activism in 2018.

In recent years, shareholder activism has prompted myriad responses from corporate boards and management. Many simply try to fend off shareholders. Many engage with shareholders, but because about 70% of the share ownership of U.S. companies is from huge investors, that is where they focus. Thus, the entire battle is fought for the opinions of a handful of executives at large asset managers.

Though the decision to engage institutional shareholders may simply be a matter of numbers, what are the long-term effects *on the company* of this sort of narrow shareholder engagement? Does engaging the view of only one group of shareholders result in a form of short-termism? Could it result in a company putting on blinders that can affect its long-term bottom line? Ultimately, how does this sort of one-sided engagement affect the company's position in the larger ecosystem?

In effect, is shareholder activism a symptom of an underlying problem or part of the cure? I believe that we need to get back to a more mutualistic relationship in order to properly answer that question.

Dual-Class Capital Structures

Another place where the concept of mutualism needs to be considered is in regard to dual-class capital structures, where certain shareholders are starting to be disenfranchised *by design*.

As you know, in typical dual-class capital structures, corporate insiders receive common stock with multiple votes per share while public shareholders receive shares with one vote per share. This structure allows these corporate insiders to control a majority of the votes of the corporation even though they own a minority of its stock. While dual-class capital structures have existed for many years, much has been written about them recently. This may be in part because of an upsurge in dual-class IPOs—from Google in 2004 to Manchester United in 2012. And we all have heard about Snap and its IPO of *non*-voting shares in 2017.

Many, including myself, see dual-class capital structures as inherently undemocratic, disconnecting the interests of a company's controlling shareholders from its other shareholders. The disassociation of interests can grow over time when certain shareholders, but not others, have the right to vote over fundamental corporate matters—like board members. It is not surprising, then, that critics include shareholder groups, asset managers, and stock indices. Or that they are prohibited by some countries. Yet, we are still inexplicably letting dual-class share structures persist.

Why does the appetite for dual-class capital structures exist despite wide investor disapproval of such structures? Where is the symbiosis? Can investors afford not to invest in another Google, even if they do not agree with the share structure? What leverage do they have? What happens when the interests of a company's controlling shareholders continue to diverge from its other shareholders? Is there a risk that a company's controlling shareholders will acquire conflicts of interest so large that the company cannot act in the best interests of all of its shareholders?

While some say dual-class capital structures are designed to prevent a takeover or shareholder activism, they also may provide a means to evade management and board accountability. Structures where a minority of insiders lock out the interests and rights of the majority may also have collateral effects on our capital markets. They may be harmful not just for those companies, their shareholders, and their employees, but for the economy as a whole. Dual-class capital structures, in effect, turn the mutualism underlying the corporation-shareholder relationship on its head.

A Way Forward

While it is clear that the relationship between a company and its shareholders is currently in flux, it is less clear how we should move forward. How can we restore the mutualism that serves as the foundation for the corporation-shareholder relationship, and that has benefited companies, their shareholders, and the economy as whole since the 1700s?

Shareholder empowerment is key. As I have discussed tonight, the benefits of shareholder involvement are not abstract. Shareholders often fight for corporate values—such as diverse boards—that empirically have positive, direct effects on the corporate bottom line. They often do this well before managers or boards are willing to consider or implement such changes. Despite this, corporations appear to be searching for ways to ignore shareholders, even on a structural level.

Shareholder engagement is, I believe, a good first step in enhancing the corporation-shareholder relationship for the benefit of both. Despite the trends toward a less mutualistic relationship, there are some positive signs. For example, companies and their shareholders are increasingly sitting down at the same table these days. Companies are also hiring advisors to help them engage directly and consistently with their shareholders. This has allowed companies to have a continuing dialogue with their shareholders.

Many companies are also utilizing technology to better facilitate engagement with their shareholders. From hosting virtual or live webcasts of their shareholder meetings, to using social media and mobile technology, companies are searching for new and better ways to actively engage their shareholders.

Unfortunately, this shareholder engagement has largely been geared toward those with the most voting power. Companies can also benefit from the engagement of retail investors. And, as I have said before, technology can also serve this purpose. After all, more Americans are technology-literate than ever before. Indeed, approximately 80% of Americans had a social media profile in 2016. Perhaps, shareholders should be allowed to vote through social media or a mobile phone application, like in Estonia.

New and cutting-edge technologies may help in other ways. Companies might be able to use distributed ledger or blockchain technology to identify and reach their shareholder bases more effectively. Currently, companies mainly communicate with shareholders through broker or bank intermediaries, because the shares are held in the names of these intermediaries rather than in the names of the beneficial owners. This means that, in some cases, companies do not actually know who their shareholders are. While this complex construct may have been necessary in the 1970s, current technology could enable companies to directly communicate with shareholders without the need for intermediaries.

The Commission can do more, too. While we have issued rules that shape the means by which a company communicates with its shareholders, we should continue to be ready to help fortify the corporation-shareholder relationship as we move forward. For example, we should adopt final rules regarding the use of universal proxy cards. These rules should recognize that few shareholders can dedicate the time and resources necessary to attend a company's meeting in person and that, in the modern marketplace, most voting is done by proxy. The Commission's rules need to change to reflect our current reality, empowering companies and shareholders alike.

In a time when ownership is global and disparate, the use of technology and the Commission's rules are simply tools to further the empowerment of a corporation's owners. We have seen throughout history that a company's growth and its owners' prosperity are often enhanced by direct engagement. In other words, both engaging with one another for the good of all, or mutualism. The result is a corporation that is more nimble and grows in an ecosystem that thrives on transparency. This was true in the 1700s and it is still true today.

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As we move forward, we have to ask ourselves how we can strengthen the corporation-shareholder relationship. For it has been foundational to the success of the American corporate form.

As I have discussed tonight, the corporation-shareholder relationship must be reimagined in the context of modern corporate governance to recapture its benefits. Shareholders, like management, share the desire to grow a company's bottom line. But they can only help if they are heard.

We need to go back to first principles: A corporation's growth and its shareholders' prosperity are intertwined. To succeed, they must work together.

Thank you for your time, and for inviting me to speak with you this evening.

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The complete publication, including footnotes, is available here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Perpetual Dual-Class Stock: The Case Against Corporate Royalty

Posted by Robert J. Jackson, Jr., U.S. Securities and Exchange Commission, on Friday, February 16, 2018

Editor's note: Robert J. Jackson, Jr. is a Commissioner at the U.S. Securities and Exchange Commission. The following post is based on Commissioner Jackson's recent remarks at the UC Berkeley School of Law, available here. The views expressed in the post are those of Commissioner Jackson and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff. 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).

My first few weeks at the SEC have been a whirlwind—and just to be clear, I am *not* talking about the markets. In a few short weeks, I have gotten a crash course on SEC policymaking—and enough reading to empathize with my former law students, who used to tell me, to my puzzlement, that my Corporate Law syllabus was not exactly beach material.

But in between the policy memos that come across my desk, I've also had the pleasure of working with my new colleagues on the SEC's Staff. They've taught me a lot in a short time, and I'm grateful for their insights and assistance. The hard work and dedication of these folks gives me confidence that we are up to the challenge of making sure our financial markets are the safest, strongest, and most efficient in the world.

So the first few months of 2018 have been quite a blur. Fortunately, they have not been as stressful for me as the last few months of 2017.

You see, last fall, I took part in two of the most nerve-wracking Q&A sessions of my life. In late October, I had the ultimate job interview: a two-hour, televised confirmation hearing in front of the Senate Banking Committee.[1] Then, two months later, I found *myself* the one posing the life-changing questions. I asked my girlfriend Bryana to marry me.

I'm happy to report that, to my surprise, both Bryana and the Senate offered a resounding yes—literally within 24 hours of each other. But, let me just say, I now have newfound respect for the staff and Senators on the Committee. I only had to ask one question, and it nearly gave me a heart attack.

Now, as a newly engaged guy, I fully embrace the notion that a strong marriage must be built on a foundation of eternal trust. But today, I would like to ask whether it is wise to apply that standard

[1] To be fair, I'm using the phrase "televised" a little loosely here. Because my Mom and Dad were present at my confirmation hearing, I'm pretty sure viewership was close to zero.

to corporate governance. Should our public investors have to place eternal trust in corporate insiders? That is, should so-called perpetual dual-class stock ownership structures, which grant corporate executives control of our public companies literally *forever*, be acceptable?

The Law and Legacy of Dual-Class Stock

As you know, "dual class" voting typically involves capitalization structures that contain two or more classes of shares—one of which has significantly more voting power than the other. That's distinct from the more common single-class structure, which gives shareholders equal equity and voting power. In a dual-class structure, public shareholders receive shares with one vote per share, while insiders receive shares that empower them with multiple votes. And some firms have recently issued shares that give ordinary public investors no vote at all.[2]

For most of the modern history of American equity markets, the New York Stock Exchange did not list companies with dual-class voting. That's because the Exchange's commitment to corporate democracy and accountability dates back to before the Great Depression.[3] But in the midst of the takeover battles of the 1980s, corporate insiders "who saw their firms as being vulnerable to takeovers began lobbying [the exchanges] to liberalize their rules on shareholder voting rights."[4] Facing pressure from corporate management and fellow exchanges, the NYSE reversed course, and today permits firms to go public with structures that were once prohibited.[5]

As you all know well, more and more companies choose today to go public with dual-class. Public companies using dual-class are today worth more than $5 trillion, and more than 14% of the 133 companies that listed on U.S. exchanges in 2015 have dual-class voting.[6] That compares with 12% of firms that listed on U.S. exchanges in 2014, and just 1% in 2005.[7]

There's a long-running debate on dual-class. On one hand, you have visionary founders who want to retain control while gaining access to our public markets. On the other, you have a structure that undermines accountability: management can outvote ordinary investors on virtually anything.

There is reason to think that, at least for a defined period of time early in a company's life, dual-class can be beneficial. The structure can allow entrepreneurs to build for the long term—and even transform entire industries—without being subject to short-term pressure.[8] When many

[2] Snap Inc., Form S-1 (February 2, 2017) ("Holders of our Class A common stock—the only class being sold in this offering—are entitled to no vote on matters submitted to our stockholders.").

[3] In 1926, the NYSE's famous decision to list nonvoting shares in Dodge Motor Company resulted in a public outcry. In response, the Exchange announced that it would consider voting control when making listing decisions, and in 1940 the NYSE announced a flat policy against nonvoting common stock. Prior to these events, restrictions on shareholder voting rights were more common. *See* Stephen Bainbridge, ProfessorBainbridge.com, *Understanding Dual Class Stock Part I: An Historical Perspective* (September 9, 2017). Then again, prior to these events, the Securities and Exchange Commission did not exist.

[4] Stephen M. Bainbridge, Comments to the Securities and Exchange Commission on No. 4-537: *The Scope of the SEC's Authority Over Shareholder Voting Rights* (May 7, 2007).

[5] The SEC, led at the time by Chairman Arthur Levitt, attempted to intervene—but was thwarted by a controversial ruling of the D.C. Circuit. *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

[6] Wall Street Journal Business Blog: The Big Number, Wall. St. J. (Aug. 17, 2015).

[7] These trends are consistent with those noted by an insightful preliminary report by the Investor as Owner Subcommittee of the SEC's Investor Advisory Committee. *See* SEC, Investor Advisory Committee, *Discussion Draft: Dual Class and Other Entrenching Governance Structures in Public Companies* (December 17, 2017).

[8] *See, e.g.*, Alphabet Investor Relations, 2011 Founders' Letter ("In our experience, success is more likely if you concentrate on the long term. . . . For example, it took over three years just to ship our first Android handset, and then another three years on top of that before the operating system truly reached critical mass.").

managers are at the mercy of daily stock-market pressure, dual-class can help America's most innovative companies create the sustainable long-term value we need to grow our economy.[9]

Many have argued forcefully, however, that one-share, one-vote should be the rule for all public corporations.[10] Whatever the benefits may be of permitting dual-class in a few well-known cases, these advocates argue, the costs for investors—who are left with no way to hold management's feet to the fire while dual-class is in place—outweigh those benefits.

But the question I want to ask today is not whether dual-class ownership is *always* good or bad. It's whether dual-class structures, once adopted, should last forever. Do Main Street investors in our public markets benefit when corporate insiders maintain outsized control *in perpetuity*?

This is not an academic exercise. You see, nearly half of the companies who went public with dual-class over the last 15 years gave corporate insiders outsized voting rights in perpetuity. Those companies are asking shareholders to trust management's business judgment—not just for five years, or 10 years, or even 50 years. *Forever*.

Corporate Royalty and Our Values

So perpetual dual-class ownership—forever shares—don't just ask investors to trust a visionary founder. It asks them to trust that founder's kids. And their kids' kids. And their *grandkid's* kids. (Some of whom may, or may not, be visionaries.) It raises the prospect that control over our public companies, and ultimately of Main Street's retirement savings, will be forever held by a small, elite group of corporate insiders—who will pass that power down to their heirs.

I cannot see how to square that with our nation's foundational ideas.[11] In America, we don't inherit power, and we don't hold power forever. We fought a war against that system, and the good guys won. That's why, following Thomas Jefferson's lead in Virginia, after Independence, state governments "laid axe to the root of pseudo-aristocracy," as Jefferson put it, by abolishing the laws of entail and primogeniture.[12] It's why our Constitution gives our legislature the broad authority to promote the general welfare, but carefully enumerated what Congress *cannot* do: grant titles of nobility.[13] It's why our founders rejected a permanent dual-class legislature: a House of Lords for the royalty and a House of Commons for Main Street.[14]

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[9] *See, e.g.*, Sens. Elizabeth Warren & Joe Donnelly, ***Trump's SEC Chairman Must Look Out for American** Families, Not Big Corporations*, Wash. Post. (March 22, 2017) ("[S]hortsighted corporations [are]chasing quick profits at the expense of their workers and the long-term health of their companies."

[10] *See, e.g.*, Council of Institutional Investors: Dual-Class Stock (Jan. 2018), *at* http://www.cii.org/dualclass_stock ("CII continues to view one-share equal voting rights upon IPO as the optimal approach.").

[11] Many prominent dual-class companies and their managers seem to understand this problem and have addressed the concern. *See, e.g.*, Sujeet Indap, *Dual-Class Shares Should Build in Expiration Plan*, Fin. Times (October 26, 2017).

[12] The Elusive Thomas Jefferson: The Man Behind the Myths 38 (M. Andrew Holowchak & Brian W. Dotts eds., 2012) (quoting an early letter from Jefferson to John Adams).

[13] U.S. Const. art. I § 9, cl. 8 ("No Title of Nobility shall be granted by the United States: And no Person holding any Office or Profit of Public Trust under them, shall, without the Consent of the Congress, accept any present, Emolument, Office, or Title, of any kind whatever, from any King, Prince, or foreign State.").

[14] Publius, The Federalist No. 63 (B. Wright ed., 1961) (arguing, by dint of comparison between the proposed Senate and the British House of Lords, that the former was not, and was unlikely to become, "[]confined to particular families and fortunes[or]an hereditary assembly of opulent nobles.").

Now, our public markets aren't our government, but our country's spirit of democratic accountability has long animated how we think about economics. That's why Adam Smith worried in his early writings about how economic models could account for the possibility that power could be wielded by royalty from beyond the grave.[15] And that's why today we require companies to give investors regular updates on their performance. If you run a public company in America, you're supposed to be held accountable for your work—maybe not today, maybe not tomorrow, but someday.[16]

So one problem with perpetual dual-class is it removes entrenched managers—and their kids, and their kids' kids—from the discipline of the market forever. Simply put: asking investors to put eternal trust in corporate royalty is antithetical to our values as Americans.[17]

Perpetual Dual-Class Stock and Corporate Performance

It's not just that perpetual dual-class stock ownership is disconcerting in principle. The data suggest that it is troubling in practice. And I know this because my staff and I ran the numbers. More on that in a moment.

But let's start with what existing research in this area can already tell us. One recent study shows that the costs and benefits of dual-class structures evolve over a company's lifetime.[18] Shortly after the IPO, dual-class firms trade at a premium—but, as the company matures, this premium eventually disappears. Early in a company's life, then, giving control to the firm's visionary founders makes sense—but at some point that structure is no longer beneficial.

For that reason, some argue that dual-class firms should include some limit on the amount of time before ordinary shareholders can weigh in on whether dual-class still makes sense for the company.[19] Whether a fixed term of years or upon a founder's passing, at that point, sometimes called a "sunset," shareholders get to have their say.

To explore these questions, my staff and I took a close look at 157 dual-class IPOs that have occurred over the past 15 years. We immediately noticed some pretty significant differences between the 71 dual-class companies with sunset provisions and the 86 who gave insiders control forever. Our regression models predicted relatively similar valuations at their IPO dates, a trend that continued for two years after the IPO. But over time, their predicted valuations diverged:

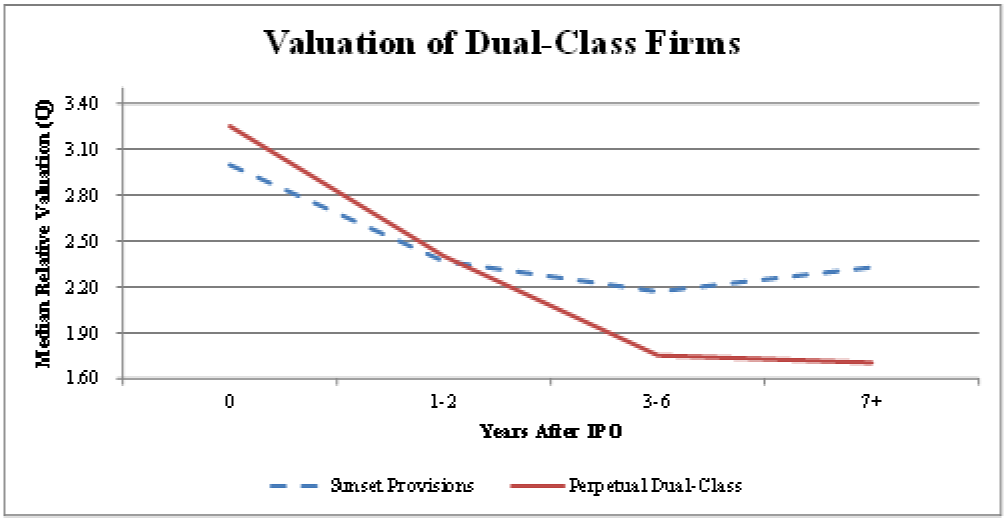
[15] Samuel Fleischacker, On Adam Smith's "Wealth of Nations": A Philosophical Companion (2014) (quoting Smith's lectures on jurisprudence).

[16] Casablanca, Dir. Michael Curtiz (Warner Bros. 1942).

[17] The idea that concentrated corporate power is held in just a few individuals' hands and will be passed down to their heirs is made all the more troubling by the fact that so few corporations today wield so much influence over so many American lives. I wonder how many of the problems plaguing our securities markets today can and should be treated by that old, familiar, and uniquely American medicine: competition.

[18] Martijn Cremers, Beni Lauterbach, and Anete Pajuste, *The Life-Cycle of Dual-Class Firms* (Jan. 1, 2018), *at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3062895.

[19] Lucian Bebchuk & Kobi Kastiel, *The Untenable Case for Dual-Class Stock*, 103 Va. L. Rev. 585 (2017).



Seven or more years out from their IPOs, firms with perpetual dual-class stock trade at a significant discount[20] to those with sunset provisions.[21] We also found that, among the small subset of firms that decided to drop their dual-class structures later in their life cycles, those decisions were associated with a significant increase in valuations.[22] To be sure, our analysis is preliminary, and this is a subject that deserves much further study. In the spirit of a robust debate, I am making public the results of our analysis as well as our underlying data and assumptions.[23]

The Path Ahead

I'm not the only one concerned about dual-class stock and its effects on our markets. Investors have loudly and clearly registered their objections to this structure, both through the SEC's Investor Advisory Committee and the Council of Institutional Investors.[24]

As a result of that engagement, three major providers have moved to exclude dual-class companies from significant stock indexes. FTSE Russell will exclude all companies whose free

[20] For our principal analysis we assess value with a much-maligned measure of corporate performance: Tobin's Q. Important recent work, however, has shown the danger in relying exclusively on Tobin's Q for purposes like these. *See* Robert P. Bartlett & Frank Partnoy, *The Misuse of Tobin's Q* (February 4, 2018); *see also* Emiliano Catan & Michael Klausner, *Board Declassifications and Firm Value: Have Shareholders Really Destroyed Billions in Value?* (October 10, 2017). So we re-ran our analysis using monthly equal-weighted portfolio returns for the perpetual sample versus the sunset sample. We did this in both calendar time and then, separately, in event time, with each firm's life cycle starting at zero and proceeding for 48 months. We then constructed a long-short cumulative return for the difference between the two portfolios, and the results are very consistent with those described above.

[21] One might ask why we compare firms with perpetual dual-class to those with dual-class sunset provisions rather than firms with a single class of stock. We do this because we, like scholars in the area, worry that any attempt to match perpetual dual-class firms with single-class firms will omit important differences that cannot be adequately controlled for. *See* Cremers, Lauterbach, and Pajuste, *supra.* Since our sample includes only dual-class firms, we avoid the possibility that underlying differences between single-class and dual-class firms drive our results.

[22] This evidence does not, of course, establish that perpetual dual-class structures *cause* firms to suffer lower valuations. It may be, for example, that the causal arrow runs the other way: that firms anticipating that they will be worth less later in their life cycle select perpetual dual class structures. Either way, the evidence suggests that this governance structure is associated with lower firm value. These data make it unsurprising that investors have expressed such significant concern about the use of dual class.

[23] I could bore you with the details of our regressions, fixed effects, and clustered standard errors, but I know that's not what you came to hear about. Instead, I'll point the interested listener to the data appendix to this speech, where you can learn more about our methodology and analysis. I hope that this first step will help bring increased academic interest to dual-class stock—and the ongoing debate about its costs and benefits for investors.

[24] *See* Investor Advisory Committee, *supra*; Council of Institutional Investors*, supra*.

float constitutes less than 5% of total voting power;[25] S&P Dow Jones will, going forward, exclude *all* dual-class firms;[26] and MSCI will reduce the weight that dual-class firms occupy in its indexes.[27]

Investors, facing a wave of companies using dual-class to insulate their managers from accountability, have every right to bring those complaints to index providers. And there's no doubt about it: the indices' decisions sent a loud message to the markets.[28] But excluding all dual-class firms from our major market indices is a blunt tool. And it's one I'm deeply worried about.

Let me explain why. We face a growing gap in this country between our markets and Main Street investors. The middle class watches our markets rise and increasingly—and correctly—senses that they are left out, that the benefits of that growth are accruing to someone else. And middle class investors often own stock in American public companies through an index. Though their holdings may be small, those holdings reflect their participation in our economic future.[29]

If we ban all dual-class companies from our major indices, Main Street investors may lose out on the chance to be a part of the growth of our most innovative companies. The next Google or the next Facebook will deliver spectacular returns, but average Americans will, quite literally, not be invested in their growth. No one here in Silicon Valley should want to leave average Americans out of their growth story. And investors should not be forced to choose being long American innovation and signing up for corporate royalty.

That's why I hope that our national securities exchanges will soon consider proposed listing standards addressing the use of perpetual dual-class stock. Such standards would allow Main Street investors to share in our economy's growth—but avoid asking them to trust corporate management forever. Companies would still be able to IPO with dual-class voting arrangements—but only if management is willing to someday give shareholders their say.[30] And while cynics may say that companies will flee abroad to list, I think it's pretty unlikely that we'll see a mass exodus of listings away from the deepest, most liquid capital markets in the world just so founders' children can inherit and run America's public companies.

* * *

While it is fair to ask people to place their eternal trust in their partner, our country's founding principles and our corporate law counsel against the creation of corporate royalty. The solution to

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[25] FTSE Russell, FTSE Russell Voting Rights Consultation: Next Steps (July 2017), *available at* http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf.

[26] S&P Dow Jones Indices, Decision on Multi-Class Shares and Voting Rights (July 2017), *available at* https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classshares andvotingrulesannouncement7.31.17.pdf?force_download=true.

[27] MSCI, Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes (January 2018), *at* https://www.msci.com/documents/1296102/8328554/Consultation__Voting+Rights.pdf.

[28] *See, e.g.*, Matt Levine, *Listing Standards and Dividend Shares*, Bloomberg View: Money Stuff (April 13, 2017) (arguing that excluding firms on the basis of governance characteristics is a "weird role" for stock indices, and pointing to the "long tradition of corporate governance standards being imposed by stock exchanges as 'listing standards,' a sort of seal of approval.

[29] Edward N. Wolff, *Household Wealth Trends in the United States, 1962 to 2016: Has Middle Class Wealth Recovered?* (November 2017, NBER Working Paper No. 24085).

[30] Some may argue that, since investors can price the effects of perpetual dual-class at the IPO stage, there is no need for such standards. I am unconvinced that the IPO markets we have today reflect the kind of efficiency that argument demands. In any event, exchange standards need not require dual-class to end—just that shareholders get to vote on the structure. If managers can convince the markets of their merits, they'll be free to retain dual-class.

that problem is not to leave ordinary Americans out of the growth that all of you here in Silicon Valley are creating. The solution is to return to the tradition of accountability that has served our nation and our markets so well.

As a Commissioner, my job is to pursue a three-part mission at the SEC: protect investors, maintain fair and efficient markets, and facilitate capital formation. All three would be advanced if the exchanges promptly pursue this issue. By giving investors more say in the governance of their companies, we can help protect them from managers who would misuse dual-class to extract value rather than build it. By providing clear rules of the game for both shareholders and management, we help them understand and price the risks they're taking. And by giving visionary founders the space to control their companies soon after their IPO, we encourage them to use our public markets—and share their growth with Main Street investors.

The exact form that exchange standards might take—and the best way to "sunset," or limit, dual-class structures—is beyond the scope of my talk today. And besides, I have no doubt that the folks in this room can come up with innovative ways to solve that problem.[31] I know that all of you share my goal of finding a way to allow today's visionaries to access our public markets in a way consistent with our values. And I urge you all to get to work, alongside our exchanges, to make sure that Main Street investors share in the future you're shaping here every day.

* * *

The complete publication, including footnotes, is available here.

[31] For innovative proposals in this respect, *see* Bebchuk & Kastiel, *supra*, at 619-628.

Why Dual-Class Stock: A Brief Response to Commissioners Jackson and Stein

Posted by David Berger, Wilson Sonsini Goodrich & Rosati, on Thursday, February 22, 2018

Editor's note: David Berger is a partner at Wilson Sonsini Goodrich & Rosati. This post is based on a publication by Mr. Berger. 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).

Two SEC Commissioners—Robert Jackson and Kara Stein—separately visited Silicon Valley last week, and both used the opportunity to sharply criticize the practice among some companies—most notably but not exclusively technology companies—to adopt so-called "perpetual" dual-class stock.[1] In typical dual-class structures, one group of stockholders (typically the founders and other insiders) receive stock with multiple votes per share, while shares purchased by investors in the company's initial public offering ("IPO") or thereafter on the open market have just one vote per share.[2]

The debate over dual-class stock, including perpetual dual-class stock is not new; just last fall two leading academics, Professors Lucian Bebchuk and Kobi Kastiel, published an article calling for a sunset provision on all dual-class stock, using the situation in Viacom in support of their proposal.[3] Their position is similar to the one proposed by Commissioner Jackson.[4]

The purpose of this short response is to (1) identify some of the underlying causes that have led companies, including many of our most innovative and dynamic public companies, to adopt dual-class stock and (2) offer some broader solutions that the SEC can consider as it seeks to address some of the perceived problems with dual-class stock. In particular, while Commissioners Jackson and Stein focused on some of the perceived and/or potential problems with dual-class

[1] *See* Commissioner Robert J. Jackson, Jr., *"Perpetual Dual-Class Stock: The Case Against Corporate Royalty,"* February 15, 2018, available at https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty; and Commissioner Kara M. Stein, *"Mutualism: Reimagining the Role of Shareholders in Modern Corporate Governance,"* February 13, 2018, available at https://www.sec.gov/news/speech/speech-stein-021318.

[2] Although the primary focus of Commissioner Jackson's talk was against "Perpetual dual-class stock," most technology companies do not have perpetual dual-class stock structures. Ironically, perpetual dual-class stock structures are most common in companies founded by very conservative, supposedly "free-market" entrepreneurs, such as Rupert Murdoch's News Corp., the Smith family's Sinclair Broadcast Group, and John Malone's Liberty Media Group. In March 2017 the Council of Institutional Investors ("CII") published the most complete list of dual-class companies. *See* http://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf.

[3] See Lucian Bebchuk and Kobi Kastiel, "The Case Against Perpetual Dual-Class Stock," 103 *Virginia L.Rev*. 585, (2017).

[4] I opposed mandatory sunset provisions for dual-class stock in a post in these pages, arguing that private ordering was a better system of regulation for dual-class stock, and again urging regulators to look at the broader factors leading companies to consider dual-class stock. *See* David J. Berger, "*Dual-Class Stock and Private Ordering: A System that Works*," Harv. Corp. Gov. Blog, May 24, 2017.

stock, the challenges faced by our corporate republic are far greater than those caused by dual-class stock.

The problem arises as a result of the growing “financialization” of our corporate governance structures since the 1980s, which includes allowing equity capital to become the lone determinant voice of what constitutes “good governance.” These issues have become exasperated by the changing nature of equity capital itself, as the retail investor has largely disappeared and been replaced by a handful of large institutional investors.

The issues with dual-class stock should not be addressed in isolation, but rather as part of a broader review of the issues facing our corporate “republic.” This includes looking at the changing nature of share ownership, the role of the institutional investor (and shareholder activists) and an understanding that about half of all households in the U.S. have no direct or indirect ownership of equities—and thus no say in what constitutes good corporate governance or how corporations should behave—yet are often reliant on these same corporations for everything from employment to retirement, while the corporation is equally dependent on these households for finding qualified employees to consumers for their products. Within this broader context the notion of dual-class stock should be considered, as it really was developed to respond to the changing nature of our corporate republic.

The rest of this response addresses these issues. Part I quickly summarizes the growth and use of dual-class stock today. Part II briefly reviews the changes in our corporate governance regime since the 1980s, including the financialization of corporate governance, the changing role of institutional investors, and how these factors led to the growth of dual-class stock. The essay concludes by offering some suggestions and options for the SEC to consider if it wants to address these issues more broadly.

A full copy of the essay can be found here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Summary of MSCI Consultation Paper on Voting Rights and Index Inclusion

Posted by Dimitris Melas, MSCI, Inc., on Tuesday, May 22, 2018

Editor's note: Dimitris Melas is Managing Director and Global Head of Core Equity Research at MSCI, Inc. This post is based on his MSCI publication.

Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock (discussed on the Forum here) and The Perils of Small-Minority Controllers (discussed on the Forum here), both by Lucian Bebchuk and Kobi Kastiel.

Equity indexes have evolved to fulfil multiple roles in the investment process and meet the needs of various types of investors. All institutional investors use indexes as market indicators and research tools. Asset owners employ them as policy benchmarks in their asset allocation. Active managers use them as performance benchmarks while passive investors use indexes as the basis for investment vehicles. To fulfil these multiple roles successfully, equity indexes aim to achieve comprehensive coverage of the underlying opportunity set by including all investable equity securities listed in the markets they seek to represent. In the MSCI consultation discussion paper,[1] we address the question of whether stocks of companies with multiple share classes having unequal voting rights ("unequal voting shares or stocks") should be eligible for inclusion in equity indexes. We approach the question in two steps. First, we assess if unequal voting shares meet the definition of equity. Then, we examine the impact of unequal voting stocks from different institutional investor perspectives.

Are share classes with unequal voting rights equity securities? Are economic rights alone sufficient for a security to be deemed to be equity? Or are control rights also an inherent characteristic of equity? Separation between ownership and control is a common premise underpinning many corporate and investment structures. Examples include general partners and limited partners in private equity funds, investment managers and unit holders in mutual funds, and plan sponsors and beneficiaries in defined benefit pension funds. In the corporate world, companies obtain funding through different types of debt and equity capital. Investors hold particular debt and equity instruments to meet their objectives and constraints. Unequal voting rights stocks may be attractive to issuers who wish to separate ownership from control and to investors who require economic exposure without the need or desire to exercise control.

In addition to meeting the definition of equity, a security must be deemed to be investable in order to qualify for benchmark inclusion. In particular, the security must be deemed investable from the perspective of different types of international institutional investors, including asset owners, active managers and passive managers. Investability for the purpose of index inclusion is typically

[1] See "Should equity indexes include stocks of companies with share classes having unequal voting rights?"

assessed in terms of company size, trading liquidity and security free float. As more unequal voting power issues come to the market and as indexes are increasingly used as portfolio implementation tools in passive investing, it may be appropriate to add voting to the existing criteria for index construction.

The need to add a new category of inclusion eligibility criteria to the set of investability criteria used in index construction results from the fact that unequal voting rights affect different investors in different ways. Active investors may judge for themselves if the growth prospects of a particular company or the superior skills of a visionary founder justify relinquishing voting rights. After assessing the potential benefits and drawbacks, an active investor may decide not to buy or to sell at a later stage. Passive investors have no such choice, their process mandates holding all index constituents. Large institutions with a long-term investment horizon (universal owners) also have little choice but to hold all index constituents. These investors may influence corporate policy only through voting, making voting rights an important dimension of investability for this group.

In this post, we argue that unequal voting shares represent equity securities and therefore should be eligible for index inclusion. However, we note that these securities have different impacts from certain investor perspectives. As a result, we propose to adjust the index weights of unequal voting stocks to reflect both their free float as well as their company-level listed voting power. Before discussing the rationale and implications of this proposal, we review the theoretical and empirical evidence around unequal voting structures.

Why we propose adjusting index weights

Equity indexes adjust constituent weights for free float, defined as the proportion of listed equity that is available to purchase in the market. Shares deemed strategic holdings are excluded from the calculation of free float because these shares are not investable. Our proposal to adjust constituent weights according to their issuer-listed voting power follows the same logic. Only the portion of total share capital that offers voting rights is deemed to be eligible for inclusion.

The ability to influence corporate policy through voting may be less important for certain types of investors. Active investors, such as actively managed mutual funds or hedge funds, are able to act on their assessment of the growth prospects and management quality of companies that offer reduced or zero voting rights equity. Following an informed assessment of potential risks and rewards, they may decide to invest in these companies. Even without equal voting rights, active investors can subsequently sell or short the stock of companies when growth prospects deteriorate or when insiders mismanage the company or fail to use their voting power to maximize shareholder value.

On the other hand, the ability to vote is particularly important for passive investors and large asset owners that have very long investment horizons and hold the “entire” market (universal owners). These types of institutions, either because of their process or because of their size and investment horizon, have committed to not sell the stock of public companies when insiders misuse their superior control rights. In these cases, engagement through voting or public agitation is the only way to affect changes in corporate policy for the benefit of outside shareholders, making voting power a more important criterion for passive investors.

How can equity indexes continue to offer comprehensive coverage while recognizing the importance of voting power for certain types of investors? One solution that would satisfy the need for complete coverage would be to continue to include in indexes all companies at their full weight irrespective of voting power. This approach may have been satisfactory in the past when relatively few companies listed unequal voting shares and when the primary purpose of benchmarks was to act as market indicators and research tools.

However, two recent trends in corporate governance and institutional investing may render the legacy approach obsolete or inadequate. First, we have seen a rising number of companies offer reduced or even zero voting power shares to outside investors. In addition, as passive investing grows in popularity, indexes become the building blocks for asset allocation and portfolio construction. In this new paradigm, the legacy approach of ignoring voting rights in index construction may no longer be adequate for passive investors and universal owners as it would create misalignment between economic exposure and voting power. In other words, it would force them to have excessive capital allocation to public companies where they have relatively low protection against insider misuse of control and limited or no possibility to influence corporate policy through engagement and voting.

At the other extreme, a solution that would recognize the importance of voting power would be to exclude all companies that offer differential voting rights from equity indexes. This approach would also be problematic for all index-linked investors as it would reduce their opportunity set and violate the basic index principle of offering comprehensive coverage of the listed investable equity market.

Other possible solutions that would avoid the two extremes of full inclusion irrespective of voting power or complete exclusion of all unequal voting structures would require arbitrary thresholds to determine at what level of listed voting power securities should be included in benchmarks. The challenge with these approaches is that there is no clear theoretical or empirical basis on which to select an appropriate exclusion level. Fifty percent appears to be an intuitively appealing middle point but screening out companies with listed voting power below 50% may lead to the exclusion from indexes of several successful high-profile companies. This would deprive investors of the opportunity to benefit from the growth prospects and diversification potential offered by these companies.[2]

In the MSCI paper, we propose to continue to include unequal voting stocks in equity indexes but to adjust their weights to reflect both free float and listed voting power. This proposal recognizes the additional constraints of passive investors and universal owners by aligning economic exposure and listed voting power, while continuing to offer all investors access to the entire universe of listed and investable equity securities.

Conclusion

A quote from *Financial Times* journalist Andrew Hill aptly summarizes the ambiguous nature of the one share, one vote debate:

[2] See "Putting the Spotlight on Spotify: Why Have Stocks with Unequal Voting Rights Outperformed?"

> “The advantage of a dual class share structure is that it protects entrepreneurial management from the demands of shareholders. The disadvantage of a dual class share structure is that it protects entrepreneurial management from the demands of shareholders.”

We examined the literature surrounding unequal voting structures. We found credible theoretical arguments both for and against the existence of these structures. The empirical evidence regarding the impact of unequal voting rights on company performance and portfolio returns was also mixed, with roughly similar number of studies reporting positive and negative effects. Our own analysis of index constituents with unequal voting power revealed substantial differences in the exposures of these securities to risk and return drivers, compared to the overall equity market. These differences are likely to have an impact on the performance of portfolios and indexes with varying allocations to unequal voting stocks.

Equity indexes aim to include all investable equity securities. Therefore, unequal voting shares must pass two tests to qualify for index inclusion. First, they must be listed equity. This is indeed often the case, as they offer economic rights and proportional ownership and many exchanges will agree to list such securities. Second, they must be deemed to be investable. Many unequal voting stocks may be highly investable in terms of size, liquidity and free float. However, we argued that the rising number of new issues with unequal voting rights and the increasing popularity of passive investing through indexes call for adding another eligibility requirement. The challenge for index construction is to include differential voting rights shares in the index to maintain comprehensive coverage of the equity universe, while appropriately reflecting the reduced voting power characteristics of these securities in index weights.

Our proposed solution: Continue to include in equity indexes securities with differential voting rights but with adjusted weights that reflect both free float and company-level listed voting power. This approach offers several potential benefits. It avoids artificial cut-off points that create binary outcomes and may be subject to gaming. It provides an incentive to companies to reduce the gap between free float and voting power. It penalizes companies that offer low voting power but excludes only a very small number of companies, such as Snap Inc., that provide zero voting power to outside shareholders. It enables indexes to continue to capture all investable equity securities and offer all investors the possibility of benefitting from the growth prospects of new companies that may have elected to offer differential voting rights. At the same time, the weight of constituents with reduced voting rights is adjusted according to company-level listed voting power, recognizing the impact of unequal voting rights, particularly for passive investors.

Equity markets and investment processes evolve through time. Index methodologies should follow this evolution to ensure they continue to serve the needs of market participants. We believe our proposal achieves the right balance between comprehensive coverage and index investability, and appropriately reflects the evolving needs and priorities of different types of investors by keeping unequal voting shares in indexes with weights that align economic exposure and listed voting power.

CII Comment Letter to MSCI On Unequal Voting Structures

Posted by Ken Bertsch, Council of Institutional Investors, on Wednesday, May 16, 2018

Editor's note: Ken Bertsch is Executive Director at the Council of Institutional Investors (CII). This post is based on a letter from CII to the MSCI Equity Index Committee.

Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock (discussed on the Forum here) and The Perils of Small-Minority Controllers (discussed on the Forum here), both by Lucian Bebchuk and Kobi Kastiel.

May 9, 2018

MSCI Equity Index Committee
7 World Trade Center
250 Greenwich Street
New York, NY 10007

Dear Members of the MSCI Equity Index Committee:

I am writing in response to MSCI's *Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes* (Expanded Consultation), which generally contemplates incorporating the proportion of total voting power in the hands of non-strategic shareholders of listed securities into each security's float-adjusted market cap contribution to MSCI's developed and emerging market indexes. I want to compliment MSCI on the care and thought it has brought to this proposal.

The Council of Institutional Investors (CII) is committed to the alignment of economic rights and voting power (Alignment). We support the substance of the proposal with certain qualifications, described further below. Most notably, our suggested revisions seek to mitigate disruption related to the proposal's implementation and afford companies an enhanced incentive to commit to phasing out unequal voting structures after a reasonable period.

CII is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, and other employee benefit plans, foundations and endowments with combined assets under management exceeding $3.5 trillion. CII member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $25 trillion in assets under management. Our response is divided into three sections: a comment on why we believe index providers have a legitimate and important role to play in this matter; a suggestion to provide relief to companies that adopt reasonable time-based sunset provisions; and answers to specific questions posed in the Expanded Consultation.

I. Basis for index provider action

We offer four broad factors, which considered together, lead us to believe that index providers have a legitimate and important role to play in this matter.

Index providers' action is entirely consistent with their history of carefully constructing indexes to cover an asset class extensively, not exhaustively.

Index providers including MSCI have a long tradition of applying discretion to adjust the size of a constituent's contribution to an index, resulting in a track record of ensuring broad exposure to a given asset class without covering the entire market in a careless or indiscriminate manner.

We agree with MSCI's objective of "offering comprehensive coverage while recognizing the importance of voting power," and emphasize that "comprehensive" in this context does not imply covering an asset class in its entirety.

Methodology that ignores voting rights altogether is neither neutral nor moderate, but a stark exception to index providers' careful approach with critical factors to determine index construction and what qualifies as a particular type of security. To treat the 2017 no-vote IPO of Snap, Inc. in the same way as the 2018 "one share, one vote" IPO of DocuSign Inc., *ceteris paribus*, is an extreme position that gives founders or other holders of super-voting rights no incentive to uphold the Alignment principle (which we consider core to the nature of public equity) and arguably encourages founders, including those who hold board and executive roles, to shield themselves indefinitely from accountability and oversight.

Regardless of where one stands on whether voting rights are "core" to the nature of public equity, the former MSCI methodology presupposes that Alignment has *zero* connection to public equity, and that misalignment warrants *zero* adjustment. Index providers are in position to change that by addressing voting rights in a measured way, as they already do with other critical factors.

Index providers' action responds to a void left by years of inaction from stock exchanges, regulators and global regulatory coordinators.

Stock exchanges, regulators and global regulatory coordinators have not adequately responded to the growing separation of ownership and control. While various reasons explain this inaction, and fault cannot not be pinned on any one entity, what is ultimately most important is that for years, public equity has continued to slide down the path toward greater misalignment, and index providers are in position to do something substantive about it.

When the Securities and Exchange Commission (SEC) attempted to require national stock exchanges to adopt "one share, one vote" listing standards under the 1933 Exchange Act, a federal court in 1990 barred the SEC from doing so on the grounds that it would encroach on listed companies' governance. U.S. exchanges subsequently received formal requests to voluntarily adopt forward-looking, "one share, one vote" listing standards, but declined to take action. Multiple other stock exchanges, in competition with U.S. exchanges to win listings, recently adopted (or are actively seeking to adopt) listing requirements to further accommodate misalignment. CII certainly recognizes the responsibility of stock exchanges in this area, and holds out hope for listing standards that would better protect the Alignment principle. But race-to-the-bottom market forces are powerful, and we perceive there to be political pressures on some global exchanges to “race faster.”

It is far from certain whether global financial regulatory coordinators could ever generate substantive change on this matter, given their advisory function and their apparent reticence to undertake such an initiative in the past, even as misalignment grew and stock market listing requirements deteriorated. The International Organization of Securities Commissions (IOSCO) develops guidance for national securities regulators but does not make legally binding decisions. Similarly, the Council of the Organization for Economic Cooperation and Development (OECD) has the ability to set best practices and policy guidelines but they do not bind participating OECD members.

Index providers are well-positioned to apply the alignment principle fairly and broadly.

The market is already seeing signs of capital structures that appear designed explicitly to lock in founder control while complying with a technical definition of “one share, one vote.” In light of index providers’ relatively nimble process for interpreting, reviewing and updating methodologies, they stand in relatively good position to deal with such gamesmanship fairly and expeditiously. Stock exchanges have a business reason to take a lenient approach with the application and strengthening of listing standards, and have a more bureaucratic rulemaking process in responding to investor concerns on listing standards. This could complicate keeping pace with evasion strategies as they shift. Also to index providers’ advantage is the broad global reach of index constituents; the benefits of a stock exchange policy on voting rights are limited to companies listed on that exchange.

Action from index providers is overdue as long-term, fundamental shifts in public capital markets have occurred since the original decision to exclude voting rights from equity index methodology.

As capital markets evolve in fundamental ways, so too should index methodology. The growth of misalignment and the rising popularity of passive investment strategies are two major developments cited by the Discussion Paper as reasons for incorporating voting power into index methodology. We would add a third trend: the ascent of engaged ownership, including through proxy voting, as an important investor tool for driving shareholder value. In the new era of genuine accountability—particularly annual election of board members, majority vote requirements to elect uncontested directors, and a robust process for challenging underperforming boards—voting authority and vote outcomes shape corporate behavior in ways not imagined decades ago. Each of these three trends may continue, making it increasingly difficult to defend an index methodology that is blind to voting rights.

II. Suggestion to exempt companies opting to sunset their unequal voting structures from voting power calculation

We generally support the revised proposal, but there are two primary concerns that give us pause. First, we have practical concerns about the substantial turnover anticipated in connection with revising the index contributions of existing constituents, who we note adopted their capital structures having no knowledge of MSCI's proposed revision to its methodology, and the extent to which certain current constituents and markets will be underweighted relative to the old methodology. Second, we are aware of growing empirical evidence indicating that the harm caused by misalignment tends to manifest after the earliest stage of a company's public life. As a practical matter, we observe several companies already embrace this concept, having arranged in advance to wind down their misaligned structure through time-based sunset provisions.

Given both of these considerations, we suggest providing exemptive relief to prospective constituents and existing constituents that choose to adopt firm, reasonable, time-based sunset provisions in their governing documents.

New IPOs: We consider "reasonable" any sunset provision that would automatically convert the share structure to a single "one share, one vote" class within a period of no more than seven years of the IPO date. We also believe it would be reasonable if a sunset structure includes a "renewable" feature that provides that the weighted voting rights structure may be extended for additional terms, each of no more than seven years, with the approval of at least a majority of outstanding shares with inferior rights, voting separately on a "one share, one vote" basis. Any such vote to extend should be scheduled to occur no earlier than one year before the date at which the structure otherwise would automatically convert.

Existing companies: We believe that any company that is an existing index constituent or otherwise eligible to join an index also should be exempted from the new MSCI policy (that is, receive full weighting) if within the three-year grace period the company changes its governing documents to provide for a sunset, with or without a renewable feature on the terms described above, within seven years or less of the commencement of the application of MSCI's new methodology.

We observe that a seven-year sunset exemption would permit those relying on the index for investment or benchmarking to capture early-stage public company growth, even with entities with protective structures in place, while assuring that in the longer term, there are appropriate structures of accountability to shareholders. And the approach described here would provide an option to give full weighting to existing companies that persuade low-vote shareholders that the weighted voting rights structure provides long-term value and should be sustained.

We accept that much can go wrong in the short-term, and a protective structure even for seven years is not ideal and in some cases will delay necessary and appropriate corrective action. However, we recognize a strong desire by management and boards of some private companies considering tapping public markets for protective structures, and the core of our concern is lack of accountability in the long-term, beyond a reasonable time horizon for understanding risks and opportunities.

III. Answers to specific questions posed by the Expanded Consultation

MSCI: Do you agree that unequal voting shares should remain eligible for index inclusion?

We can support inclusion of unequal voting shares on an underweighted basis, as proposed by MSCI. Unequal voting shares are still equity by definition (although we question whether shares with zero voting rights should be considered true “equity”).

MSCI: Do you agree that the index weight of securities with unequal voting structures should be linked to voting power?

Yes. Factoring into each security the proportion of total voting power in the hands of non-strategic holders of listed shares is appropriate.

MSCI: Is it appropriate to delete securities with zero company voting power from the MSCI Equity Indexes?

Yes. It is appropriate to delete securities with no listed voting power in the hands of non-strategic shareholders if after three years those companies do not revise their capital structure or adopt a time-based sunset provision as described above in Section II.

MSCI: Is the application of a voting power adjustment an appropriate way to reflect misalignment between voting power and economic interest?

We believe the proposed adjustment to each security, based on the proportion of total voting power in the hands of non-strategic shareholders of listed shares, appropriately reflects misalignment.

MSCI: Is the method for calculating the adjustment adequate?

We generally believe this method is adequate for calculating the adjustment of securities with similar economic rights. However, we disagree with the proposal to ignore partial restrictions on the election of directors. We believe taking that approach will encourage companies to design capital structures around establishing control solely through the right to elect directors. We propose that for partial restrictions on the election of directors, MSCI should peg the adjustment to the lower of (a) company voting power (i.e. proportion of total voting power held by non-strategic shareholders of listed securities) on voting items *other than the election of directors*, or (b) the percentage of total board seats on which inferior class holders can vote on a “one share, one vote” basis.

MSCI: Do you agree that the votes per share should be zero in cases where voting rights are restricted, as described on page 10?

We generally agree with assigning zero votes per share in cases where shareholders cannot vote on the same items on the agenda as another share class; a share class for which certain types of shareholders cannot vote on the same items on the agenda as other types of shareholders; and share classes for which the voting rights are conditional. To be clear, we disagree with certain proposed exceptions, as detailed immediately below.

MSCI: Do you agree with the proposed exceptions on page 10?

As previously stated, we disagree with the proposed exception under which MSCI would ignore partial restrictions on the election of directors. We believe taking that approach will encourage companies to design capital structures around establishing control solely through the right to elect directors. We propose that for partial restrictions on the election of directors, MSCI should peg the adjustment to the *lower* of (a) company voting power (i.e. proportion of total voting power held by non-strategic shareholders of listed securities) on voting items *other than the election of directors* or (b) the percentage of total board seats on which inferior class holders can vote on a "one share, one vote" basis.

Additionally, while we accept that votes per share cannot be calculated for companies with "loyalty share" structures, MSCI should still expect those companies to provide, on an annual basis, sufficient information to calculate the proportion of total voting power in the hands of non-strategic shareholders of listed securities.

MSCI: Is it appropriate to grant a grace period for current constituents?

It is appropriate and critically important to grant a grace period for current constituents.

MSCI: Is a three-year grace period sufficient or should more time be given?

A three-year grace period alone is not sufficient. We believe it is appropriate for reasons stated above to supplement the three-year grace period with a time-based sunset exemption for both existing and prospective constituents. We also could support a multi-step transition lasting up to three years (see response to "multiple step transition" question below).

MSCI: Are the proposed index maintenance rules for the Vote Adjusted Security Free Float appropriate?

We have no objection to the maintenance rules described in the proposal.

MSCI: Should MSCI implement the changes for current index constituents in one step or would a multiple step transition be appropriate?

We are aware of some investor appetite to spread the implementation of the proposed changes over a period of time. Doing so could be beneficial to affected companies and investors facing the prospect of significant portfolio turnover. A multi-step approach could also be particularly appealing to certain international markets anticipated to have substantial impacts from the proposed changes. We would envision a multi-step implementation applying only to existing constituents, commencing upon the end of the three-year grace period, and concluding no later than three years thereafter.

In conclusion, we support MSCI and other major index providers taking proactive and necessary steps to revitalize long-term adherence to the Alignment principle. The Appendix [to the complete publication, available here] generally summarizes our recommendation. Thank you for consideration of our views. If we can answer any questions or provide additional information on this important matter, please do not hesitate to contact me at 202.822.0800 or ken@cii.org.

Sincerely,

Kenneth A. Bertsch
Executive Director
Council of Institutional Investors

The complete publication, including footnotes and appendix, is available here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Open Letter Regarding Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes

Posted by Barbara Novick, BlackRock, Inc., on Friday, April 20, 2018

Editor's note: Barbara Novick is Vice Chairman at BlackRock, Inc. This post is based on an open letter from BlackRock to Baer Pettit, President of MSCI, Inc. 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).

Mr. Baer Pettit President MSCI, Inc.
Ten Bishops Square, Ninth Floor
London E1 6EG United Kingdom

Re: Open Letter Regarding Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes

Dear Mr. Pettit:

BlackRock, Inc. (together with its affiliates, "BlackRock") appreciates the opportunity to comment on MSCI's *Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes*.[1] As one of the world's leading asset management firms, BlackRock manages assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

BlackRock is a strong advocate for sound corporate governance practices at publicly traded companies in which we invest on behalf of our clients, and for the preservation of investor rights. We, therefore, appreciate MSCI's attention to the issue of unequal voting rights in publicly traded companies, as these structures reduce the rights of shareholders. **However, we believe policymakers, not index providers, should set corporate governance standards.** While the objectives of MSCI's proposal are aligned with our view that "one vote for one share" is the preferable structure for publicly-traded companies, we believe that an alternative approach would

[1] MSCI, Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes (Jan. 2018), available at https://www.msci.com/documents/1296102/8328554/Consultation_Voting+Rights.pdf/15d99336-9346-4e42-9cd3-a4a03ecff339.

be more effective in achieving this objective while avoiding the significant changes to existing MSCI broad market indexes that would be required to effectuate MSCI's proposed solution.

In our view, broad market indexes should be as expansive and diverse as the underlying industries and economies whose performance they seek to capture. In constructing indexes, index providers should make every effort to reflect the investable marketplace in the broad benchmark indexes that they produce. In addition to limiting the opportunity set for index investors, the proposed changes will be costly for investors in index products that reference these indices, and these costs would be incurred for changes not related to accurate representation of the investable universe (See Appendix). For example, the turnover in ACWI, Emerging Market, and US Indexes would each result in billions of dollars of trades to adjust to the new index weightings. And in some markets, such as the UAE Index, close to 25% of the market value will be deleted from the existing index.

We recommend that MSCI pursue an alternative approach that would allow index investors to choose between (i) broad market indexes that reflect the investable universe and (ii) indexes that have alternative weightings or screen companies based on governance principles, similar to index offerings with tobacco or social screens. This solution would allow investors who feel strongly about corporate governance issues to "vote with their feet" without creating the market disruption or transaction costs associated with the proposed approach.

We believe that the context for our views on MSCI's proposal is important. Therefore, we have sought to first stake out some broad principles that BlackRock believes are important in relation to any discussion about dual share class (or weighted voting rights) companies.

BlackRock's Philosophy on Corporate Governance

We believe that certain fundamental rights should be attached to share ownership. Companies and their boards should be accountable to shareholders and structured with appropriate checks and balances to ensure that they operate in shareholders' interests. Studies have shown that good corporate governance contributes to improved corporate performance and accountability in creating long-term shareholder value for publicly traded companies.[2] The guiding principles to ensure strong corporate governance, include board accountability to shareholders, development of an independent leadership structure, and voting rights in proportion to shareholders' economic interest—in other words, "one share, one vote".

Effective voting rights are central to the rights of ownership and we believe strongly in one vote for one share as a guiding principle that supports good corporate governance. Shareholders, as the residual claimants, have the strongest interest in protecting firm value, and voting power should match economic exposure. It is at the core of corporate governance that to reduce the agency problem, all shareholders need to effectively monitor companies. Shareholders should have the right to elect, remove and nominate directors, approve the appointment of the auditor and to amend the corporate charter or bylaws. Shareholders should be able to vote on matters that are material to the protection of their investment including but not limited to changes to the

[2] For a review of the academic literature, see Inessa Love, *Corporate Governance and Performance around the World: What We Know and What We Don't*, World Bank Research Observer, Vol. 26, Issue 1 (2011), available at https://elibrary.worldbank.org/doi/pdf/10.1093/wbro/lkp030.

purpose of the business, matters related to capital issuance such as dilution levels and preemptive rights, the distribution of income and the capital structure.

BlackRock's View on Dual Share Class Listings

We are concerned that the creation of a dual share class may result in an over- concentration of power in the hands of a few shareholders, thus disenfranchising other shareholders and amplifying the conflict of interest, which the one share, one vote principle is designed to mitigate. As such, we are concerned that dual class structures call into question a fundamental tenet of good corporate governance and undermine the efforts to improve the quality of investor stewardship, potentially making such structures less than ideal for investors. As regulators call on investors to further engage with issuers in a deeper and more responsible way, we believe they equally should protect shareholders' rights, particularly those of minority shareholders, by promoting the one share, one vote principle.

While our preference is for one share, one vote companies, we recognize that in certain circumstances, there may be a valid argument for dual-class listings, at least for a limited period of time. We also recognize that dual share class structures are not "new" and in fact have been used for many decades. The proponents of dual class shares make the argument that unequal voting rights allow entrepreneurial founders to retain control and invest for long- term results without being exposed to outside pressure to maximize short-term results. **We recognize the potential benefits of dual class shares to newly public companies as they establish themselves, however, we believe that these structures should have a specific and limited duration.**[3] We recommend that companies incorporate sunset provisions based upon time or a triggered event to eliminate unequal share classes. Alternatively, companies could put their company capital structure to a vote of all shareholders every 5 to 10 years. The latter approach would give the company and shareholders the ability to review and discuss the merits of maintaining the structure or converting to a single share class. We note that each of these solutions would balance companies' needs to focus on the long-term with shareholders' needs for accountability.

Roles and Responsibilities of Various Stakeholders

Within this discussion, it is important to remember that there are multiple stakeholders, each with an important role to play. For example, stock exchanges, market regulators, global policy bodies, publicly listed companies, asset managers, end-investors, and index providers have roles to play in the discussion. Two of the global policy bodies that have been involved in corporate governance issues are International Organization for Securities Commissions ("IOSCO") and Organization for Economic Co-operation and Development ("OECD").

[3] Looking over 35 years of data, a research found that "at the time of the IPO, dual class firms tend to have higher valuations than single-class firms, which valuation premium dissipates over time and turns into a discount about six years after the IPO." See Martijn Cremers, Beni Lauterbach, and Anete Pajuste, *The Life-Cycle of Dual Class Firms*, European Corporate Governance Institute (ECGI) – Finance Working Paper No. 550/2018 (2018), available at https://ssrn.com/abstract=3062895. Harvard Law School professor Lucian Bebchuk also argues that "as time passes, the potential costs of a dual-class structure tend to increase and the potential benefits tend to erode". See Lucian A. Bebchuk and Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, Virginia Law Review, Vol. 103, (Jun. 2017), available at https://ssrn.com/abstract=2954630 at 585-631.

We believe that regulators in conjunction with listing exchanges should be the arbiters of corporate governance standards for publicly listed companies. Ideally, exchanges would limit the use of dual share class structures and market regulators would mandate minimum listing standards. However, we recognize that competitive pressures may discourage these stakeholders from imposing standards that would create an uneven playing field across jurisdictions. In fact, we are concerned that the current system will lead to a race to the bottom as exchanges compete for listings by lowering their standards for corporate governance. **In light of this collective action problem, a global agreement is necessary to establish minimum corporate governance standards that would ensure a minimum level of investor protection.** We believe a global body such as IOSCO is well positioned to establish global guidelines for listing standards that could then be translated into national regulation. While we recognize that individual countries are not required to implement global standards, the introduction of global principles has worked well in the past to establish a benchmark that creates a level playing field for regulation that is in the best interests of end- investors.

In our view, the role of index providers differs significantly from the role of exchanges and regulators. Specifically, the role of index providers is to provide indexes that reflect the investable universe that the index seeks to represent, as well as offer more specialized indexes that reflect investor preferences. Index providers can support efforts to promote good governance by creating alternative indexes that incorporate corporate governance screens, such as alternative weightings or exclusion of companies with unequal voting rights, following a similar approach to index offerings with tobacco or social screens. This solution would allow investors who feel strongly about corporate governance issues to "vote with their feet", while allowing other investors who prefer their broad market index investments to reflect the investable universe to continue to do so. In addition, this approach would avoid the market disruption or transaction costs associated with reconstituting the broad market indexes.

In summary, **policymakers, not index providers, should set corporate governance standards.**

BlackRock's View on MSCI's Proposal

We believe index providers should make every effort to reflect the investable marketplace in the broad market indexes that they produce. In our view, broad market indexes should be as expansive and diverse as the underlying industries and economies whose performance they seek to capture. This inclusive approach better facilitates investors' use of benchmark indices and aligns with the diversity of objectives across public equity investors. **BlackRock recommends that MSCI continue to include securities with unequal voting rights at the current weights. In addition, we recommend MSCI offer a range of bespoke indices, some of which may include or exclude certain securities across a variety of financial characteristics and/or environmental, social and governance factors, thus allowing investors to reflect their individual preferences. Furthermore, BlackRock recommends that the index providers as well as asset managers and end investors petition IOSCO to engage in a project whereby IOSCO would establish minimum corporate governance standards for companies to be eligible for public listing regardless of the jurisdiction of the exchange.**

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We thank MSCI for providing BlackRock the opportunity to comment on the MSCI's *Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes*. Please contact the undersigned if you have any questions or comments regarding BlackRock's views.

Sincerely, Barbara Novick

Vice Chairman

Appendix: Transaction costs and liquidity implications

Under MSCI's proposed change to exclude or down-weight company stocks based on weighted voting rights, investors will experience transaction costs and liquidity challenges upon implementation of these changes. To put this in perspective, below are a few of the practical impacts of MSCI's proposed change:

- Lowering weights of securities with unequal voting shares will lead to two-way turnover of 8.5% and 10.7% for the ACWI and Emerging Market Indices, respectively. The weight of Facebook in the MSCI USA Index would drop 1.15%, resulting in an estimated $5 billion sell trade in the market across indexers over two days.
- Deleting securities with zero voting power will lead to 11 deleted securities. The largest is Emirates Telecom Group, which represents 23.3% of the UAE index.
- Reinvestment of sale proceeds in illiquid markets will be challenging, leading to multiple days of trading and ticketing costs.

Part II: Environmental and Social Activism

A Sense of Purpose

Posted by Larry Fink, BlackRock, Inc., on Wednesday, January 17, 2018

Editor's note: Larry Fink is Founder, Chairman and CEO of BlackRock, Inc. This post is based on Mr. Fink's annual letter to CEOs.

Dear CEO,

As BlackRock approaches its 30th anniversary this year, I have had the opportunity to reflect on the most pressing issues facing investors today and how BlackRock must adapt to serve our clients more effectively. It is a great privilege and responsibility to manage the assets clients have entrusted to us, most of which are invested for long-term goals such as retirement. As a fiduciary, BlackRock engages with companies to drive the sustainable, long-term growth that our clients need to meet their goals.

In 2017, equities enjoyed an extraordinary run—with record highs across a wide range of sectors—and yet popular frustration and apprehension about the future simultaneously reached new heights. We are seeing a paradox of high returns and high anxiety. Since the financial crisis, those with capital have reaped enormous benefits. At the same time, many individuals across the world are facing a combination of low rates, low wage growth, and inadequate retirement systems. Many don't have the financial capacity, the resources, or the tools to save effectively; those who are invested are too often over-allocated to cash. For millions, the prospect of a secure retirement is slipping further and further away—especially among workers with less education, whose job security is increasingly tenuous. I believe these trends are a major source of the anxiety and polarization that we see across the world today.

We also see many governments failing to prepare for the future, on issues ranging from retirement and infrastructure to automation and worker retraining. As a result, society increasingly is turning to the private sector and asking that companies respond to broader societal challenges. Indeed, the public expectations of your company have never been greater. Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.

A new model for corporate governance

Globally, investors' increasing use of index funds is driving a transformation in BlackRock's fiduciary responsibility and the wider landscape of corporate governance. In the $1.7 trillion in active funds we manage, BlackRock can choose to sell the securities of a company if we are doubtful about its strategic direction or long-term growth. In managing our index funds, however, BlackRock cannot express its disapproval by selling the company's securities as long as that company remains in the relevant index. As a result, our responsibility to engage and vote is more important than ever. In this sense, index investors are the ultimate long-term investors—providing patient capital for companies to grow and prosper.

Just as the responsibilities your company faces have grown, so too have the responsibilities of asset managers. We must be active, engaged agents on behalf of the clients invested with BlackRock, who are the true owners of your company. This responsibility goes beyond casting proxy votes at annual meetings—it means investing the time and resources necessary to foster long-term value.

The time has come for a new model of shareholder engagement—one that strengthens and deepens communication between shareholders and the companies that they own. I have written before that companies have been too focused on quarterly results; similarly, shareholder engagement has been too focused on annual meetings and proxy votes. If engagement is to be meaningful and productive—if we collectively are going to focus on benefitting shareholders instead of wasting time and money in proxy fights—then engagement needs to be a year-round conversation about improving long-term value.

BlackRock recognizes and embraces our responsibility to help drive this change. Over the past several years, we have undertaken a concentrated effort to evolve our approach, led by Michelle Edkins, our global head of investment stewardship. Since 2011, Michelle has helped transform our practice from one predominantly focused on proxy voting towards an approach based on engagement with companies.

The growth of indexing demands that we now take this function to a new level. Reflecting the growing importance of investment stewardship, I have asked Barbara Novick, Vice Chairman and a co-founder of BlackRock, to oversee the firm's efforts. Michelle will continue to lead the global investment stewardship group day-to-day. We also intend to double the size of the investment stewardship team over the next three years. The growth of our team will help foster even more effective engagement with your company by building a framework for deeper, more frequent, and more productive conversations.

Your strategy, your board, and your purpose

In order to make engagement with shareholders as productive as possible, companies must be able to describe their strategy for long-term growth. I want to reiterate our request, outlined in past letters, that you publicly articulate your company's strategic framework for long-term value creation and explicitly affirm that it has been reviewed by your board of directors. This demonstrates to investors that your board is engaged with the strategic direction of the company. When we meet with directors, we also expect them to describe the Board process for overseeing your strategy.

The statement of long-term strategy is essential to understanding a company's actions and policies, its preparation for potential challenges, and the context of its shorter-term decisions. Your company's strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also understand the societal impact of your business as well as the ways that broad, structural trends—from slow wage growth to rising automation to climate change—affect your potential for growth.

These strategy statements are not meant to be set in stone—rather, they should continue to evolve along with the business environment and explicitly recognize possible areas of investor dissatisfaction. Of course, we recognize that the market is far more comfortable with 10Qs and colored proxy cards than complex strategy discussions. But a central reason for the rise of activism—and wasteful proxy fights—is that companies have not been explicit enough about their long-term strategies.

In the United States, for example, companies should explain to investors how the significant changes to tax law fit into their long-term strategy. What will you do with increased after-tax cash flow, and how will you use it to create long-term value? This is a particularly critical moment for companies to explain their long-term plans to investors. Tax changes will embolden those activists with a short-term focus to demand answers on the use of increased cash flows, and companies who have not already developed and explained their plans will find it difficult to defend against these campaigns. The U.S. tax bill is only one such example—regardless of a company's jurisdiction, it is your responsibility to explain to shareholders how major legislative or regulatory changes will impact not just next year's balance sheet, but also your long-term strategy for growth.

Where activists do offer valuable ideas—which is more often than some detractors suggest—we encourage companies to begin discussions early, to engage with shareholders like BlackRock, and to bring other critical stakeholders to the table. But when a company waits until a proxy proposal to engage or fails to express its long-term strategy in a compelling manner, we believe the opportunity for meaningful dialogue has often already been missed.

The board's engagement in developing your long-term strategy is essential because an engaged board and a long-term approach are valuable indicators of a company's ability to create long-term value for shareholders. Just as we seek deeper conversation between companies and shareholders, we also ask that directors assume deeper involvement with a firm's long-term strategy. Boards meet only periodically, but their responsibility is continuous. Directors whose knowledge is derived only from sporadic meetings are not fulfilling their duty to shareholders. Likewise, executives who view boards as a nuisance only undermine themselves and the company's prospects for long-term growth.

We also will continue to emphasize the importance of a diverse board. Boards with a diverse mix of genders, ethnicities, career experiences, and ways of thinking have, as a result, a more diverse and aware mindset. They are less likely to succumb to groupthink or miss new threats to a company’s business model. And they are better able to identify opportunities that promote long-term growth.

Furthermore, the board is essential to helping a company articulate and pursue its purpose, as well as respond to the questions that are increasingly important to its investors, its consumers, and the communities in which it operates. In the current environment, these stakeholders are demanding that companies exercise leadership on a broader range of issues. And they are right to: a company’s ability to manage environmental, social, and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process.

Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that that will help them achieve their goals?

As we enter 2018, BlackRock is eager to participate in discussions about long-term value creation and work to build a better framework for serving all your stakeholders. Today, our clients—who are your company’s owners—are asking you to demonstrate the leadership and clarity that will drive not only their own investment returns, but also the prosperity and security of their fellow citizens. We look forward to engaging with you on these issues.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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BlackRock Investment Stewardship's Approach to Engagement on Human Capital Management

Posted by Michelle Edkins, BlackRock Investment Stewardship, on Wednesday, March 28, 2018

Editor's note: Michelle Edkins is the Managing Director and Global Head of BlackRock Investment Stewardship. This post is based on a publication prepared by BlackRock Investment Stewardship.

BlackRock has an industry leading global investment stewardship program that promotes corporate governance best practices at the companies in which we invest. This program is part of the investment function at BlackRock, fulfilling our fiduciary duty to protect and enhance the value of our clients' assets.

As Larry Fink recently wrote in his 2018 annual letter to CEOs:

> Companies must ask themselves: What role do we play in the community? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world?

For several years, the BlackRock Investment Stewardship (BIS) team has been engaging companies on the topic of human capital which we also identify as one of our 2018 engagement priorities.[1] The BIS team has been in discussions with companies about their management of employees as an investment issue.

This post sets out in some detail our thinking on human capital management (HCM) and explains how we approach engagement on the topic.

Why Human Capital Management is an Investment Issue

Most companies BlackRock invests in on behalf of clients have, to varying degrees, articulated in their public disclosures that they are operating in a talent constrained environment, or put differently, are in a war for talent. It is therefore important to investors that companies explain as part of their corporate strategy how they establish themselves as the employer of choice for the workers on whom they depend. A company's approach to HCM—employee development, diversity and a commitment to equal employment opportunity, health and safety, labor relations, and supply chain labor standards, amongst other things—will vary across sectors but is a factor in

[1] BIS' 2017-2018 engagement priorities are publicly available on our website at https://www.blackrock.com/corporate/en-gb/about-us/investment-stewardship/voting-guidelines-reports-position-papers#2017-2018-priorities

business continuity and success. In light of evolving market trends like shortages of skilled labor, uneven wage growth, and technology that is transforming the labor market, many companies and investors consider robust HCM a competitive advantage.

Research has consistently shown the importance of human capital to company performance. Companies included in Fortune magazine's "100 Best Companies to Work For" lists earned, over the long-term, excess risk-adjusted returns of 3.5%.[2] Another report surveyed a multitude of studies on human capital and found that there is a positive correlation between human resource initiatives and investment outcomes such as total shareholder return, return on assets, return on earnings, return on investment and return on capital employed.[3] A survey concluded that companies that had a workforce that was not engaged had an average one-year operating margin below 10%; however, those that consistently promoted workers' well-being had an average one-year operating margin of 27%.

BlackRock's Engagement On Human Capital Management

HCM is both a board and a management issue. We would expect a company's board to be deeply engaged in the oversight of a company's strategy and the defining of a company's purpose—to help ensure the effective strategic implementation of HCM throughout their organization. Companies that can better articulate their purpose are more likely to build strong relationships with their employees (and customers), and have a clear sense of their strategic objectives. These are essential components of long-term growth. Employees who do not feel valued by their organization are generally less productive or more likely to leave. Product quality and reputation can suffer when employees are not fully engaged and supportive of the company, its business and goals. When present, these dynamics make it much more difficult for a company to meet its strategic objectives. For management, it is an issue that is central to their everyday duties. We also expect that boards, acting as fiduciaries on behalf of investors and as those who help set the tone at the top, to be focused on the opportunities and risks associated with HCM.

The BIS team is aware that disclosure of information on HCM is still evolving and that the way HCM risks manifest themselves may vary by industry and market. We are members of the Investor Advisory Group of the Sustainability Accounting Standards Board (SASB), which provides industry-specific HCM metrics. We encourage companies to aim over time to go beyond commentaries and provide more transparency on their practices. Investors recognize that most companies are already in possession of HCM data on their workforce, but are cautious of disclosing this information. We believe that both qualitative and quantifiable indicators can help effectively distinguish companies that are managing this important driver of value in their business.

Our engagements seek to be constructive, aiming to build mutual understanding while asking probing questions. Where we believe a company's practices fall short relative to market or peer practice, we will share our insights and perspectives.

[2] Edmans, Alex. "Does the Stock Market Fully Value Intangibles," *Journal of Financial Economics*101 (2011): 621-640.

[3] Bernstein, Aaron and Larry Beeferman, "The Materiality of Human Capital to Corporate Financial Performance," Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School, April 2015

When engaging boards on HCM we are likely to discuss:

- Oversight of policies meant to protect employees (e.g., whistleblowing, codes of conduct, EEO policies) and the level of reporting the board receives from management to assess their implementation
- Process to oversee that the many components of a company's HCM strategy align themselves to create a healthy culture and prevent unwanted behaviors
- Reporting to the board on the integration of HCM risks into risk management processes
- Current board and employee composition as it relates to diversity
- Consideration of linking HCM performance to executive compensation to promote board accountability
- Board member visits to establishments or factories to independently assess the culture and operations of the company

When engaging management teams, the topics we may cover include:

- Policies to encourage employee engagement outcomes and key drivers (e.g., wellness programs, support of employee networks, training and development programs, and stock participation programs)
- Process for ensuring employee health and safety and complying with occupational health and safety policies
- Voluntary and involuntary turnover on various dimensions (e.g., seniority of roles, tenure, gender, and ethnicity)
- Statistics on gender and other diversity characteristics as well as promotion rates for and compensation gaps across different employee demographics
- Programs to engage organized labor and their representatives, where relevant
- Systems to oversee matters related to the supply chain (including contingent workers, contractors and subcontractors)

BlackRock Talks ... and U.S. Companies Must Listen

Posted by Ed Batts, Orrick, Herrington & Sutcliffe LLP, on Tuesday, February 13, 2018

Editor's note: Ed Batts is partner and Chair of the M&A and Private Equity groups at Orrick, Herrington & Sutcliffe LLP. This post is based on an Orrick publication by Mr. Batts. Related research from the Program on Corporate Governance includes The Agency Problems of Institutional Investors by Lucian Bebchuk, Alma Cohen, and Scott Hirst; and Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

In BlackRock CEO and Co-founder Larry Fink's annual letter to companies on January 16, he issued a call to action for companies to have "a clear sense of purpose." To BlackRock, having "a clear sense of purpose" means much more than simply delivering quarterly financial results—companies will be expected to have a strong commitment to evolving Environmental, Social and Governance (ESG) issues.

This letter matters both because BlackRock is an important large investor of actively managed assets and—more importantly—because we are living in a new world order of many fewer public companies with, at the same time, a continued crescendo of passive investment allocation. These changes in the U.S. equities markets have been underway for some time, but with the recent significant bull market run they are being magnified at an accelerated pace.

Below is a quick tour of how we got here. And then we discuss the take-away: For the foreseeable future, companies and their boards need to be in dialogue with passive investors' governance departments. And they need to be prepared for a conversation in which ESG issues are squarely on the agenda.

Part I: The Revolution in U.S. Equity Markets

Pre-Index Investing

In the "old" days (think when EF Hutton was making those "people listen" commercials), a company's stockholders were divided into:

- **Active/Fundamental Mutual Funds** (e.g. Fidelity, T. Rowe, Wellington)
- **Hedge Funds** (e.g. Tiger Management, Bridgewater Associates)
- **Pension Funds** (e.g. CalPERS/CalSTRS, Ontario Teachers' Pension Plan)
- **Labor Funds** (a.k.a. Taft-Hartley multi-employer funds) (e.g. Service Employees International Union or the Sheet Metal Workers International Association)
- **Activist Investors** (essentially a subset of hedge) (e.g. Carl Icahn and Nelson Peltz)
- **Retail Investors**
- **Insiders/Management**

The Ongoing Massive Shift in U.S. Equities Ownership

Two market phenomena have radically altered that landscape.

First, ***the number of actors/companies in which broad-market passive funds may invest has roughly halved, while average market capitalization has more than tripled***.

- The total number of domestic public companies has shrunk from over 8,100 in 1996 to 4,300 today (*World Bank/World Federation of Exchanges*). That essentially eliminates half the domestic (non-foreign listing) investment targets in the U.S. And foreign companies listed in the U.S. add only 900.
- Total U.S. domestic equity market value in that same twenty-year period has doubled, from just over $12 trillion to $27 trillion (held constant in 2017 dollars) *(Credit Suisse)*, going from 105 percent to 147 percent of annual U.S. GDP (*World Bank/World Federation of Exchanges*).
- Commensurately, to balance out fewer companies with greater total value, average domestic public market capitalization of a given public company has increased from $1.7 billion to over $6.9 billion in constant dollars (*Credit Suisse*). Median value is $832 million—and that median value is essentially what market observers would posit is the minimum value necessary for a public company to have scale and liquidity in its public float (*E&Y*).
- The top 1 percent of domestic public companies—roughly 30 companies—account for 29 percent of aggregate market value (*E&Y*).
- The top 4 percent of domestic public companies—roughly 130 companies, each of which is worth more than $50 billion—account for over 50 percent of aggregate market value (*E&Y*).
- To draw further conclusions: Roughly 1,650 domestic public companies are under $832 million in market capitalization. That leaves approximately 1,500 companies “in the middle”—a middle that ranges vastly from roughly $1 billion to $50 billion. And this is the concentrated set of companies on which the broad-based passive index funds by definition must be focused.

Second, as “the market” has decreased in number of actors/companies, ***it has been flooded with allocation to passive vehicles***, whether Exchange Traded Funds (ETFs, whose prices fluctuate intra-day on a securities exchange) or mutual funds (whose prices are calculated once a day after market close):

- *Total Market Value*: More than 40 percent of U.S. equity assets under management (AUM) are in passive vehicles (*Goldman Sachs*) and, out of the entire U.S. equity market (professionally held plus individually invested), 30 percent are in passive vehicles (*Morningstar*).
- *Concurrent Decline in Individual Ownership:* Individual ownership has dropped precipitously from ½ of the market to 1/5 of the market—50 percent in 1976, 27 percent in 1996 and 21.5 percent in 2016 (*Credit Suisse).*
- *Trend*: In 2016, $506 billion flowed into passive funds, while $341 billion was hemorrhaged from active funds (*Morningstar*).

- *Trading Volume*: 25 percent of daily trading volume on U.S. exchanges is in ETFs—not actual stocks (*Goldman Sachs*). There were 2 ETFs in 1996. There were 658 as of 2016, and the number is growing (*Credit Suisse)*.

The three largest passive investment management firms are (with numbers as of September 30, 2017—and no doubt increased since then):

- **BlackRock, New York City:** Out of almost $6 trillion AUM, $1.2 trillion is in the popular iShares equity-based ETFs (which tripled since BlackRock purchased the business from Barclays in 2009); another $1.6 trillion is in institutional passive equity funds. BlackRock, then, holds $2.8 trillion in passive equity strategy vehicles. While BlackRock does not report specific geographic investment mix, a rough approximation would be that some 70 percent of it is likely in U.S. markets (BlackRock 3Q18 Form 10-Q).
- **Vanguard, Valley Forge, Pennsylvania:** $4.5 trillion AUM—the vast majority in U.S. index investing. Its founder, Jack Bogle—after having been fired from active manager Wellington—was the original primary advocate of indexing and created an index giant. In contrast, its large fundamental-based mutual fund competitor, Fidelity, has under $2 trillion AUM. Four of five of the largest U.S. mutual funds are index funds from Vanguard—the fifth is Fidelity's money market fund—an investment in essentially cash, not portfolio management (*Investopedia*). In the past three years, Vanguard received about 85 percent of all new U.S. mutual fund investment money, while the remaining 15 percent went to all of Vanguard's other 4,000 mutual fund competitors <u>all combined</u> (*Morningstar/The New York Times*).
- **State Street Global Advisors (SSgA), Boston:** $2.6 trillion AUM of which 70 percent is in North America, $1.5 trillion in passive equity. State Street, while separately a behemoth in third party securities custodianship, remains the smallest of the passive investment management shops—but has the well-known SPDR ETFs.

The result is that passive investment management firms now hold massive portions (closing in on 1/3) of U.S. equities. And because they are passive, they cannot summarily buy—or sell. Once a passive fund purchases an equity, it is there to stay … forever … unless the company runs into so much trouble as to fall off the particular index. A passive fund's holdings may fluctuate with overall investment levels in U.S. equities; however, a passive fund's ownership level relative to other investors is unlikely to materially change and, in fact, given the seeming march towards greater value, such fluctuations of late have meant only increased ownership levels as "dry powder" continues to aggressively enter the markets.

Part II: Three Ground Rules for Companies Living in a New World Order of Passive Investing

Ground Rule #1: Each of the "Big 3" Passive Shops Has an In-House Governance Function. Get to know them well in advance—to avoid barely getting a short, rushed meeting with them when it is crunch time.

As of January 2018, the heads of these departments (referred to as "Investment Stewardship") were:

- **BlackRock:** ***Michelle Edkins***, who Larry Fink announced in his message will be supplemented by BlackRock's Vice Chairman and Co-founder, ***Barbara Novick***. Ms. Edkins is a New Zealander who began in investment management in 1997 in the UK and joined BlackRock in 2009.
- **Vanguard:** ***Glenn Booream***, who joined Vanguard directly from college in 1989.
- **SSgA**: ***Rakhi Kumar***, a former chartered accountant in India who picked up an MBA from Yale and worked for Moody's before spending the last seven years at SSgA.

Ground Rule #2: Passive Investors' Influence Cannot Be Underestimated.

Take, for example, the heated October 2017 proxy contest between Proctor & Gamble and Nelson Peltz's Trian Management. P&G's share ownership falls out as (data from *Proxy Insight*; shares rounded to nearest million):

- Passives: Vanguard (187 million), BlackRock (159 million) and SSgA (113 million): They are #1-3 of the top stockholders—and the next largest holder is Bank of America at a distant 44 million.
- Major Actives (cross-section based on past importance/author experience): Capital, Dimensional, Fidelity, T.Rowe, TIAA-CREF and Wellington, <u>all combined</u>: 106 million.
- Teacher and state/municipal employee pension funds in California, Florida, New York, Ontario and Texas, <u>all combined</u>: 29 million.
- In other words, the most well-known active funds and major pension funds <u>all combined</u> hold 135 million shares in P&G—versus the smallest of the major 3 passive positions, SSgA, at 113 million shares.

All of the intensive proxy solicitation and lobbying effort invested into hitherto major (and still relatively large) funds spread throughout North America can be matched or dwarfed in a single vote from a passive investment management company.

Ground Rule #3: Passive Shops Are Independent Thinkers Who Do Not Necessarily Follow the Herd. Moreover, ISS and Glass Lewis No Longer Are the Undisputed Shepherds of the Herd.

Historically, fundamental/active fund portfolio managers focused almost exclusively on quantitative return of equity value. Beginning in the late 1980s, however, the U.S. Department of Labor's Pension and Welfare Benefits Administration—exercising its jurisdiction for retirement plan investments through ERISA—issued advisory letters in *Avon* (1988) and *Monks* (1990) and then a 1994 Interpretive Bulletin, which cumulatively resulted as a practical matter in forcing investment advisers to vote. From *Avon*: "In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock." Rather than each investment adviser devoting the significant resources to establishing individual corporate governance departments to vote on thousands of annual proxies, most instead outsourced the substantive analysis to proxy advisory firms, first ISS and then its later arch rival, Glass Lewis. These outsourced proxy advisory firms for many years reigned supreme, particularly with ISS's near-monolithic dominance of vote recommendations for funds.

Such hegemony has substantially eroded. Using the recent P&G context example, while both ISS and Glass Lewis recommended voting in favor of Mr. Peltz, P&G's single largest shareholder, Vanguard, reportedly ignored those recommendations and voted with P&G management's slate of directors. After a *very*, *very* close vote, Mr. Peltz ultimately was seated on the P&G board. This also shows that while the Big 3 passives matter, if they split—then every vote from non-passive stockholders suddenly becomes mathematically critical. Try hard to avoid ignoring or making an enemy of any institutional stockholder.

BlackRock's 2018 Annual Letter to Companies

Index investing is an interesting commercial environment, since the primary historical factor for investing—seeking individual equity or fund return/Alpha—is stripped from consideration. Instead, fund expenses become key—but there are only so many fractions of a basis point to cut further before the expenses are very similar among competitors—and very, very cheap, at least in contrast to active trader funds or the steep carry and management fees of hedge funds. After two years of steep outflows and sub-market returns, hedge funds have stabilized of late—but even so, *Boston Consulting Group* is forecasting that a reasonable bad case—where hedge returns continue to suffer as they did in the past couple of years—could entail a further 30 percent shrinkage in hedge AUM by 2020. Conversely, keep in mind that, according to *The New York Times*, Vanguard has one employee (in any function …) for every approximately $44 billion of AUM—and that Vanguard's indices have significantly outperformed hedge fund median returns in this bull market.

In recent years, SSgA has increasingly differentiated itself from index fund purchasers by advocating for attention to Environmental, Social and Governance (ESG) issues. And while BlackRock certainly has not avoided the subject, it hitherto did not issue as clear a call to action. Indeed, while many similar themes were raised in last year's annual letter, they were couched in more gentle coaxing, rather than this year's direct call to action:

"Furthermore, the board is essential to helping a company articulate and pursue its purpose, as well as respond to the questions that are increasingly important to its investors, its consumers, and the communities in which it operates. In the current environment, these stakeholders are demanding that companies exercise leadership on a broader range of issues. And they are right to: a company's ability to manage environmental, social, and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process.

"Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that will help them achieve their goals?"

What Does This Mean in Practice?

There undoubtedly is a hypothetical saturation point at which macro-economic headwinds and increasing concentration of equity ownership in passive investment funds will collide—where too much investing dollars could be postulated to be “stranded” in rule-based investing at much more higher levels than indices are now in the aggregate. This potentially could create greater volatility since wholesale rotation out of equities entirely, rather than from one stock to another, seems more likely when dumping an index. Perhaps then, “seeking alpha” (and a bit more of Buffet’s value investing) may return with vengeance.

But don’t bet on it anytime soon. If anything, we appear headed for significant macro-economic tailwinds for the near future. As but one indicator, the new tax bill will likely significantly bolster equity prices, as both lower domestic effective tax rates and repatriation of foreign cash will likely be used to both repurchase stock and provide tidy sums for either dividends or fights over capital allocation strategies with activist investors—buckle up! A rising tide of equity prices raises all ships—and a continuing bull market is unlikely to shake investors’ seemingly unending appetite for smile-inducing returns from low cost, low hassle passive funds—further concentrating voting.

Companies need to expect:

- The continued need to **engage in discussion routinely** with governance departments. In fact, **ask to do so**.
- One or more **independent directors to be part of those discussions**. Depending on the circumstance, it may be necessary to give an investment steward the opportunity to talk without the CEO present for some part of the conversation—still a generally unpopular concept with management.
- **Pointed questions on board diversity**—gender and racial in particular—as well as pay equity.
- To **substantively engage on environmental topics**, such as climate change impact.

The road shows of yesteryear meant relatively narrow lanes of traipsing up and down the Northeastern Corridor—from Baltimore to New York and then Philly to Boston—to perform a pilgrimage to a few portfolio active fund managers and review a financial model. Now management—and importantly, board members—get to add passive shops to their tours. The sooner that boards and, of course, management accept a new reality driven by enormous underlying market dynamics, the sooner they will adapt to a new power structure that increasingly looks far beyond EPS guidance.

Harvard Law School Forum on Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

Corporate Purpose: ESG, CSR, PRI and Sustainable Long-Term Investment

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Friday, May 4, 2018

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 *The New Paradigm* for corporate governance and investor stewardship (discussed on the Forum here), I, together with a Wachtell Lipton team, created for the International Business Council of the World Economic Forum, deliberately conflated ESG (environmental, social and governance), CSR (corporate social responsibility), PRI (the UN's principles for responsible investment) and sustainability because they are all essential elements of long-term investment strategies designed to create increasing profits and value for shareholders.

Now, the April 23rd Department of Labor Field Assistance Bulletin No. 2018-01 has raised questions about the role of ESG factors in investment. Some have read it as foreclosing ERISA investors from promoting ESG on the assumption that it is at the expense of profits and shareholder value. Others have argued that that is an extreme interpretation. As set forth in our April 27 note on the DOL bulletin, there is no need for the debate when it is recognized that ESG, CSR and PRI are essential factors in sustainable long-term investment to create growing shareholder value. If the purpose of a corporation does not include ESG, CSR and PRI, it is unlikely that it will be able to create the sustainable long-term growth being sought by the people for whom the investors are acting. This was made clear in Larry Fink's 2018 letter to CEOs (discussed on the Forum here):

> Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.

The question of purpose of the corporation has been long debated and in recent years has become the subject of intense academic discussion and proposed and enacted regulation.

> The Dutch Corporate Governance Code, issued December 8, 2016, expressed purpose as the duty of the management board:

> The management board should develop a view on long-term value creation by the company and its affiliated enterprise and should formulate a strategy in line with this. Depending on market dynamics, it may be necessary to make short-term adjustments to the strategy.
>
> 1. When developing the strategy, attention should in any event be paid to the following:
> 2. the strategy's implementation and feasibility;
> 3. the business model applied by the company and the market in which the company and its affiliated enterprise operate;
> 4. opportunities and risks for the company;
> 5. the company's operational and financial goals and their impact on its future position in relevant markets;
> 6. the interests of the stakeholders; and
> 7. any other aspects relevant to the company and its affiliated enterprise, such as the environment, social and employee-related matters, the chain within which the enterprise operates, respect for human rights, and fighting corruption and bribery.

In March of this year, a report of a commission appointed by the French Government recommended amendment to the French Civil Code to add, "The company shall be managed in its own interest, considering the social and environmental consequences of its activity," following the existing, "All companies shall have a lawful purpose and be incorporated in the common interest of the shareholders." The draft amendment is intended to establish the principle that each company should pursue its own interests—namely, the continuity of its operation, sustainability through investment, collective creation and innovation. The report notes that this amendment integrates corporate and social responsibility considerations into corporate governance and goes on to state that each company has a purpose not reducible to profit and needs to be aware of its purpose. The report recommends an amendment to the French Commercial Code for the purpose of entrusting boards of directors to define a company's purpose in order to guide the company's strategy, taking into account its social and environmental consequences.

Also, in March, the European Commission in its *Action Plan: Financing Sustainable Growth* proposed both corporate governance and investor stewardship requirements:

> Subject to the outcome of its impact assessment, the Commission will table a legislative proposal to clarify institutional investors' and asset managers' duties in relation to sustainability considerations by Q2 2018. The proposal will aim to (i) explicitly require institutional investors and asset managers to integrate sustainability considerations in the investment decision-making process and (ii) increase transparency towards end-investors on how they integrate such sustainability factors in their investment decisions in particular as concerns their exposure to sustainability risks.

Further, the European Commission proposes a number of other laws or regulations designed to promote ESG, CSR and sustainable long-term investment.

While I agree with the legislative and regulatory proposals to establish the purpose of the corporation, I would prefer that they not be necessary. Such measures are often accompanied by, or soon beget, restrictions on corporate what I proposed in *The New Paradigm*:

The New Paradigm is an emerging corporate governance framework that derives from the recognition by corporations, their CEOs and boards of directors, and by leading institutional investors and asset managers ("investors"), that short-termism and attacks by short-term financial activists significantly impede long-term economic prosperity. The economic impact of a short-term myopic approach to managing and investing in businesses has become abundantly clear and has been generating rising levels of concern across a broad spectrum of stakeholders, including corporations, investors, policymakers and academics. The proposition that short-term financial activists and reactive corporate behavior spur sustainable improvements in corporate performance, and thereby systemically increase rather than undermine long-term economic prosperity and social welfare, has been overwhelmingly disproved by the real world experience of corporate decision-makers as well as a growing body of academic research. This emerging consensus has reached a tipping point, and decisive action is imperative. *The New Paradigm* is premised on the idea that corporations and institutional investors can forge a meaningful and successful private-sector solution, which may preempt a new wave of legislation and regulation.

January 6, 2018

Board of Directors
Apple Inc.
1 Infinite Loop
Cupertino, California 95014

Ladies & Gentlemen,

JANA Partners LLC and the California State Teachers' Retirement System ("we" or "us") collectively own approximately $2 billion in value of shares of Apple Inc. ("Apple" or "you"). As shareholders, we recognize your unique role in the history of innovation and the fact that Apple is one of the most valuable brand names in the world. In partnership with experts including Dr. Michael Rich, founding director of the Center on Media and Child Health at Boston Children's Hospital/Harvard Medical School Teaching Hospital and Associate Professor of Pediatrics at Harvard Medical School, and Professor Jean M. Twenge, psychologist at San Diego State University and author of the book *iGen*, we have reviewed the evidence and we believe there is a clear need for Apple to offer parents more choices and tools to help them ensure that young consumers are using your products in an optimal manner. By doing so, we believe Apple would once again be playing a pioneering role, this time by setting an example about the obligations of technology companies to their youngest customers. As a company that prides itself on values like inclusiveness, quality education, environmental protection, and supplier responsibility, Apple would also once again be showcasing the innovative spirit that made you the most valuable public company in the world. In fact, we believe that addressing this issue now will enhance long-term value for all shareholders, by creating more choices and options for your customers today and helping to protect the next generation of leaders, innovators, and customers tomorrow.

More than 10 years after the iPhone's release, it is a cliché to point out the ubiquity of Apple's devices among children and teenagers, as well as the attendant growth in social media use by this group. What is less well known is that there is a growing body of evidence that, for at least some of the most frequent young users, this may be having unintentional negative consequences:

- A study conducted recently by the Center on Media and Child Health and the University of Alberta found that 67% of the over 2,300 teachers surveyed observed that the number of students who are negatively distracted by digital technologies in the classroom is growing and 75% say students' ability to focus on educational tasks has decreased. In the past 3 to 5 years since personal technologies have entered the classroom, 90% stated that the number of students with emotional challenges has increased and 86% said the number with social challenges has increased. One junior high teacher noted that, "I see youth who used to go outside at lunch break and engage in physical activity and socialization. Today, many of our students sit all lunch hour and play on their personal devices."[i]

- Professor Twenge's research shows that U.S. teenagers who spend 3 hours a day or more on electronic devices are 35% more likely, and those who spend 5 hours or more are 71% more likely, to have a risk factor for suicide than those who spend less than 1 hour.[ii]
- This research also shows that 8th graders who are heavy users of social media have a 27% higher risk of depression, while those who exceed the average time spent playing sports, hanging out with friends in person, or doing homework have a significantly lower risk. Experiencing depression as a teenager significantly increases the risk of becoming depressed again later in life.[iii]
- Also, teens who spend 5 or more hours a day (versus less than 1) on electronic devices are 51% more likely to get less than 7 hours of sleep (versus the recommended 9). Sleep deprivation is linked to long-term issues like weight gain and high blood pressure.[iv]
- A study by UCLA researchers showed that after 5 days at a device-free outdoor camp, children performed far better on tests for empathy than a control group.[v]
- According to an American Psychological Association (APA) survey of over 3,500 U.S. parents, 58% say they worry about the influence of social media on their child's physical and mental health, 48% say that regulating their child's screen time is a "constant battle," and 58% say they feel like their child is "attached" to their phone or tablet.[vi]

Some may argue that the research is not definitive, that other factors are also at work, and that in any case parents must take ultimate responsibility for their children. These statements are undoubtedly true, but they also miss the point. The average American teenager who uses a smart phone receives her first phone at age 10[vii] and spends over 4.5 hours a day on it (excluding texting and talking).[viii] 78% of teens check their phones at least hourly and 50% report feeling "addicted" to their phones.[ix] It would defy common sense to argue that this level of usage, by children whose brains are still developing, is not having at least some impact, or that the maker of such a powerful product has no role to play in helping parents to ensure it is being used optimally. It is also no secret that social media sites and applications for which the iPhone and iPad are a primary gateway are usually designed to be as addictive and time-consuming as possible, as many of their original creators have publicly acknowledged.[x] According to the APA survey cited above, 94% of parents have taken some action to manage their child's technology use, but it is both unrealistic and a poor long-term business strategy to ask parents to fight this battle alone. Imagine the goodwill Apple can generate with parents by partnering with them in this effort and with the next generation of customers by offering their parents more options to protect their health and well-being.

To be clear, we are not advocating an all or nothing approach. While expert opinions vary on this issue, there appears to be a developing consensus that the goal for parents should be ensuring the *developmentally optimal* amount and type of access, particularly given the educational benefits mobile devices can offer. For example, Professor Twenge's research cited above has revealed peak mental health levels among teenagers who use devices 1 hour or less a day, with teens engaging in this limited use happier than teens who do not use devices at all. According to a study of more than 10,000 North American parents conducted by researcher Alexandra Samuel, the children of parents who focus primarily on denying screen access are more likely to engage in problematic behaviors online than the children of parents who take an active role in guiding their technology usage.[xi] Likewise, researchers at the University of Pittsburgh Center for Research on

Media, Technology, and Health have found that while using a high number of social media platforms daily is linked to depression and anxiety in young adults, using a limited number does not have the same impact.[xii]

While these studies (and common sense) would suggest a balanced approach, we note that Apple's current limited set of parental controls in fact dictate a more binary, all or nothing approach, with parental options limited largely to shutting down or allowing full access to various tools and functions. While there are apps that offer more options, there are a dizzying array of them (which often leads people to make no choice at all), it is not clear what research has gone into developing them, few if any offer the full array of options that the research would suggest, and they are clearly no substitute for Apple putting these choices front and center for parents. As Apple understands better than any company, technology is best when it is intuitive and easy to use. More importantly, technology will continue to evolve as time goes on and play a greater and greater role in all of our lives. There is a developing consensus around the world including Silicon Valley that the potential long-term consequences of new technologies need to be factored in at the outset, and no company can outsource that responsibility to an app designer, or more accurately to hundreds of app designers, none of whom have critical mass.

This is a complex issue and we hope that this is the start of a constructive and well-informed dialogue, but we think there are clear initial steps that Apple can follow, including:

- *Expert Committee:* Convening a committee of experts including child development specialists (we would recommend Dr. Rich and Professor Twenge be included) to help study this issue and monitor ongoing developments in technology, including how such developments are integrated into the lives of children and teenagers.
- *Research:* Partnering with these and other experts and offering your vast information resources to assist additional research efforts.
- *New Tools and Options:* Based on the best available research, enhancing mobile device software so that parents (if they wish) can implement changes so that their child or teenager is not being handed the same phone as a 40-year old, just as most products are made safer for younger users. For example, the initial setup menu could be expanded so that, just as users choose a language and time zone, parents can enter the age of the user and be given age-appropriate setup options based on the best available research including limiting screen time, restricting use to certain hours, reducing the available number of social media sites, setting up parental monitoring, and many other options.
- *Education:* Explaining to parents why Apple is offering additional choices and the research that went into them, to help parents make more informed decisions.
- *Reporting:* Hiring or assigning a high-level executive to monitor this issue and issuing annual progress reports, just as Apple does for environmental and supply chain issues.

It is true that Apple's customer satisfaction levels remain incredibly high, which is no surprise given the quality of its products. However, there is also a growing societal unease about whether at least some people are getting too much of a good thing when it comes to technology,[xiii] which at some point is likely to impact even Apple given the issues described above. In fact, even the original designers of the iPhone user interface and Apple's current chief design officer have publicly worried about the iPhone's potential for overuse,[xiv] and there is no good reason why you should not address this issue proactively. As one of the most innovative companies in the history of technology, Apple can play a defining role in signaling to the industry that paying special attention to the health and development of the next generation is both good business and the right thing to do. Doing so poses no threat to Apple, given that this is a software (not hardware) issue and that, unlike many other technology companies, Apple's business model is not predicated on excessive use of your products. In fact, we believe addressing this issue now by offering parents more tools and choices could enhance Apple's business and increase demand for its products.

Increasingly today the gap between "short-term" and "long-term" thinking is narrowing, on issues like public health, human capital management, environmental protection, and more, and companies pursuing business practices that make short-term sense may be undermining their own long-term viability. In the case of Apple, we believe the long-term health of its youngest customers and the health of society, our economy, and the Company itself, are inextricably linked, and thus the only difference between the changes we are advocating at Apple now and the type of change shareholders are better known for advocating is the time period over which they will enhance and protect value. As you can imagine, this is a matter of particular concern for CalSTRS' beneficiaries, the teachers of California, who care deeply about the health and welfare of the children in their classrooms.

While you may already have started work on addressing the issues raised here, we would nonetheless appreciate the opportunity to discuss this matter further with the board to bring in a wider range of voices. We also encourage you to discuss this matter directly with Dr. Rich, Professor Twenge, or any member of JANA's board of advisors for our new impact investing fund, which includes Patricia A. Daly, OP, Professor Robert G. Eccles, Sting, and Trudie Styler. In the meantime, should you wish to contact us we can be reached at (212) 455-0900 or (916) 414-7410.

Sincerely,

Barry Rosenstein
Managing Partner
JANA Partners LLC

Anne Sheehan
Director of Corporate Governance
The California State Teachers' Retirement System

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[i] "*Growing Up Digital Alberta*". A collaborative research project by Harvard Medical School Teaching Hospital, the Center on Media and Child Health, Boston Children's Hospital, University of Alberta, and the Alberta Teachers' Association (2016)

[ii] Jean M. Twenge, PhD. *iGen*. New York: Atria Books (an imprint of Simon & Schuster), 2017.

[iii] *Id.*

[iv] *Id.*

[v] Yalda T. Uhls, Minas Michikyan, Jordan Morris, Debra Garcia, Gary W. Small, Eleni Zgourou, & Patricia M. Greenfield. "Five days at outdoor education camp without screens improves preteen skills with nonverbal emotion cues." *Computers in Human Behavior Journal* (Oct. 2014): 387-392

[vi] American Psychological Association. (2017). *APA's Survey Finds Constantly Checking Electronic Devices Linked to Significant Stress for Most Americans: Stress in America™ poll shows parents struggling to balance personal and family technology use* [press release]

[vii] Influence Central. (2016) *Kids & Tech: The Evolution of Today's Digital Natives*

[viii] Common Sense Media. (2015). *The Common Sense Census: Media Use by Tweens and Teens*

[ix] Common Sense Media. (2016). *Technology Addiction: Concern, Controversy, and Finding Balance*

[x] James Vincent. (Dec. 11, 2017). *Former Facebook exec says social media is ripping apart society.* Retrieved from http://www.theverge.com ("He says he tries to use Facebook as little as possible, and that his children 'aren't allowed to use that shit.'") *and* Mike Allen. (Nov. 9, 2017) *Sean Parker unloads on Facebook "exploiting" human psychology.* Retrieved from http://www.axios.com ("God only knows what it's doing to our children's brains.")

[xi] Alexandra Samuel. (Nov. 4, 2015). "Parents: Reject Technology Shame." *The Atlantic*

[xii] Brian A. Primack, Ariel Shensa, César G. Escobar-Viera, Erica L. Barrett, Jaime E. Sidani, Jason B. Colditz, A. Everett James. "Use of multiple social media platforms and symptoms of depression and anxiety: A nationally-representative study among U.S. young adults." *Computers in Human Behavior Journal* (Apr. 2017): 1-9

[xiii] See e.g., Laurent Hrybyk. (Dec. 16, 2017). *The Other Tech Bubble.* Retrieved from http://www.wired.com ("In 2008, it was Wall Street bankers. In 2017, tech workers are the world's villain.") *and* David Streitfeld. (Oct. 12, 2017). *Tech Giants, Once Seen as Saviors, Are Now Viewed as Threats.* The New York Times.

[xiv] Nick Statt. (Jun. 29, 2017). *The creators of the iPhone are worried we're too addicted to technology.* Retrieved from http://www.theverge.com *and* Kif Leswing. (Oct. 9, 2017). *Apple's head of design says some people 'misuse' iPhones – and it reveals a growing problem for Apple.* Retrieved from http://www.businessinsider.com

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Activists and Socially Responsible Investing

Posted by Charles Nathan, Finsbury LLC, on Tuesday, January 30, 2018

Editor's note: Charles Nathan is a senior advisor at Finsbury LLC, and an adjunct professor of law at Yale Law School and Columbia Law School. This post is based on a commentary by Mr. Nathan. Related research from the Program on Corporate Governance includes Who Bleeds When the Wolves Bite? By Leo E. Strine, Jr. (discussed on the Forum here), and Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

At first blush, activists embracing socially responsible investing sounds like an oxymoron. After all, a common perception is that activist investors are solely financial engineers who seek short-term stock market gains by leveraging balance sheets, selling off valuable corporate assets and imprudent cost-cutting of R&D and other long-term value creators. What could be farther from short-term financial engineering than socially responsible investing, which typically looks to a much longer-term impact on the company's financial and commercial performance?

However, like so much in life, the real world is far more complicated and harder to categorize. First, many activist campaigns are not about financial engineering in any sense. While activists sometimes do campaign on platforms that include (or perhaps consist principally of) cost-cutting, far from all of these are imprudent cost reductions at the expense of long-term growth. More important, many activist campaigns focus on building the business through better organizational structures and/or more effective focus on improving the quality of goods and services. Indeed, the latter type of activist investor policy has been in the ascendant among leading activist investors for several years now.

But even so, a focus on organizational, operational and product improvement seems a far cry from socially responsible investing. So it attracted some notice when Trian Partners modified its web site last year to add a statement embracing ESG and a compendium of ESG highlights at its current portfolio companies. For example:

> "Trian believes that ESG issues can have an impact on a company's culture and long-term performance and that companies can implement appropriate ESG initiatives that increase their sales and earnings."
>
> "We also believe that ***the consideration of ESG factors enhances our overall investment process***."

Trian's ESG investment policy does not seem significantly different from the ESG investment policies of many leading institutional investors, particularly the largest index investors (e.g., BlackRock, Vanguard and State Street). Indeed, the examples of its ESG investing which Trian provides on its website could as easily have been posted by a conventional institutional investor highlighting its ESG initiatives, such as promoting diversity in the workforce, director independence, board refreshment, emission and waste reduction and adoption of supplier codes of conduct.

The similarity of Trian's ESG policy to that of other major institutional investors suggests it has two complementary purposes.

- First, an increasing number of institutional investors believe that a company's economic performance and stock market valuation is frequently dependent on specific ESG issues inherent in its business model and are thus integral to any investment decision involving the company. It is natural for Trian as a value investor to subscribe to this investing policy.
- Second, the success of Trian's activist business model depends on support for its company specific campaigns from traditional long institutional investors. In this view, Trian's very public embrace of ESG investing can be viewed as courting, in particular, the three major index investors (all of whom are staunch supporters of ESG investing), as well as state and local pension funds, union pension funds and other core corporate governance activists who almost universally champion ESG investing.

More recently and far more dramatically than Trian's embrace of ESG investing, Jana Partners published a joint letter with CalSTRS calling on Apple to recognize the potential dangers to children and teenagers of too frequent use and abuse of their iPhones and to implement a far-reaching program of research on the effects of excessive social media use by youngsters as well as far more sophisticated and effective programming choices on iPhones to enable parents to limit the devices' usage by their children.

In addition, Jana announced that it was planning to raise a new fund, called Jana Impact Capital. According to a press report, the new Jana fund is targeted at $1.7 billion and would invest in companies that "are good bets but could do better for the world. The fund's board of advisers includes Sting and others who have a track record of pressuring companies on environmental, social and governance issues."

The Jana and CalSTRS campaign at Apple, and presumably the investment thesis of its proposed Impact Fund, are clearly of a different order from Trian's approach to ESG investing. Jana is not merely taking ESG into account in its investment analysis, it is going a significant step further by using one or several ESG issues as the fulcrum of its activist campaign. The obvious questions are what is Jana hoping to accomplish and what are the possible impediments to its goals?

An obvious answer would be to foster positive ESG change at a target company thereby enhancing the value of Jana's equity position. There are, however, at least two underlying problems with this explanation.

- Will the ESG issue championed by Jana resonate sufficiently with other investors to motivate the target company to adopt the proposed policy change without requiring more aggressive moves by Jana? The answer is more complicated than it might initially seem. It is probably yes, if there is broad institutional investor support and the change doesn't materially alter the company's business model. But if that's the case, how likely is the change to produce a sufficient up-tick in the company's stock price to justify the activist campaign?

- On the other hand, if the company rejects the proposed ESG change, will it matter enough to enough shareholders to give credence to further more aggressive agitation by the activist? Historically, ESG issues have not been viewed as sufficiently connected to value to create this sort of leverage for its proponents. Will Jana be able to identify ESG issues that have so much appeal to institutional shareholders that the ESG issues can serve as the fulcrum for a threatened or actual proxy contest?

There is, however, another, somewhat cynical, explanation of Jana's ESG strategy. As one commentator speculated:

> "The [Apple campaign] will almost certainly help Rosenstein [the head of Jana] as he seeks capital allocations from public pension funds for his traditional activist fund and its more aggressive, less friendly agitations….Also, it could help Jana Partners gain support for its campaigns in the form of votes of big institutional investors…The [Apple] campaign fits squarely within the category of…ESG, an investing category that sizeable public pension funds such as CalSTRS as well as the primary index funds, including Vanguard Group, State Street, and BlackRock, are concentrating on heavily."

This speculation about Jana's motives also notes that the Jana's new fund will not charge investors the traditional hedge fund "2 and 20"—that is a fee equal to 2% of the investment plus 20% of the profits. Rather, according to press reports its fee structure will be just 2% of invested fund with no success fee. The supposition is that the proposed fee structure illustrates that Jana is not counting on its ESG activism to achieve profits of the same order as its more traditional activist investing. Rather, Jana's principal purpose is to create a "halo" effect that will advance Jana's traditional activist investing model in terms of support for its activist campaigns by and its asset gathering from the larger index investors and state, local and union pension funds.

The more cynical explanation of Jana's strategy has its flaws, as well. It ignores that Jana's business model, both as an asset gatherer and as an activist investor, is wholly dependent on its ability to provide outsize returns for its investors. Creating an ESG fund that doesn't and isn't intended do this may adversely affect its conventional asset gathering. Moreover, Jana's credibility and success as an activist investor is clearly based in large part on its history as a successful and to be feared opponent. A history of issuer friendly ESG investing (as it seemingly is positioning its Apple foray) and/or of failed activist ESG campaigns will not burnish its record as a conventional "to be feared" activist investor.

If Jana's strategy and the success of that strategy are murky, so is the play book for its corporate targets. Right now, the strategy is too new and uncertain to make useful predictions, let alone develop prototype company response playbooks. At least initially, a company that is targeted by an activist ESG campaign will have to evaluate its situation against a relatively blank slate in terms of prior experience. Moreover, its response will have to be tailored to the precise ESG issue it is facing and the economic consequences of its acceding to or contesting the proposal. For Apple to embrace the Jana/CalSTRS proposals would not be the same as Exxon agreeing to an ESG based proposal to cease its ocean-based oil drilling and production. The only sensible advice for companies worrying about the implications of Jana's attempt to create an ESG based version of activist investing is simply to "stay tuned to the program."

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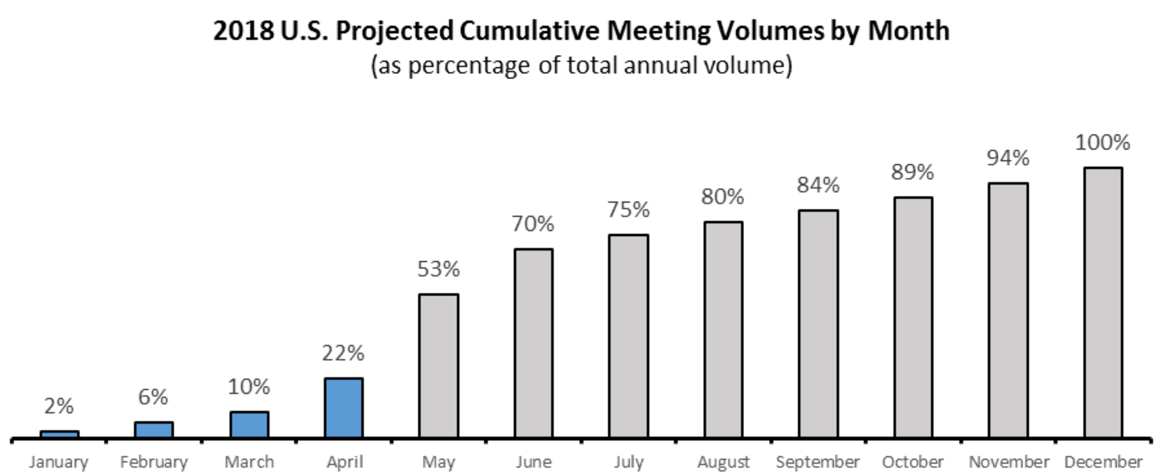
An Early Look at US 2018 Proxy Season Trends

Posted by Subodh Mishra, Institutional Shareholder Services, Inc., on Tuesday, May 15, 2018

Editor's note: Subodh Mishra is Executive Director at Institutional Shareholder Services, Inc. This post is based on an ISS Analytics publication by Kosmas Papadopoulos, Managing Editor at ISS Analytics.

The U.S. proxy season is in full swing, with about 4,000 general meetings (or approximately 60% of annual meeting volume covered by ISS research) taking place in the months of April, May, and June. As we reach the end of April, investors are making voting decisions about the highest volume of meetings, which take place in May (not to mention all other markets in the Americas, Europe, and Asia that are also in peak season). As a meaningful number of meetings have already taken place, we take a look at some emerging trends forming in the beginning of proxy season 2018. While we have a long way to go for a complete picture to develop, the trends we observe now can serve as indicators of potential changes in the governance landscape.



Source: ISS Analytics.

Virtual-only meetings are on the rise

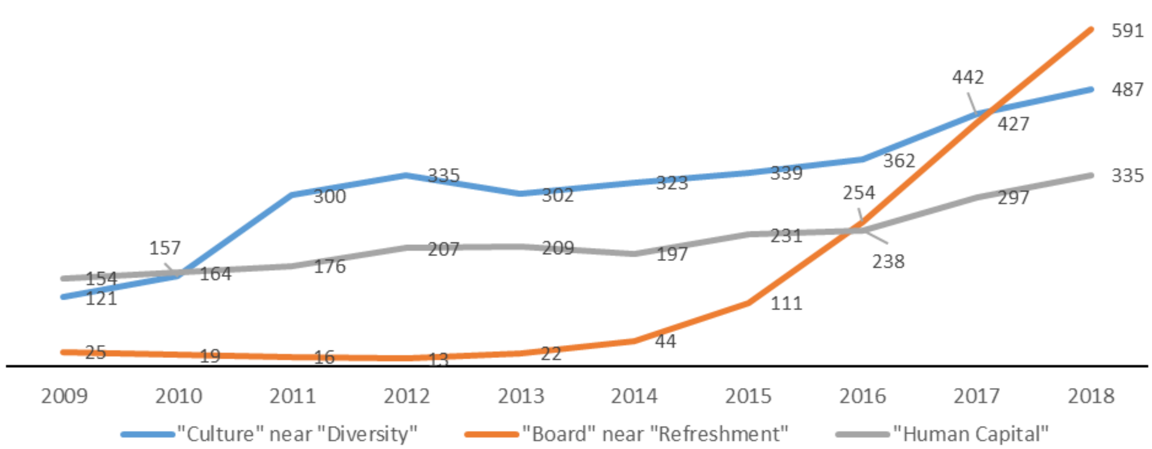
In the first five months of the year, we observe a growing number of companies favoring virtual shareholder meetings, continuing a trend from the past three years. A review of ISS Analytics data identified 127 virtual-only U.S. meetings taking place from January to May of 2018, compared to 99 virtual-only meetings during the same period last year. Virtual meetings present a number of advantages to both shareholders and the company, such as wider participation, lower costs, and ease of submission of questions. However, companies and investors will have to also consider and manage potential risks, such as less direct communication and lack of transparency in filtering or pre-screening of questions.

More proxy disclosures feature culture, refreshment, and diversity

An analysis of proxy filings from the past decade suggests that proxy disclosures continue to evolve, as discussions about culture, diversity, board refreshment, and human capital management reach record highs. This trend is not surprising, considering the increased focus on board diversity and renewal by many institutional investors. Moreover, companies appear to proactively address areas of potential concern, in light of several high-profile cases where questions of culture or problematic human capital management were identified as key points of failure at firms dealing with governance crises and reputational risks.

Proxy statement disclosures on diversity, board refreshment, human capital management

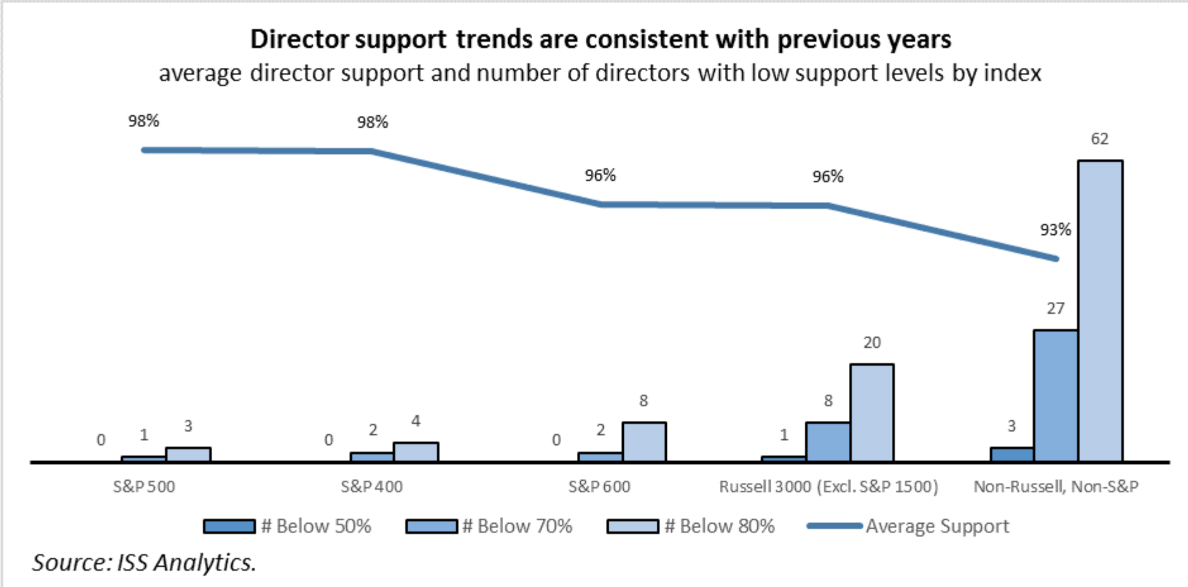
number of U.S. companies with word search results in their proxy statements (by 12-month periods ending in March of each year)



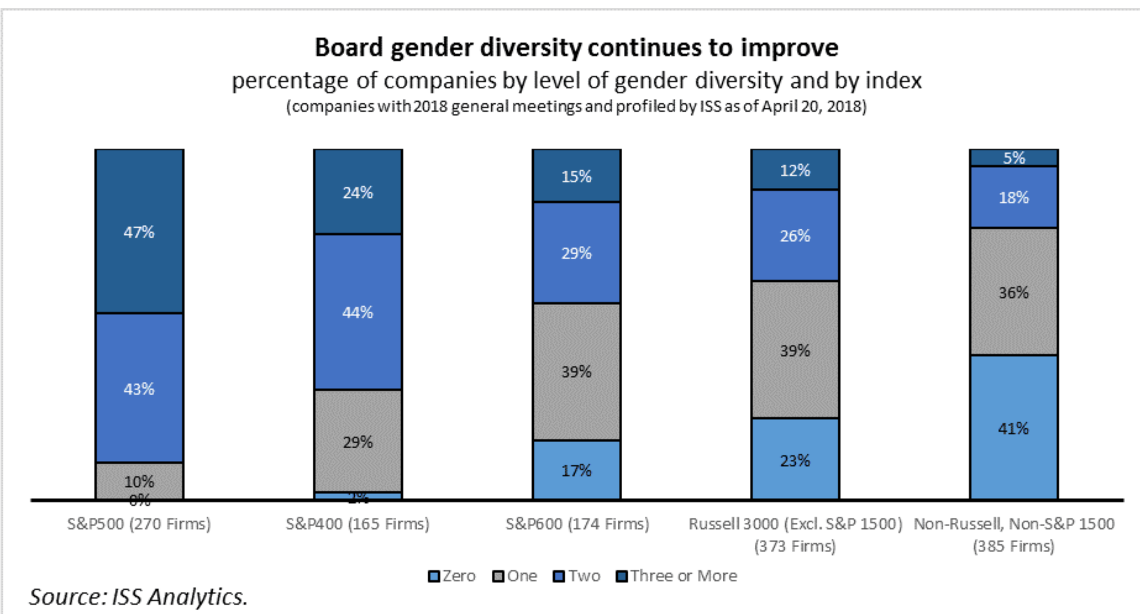
Source: ISS Analytics.

Director Elections and Board Practices

Director elections proposals have so far received similar levels of support as in previous years, with directors at small-cap firms generally seeing higher levels of opposition compared to directors at large-cap firms. In total, 40 directors at 19 companies received shareholder support below 70% of votes cast, and only four directors have failed to receive majority support. An analysis of potential reasons for concerns shows that about half of the boards that received low support rates (below 70% of votes cast) had structural issues, such as poor director attendance at board meetings and board and committee independence concerns, while the other half dealt with board accountability concerns, such as poison pill adoptions, unilateral bylaw amendments, and compensation concerns.

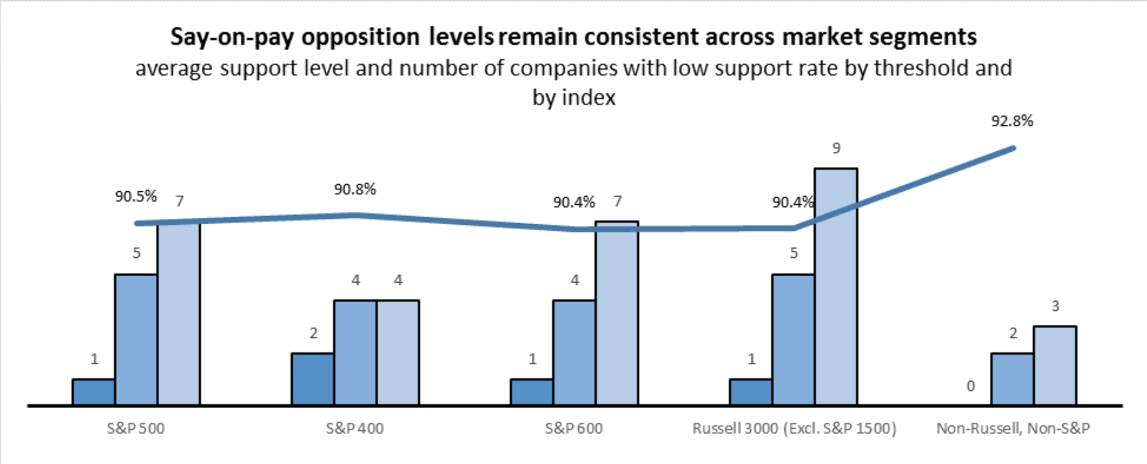


Companies continue to make strides in the area of board gender diversity, as the percentage of new directors who are female reaches a record high of 35% in the Russell 3000 and close to 39% in the S&P 500. By now, approximately 90% of S&P 500 and 58% of Russell 3000 companies have at least two female directors. As expected, board gender diversity practices differ significantly by company size, with smaller companies having fewer women on their boards despite recent improvements.



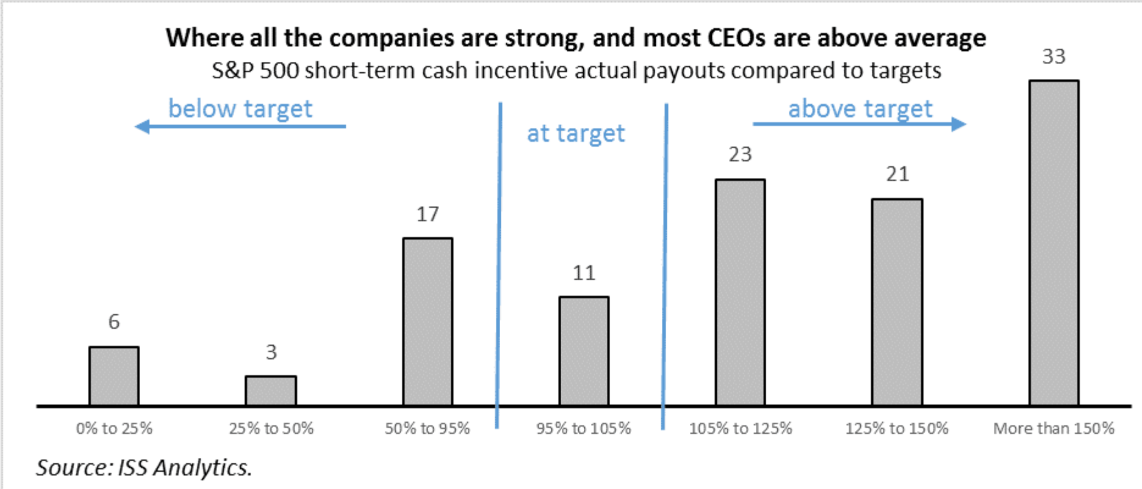
CEO pay increases, raising concerns about quantum and performance rigor

On the compensation front, support levels for say-on-pay proposals are at similar levels as in previous years. Unlike director election proposals, say-on-pay opposition is equally distributed between large and small firms, with the exception of micro-cap firms, which appear to gain higher support levels so far this year. Five proposals failed to receive majority support, among them one S&P 500 firm, the high-profile case of **Walt Disney Company**. The other four companies are **Nuance Communications Inc.**, **AECOM**, **Commercial Metals Company**, and **Sanmina Corporation**. Among the S&P 500, four other companies received levels of support below 70% of votes cast: **Schlumberger Limited**, **Transdigm Group Incorporated**, **Broadcom Limited**, and **Johnson Controls International plc**. In most of the cases above, the key concerns constituted a combination of lack of rigor in performance criteria and high quantum of pay, as four of the five S&P 500 companies that received low support levels made payouts to individual executives exceeding $40 million, approximately four times the median CEO pay in the index.



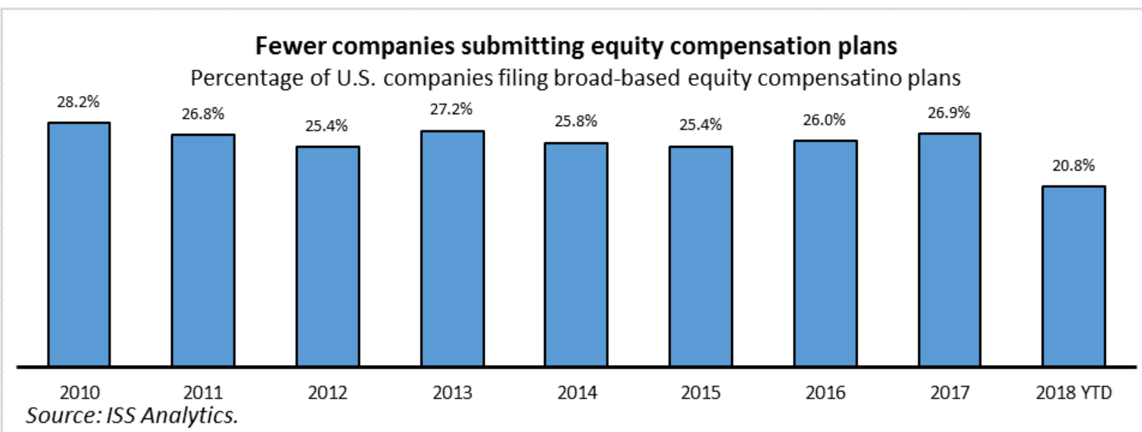
Source: ISS Analytics.

As discussed in our early look at the status of U.S. CEO pay, CEO compensation levels see some of the highest increases in the past decade, with an average increase of approximately 10% compared to the previous year. Stock awards and annual incentives make up 90% of these increases in pay, while base salaries and discretionary bonuses remain fairly stable, and option grants are in decline. Strong 2017 results have resulted in more than two-thirds of S&P 500 CEOs receiving annual incentive payouts above targets, raising concerns about a potential Lake Wobegon effect in CEO pay (i.e. companies overestimating their achievements in relation to the rest of the market).



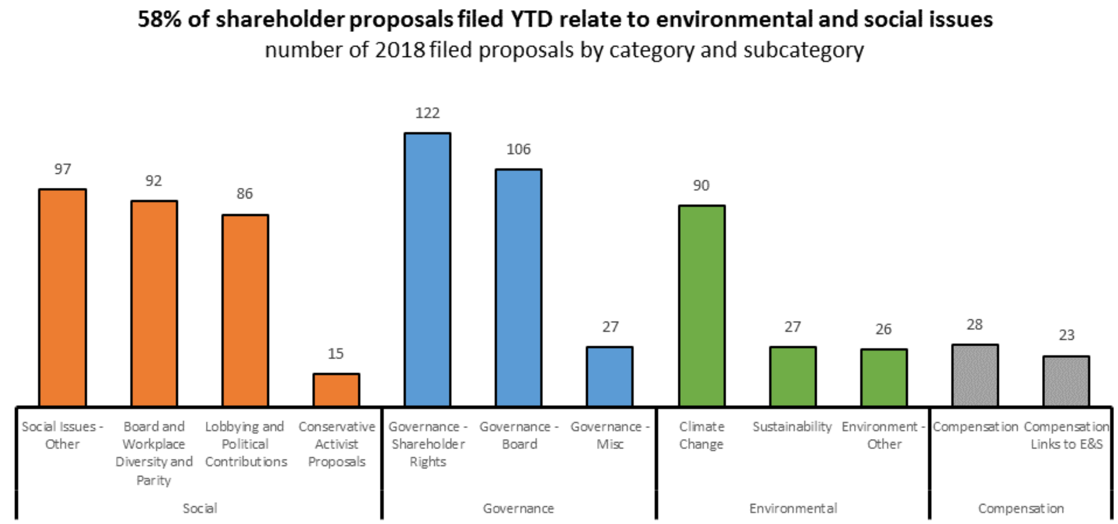
Farewell to most 162(m) proposals

The recent U.S. tax reform eliminated certain tax deductibility provisions for performance-based pay, including most stock-based awards granted under equity compensation plans. Among other criteria, section 162(m) of the code required companies to request shareholder approval to gain tax deductibility status for awards under equity compensation plans at least every five years. As companies are no longer required to request this approval, we already see fewer firms submitting equity compensation plan requests on ballot. While many investors did not consider 162(m)-related requests material, the rule forced a regular check on the state of the plan and its provisions. The loss of 162(m) proposals raises the question of whether companies will opt for requesting higher volumes of shares, while returning to shareholder for approval once every ten years per the minimum regulatory requirement.



Shareholder Proposals

To date, ISS has identified 739 shareholder proposal filings at U.S. companies, with 123 proposals omitted and 114 proposals withdrawn from ballots, while 55 have been voted. This leaves 447 pending proposals. Social issues take the lead in terms of the number of filed proposals, as several campaigns have increased their efforts in 2018: lobbying and political contribution disclosures (86 proposals), board diversity (29 proposals), and disclosures on the gender pay gap (22 proposals). New types of requests include three pending proposals on gun safety and gun violence at **American Outdoor Brands Corporation**, **Dick's Sporting Goods Inc.**, and **Sturm, Ruger & Company Inc.**, as well as three pending proposals on content management and "fake news" at social media giants **Alphabet Inc.**, **Facebook Inc.**, and **Twitter Inc.**



Source: ISS Analytics.

However, the majority of voted proposals dealt with governance issues, with resolutions seeking to reduce the ownership threshold for the right to call a special meeting and requests to establish an independent chair on the board featuring as the most common shareholder requests. In fact, requests regarding the right to call a special meeting are the most numerous filed so far this year, led by campaigns by John Chevedden and James McRitchie.

Proposal Type	Proposals Filed
Right to Call Special Meeting	68
Lobbying Disclosure	48
Independent Chair	41
Carbon Emissions	39
Political Contributions Disclosure	38
Right to Act by Written Consent	30
Board Diversity	29
Sustainability	27

Pay Inequality	24
Amend Proxy Access	23

Source: ISS Analytics.

Environmental proposals also have a very strong presence, with approximately 90 proposal filings related to climate change, including requests for carbon emissions targets and disclosures, 2-degree scenario reporting, and renewable energy reporting.

Support levels for shareholder proposals are relatively high, as approximately 54% of voted proposals received support above 30% of votes cast. This is true for environmental and social proposals also, with 11 of 23 voted E&S proposals receiving support levels above 30% of votes cast, and five proposals receiving support of more than 40% of votes cast. Four governance-related proposals have received a majority votes cast, as listed in the table below.

Company Name	**Proposal Type**	**Support (F/(F+A))**
Applied Energetics, Inc.	Amend Articles	94%
Nuance Communications, Inc.	Amend Bylaws—Call Special Meetings	94%
Costco Wholesale Corporation	Adopt Simple Majority Vote	87%
Kaman Corporation	Eliminate Supermajority Vote Requirement	59%

Source: ISS Analytics.

Environmental and Social Proposals in the 2017 Proxy Season

Posted by Thomas Singer, The Conference Board, Inc., on Thursday, October 26, 2017

Editor's note: Thomas Singer is a principal researcher in corporate leadership at The Conference Board, Inc. This post is based on a publication from The Conference Board, authored by Mr. Singer and Ramsha Khursheed. Related research from the Program on Corporate Governance includes Social Responsibility Proposals by Scott Hirst (discussed on the Forum here).

The Conference Board recently released a report that reviews the key environmental and social (E&S) proposals in the 2017 proxy season. The report provides details on some of the most prominent topics, including topics which received high levels of shareholder support and topics that have seen notable changes in support levels compared to previous years.

The report reviews the period between January 1 and June 30, 2017. Of the 465 voted proposals brought to shareholders at Russell 3000 companies 201 related to E&S issues, making up 43.2 percent of proposals brought to a vote during this period. The report finds the volume of E&S proposals has consistently gone up in the past five years.

Although proposals on E&S issues received average support of only 21.4 percent of votes cast in 2017, support levels for these proposals continue an upward trend. For instance, in 2016 these proposals received average support of 19.7 percent of votes cast. The number of E&S proposals that have won majority support has also increased over the last few years: six proposals passed in 2017, compared to four in 2016 and four in 2013. The E&S topics that had successful proposals this year were recently summarized in a column on Chief Executive.

The uptick in successful E&S proposals can largely be attributed to a shift in the voting policies of traditionally passive investors. Large institutional investors, such as BlackRock and Vanguard, are beginning to exert pressure on companies by supporting E&S proposals that call for greater disclosure of issues they deem material to shareholder value.

The following are the E&S highlights of the 2017 proxy season:

Proposals calling for the disclosure of corporate political participation and/or lobbying policy/payments continue to be the issue most frequently brought to vote for the past few years. Proponents say disclosure enables shareholders to evaluate whether a company's lobbying is consistent with the company's expressed business goals and objectives and whether it may present any risks, particularly reputational risk. The Center for Political Accountability, for example, has been leading a campaign since 2003 for disclosure and accountability in corporate political spending, and shareholder engagement has been central to the organization's campaign. The 57 proposals that went to a vote in 2017 received average support of 25.8 percent of votes cast, up slightly from 2016 when the average support was 24 percent for the 67 proposals. While no proposals on this topic passed in 2017, two proposals received support of over 40 percent of for votes.

Proposals on this topic typically seek disclosure of payments to trade associations (such as the US Chamber of Commerce) used for lobbying as well as support for tax-exempt organizations that write and endorse model legislation (such as the American Legislative Exchange Council (ALEC)). For example, a shareholder proposal submitted at AT&T requested the company prepare a lobbying report.[1] Proponents of the proposal argued that AT&T's recognition of climate change as a serious concern is at odds with the company's position on the board of the Chamber of Commerce, which has publicly criticized the EPA's Clean Power Plan and efforts to address climate change.

Shareholder proposals asking companies to disclose the business risks related to climate change reached historically high levels of support. This year 18 proposals on climate risk disclosure were brought to a vote, up from 15 in 2016. These proposals have now reached historically high levels of support—average support of 39.2 percent of votes cast in 2017, up from 27.5 percent in 2016 and 16.7 percent in 2015. In fact, of the six proposals on environmental and social topics that passed this year, three of them called for climate risk disclosure. All three of these proposals were submitted at energy companies and all had a public pension fund as the main proponent. Notably, the New York State Common Retirement Fund was the most frequent sponsor of proposals on climate risk disclosure, sponsoring almost one-third of proposals on this topic.

Recent activity related to climate change risk disclosure is contributing to shareholders' increased interest in this topic. In 2010, for example, the U.S. Securities and Exchange Commission (SEC) published the Commission Guidance Regarding Disclosure Related to Climate Change, a document to help guide public companies on what climate change-related disclosures must be made. More recently, in April 2016, the international Financial Stability Board's Task Force on Climate Related Financial Disclosure (TCFD) sought public comment on its goal for creating disclosure recommendations to help companies practice "more methodical, comparable and consistent disclosure on climate-related risks and opportunities." In its June 2017 report the TCFD recommended that preparers of climate-related financial disclosures provide these disclosures in their mainstream financial filings.

Some of the largest passive investors, including BlackRock and Vanguard, are now looking at climate change as a major investment risk issue and are beginning to exert pressure on companies to disclose and manage their climate-related risks.[2] This pressure is having an impact: more than one quarter of S&P 500 companies now disclose climate change risks in their annual reports, up from only 5 percent just three years ago.[3] As evidenced by the historically high levels

[1] AT&T 2017 proxy statement, p.22, https://www.att.com/Investor/ATT_Annual/2016/downloads/notice_2017_annual_meeting_proxy.pdf

[2] "Financial firms lead shareholder rebellion against ExxonMobil climate change policies", The Washington Post, May 31, 2017, https://www.washingtonpost.com/news/energy-environment/wp/2017/05/31/exxonmobil-is-trying-to-fend-off-a-shareholder-rebellion-over-climate-change/

[3] Sustainability Practices Dashboard, The Conference Board, November 2016, http://www.conference-board.org/sustainabilitypractices

of support for proposals on climate change risk disclosure, shareholders are likely to continue to engage companies on this issue.

Shareholders are increasingly calling for companies to adopt policies and measures to enhance employee and board diversity. In 2017 shareholders voted on 14 proposals related to diversity issues, up considerably from the five proposals brought to a vote in 2016. Of the 14 proposals on diversity issues, eight proposals asked for the preparation of a report on the company's steps towards increasing board diversity (up from six in 2016). One of these proposals went beyond board diversity and asked for the company to work towards ensuring both board and senior management diversity. Two proposals on the topic of board diversity passed in 2017.

While the SEC introduced a board diversity disclosure requirement in 2009, the rule does little more than require companies to disclose how they consider board diversity. Critics point out that the current requirement does not define diversity nor does it offer investors sufficient and meaningful information on board diversity. The SEC, however, is working on a proposal to revise the existing diversity disclosure rule.[4] Revised disclosure requirements on board diversity may help shine more light on significant diversity imbalances among company boards. With respect to gender diversity, for example, women occupied less than 18 percent of Fortune 1000 corporate board seats in 2015. And while there has been progress, the current level of female representation is only a few percentage points higher than it was in 2011.[5]

Proposals related to employee diversity showed slight increases in both volume and support levels, going up from 4 proposals voted in 2016 to 6 voted in 2017. Support levels also increased from an average of 24.5 percent of *for* votes in 2016 to 26 percent of *for* votes in 2017.

A shareholder proposal on the topic of gender pay gap was first put on the proxy ballot of a US company in 2015, and since then the topic of gender pay gap has become one of the most frequently voted E&S topics during the proxy season. In 2017, 13 shareholder proposals were brought to a vote calling for companies to prepare gender pay gap reports. These proposals, the majority of which were sponsored by individuals, received average support of 12.1 percent of *for* votes. The volume of proposals on this topic was significantly up from 2016, when only five gender pay gap proposals were brought to a vote that entire year, receiving average support of 15 percent of *for* votes.

When the first shareholder proposal on this topic was brought to eBay in 2015 the proposal received a mere 7.4 percent of *for* votes. One year later, in 2016, support for the proposal at eBay surged to 44.6 percent of *for* votes. The significant increase in support for the proposal can be in part explained by a recommendation from proxy advisor Institutional Shareholder Services suggesting investors vote in favor of the gender pay gap proposal at eBay, stating that the resolution "is warranted, as eBay lags its peers in addressing gender pay disparity at its company."[6]

[4] https://www.sec.gov/news/speech/chair-white-icgn-speech.html

[5] Every Other One: A Status Update on Women on Boards from the Committee for Economic Development, The Committee for Economic Development, November 2016, p. 5.

[6] "A surprising number of investors voted for a gender pay gap measure at eBay", The Washington Post, April 28, 2016, https://www.washingtonpost.com/news/on-leadership/wp/2016/04/28/a-surprising-number-ofinvestors-voted-for-a-gender-pay-gap-measure-at-ebay/?utm_term=.ccc279476bf5

Compared to last year, the number of proposals calling for companies to increase activity on the "Holy Land principles" rose considerably, making this one of the top five E&S topics of 2017 in terms of volume. In the January-June period, shareholders voted on 12 proposals related to the Holy Land principles, up from eight proposals in 2016. Support levels for these proposals remain very low, with average support of only 3.4 percent of votes cast.

Proposals on the Holy Land principles generally call for American companies conducting business in Palestine-Israel to practice fair employment. The Holy Land principles were launched by Father Sean McManus in 2012 and are based on the MacBride Principles, which Father McManus also launched in 1984.

Proposals asking companies to publish a sustainability report continue to gain support. These proposals call for companies to publish annual reports disclosing their various short term and long-term efforts related to environmental, social, and governance issues. In the first half of 2017 shareholders voted on 10 proposals on this topic, compared to 13 in all of 2016. Support for this topic reached historically high levels in 2017, with average support of 31.5 percent of *for* votes, up from 26.3 percent in 2016. In 2017 four proposals received over 30 percent of *for* votes, including one proposal that passed at Pioneer Natural Resources with 50.6 percent of votes.

* * *

The complete publication is available for download here. For details regarding how to obtain a copy of the report, please contact matteo.tonello@conference-board.org

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Doubling Down on Two-Degrees: The Rise in Support for Climate Risk Proposals

Posted by Cristina Banahan, ISS Corporate Solutions, on Tuesday, January 23, 2018

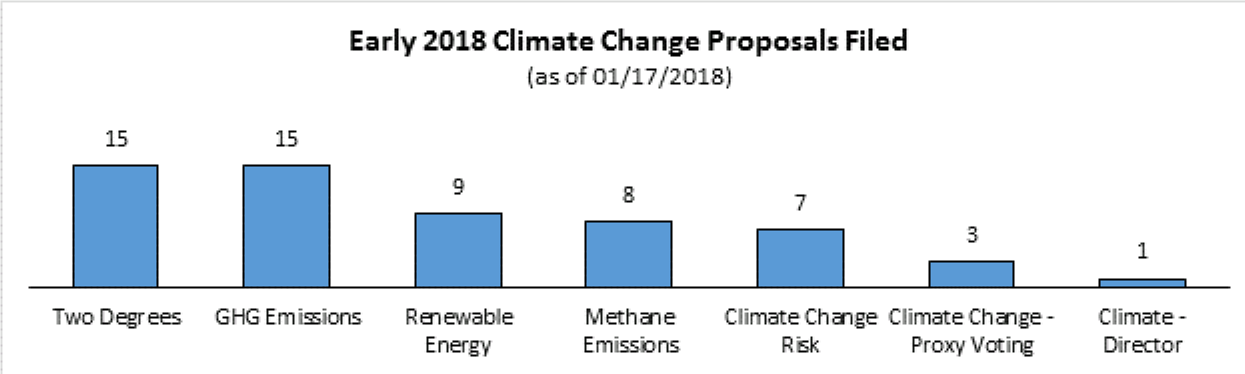
Editor's note: Cristina Banahan is an Advisor with ISS Corporate Solutions. This post is based on an publication by ISS, the parent company of ISS Corporate Solutions.

[Last week], BlackRock CEO Larry Fink released his annual letter to CEOs, an important signpost for investor priorities in the coming year. In his letter, titled "A Sense of Purpose," Mr. Fink says:

> "In order to make engagement with shareholders as productive as possible, companies must be able to describe their strategy for long-term growth.
>
> The statement of long-term strategy is essential to understanding a company's actions and policies, its preparation for potential challenges, and the context of its shorter-term decisions. Your company's strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also understand the societal impact of your business as well as the ways that broad, structural trends—from slow wage growth to rising automation to *climate change* [emphasis added]—affect your potential for growth."

As investors such as BlackRock look deeper into strategy and climate change issues (and call them out specifically in their shareholder engagement activities), they are increasingly becoming more active in their support for calls for increased transparency and disclosure regarding portfolio companies' preparedness for climate change. And, when shareholder proposals are filed calling for increased transparency and disclosure, support rates are increasing.

In 2018, these types of proposals will likely feature even more prominently on the proxy landscape. ISS is aware of 59 filed proposals related to climate change for 2018 proxy season, including 15 two-degree scenario proposals (one already withdrawn—at Exxon Mobil) and seven proposals on climate change risk management. The two-degree scenario proposals were filed by ten different main filers (not counting any co-filers), which shows that these filings are not the result of a single campaign—as is often the case with environmental and social proposals—but the outcome of a widespread initiative.



Source: ISS Shareholder Proponent Database

Background of Two-Degree Proposals

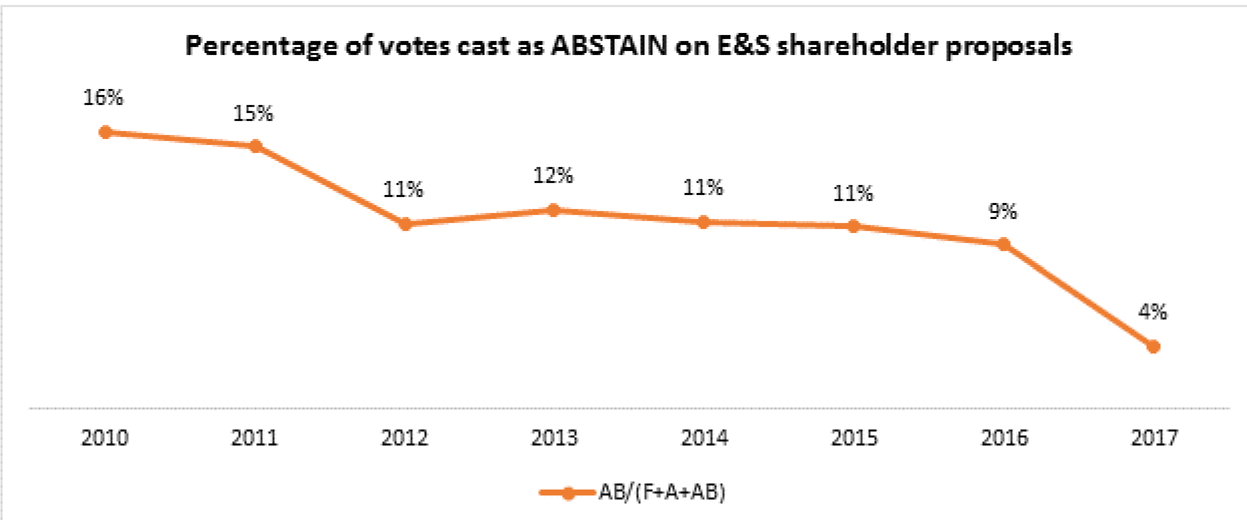
Two-degree scenario proposals are an evolution of shareholder requests for disclosure on how companies manage potential climate-related risks. Unlike former proposal types that sought for general disclosure on addressing climate change risks, the two-degree scenario proposals focus on two degrees Celsius above pre-industrial levels as the uppermost limit in global temperatures tolerable to the environment, as substantiated by the Intergovernmental Panel on Climate Change's scientific findings. In the United Nations Framework Convention on Climate Change's 2015 Paris Agreement, the international community pledged to adopt policies and programs to curb carbon emissions in order to reach the two-degree target. Shareholder proponents anticipate that, in order to meet the two-degree goal, governments will have to increase regulation, and the private sector will have to accelerate innovation. In particular, proponents seek disclosure on how companies are preparing for climate-related risks and how they account for these risks in their capital investment decisions. While shareholders argue that planning for a two-degree scenario is necessary for protecting the long-term value of their investments, corporate boards have broadly responded by saying that this risk analysis is conducted as part of the regular course of business. The financial risks, however, appear too high for shareholders to ignore; hence, proponents continued to push for greater disclosure.

Proponents of two-degree proposals include asset owners, SRI funds, foundations, and shareholder advocacy groups each with a long history of filing shareholder proposals. Notable filers include the New York State Common Retirement Fund, the As You Sow Foundation, Mercy Investment Services, Wespath Investment Management and many others. On some occasions, large asset owners like city and state pension funds brought forward proposals using the full weight of their shares. For example, in 2017, the New York State Common Retirement Fund owned 11.6 million shares valued at approximately $1 billion before bringing the two-degree proposal at ExxonMobil. On other occasions, proponents seeking additional disclosure were small asset owners with minor stakes in the company that barely met the minimum ownership requirement to file a proposal. It is common for multiple proponents to join forces and co-file proposals.

Changing Shareholder Attitudes

Marking a departure from previous trends, recent studies indicate that ESG and climate change considerations are gaining traction among investors. EY's 2017 investor survey on ESG issues found that investors routinely included ESG considerations as part of their investment decisions. Shareholders are not only paying closer attention to non-financial indicators, but they are also more likely to take action on such information. According to the study, the percentage of respondents who consider nonfinancial disclosures to be seldom material or have no financial impact dropped from 60% in 2013 to 16% in 2016. Furthermore, the report found that, when faced with disclosures of risk or history of poor environmental performance, 15 percent of investors responded that they would rule out the investment immediately, while 76 percent would reconsider the investment. Similarly, 8 percent of investors responded that they would rule out an investment with disclosures involving risk from climate change, while 71 percent would reconsider the investment.

Actual voting data seems to confirm the study; many shareholders are coming off the sidelines on environmental and social shareholder proposals. The trend of abstain votes has been downward over the past eight years, and took a sharp decrease in 2017.



Source: ISS Voting Analytics

Asset owners have pioneered efforts in climate change not only as filers of shareholder proposals but also as public advocates for risk management and transparency. Asset owners comprise the majority of the 409 signatories to the Global Investor Statement on Climate Change, representing more than $24 trillion in assets. Participating asset owners view climate change engagement as a part of their fiduciary duty to their beneficiaries. As signatories, they have committed to identifying low-carbon opportunities, assessing climate-related risk, and working with corporate issuers on disclosure practices. Some asset owners have gone further, identifying inaction on climate change as a failure to recognize the energy sector's vulnerability to an imminent paradigm shift. Moreover, a few public funds look at divestment from fossil fuel assets as the ultimate way of addressing climate risk concerns in their portfolio. New York City recently announced its decision to divest its pension funds of about $5 billion in fossil fuel investments, while New York State is reviewing a similar initiative upon the proposal of Governor Cuomo. The Norwegian government is also considering a recent proposal by its central bank to divest fossil fuel stocks from its $1 trillion sovereign wealth fund. Some in the asset owner community, including New York State Comptroller Thomas DiNapoli, argue that pension funds can achieve more on climate change through shareholder power in fossil fuel investments instead of divesting.

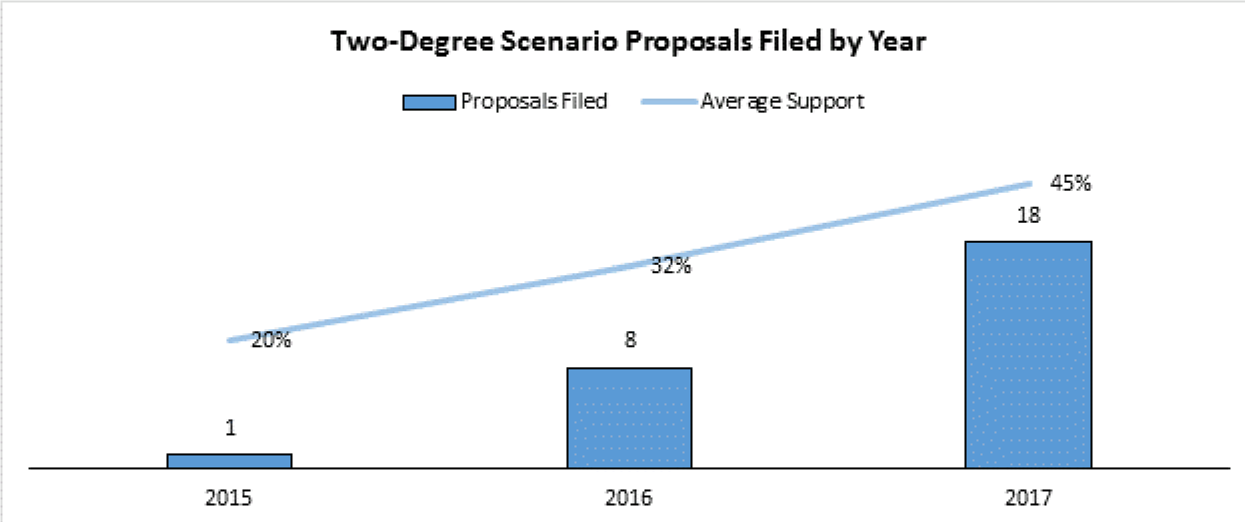
In the asset management community, we have seen an even more significant shift towards greater climate risk awareness in recent years. Asset managers' changes in attitude have emerged in the form policy updates and a closer look at sectors perceived to be particularly vulnerable. This trend becomes evident even among investors who were historically less supportive of environmental proposals. For example, in 2017, Fidelity Investments updated its proxy voting policy guidelines stating that, although it generally supports management on environmental proposals, it would consider supporting shareholders where the burden on the company would be low, and where disclosure would provide meaningful information. Specifically, Fidelity highlighted areas where it might support proposals to include disclosure on renewable energy and environmental impact. In turn, Blackrock, included climate risk disclosure as one of its main engagement priorities for 2017-2018: "Consistent disclosure of standards would enhance understanding of the impact of climate change on individual companies, sectors and investment strategies."

A change in policy does not suggest a monolithic approach to always supporting climate resolutions, since institutional shareholders generally apply a case-by-case approach. For example, institutions often vote differently at companies that appear to have similar climate risk profiles. Company-specific factors, such as current disclosure practices, overall performance, and future disclosure commitments may typically drive the voting decision. Improved company practice as a result of engagement may even lead to the withdrawal of proposals, as was the case with Chevron in 2017 in response to the company's release of its climate risk management report.

The success of two-degree proposals has been limited to the energy sector for the time being, while shareholder activists in other industries focus on different kinds climate change proposals. Two-degree proponents have been particularly interested in sectors perceived to be vulnerable to climate change regulation and renewable energy innovation, *i.e.*, utilities, oil and gas. However, proposals requesting general climate change action have extended beyond the energy sector to encompass finance, consumer goods, natural resources, technology, telecommunications, and healthcare. Climate change proposals for non-energy sectors mostly focus on setting GHG emissions goals, renewable energy targets, and changing proxy voting guidelines at asset managers. Excluding the energy sector, the next three industries to receive the most climate change proposals are the financial, consumer discretion, and consumer staples sectors.

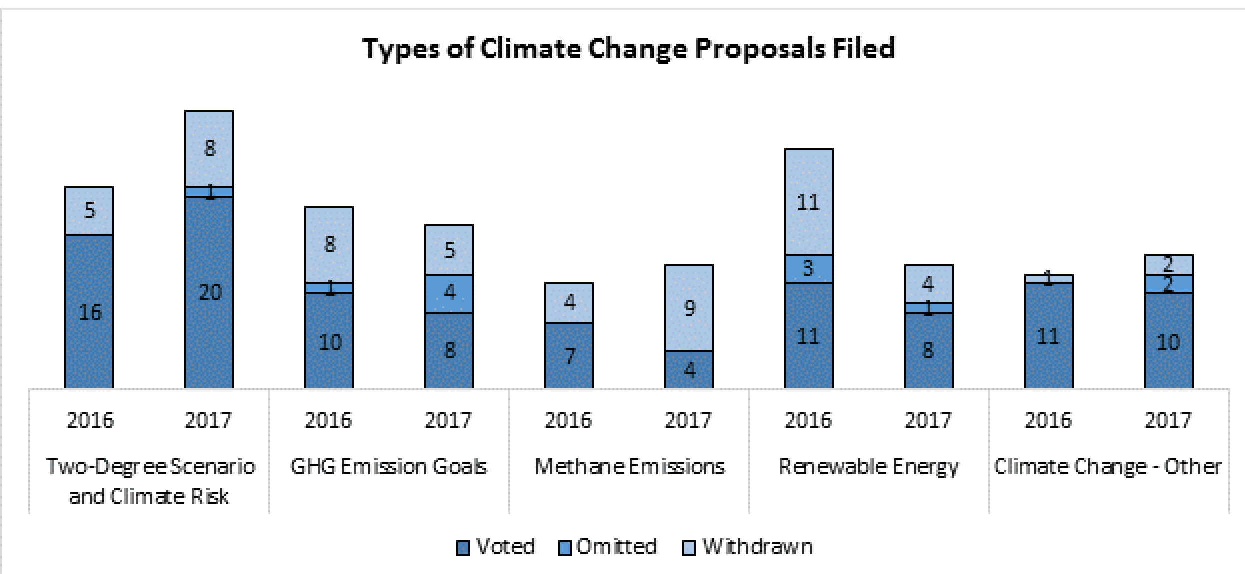
Two-degree proposals gaining momentum

The number of filings and support levels for two-degree proposals demonstrate the aforementioned shift in shareholder preferences. In 2015, there was a single two-degree proposal on ballot at Noble Energy, which received 20% support. In 2016, there were seven proposals, including those at Chevron, Exxon and Occidental Petroleum with support levels close to 40% of votes cast. The trend continued in 2017, as the number of filed proposals increased to eighteen, and average support levels exceeded 40% of the vote, with three proposals receiving majority support: ExxonMobil, Occidental Petroleum and PPL Corporation.



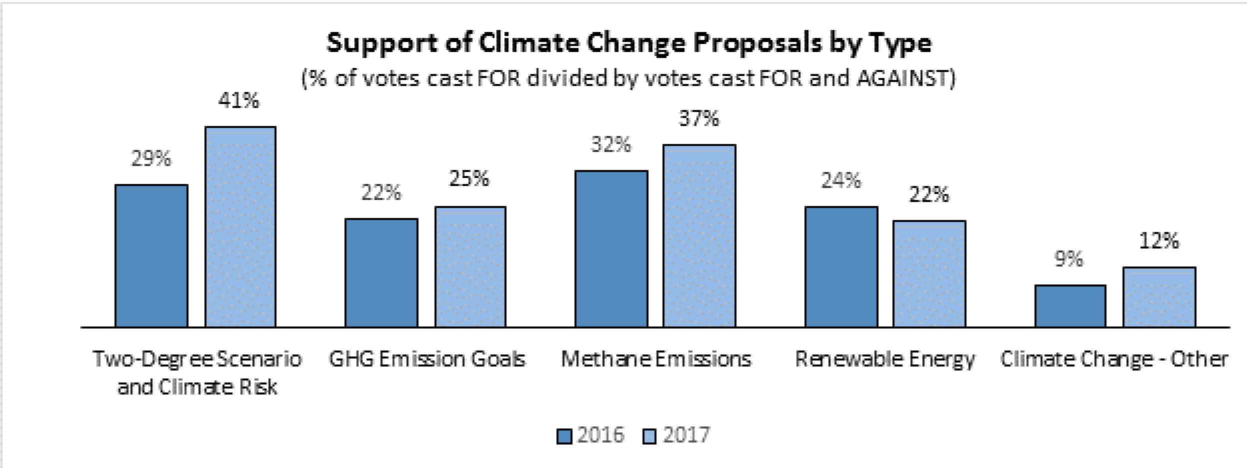
Source: ISS Voting Analytics

Two-degree and climate change risk proposals have outpaced the number of filings for all other climate change proposals. Proposals for greenhouse gas (“GHG”) emission goals and renewable energy continue to be filed in large numbers. Other types of climate change proposals include: requests for review of proxy guidelines, nomination of directors with environmental experience, increase of return on capital in light climate change risks, among others.



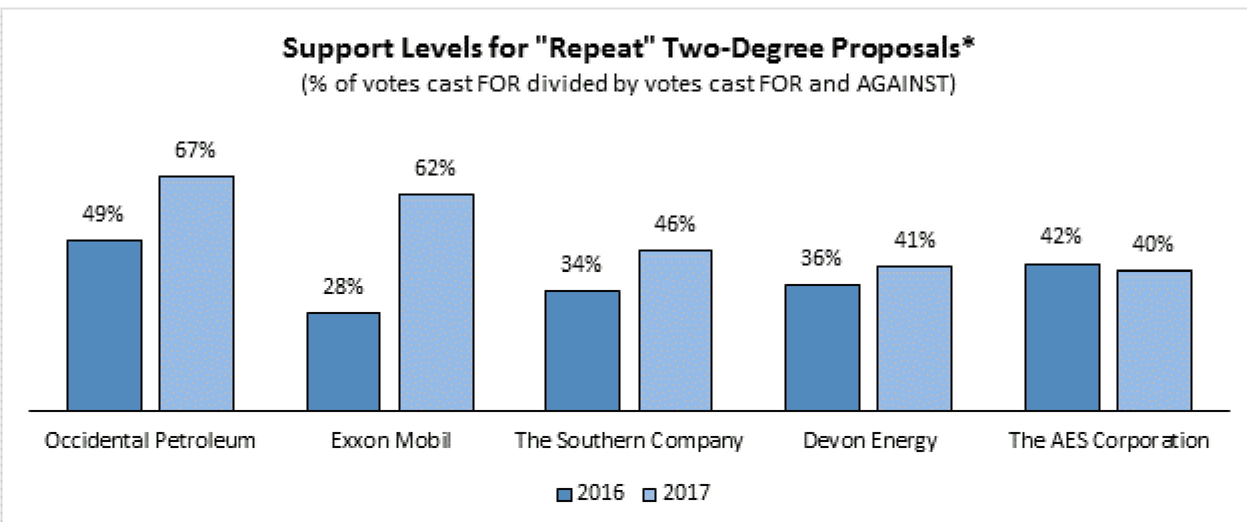
Source: ISS Voting Analytics

Two-degree and climate risk proposals not only outpaced other types of climate change proposals in the number of proposals filed, but also outpaced them in levels of support. Two-degree and climate risk proposals received almost twice the amount of support of the next two most frequently filed proposals—GHG Emission Goals and Renewable Energy. Although Methane Emissions also fared well in levels of support, the number of voted proposals in this category was limited.



Source: ISS Voting Analytics

While three climate risk proposals received majority support, several more fell just short. For instance, shareholder proposals at AES, FirstEnergy, Southern Company, Devon Energy, and Dominion Energy all received more than 40 percent support in 2017.



**Covers only companies that received proposals both years and the proposals went to a vote.*

Source: ISS Voting Analytics

The Path Ahead

Early indications are that the number of shareholder proposals on climate change issues will remain strong in 2018—perhaps even a record-breaking year. And with evolving voting policies at influential investors and some strong investor statements confirming a stronger dedication to climate change issues, it seems that those proposals will be met with increasing support at the ballot.

Through 2017, climate change risk proposals in the fossil fuel and utility sectors have received significant support, but proposals outside those sectors have not received the same energetic reception. 2018 may be the year where shareholder perceptions regarding the importance of climate change risk will extend outside the energy industry.

Perhaps the largest question remaining is: How open will companies be to negotiating climate change strategy, transparency and disclosure before the shareholder proposals reach the ballot? This could be the year where shareholder-initiated engagement efforts on climate change ramp up significantly; the number of filed and withdrawn proposals over proxy season 2018, and subsequent enhanced disclosures, may tell an interesting story.

Looking Beyond Sustainability Disclosure

Posted by Linda-Eling Lee & Matt Moscardi, MSCI, Inc., on Wednesday, February 28, 2018

Editor's note: Linda-Eling Lee is Global Head of ESG Research at MSCI, and Matt Moscardi is Head of Financial Sector Research for MSCI ESG Research. This post is based on an MSCI publication by Ms. Lee and Mr. Moscardi.

For years, a growing number of institutional investors have pressured companies to disclose more of their ESG practices. Companies are responding, but voluntary disclosure has its limits in providing a full picture of companies' ESG risks. In 2018, we anticipate that the disclosure movement reaches a tipping point, as investors seek broader data sources that can balance the corporate narrative and yield better signals for understanding the ESG risk landscape actually faced by portfolio companies.

Companies historically have been caught between investor demands for transparency and a desire to control their corporate narrative. On one side, investors have supported numerous efforts to encourage company disclosure.[1] They have enlisted regulators to compel disclosure on select topics or metrics and influenced exchanges to require more disclosure on sustainability as part of their listing requirements.[2] On the other side, some companies may carefully manage disclosures through a painstaking editing and brand-polishing process[3] while protecting proprietary information.

As one of the world's largest consumers of voluntary sustainability disclosures,[4] MSCI ESG Research observes this pressure firsthand. What we see suggests corporate resistance is increasingly futile as investors globally are pressing hard for greater transparency around ESG and sustainability issues.[5] In response, companies are boosting the volume of voluntary disclosures and sustainability reports.

These public voluntary disclosures are a part of our ESG ratings research process. MSCI ESG Research shares with each company the data that we have collected from publicly disclosed documents.[6] Companies are invited to provide comments and feedback on the data in the

[1] https://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-exploring-esg-a-practitioners-perspective-june-2016.pdf shortlists the major disclosure frameworks on pages 4-5, including CDP, GRI, SASB, IIRC, and the FSB.

[2] See for example: http://www.sseinitiative.org; https://www.world-exchanges.org/home/docs/studies-reports/SE&SD-Report17.pdf; http://iri.hks.harvard.edu/files/iri/files/corporate_social_responsibility_disclosure_3-27-15.pdf

[3] https://www.theguardian.com/sustainable-business/2016/aug/20/greenwashing-environmentalism-lies-companies

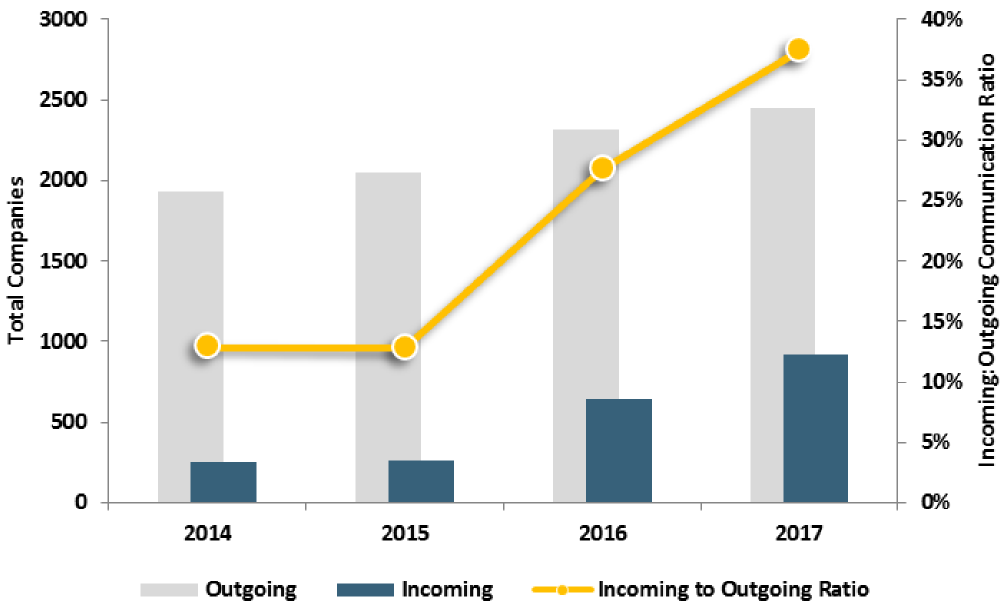
[4] https://www.msci.com/documents/1296102/1636401/MSCI_ESG_Research_Factsheet.pdf/411954d3-68af-44d6-b222-d89708c5120d

[5] https://corpgov.law.harvard.edu/2017/04/25/the-importance-of-nonfinancial-performance-to-investors

[6] MSCI ESG Research does not conduct surveys of companies, nor will it use or accept non-public information from companies or other sources. Any company disclosed information that is used in MS CIESG Research's ratings research process must be publicly disclosed. See https://www.msci.com/for-corporate-issuers. MSCI ESG Research

reports. We have observed a dramatic increase in the volume of “inbound” communications from issuers asking about their ESG assessments, while the volume of our “outbound” communications (invitations to review their data) has stayed relatively level. Between January 1, 2014 and November 30, 2017, the ratio of incoming company queries to outgoing company communications nearly tripled for MSCI ACWI Index constituents, a statistic we take as a sign that companies are paying increased attention to how they are assessed.

Volume of Communications With Issuers by Year, Outgoing vs. Incoming



Source: MSCI ACWI Index constituents as of November 30, 2017. MSCI ESG Research, 2017

Investors should be encouraged by companies’ increased willingness to invest in providing more transparency around ESG issues. At the same time, it is important to note that company disclosure provides only a partial understanding of a company’s underlying risks. Take the Wells Fargo customer account scandal as an example. At the beginning of 2016, Wells Fargo’s cross-selling prowess, for which the company has reported metrics such as percentage of customers with multiple Wells Fargo accounts,[7] was the envy of other banks.[8] By the end of the year, other members of the banking industry were questioning the practice and scrutinizing their own cross-selling policies.[9]

In fact, even relying on audited, regulator-mandated financial data can provide an imperfect picture. In 2016 alone, 22% of all U.S.-listed companies issued “non-material” restatements on their regulatory filings and 7%, or 669 companies, issued a material restatement; both statistics

invites all corporate issuers at least once per year to engage in a standardized data review process through which issuers may review the ESG data that we have collected on their company to produce various MSCI ESG Research reports, including the MSCI ESG Ratings report.

[7] https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2014/consumer-lending-presentation.pdf

[8] https://www.forbes.com/sites/halahtouryalai/2012/01/25/the-art-of-the-cross-sell/#72023b1a55a3

[9] https://www.apnews.com/7007a4cd928240679a0c7cd359d1607b

were actually six-year *lows*.[10] Whether disclosure is voluntary or mandatory, it may not provide a full picture of a company's practices or reveal obvious lapses in internal controls.

The fact that companies tend to put their best foot forward may not be lost on investors. A 2017 PwC survey of U.S. investors found that 62% felt they don't "have enough trust in the information companies report" to be confident in investment analysis and decisions.[11]

What this suggests is that an objective signal of a company's ESG risks cannot primarily be driven by an issuer's own corporate narrative, particularly when much of that narrative is purely voluntary and not subject to regulatory (or even auditor) oversight. We find that additional information sources are crucial to balance self-disclosed information. In the era of big data, the opportunity exists to extract more data from a wider variety of publicly available sources that can provide a more accurate and complete picture of companies' ESG risks and performance.

To illustrate how important these additional data sources are to ESG assessments, relative to the contribution of voluntary company ESG disclosure, we decompose the contribution to our ESG ratings by sources of information. We separated sources of information into:

- **Voluntary company ESG disclosure**, which includes data from sustainability reports and corporate websites covering all MSCI ACWI Index constituents where available
- **Mandatory company disclosure**, such as financial filings and proxy statements, covering over 28,000 companies globally
- **Enforcements and media sources**, such as databases on government fines, violations and investigations, as well as 1,600+ local and global media outlets
- **Datasets on specialized topics from government, academic, NGO and commercial sources** such as those provided by the World Bank; Eurostat; International Labor Organization; Water Resources Institute; the Lamont-Doherty Earth Observatory; UK Reporting of Injuries, Diseases and Dangerous Occurrences Regulations (RIDDOR); International Chemical Secretariat (ChemSec); US Bureau of Labor Statistics; and others, covering more than 100 specialized datasets.

Different sources of information contribute to different scoring components of the ESG Rating. For example, mandatory disclosure is the predominant information source underlying the sub-model for assessing corporate governance practices.[12] We examined a sample of our coverage universe, the 2,434 constituents of the MSCI ACWI Index, as of November 30, 2017.

What we found helps illustrate both the value and potential limits of voluntary disclosure in our ESG signal. Fully 35% of any given company ESG rating, on average, is composed of scores that rely on what a company has disclosed through voluntary sources, while the other 65% is composed of scores using data from specialized data sources, enforcement and media sources,

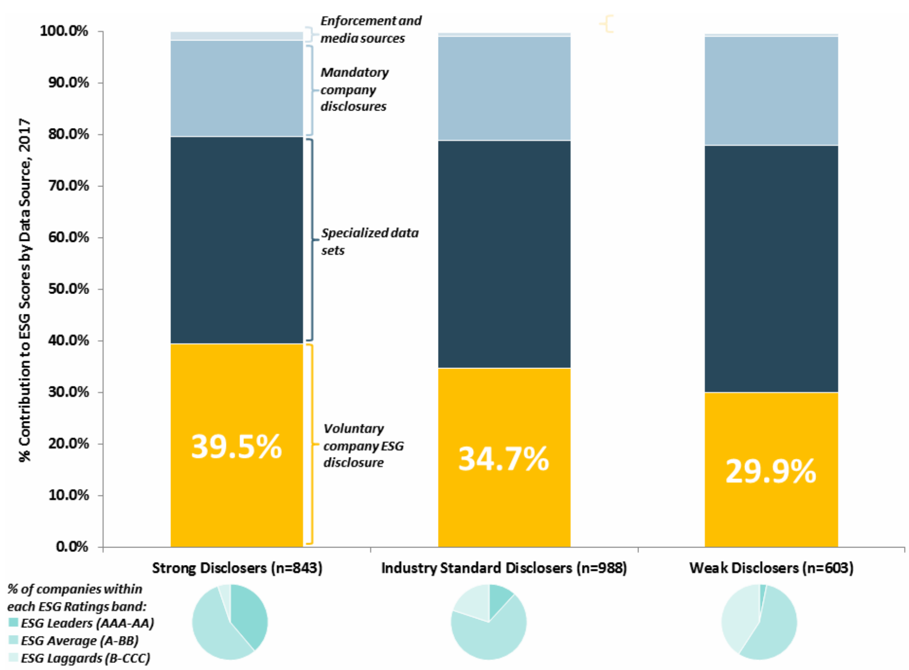
[10] https://blogs.wsj.com/cfo/2017/06/07/financial-restatements-hit-six-year-low; http://www.auditanalytics.com/blog/2016-financial-restatements-review

[11] https://www.pwc.com/gx/en/corporate-reporting/assets/cr-survey-us-final.pdf

[12] Other important sub-models that drive the overall ESG Rating include the risk exposure model which relies predominantly on specialized data sources, and the risk management model which relies predominantly on voluntary corporate ESG disclosure.

and mandatory disclosure.[13] For companies that are "strong disclosers,"[14] 39.5% of their ESG Ratings came from scores that rely on voluntary ESG disclosure. This compares to 27.4% for the "weak disclosers." Because voluntary ESG disclosure does not drive the majority of the ESG Rating, "strong disclosers" are not automatically highly rated, and "weak disclosers" are not automatically lowly rated. In fact, 5% of "strong disclosers" got a rating of B or lower (considered "ESG Laggards," as ratings range from AAA to CCC), and conversely, almost 60% of "weak disclosers" got a rating of average or above. The implication here is pretty simple: more voluntary disclosure may contribute more to the ESG rating, but may only result in improved ratings up to a point.

Voluntary Company Disclosure is a Significant, But Not Predominant, Contributor to ESG Ratings



2,434 constituents of the MSCI ACWI Index as of November 30, 2017. Source: MSCI ESG Research.

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[13] A company's ESG Rating is driven by major its management practices and performance vis-à-vis the level of industry-specific ESG risks the company faces (risk exposure) and, its corporate governance practices. To assess the first input to the signal i.e. whether the company has requisite management, the model relies heavily on voluntary ESG disclosures. Higher level of relevant company's voluntary disclosures on its practices and performance informs the model better, relying less on other three sources. The second input to the model i.e. risk exposure is informed by our modeled non-company datasets while the last input to the model, corporate governance practices is researched based on the mandatory company disclosures. To understand the how much our model signals are driven by availability of these sources.

[14] The MSCI ESG Rating model does not "score" companies on the volume of disclosure they make, nor do we make this data public as it is used for largely internal purposes. Solely for this analysis, we have categorized companies based on a qualitative assessment of companies' disclosure practices, as follows: Strong disclosers: Company reports on extensive list of KPIs found in CSR report and/or integrated with other disclosures and/or on its website; Industry standard disclosers: Company provides general statements, few datapoints/KPIs covered in CSR report, integrated with other disclosures, and/or on its website; Weak disclosers: Company provides only non-ESG specific information on career websites, investors relations page, financial or regulatory disclosure.

While investors will, and should, continue to demand greater corporate transparency, they also need objective signals that don’t overly rely on what companies say they do. As campaigns for improvements in disclosure ramp up this year, we may find that we hit a turning point in how investors view such disclosures. The availability of big data will likely increase and play a crucial role in balancing the corporate narrative to produce a more powerful ESG signal.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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ISS QualityScore: Environmental and Social Metrics

Posted by Ning Chiu, Davis Polk & Wardwell LLP, on Tuesday, February 20, 2018

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

Along with its four pillars for governance which score companies on a one to ten scale, ISS has launched Environmental & Social (E&S) QualityScore to measure corporate disclosure on environmental and social issues. Similar to the Governance QualityScore, the measures are relative based on peer companies within a specific industry group.

An initial set of 1,500 companies is being covered globally, including Energy, Materials, Capital Goods, Transportation, Automobiles & Components, and Consumer Durables & Apparel. It is expected that by Q2 2018, an additional 3,500 companies across 18 industries will be included. The scores will be part of the companies' proxy voting reports, but like all of the QualityScores, will not impact the vote recommendations.

More than 380 E&S factors, of which at least 240 apply to each industry group, will be assessed. Broad topics for the environmental disclosure include: (a) Management of Environmental Risks and Opportunities; (b) Carbon and Climate; (c) Natural Resources; and (d) Waste and Toxicity. There are 12 subcategories below this level. Social-related disclosures evaluated include: (a) Human Rights; (b) Labor, Health, and Safety; (c) Stakeholder and Society; and (d) Product Safety, Quality, and Brand. There are 25 subcategories in total.

The Key Issues document outlines for each subcategory the factors examined. For example, the category Carbon and Climate has a subcategory on Energy and Fuel Efficiency that checks whether companies have disclosed 11 metrics, including total energy use and energy derived from renewable and non-renewable sources. The category Labor, Health and Safety has a subcategory on Compensation and Benefits that looks at whether a company has made a commitment to a fair or living wage and responses to living wage controversies.

According to the ISS FAQ, the scores measure company disclosure. Unlike some of the other ESG "raters," ISS does not include assessments of corporate practices based on outside reports. ISS notes that investors report that company disclosure "is a meaningful signal in its own right."

Data is collected from company filings, sustainability and CSR reports, publicly available company policies and information on corporate websites. An additional measure is company participation in "multi-stakeholder initiatives," which are collected from those stakeholders' websites or member lists. Some of the company participation that is scored include participation in the UN Global Compact, the Global Network Initiative and the Voluntary Principles on Security and Human Rights.

The expectations for the disclosure are defined by industry and certain standard-setters that include the Global Reporting Initiative (GRI), the Sustainability Accounting Standard Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD). ISS stated that these standards were used in both selecting the factors and the weighting of those questions relative to the overall score, meaning that the factors related to these standards are more heavily weighed than other factors.

ISS indicated that the data could be updated daily. Like the Governance QualityScore, issuers can verify their data, and make submissions of corrected or updated data factors, through the ISS data verification site.

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Materiality Matters: Targeting the ESG Issues that Impact Performance

Posted by Emily Steinbarth and Scott Bennett, Russell Investments, on , May , 2018

Editor's note: Emily Steinbarth is a Quantitative Analyst and Scott Bennett is Director of Equity Strategy and Research at Russell Investments.

In our paper, Materiality Matters: Targeting the ESG issues that impact performance, we develop a new measure—the material environmental, social and governance (ESG) score. Drawing from the metrics developed by Sustainalytics and SASB (Sustainability Accounting Standards Board), our new material ESG score identifies and evaluates only those issues that are financially important to a company. The new material score allows us to differentiate between companies in a way that the traditional aggregated ESG score does not facilitate.

We can now distinguish between companies who score highly on ESG issues that are financially material to their business, from those who score highly on issues that are not financially material to their business. Our evidence suggests that the Russell Investments' material ESG scores are better predictors of return compared to traditional ESG scores.

Existing research and literature review

We are not alone in seeking a connection between sustainability and materiality, and our research builds on a growing library of literature on the topic. To pay homage to this, we feature an appendix in our paper comprised of a literature review, providing analysis of the large body of research on the financial performance of ESG investing. Our focus for the literature study is financial in that we survey only the evidence on ESG investment performance. This is not meant to imply that this is the most important dimension of ESG investing. Rather, our goal is to focus on answering one specific question: what is the link between ESG and investment performance? One strand of the literature that we build on suggests focusing on sustainability issues that are material to an industry is an important part of linking ESG performance to financial performance.

Industry bodies and Russell Investments aligned

In addition to academic research into the connection between industry-relative ESG performance and financial performance, this question is also being addressed by practitioners. Rather than adopt a one-size-fits-all approach, industry groups such as the Task Force on Climate-Related Financial Disclosures (TCFD) and sustainability reporting organisations expend considerable resources developing standards that are specific to business lines. ESG data providers weight subcategories differently based on their relevance to different industries. At Russell Investments, our investment manager research analysts identify ESG issues that are relevant to the success of a given strategy when evaluating the ESG awareness of asset managers.

Not all ESG issues matter equally

The relevance of ESG issues varies industry to industry, company by company. For example, fuel efficiency has a bigger impact on the bottom line of an airline than it does for an investment bank. So, rather than adopt a one-size-fits-all approach, we have worked to develop a new ESG scoring framework that is specific or truly material to a company and their profitability.

Why? We have found that traditional ESG scores are composed of a large number of issues that are not material for every industry or company. Specifically, for two-thirds of all securities in the Russell Global Large Cap Index universe, **less than 25% of the data items in the traditional score are considered material.**

Our paper follows a recent study by Khan, Serafeim and Yoon (2016), where the authors present evidence that investment in sustainability issues leads to financial outperformance, but only when the investment is in sustainability issues that are financially material to the firm. In contrast, they find that **investment in immaterial sustainability issues does not lead to better financial performance**, and may in fact detract from performance.

New material score methodology

We used the materiality map released by the SASB to help us determine which of the 145 ESG issues from Sustainalytics' data set could be deemed as material to companies' bottom lines. Following this, we used a number of statistical techniques to help formulate and standardise what we have coined 'the new material ESG score'.

Score analysis

To what extent these new material ESG scores resemble the original, generic ESG scores?

By looking at the correlation between traditional ESG scores and the new material score, our research has indicated that there is indeed a meaningful difference between the two scores. At roughly 65% correlation, our new material scores are indeed positively correlated—but, meaningfully different—from the traditional scores. This suggests that the **Russell Investments scores offer something different from the traditional scoring approach.** But is different better? Next, we looked at performance of the scores, which suggested the answer is yes. We have found that there is a benefit to investors who differentiate between a company's financially material ESG issues and non-financially material issues.

Results for the material ESG score

As referenced above, our work closely follows a methodology laid out in Khan, Serafeim, and Yoon (KSY, 2016). Their study uses the historical MSCI KLD[1] dataset that has a longer history

[1] KLD criteria were created by a company called KLD Research & Analytics Inc., a former social-responsible investing firm and pioneer in providing investment products like performance benchmarking, consulting services, and

than other sustainability datasets (199–2013). However, the KLD dataset's historical coverage is limited to the United States. We extended the scores' analysis on a wider universe—the Russell Global Large Cap Index—to the period December 2012–June 2017. Using the same methodology as KSY (2016) we report results for our sample in the chart below.

Differences in four-factor alphas (High – Low Quintiles)	
Material Sustainability Issues	1.19%
Immaterial Sustainability Issues	0.30%
Standard ESG Score	0.97%

Source: Russell Investments. Alphas refer to high minus low portfolio returns regressed on four-factor models.

High and low performance

The study by Khan, Serafeim, and Yoon has many important implications for our research and indicates that spending resources on immaterial issues is potentially value detracting. Going back to our original example, learning that fuel efficiency is a poor signal for future outperformance of an investment bank does not imply that the same is true for an airline. This explains why using fuel efficiency as a signal across a universe could lead to inconclusive results, even though it may be a valid signal for a subset of the universe.

Consistent with KSY, we found that the difference between high and low performers on material issues is larger than immaterial issues or the traditional scores. This suggests that **material issues are the most promising signal** among those we consider here for informing investment decisions based on ESG performance. The difference in alphas is statistically significant for material issues, but not for immaterial issues. We however, have gone one step further by isolating high performance on only material issues. The key takeaway for us from these results is that low performance on material issues is especially costly. This appears to be true even if the firm is a high performer on other ESG issues.

So, does materiality matter? Yes.

Industry bodies actively promote and recommend that companies need to focus more on the material ESG issues that directly affect their bottom line. Here, we align the way we evaluate companies with this broader industry movement and construct a new ESG score that focuses solely on material issues. Overall, we have reached conclusions consistent with existing literature in this field. That is, when measuring sustainability performance, the separation of material issues from immaterial issues matters.

compliance evaluations to the financial world. In the late 2000s, KLD became a part of the Morgan Stanley Capital International (MSCI) RiskMetrics Group, where its methods in evaluating companies' ESG performance continue to influence investment decisions.

Ultimately, our new score allows us to differentiate between companies in a way that the traditional score does not facilitate. We can now distinguish between companies who score highly on ESG issues that are financially material to their business, from those who score highly on issues that are not financial material to their business. Our research suggests that the Russell Investments material ESG scores can provide insights beyond traditional ESG scores.

Our goal was to confirm whether we could improve the information content of a standard ESG score for the tailored purpose of making investment decisions. Our analysis demonstrates this is possible. Specifically, we found that a high percentage of the underlying signals feeding into the standard score are not considered material to the firm's business; we observe correlations with factors that are modestly improved; and finally, **our material ESG scores appear to be a predictor of returns when compared to the standard score**, even after adjusting for known factor exposures. Our results up to this point are encouraging, and we remain confident.

Further research

Our study uncovered several potential areas for further research. We studied a global universe, but given regional differences in ESG integration and our inability to fully replicate a prior study's results from the United States, it is interesting to consider to what extent, if any, there should be a regional component to expectations for ESG investing. As noted above, there are many reasons to integrate ESG into an investment process.

While our study has largely focused on financial materiality, opportunities exist for developing cleaner signals based on other ESG-related goals, such as alignment with the UN Sustainable Development Goals (SDGs). Rather than mapping industries to key issues based on financial materiality, we could also focus on mapping industries to the SDGs that are relevant to their business line.

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Analysis of SEC Ruling on Apple Shareholder Proposal

Posted by Arthur H. Kohn, Sandra Flow, and Mary E. Alcock, Cleary Gottlieb Steen & Hamilton LLP, on Tuesday, January 9, 2018

Editor's note: Arthur H. Kohn and Sandra Flow are partners, and Mary E. Alcock is counsel at Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb publication by Mr. Kohn, Ms. Flow, Ms. Alcock, and Elizabeth K. Bieber. Related research from the Program on Corporate Governance includes Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

On November 1 2017, the Securities and Exchange Commission ("SEC") released guidance (Staff Legal Bulletin No. 14I ("SLB 14I")) clarifying the scope and application of the ordinary business and economic relevance grounds for excluding a shareholder proposal under Rule 14a-8 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") from a company's proxy statement.[1] On November 20, Apple Inc. became the first corporation to attempt to use this guidance in a request for no-action relief from the staff of the SEC's Division of Corporation Finance (the "Staff"), in response to governance activist Jing Zhou's proposal that Apple create a board committee focused on human rights (the "Proposal"). On December 21, 2017, the Staff responded, denying Apple's request to exclude the Proposal from its proxy materials.

In seeking no-action relief, Apple specifically relied on SLB 14I, which Apple characterized as "new staff policy regarding the application of [the ordinary business exclusion that] the Company believes supports the Company's exclusion of the proposal." Since Apple's application was filed after the 80-day deadline for a no-action relief request, Apple argued both that the release of SLB 14I was good cause for a waiver of the timing requirement and that the policy announced in it provided a substantive basis for exclusion. The Staff denied Apple's request, commenting specifically on the application of the ordinary business exclusion (the Staff's reply does not specifically address the timing issue). The Staff's reply clearly indicates that the guidance in SLB 14I should not be construed as providing an automatic pass for companies whose boards of directors can be shown to have deliberated on the issues raised by a particular shareholder proposal. That posture is consistent with informal statements by members of the Staff since the release of SLB 14I, and should give governance advocates some comfort that SLB 14I will not be applied as broadly as some have speculated.

In its request, Apple argued that issues related to human rights are fundamental to its business operations and therefore should be excludible under the ordinary business exception of Rule 14a-8(i)(7) under the Exchange Act. Apple explained that human rights concerns are integrated into its business, citing supplier compliance initiatives, prominence on its website, action that goes beyond relevant minimum standards set by the laws in various jurisdictions in which it operates and its dedication of resources to the issues. The request detailed various ways in which human

[1] See our prior Alert Memo, discussed on the Forum here.

rights concerns factor into the company's operations, and went so far as to state that "the observance of human rights standards factors into *every decision* made by management in the day-to-day operations of the Company." (emphasis added)

In light of SLB 14I's focus on board process,[2] Apple's no-action request also contained significant details regarding its Board process. It stated that the Board specifically considered and deliberated about the Proposal.

The challenge for Apple was to show that while the topic of human rights was integral to ordinary business operations, it did not raise a "significant policy issue" that transcends the Company's ordinary business. Apple argued, unsuccessfully, that because it already had significant oversight in place concerning human rights issues, the Proposal was "redundant" and therefore not a "significant policy issue." The Staff used language from Apple's no-action letter in citing its reasons for denial, finding that Apple's argument that human rights issues are an "integral component of the [company's] business operations" tended to provide more support for inclusion of the shareholder proposal. The SEC also cited a lack of analysis, including at the board level, that explained why the proposal would not "raise a significant issue for the [company]."

Notably, Apple did not make an argument for exclusion based on economic relevance. Rule 14a-8(i)(5) under the Exchange Act permits companies to exclude a proposal that "relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business." The discussion in SLB 14I raised the possibility that companies would argue that proposals related to environmental, social and governance ("ESG") issues do not meet the economic relevance standard. The Apple request highlights a further difficulty that companies may face in taking advantage of the new SLB 14I guidance: under what circumstances, if any, could a company argue on the one hand that ESG issues are ordinary course and permeate operational decisions so that they should be excludible under the ordinary business exclusion, and also argue on the other hand that they are not "economically relevant"—i.e., that they are not related to substantial business operations?

While the Staff was not persuaded by Apple's arguments, it remains to be seen whether and how a similar argument could be presented to take advantage of the apparent opportunity afforded to SLB 14I's discussion of board process. That is, how does a company show that an issue is ordinary course and without significant policy implications, but also that it was important enough for the board to have considered it in a way that evidences that conclusion? Could a company argue, for example, that an ESG or other issue is operationally important, but the board never

[2] SLB 14I states that "at issue in many Rule 14a-8(i)(7) no-action requests is whether a proposal that addresses ordinary business matters nonetheless focuses on a policy issue that is sufficiently significant. These determinations often raise difficult judgment calls that the Division believes are in the first instance matters that the board of directors is generally in a better position to determine. A board of directors, acting as steward with fiduciary duties to a company's shareholders, generally has significant duties of loyalty and care in overseeing management and the strategic direction of the company. A board acting in this capacity and with the knowledge of the company's business and the implications for a particular proposal on that company's business is well situated to analyze, determine and explain whether a particular issue is sufficiently significant because the matter transcends ordinary business and would be appropriate for a shareholder vote. Accordingly, going forward, we would expect a company's no-action request to include a discussion that reflects the board's analysis of the particular policy issue raised and its significance. That explanation would be most helpful if it detailed the specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned. We believe that a well-developed discussion of the board's analysis of these matters will greatly assist the staff with its review of no-action requests under Rule 14a-8(i)(7)."

had reason to consider it (because it raises no significant policy issues) until the company received a shareholder resolution about it?

In sum, many commentators initially assumed that SLB 14I signaled a new willingness by the Staff to defer to companies in regard to shareholder proposals, in line with the new administration's overall regulatory attitude. While it is not yet clear that this view should be adjusted, the Staff's response to the Apple request indicates that the citation of board process and an involvement of the board in an assessment of a shareholder proposal will not give rise to an automatic pass with the Staff. We continue to believe that companies should carefully consider the role that boards should play in the Rule 14a-8 process in light of SLB 14I.

Shareholder Proposals in an Era of Reform

Posted by David A. Katz and Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, on Thursday, November 30, 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*.

Securities and Exchange Commission Chair Jay Clayton has emphasized that corporate governance rulemaking under his leadership will be designed to maximize the long-term interests of the retail shareholder. On several occasions over the past year, Chairman Clayton has indicated that the shareholder proposal process is in need of reform, as it is an area in which the SEC can reduce the costs currently borne by—in Chairman Clayton's terms—"the quiet shareholder, the ordinary shareholder" on behalf of the "idiosyncratic interests" of a louder few. New SEC guidance released this month begins this process by elevating the role of boards in evaluating shareholder proposals for exclusion under Rule 14a-8. Staff Legal Bulletin 14I represents a meaningful change in the way certain shareholder proposals are addressed by boards of directors and reviewed by the SEC staff, with the potential for significant improvement in both process and results. SLB 14I should be a valuable tool for companies to minimize unnecessary costs of the shareholder proposal process while still ensuring that a worthwhile proposals will be presented for shareholder consideration. While further reform of the 14a-8 regime is necessary, SLB 14I is an important development in the right direction.

The Need for Reform

This summer, the Chamber of Commerce's Center for Capital Markets Competitiveness urged reform of the current shareholder proposal process, characterizing the status quo as "yet another burden on companies and their shareholders that only serves to make the public company model less attractive." The Chamber observed that the shareholder proposal system's protections for ordinary shareholders have weakened over time, with the result that the process "has unnecessarily devolved into a mechanism that a minority of interests use to advance idiosyncratic agendas that come at the expense of other shareholders." Recent data support this view. According to a Manhattan Institute report, half of all shareholder proposals submitted in 2016 addressed a social or policy-related matter, rather than a topic relevant to the long-term performance of the company. The same report found that six individual investors were responsible for one-third of all shareholder proposals in 2016, and 38 percent of the proposals were sponsored by institutional investors with an explicit social, religious, or policy agenda. In other words, the shareholder proposal process has been a costly tool used by few with little-to-no benefit for the majority of investors.

Both the Business Roundtable and the Chamber of Commerce have advocated for changes to the no-action process for excluding 14a-8 shareholder proposals. They cite a lack of clarity and consistency in the criteria for exclusion, and they criticize the narrowness of currently available grounds for exclusion. Both organizations call for the reversal of Staff Legal Bulletin 14H, which followed the SEC's controversial *Whole Foods* no-action decision in 2015 and dramatically limited the exclusion available for shareholder proposals that are in "direct conflict" with company proposals. The Business Roundtable's statement pointed out that this decision had a dramatic impact, yet it was made without SEC rulemaking and as the result of a "decentralized, issue by issue, review" that yields "whimsical changes in direction" and, in their view, does not well serve the majority of shareholders.

Staff Legal Bulletin 14I

SLB 14I primarily relates to two bases for exclusion of 14a-8 shareholder proposals: economic relevance and ordinary business. The economic relevance exception permits a company to exclude from its proxy statement shareholder proposals regarding operations that are not significantly related to the company's business. The ordinary business exception permits a company to exclude proposals that aim to "micromanage" company operations that are properly addressed by management and the board of directors.

With respect to both exceptions, the guidance provided in SLB 14I reflects the SEC's recently articulated perspective that the board of directors is well situated to determine how a proposal relates to the company's business. The SEC will now expect no-action requests under these two 14a-8 grounds for exclusion to include disclosure of the board's process and reasoning in reaching the conclusion that the proposal should be excluded from the company's proxy statement. While the board's analysis is not determinative, the SEC staff will give it due consideration. Mr. Matt McNair, of the Division of Corporation Finance, indicated in recent remarks that, while formal resolutions and board materials are not required to be included in a no-action submission, the information considered by the board and the board's findings and process should be described in detail and will be of increased importance to the SEC staff under this guidance. Mr. McNair also noted that though the board may delegate the matter to a committee, a well-developed record prepared by a board committee and approved by the full board is likely to carry more weight with the SEC staff.

SLB 14I is likely to have a range of positive effects. It may increase the number of proposals that are properly excluded under these two exceptions. At the same time, it may prompt proponents to submit proposals that are in fact relevant to the business of the corporation and thus could lead to improvements in governance or corporate direction. Given that the disclosures made in no-action letter requests are public, boards certainly will find their deliberative processes in this area under greater scrutiny by institutional shareholders; this may have the additional benefit of encouraging boards and shareholders to engage and negotiate in lieu of going through the shareholder proposal exclusion no-action process.

Further Elements of Reform

The federal government and independent groups have recognized the need for additional elements of shareholder proposal reform. Both the Chamber of Commerce and the Business Roundtable have recommended that disclosure and resubmission requirements be strengthened, and the Business Roundtable has advocated raising the eligibility requirements as well. Increases in the ownership eligibility and resubmission thresholds are key elements of the shareholder proposal reforms contained in the Financial CHOICE Act of 2017, which passed the House of Representatives in June but is stalled in the Senate. The U.S. Department of Treasury released in October a report recommending revisions to the eligibility and resubmission thresholds in order to promote shareholder accountability and reduce unnecessary costs. In remarks earlier this month, at the PLI 49th Annual Institute on Securities Regulation, Chairman Clayton noted with respect to shareholder proposal reform that ownership and resubmission requirements are of particular interest to many.

Every aspect of the shareholder proposal process has come under fire from interested organizations, particularly since the controversial SLB 14H in 2015. Eligibility and resubmission requirements, disclosure requirements, a range of exceptions, proposals by proxy, and the use of graphs and images in proposals (which latter two were addressed in SLB 14I), and the SEC's no-action process itself have been cited as contributing to a situation that is burdensome and counterproductive for the average investor. Yet under the right regulatory regime, shareholder proposals can be a valuable piece of the corporate governance framework. SEC Chairman Clayton has expressed support for the type of shareholder proposals that, despite their short-term costs, can ultimately lead to improvements in corporate governance, and he appears committed to reshaping the shareholder proposal process into one that adds value for investors.

As Chairman Clayton observed in his remarks at the PLI, "the shareholder proposal process is a corporate governance issue that is subject to diverse and deeply held beliefs." To successfully reconcile competing views in governance and shareholder engagement issues generally, Chairman Clayton's focus on "serving the long-term interests of Main Street investors" is the right approach. As boards of directors are the primary guardians of and advocates for long-term shareholder value in our economy, the SEC is wise to elevate their role in this important area of corporate governance. SLB 14I is a first step in the right direction toward meaningful 14a-8 reform.

Part III: Investor Activism

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Activism in 2018

Posted by Ethan A. Klingsberg and Elizabeth Bieber, Cleary Gottlieb Steen & Hamilton LLP, on Monday, January 29, 2018

Editor's note: Ethan A. Klingsberg is a partner and Elizabeth Bieber is an associate at Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb publication by Mr. Klingsberg and Ms. Bieber. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); and Dancing with Activists by Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch (discussed on the Forum here).

Two years ago, we explained to clients that the shareholder activism landscape was undergoing significant change. Returns at many of the "brand name" activist funds were down, companies had become savvier at messaging to their investors about why their positions on areas of activist focus were well-founded and, in numerous cases, companies had preemptively taken steps to adjust their strategic plans to be consistent with the approaches that activists would take.

Many clients remained on high alert, but they were regularly encountering "false alarms" when famous activists would show up in their profiles after the quarterly Form 13F filings and generate media buzz, but the investment would turn out to be for purposes of liquidity rather than influencing management. In addition, a number of clients received requests for meetings or telephone calls with activist investors, only to realize later that the investor was primarily interested in gathering information for purposes of macro-economic analysis, rather than as a first step in launching a campaign.

Meanwhile, the letters and inquiries to clients from actively managed (but not "activist") funds—such as T. Rowe Price and Neuberger Berman—became increasingly pointed and urgent, focusing on the areas that were traditionally the turf of the high-profile activists—allocation of capital, strategic alternatives and separation of parts from the whole. We regularly heard from investor relations personnel about how the actively managed funds were loyal long-term investors who "love us," and then these letters would arrive. We anticipated, at the time, a new era of "activism by traditional long-term holders" and the fading of the celebrity activists.

While activism, including threats of proxy contests, by the traditional, actively managed institutional funds is now becoming increasingly commonplace, the brand name activists are back. Their tools (white papers and threatened and actual proxy contests) remain the same. But they have shifted their time horizons and initial focus. The activists are now regularly holding investments for four to five years and focusing more consistently during the initial years of their investments on advocating for operational turnarounds. A push for a sale of the company remains a favorite solution, but many activists are prepared to maintain their investments for a few years before this alternative becomes an urgent, best next step. In addition, while campaigns to force out management still exist, the focus initially is now more typically on the need to refresh the composition of the board.

The activists had no choice but to adapt to this new, longer-term approach because companies susceptible to quick fixes—such as a spin-off or sale of a division, a leveraged recapitalization or a sale of the company to a cash-rich competitor—had largely disappeared due to preemptive actions by boards that had learned to “think like an activist.” Moreover, the market has made it worthwhile for the activist funds to adapt. Not only are assets under management for activist funds at an all-time high, but we are now seeing activist groups able to raise large, special-purpose funds for a specific, multi-year investment on short notice.

Another change in hedge fund activism is traceable to the shift of approximately $5 trillion over the last 10 years in the United States from actively managed funds to index and other passive strategy funds. This shift is causing not only companies, but also the activists themselves, to appeal to the longer-term and often structural and governance-oriented concerns of the passive strategy fund shareholders. Activists are now fluent in issues of “diversity of tenure,” “gender, race and age diversity,” “board skillset matrices” and provisions in charters, bylaw and governance guidelines that “good governance” advocates find compelling.

The activist hedge funds will shamelessly lace their communications to companies with references to these issues as a way to signal that they intend to round up the passive strategy funds and others in the “good governance” community to support their campaigns. At the same time, we are spending more time working with clients to refine their messaging and strategy in these areas, including through regular by-law and governance guideline upgrades, off-cycle governance roadshows that include meetings with the leading passive strategy funds and improvements to their disclosures in the annual meeting proxy statement, sustainability reports and other shareholder communications.

The battle for the votes and loyalty of the passive strategy fund shareholders will continue to be hard fought for the next several years. We often see tensions between what actually drives the voting decisions of the ETFs and index funds in contested situations versus the statements made on behalf of these passive strategy funds in well-publicized annual letters, in published guidelines and by their governance-oriented spokespersons at conferences. Moreover, the recommendations of ISS and Glass Lewis are no longer sufficient to lock up the votes of the passive strategy fund shareholders.

We cannot emphasize enough how precarious these relationships with the passive strategy funds may become during an activist campaign and, despite signs that all is well during “clear days,” how important it is to nurture these relationships whether or not a company’s shareholder profile has signs of activist hedge fund interest.

The settlement vs. fight calculus has become tougher as well against this backdrop. The significant growth of index funds means that the 10 top institutional holders of the stock of U.S. publicly traded companies will increasingly hold over 40 percent or even 50 percent of the voting power—making it relatively easy for shareholders to be led in an efficient revolt against incumbents if the company’s relationship with these holders is not solid. In addition, when settling with an activist, companies ought to have an action plan in place to explain to this group of 10 top institutional holders why the terms of the settlement with the activist and its implications for the company's strategic direction are in their best interest.

The fickleness of top institutional holders colored the recent "victories" by ADP and Procter & Gamble (and earlier by DuPont) against the short-slate proxy contests run by Pershing and Trian. These proxy contest "wins" not only cost these companies millions of dollars, but also left the boards having to digest voting data that indicated that very significant percentages of their institutional investors, including several top holders at each company, did not support the management slate (and, by implication, the strategic direction and leadership of the company) and, in the case of Procter & Gamble, resulted in the voluntary appointment of Nelson Peltz to the board. Moreover, and perhaps most importantly, the activists do not just go away after these votes; they continue their pressure and campaigns and often end up "winning the war while losing the first battle" as boards end up pushing back against plans that stick to the status quo.

Additionally, on the settlement front, the activist funds have been increasingly open to backing off in exchange for the appointment of directors with industry experience, as opposed to demanding that one of their funds' own founders or other senior employees join the board. Companies are frequently open to having these well-regarded individuals join their boards (and, in fact, are sometimes grateful for the catalyst to board refreshment provided by the activists). In many instances, these new outside directors energize, contribute to and build new bridges within the boardroom.

In the same vein, we have found that senior executives have largely come around to accepting that their boards will inevitably include strong personalities and leadership experience that will not translate into easy deference to management. Outside directors are more eager than ever to critically analyze strategic decisions and corporate governance and no longer view embracing activist ideas as a taboo.

Against this backdrop, management teams, including the legal department, have an opening—and indeed are under pressure—to assure their outside directors that they have all material information about and analyses of the strategic plan, that messaging to investors about the long-term plan and goals is well-articulated and not neglected due to over-focus on short-term guidance, and that the spectrum of governance "hot buttons" is being addressed by the company in a thoughtful manner. Taking up this challenge is the best preparation for and defense against activism.

Activism: The State of Play

Posted by Martin Lipton, Wachtell Lipton Rosen & Katz, on Saturday, September 23, 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. Additional posts by Martin Lipton on short-termism and corporate governance are available here. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

As we approach the start of the 2018 proxy season, developments since January 2015 prompt a brief review of the state of play.

- There has been no slowdown in the U.S.; there has been a significant increase in other countries.
- Perhaps the most cogent description of what can be expected is contained in a must-read Bloomberg article, "The World's Most Feared Investor". "Aggressive, tenacious and litigious to a fault, Paul Singer may be the most feared activist investor in the world—by hedge fund rivals, companies and even countries. Singer's Elliott Management Corp., which manages $34 billion of assets, has rarely been out of the headlines in the past 18 months. There's little indication that will change soon."
- Substantial new capital has been raised by activist hedge funds and several activists have created special purpose funds for investment in a single target.
- Attacks on large successful companies have increased.
- While an activist attack on a large successful company to force acceptance of a financial engineering strategy has generally failed, e.g., GM's resounding defeat of Greenlight Capital's attempt to get shareholder approval of converting common stock into two classes, there has been an increase in attacks to obtain a change in a company's CEO.
- There has been an increase in attacks designed to force the target into a merger or a private equity deal with the activist.
- There has been a significant increase in "bumpitrage"—buying a block of stock in a merger partner seeking shareholder approval to use the block to defeat approval, unless the merger price were increased.
- Several major funds have converted from classic activism to a form of merchant banker approach of requesting board representation to assist a company to improve operations and strategy for long-term success.

- BlackRock, State Street and Vanguard have continued to express support for sustainable long-term investment and set forth their governance and engagement expectations in letters to CEOs, speeches, annual reports and statements of policy.
- Comprehensive principles of corporate governance, investor stewardship and engagement were published, e.g.: Commonsense Corporate Governance Principles (discussed on the Forum here); The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth (discussed on the Forum here); Investor Stewardship Group's Stewardship Principles and Corporate Governance Principles (discussed on the Forum here). I created a synthesis of these and others, A Synthesized Paradigm for Corporate Governance, Investor Stewardship, and Engagement, and circulated it in the hope that companies and investors would agree on a common approach.
- A number of academic studies and articles pointed out the defects in the "empirical studies" that had been used to promote short-termism and justify attacks by activist hedge funds. Of special note was a collection of articles in the *Harvard Business Review*, Spotlight on Managing for the Long Term.
- Legislation to promote long-term investment was sought and initiated in the U.S. and the U.K., and actually adopted in the E.U.
- Failure to have successfully engaged with major investors and understand their opinion of the company's operations and strategy has, resulted in proxy fights that were lost, or won by such a narrow margin that management change quickly followed.
- The Investor Forum was founded in the U.K. to provide an intermediary to represent the views of its investor members to investee companies in the hope of reducing activism. It appears to have achieved a successful start. The Investor Forum Review 2015 and 2016.
- The Coalition for Inclusive Capitalism is undertaking a study to support long-term sustainable investment by showing there is value beyond financial results. Press release, Global business leaders and investors unite to develop framework that measures long-term value creation for all stakeholders. http://www.prnewswire.com/news-releases/global-business-leaders-and-investors-unite-to-develop-framework-that-measures-long-term-value-creation-for-all-stakeholders-300481133.html

Activism continues to grow and change. It is unlikely that in the near term it will be curbed by legislation or regulation. Companies will have to follow closely activist developments and the opinions of their major investors. Companies should perfect and maintain their engagement activities. Companies should regularly review and adjust their plans designed to avoid an activist attack and to successfully deal with an activist attack if one should occur.

The Impact of Shareholder Activism on Board Refreshment Trends at S&P 1500 Firms

Posted by Subodh Mishra, Institutional Shareholder Services, Inc., on Thursday, October 19, 2017

Editor's note: Subodh Mishra is Executive Director at Institutional Shareholder Services, Inc. This post is based on a co-publication by ISS and the Investor Responsibility Research Center Institute. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here).

Few business-related topics provoke more passionate discussions than shareholder activism at specific companies. Supporters view activists as agents of change who push complacent corporate directors and entrenched managers to unlock stranded shareholder value. Detractors charge that these aggressive investors force their way into boardrooms, bully incumbent directors into adopting short-term strategies at the expense of long-term shareholders, and then exit with big profits in hand.

Lost in this heated long- versus short-term debate is the significant, real-time impact that such activism has on corporate board membership and demographics. ISS identified a recent surge in its evaluation of refreshment trends at S&P 1500 firms between 2008 and 2016 (see *Board Refreshment Trends at S&P 1500 Firms*, published by IRRCi in January 2017). This accelerated boardroom turnover coincided with an increase in activists' success in securing board representation, particularly via negotiated settlements. A recent study of shareholder activism by *Activist Insights* pegged activists' annual U.S. boardroom gains at more than 200 seats in 2015 and 2016. While a significant portion of this activism was aimed at micro-cap firms, threats of fights have become commonplace even at S&P 500 companies in recent years.

Despite activists' recent boardroom gains, little attention has been paid to the influence of activism on broader board refreshment trends. Anecdotal media coverage, often fanned by anti-activist communications strategies, still tends to myopically focus on two long-standing dissident nominee stereotypes: the still-wet-behind-the-ears, 20- or 30-something-year-old hedge fund analyst, and the older, male, over-boarded crony of the fund manager.

These long-standing stereotypes appear to be outdated as activism has entered an era in which most dissident nominees have attenuated ties to their hedge fund patrons. The experience, qualifications, attributes, and skills of dissident nominees can appear indistinguishable from those of the incumbent directors whom they seek to supplant. Nominees' backgrounds and experiences can become even more interchangeable with those of incumbent directors when the latter transfuse their own ranks with new blood during, or in anticipation of, an activist campaign. This heightened competition can leave shareholders with a bounty of fresh-faced, highly-qualified, independent candidates on both nominee slates. Highlighting this narrowing divide, dissidents' “hand-picked” nominees have been known to reject their sponsors’ wishes and strategic plans (witness Elliott Management’s first tranche of candidates at Arconic, who were seated via a settlement, opposing the hedge fund’s second attempt to gain board seats). Similarly, nominees selected by incumbent directors to face off against dissident candidates sometimes end up endorsing the very shifts in strategic direction that they were recruited to fend off (witness the DuPont board’s “victory” over Nelson Peltz’s Trian Partners, followed by board-recruited director-turned CEO Ed Breen’s advocacy of a Peltzian-style breakup of the company).

To close this board refreshment information gap, IRRCi asked ISS to explore the broader impact of activism by focusing on nominees—regardless of the entity that backed them—and the impact of dissident campaigns on boards.

Methodology

The complete publication (available here) examines the impact of *public shareholder activism* on board refreshment at S&P 1500 companies targeted by activists from 2011 to 2015. Public shareholder activism refers to any shareholder activism that (1) occurred between Jan. 1, 2011 and Dec. 31, 2015, and (2) was publicly disclosed. The study period concludes in 2015 so that data for a full calendar year following activist campaigns could be analyzed. Data was captured as of the shareholder meeting dates.

Part I examines individual dissident nominees on ballots (whether they ultimately joined the board or not) in proxy contests, directors appointed via settlements with activist shareholders, and directors appointed unilaterally by boards in connection with shareholder activism.

Part II examines changes to board profiles made in connection with public shareholder activism.

Data was captured for all S&P 1500 directors with less than one year of tenure at meetings scheduled to be held between Jan. 1, 2011 and Dec. 31, 2015. The directors were then assigned to one of four classifications:

1. All dissident nominees on ballots in proxy contests;
2. Directors appointed or nominated by incumbent boards through publicly-disclosed settlements with activist shareholders;
3. Directors appointed or nominated unilaterally by incumbent boards in connection with public shareholder activism; and
4. Directors appointed or nominated prior to and not in connection with public shareholder activism.

If a definitive proxy contest was settled, directors added to the board as a result of the settlement were assigned to classification two.

Data for directors assigned to classification four was excluded, as it did not relate to the impact of public shareholder activism on board refreshment during the study period.

In Part II, board profile changes were assessed through a comparison of target boards in the year prior to shareholder activism and target boards in the year following shareholder activism. For example, there was shareholder activism at J. C. Penney in connection with the company’s 2011 annual meeting. The measure of change was therefore based on a comparison of the board profiles at the company's 2010 and 2012 annual meetings. In cases where there were two or more consecutive years of shareholder activism, board profile changes were assessed through a comparison of target boards in the year prior to the first year of shareholder activism and target boards in the year following the final consecutive year of shareholder activism. For example, there was shareholder activism at Juniper Networks in both 2014 and 2015. The measure of change was therefore based on a comparison of the board profiles at the company's 2013 and 2016 annual meetings.

Part II examines year-over-year trends. In these cases, study companies with two or more consecutive years of shareholder activism were excluded. Study companies were grouped by market-cap segments, i.e. S&P 500 (large-cap), S&P 400 (mid-cap), and S&P 600 (small-cap). Study companies that changed indexes over the course of the study were excluded from segment-level comparisons.

In Part II, references to changes in average director age and average director tenure at study companies (excluding those discussed in isolation) refer to averages of average company-level data. Company-level data provided average age and tenure for each specific company. For references to average age and tenure at study companies, these data points were calculated by averaging the company-level (rather than director-level) data points.

Key Findings

Part I: Individual Director Demographics

Snapshot: Public shareholder activism generally leads to younger, more independent, but less diverse, board candidates who had previous boardroom experience and relevant professional pedigrees. Typically activists favor nominees with financial experience and incumbent boards favor nominees with executive experience.

Activism drives down director ages. Dissident nominees and directors appointed via settlements (hereinafter Dissident Directors) were younger, on average, than directors appointed unilaterally by boards (hereinafter Board Appointees) in connection with shareholder activism. Study Directors (the combination of Dissident Directors and Board Appointees), regardless of who recruited them, were generally younger than their counterparts across the broader S&P 1500 index. While Dissident Directors generally reflected a wider range of ages, insurgent investors and incumbent boards both favored individuals in their fifties when picking candidates. This preference for nominees in their fifties aligns with practices in the broader S&P 1500 index over the same period.

Activism does not promote gender diversity. Less than ten percent of Study Directors were women. While the rate at which females were selected as dissident nominees or Board Appointees in contested situations increased over the course of the study, it trailed the rising tide of female board representation in the broader S&P 1500 universe*.* There were zero female Dissident Directors in 2011, two in 2012, and three in 2013. Similarly, there were two female Board Appointees in 2011, but zero in both 2012 and 2013.

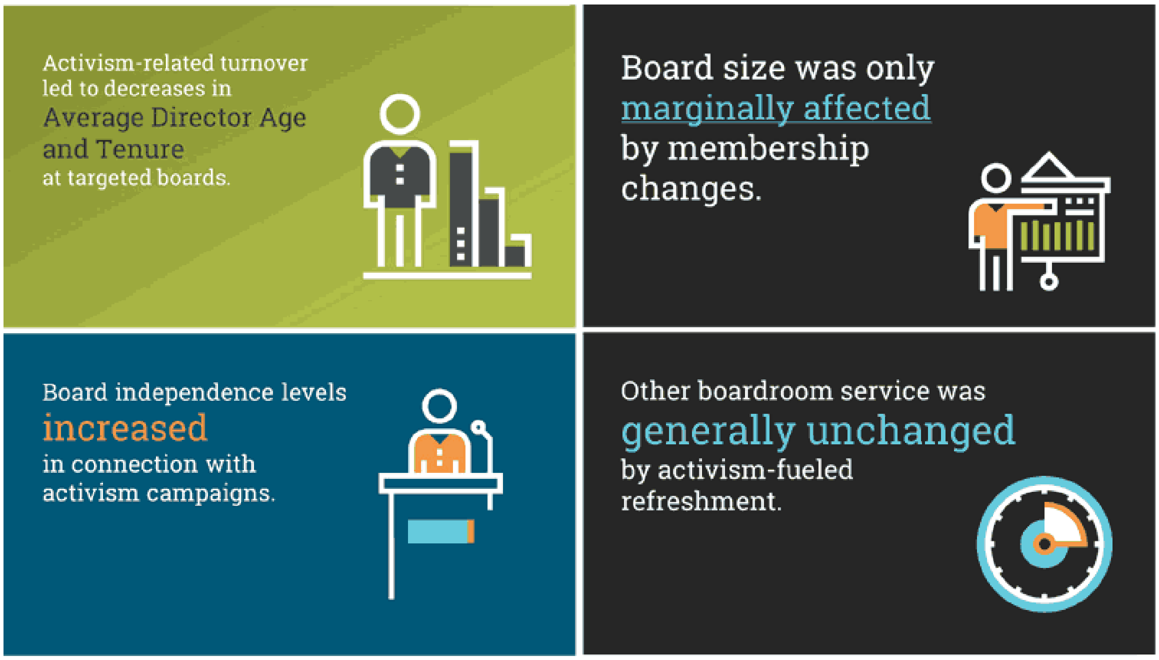
Activism does not promote racial/ethnic diversity. Less than five percent of Study Directors were ethnically or racially diverse. While minority representation across the entire S&P 1500 board universe slowly increased over the course of the study, from 9.3 percent in 2011 to 10.1 percent in 2015, the rate at which individuals with diverse ethnic and racial backgrounds were selected as Dissident Directors and Board Appointees was relatively uniform and trailed that of the broader index by more than five percentage points.

Activism boosts boardroom independence. Study Directors were generally more independent than their counterparts across the broader S&P 1500. Not surprisingly, dissident nominees and directors appointed to boards via settlements were more likely to be “independent” than directors appointed unilaterally by boards in connection with shareholder activism. It is worth pointing out that the measure of “independence” focused on a nominee’s degree of separation from management rather than from the dissident. Indeed, as the examination of prior boardroom experience suggests, there may be questions of independence from activist sponsors for a subset of Study Directors.

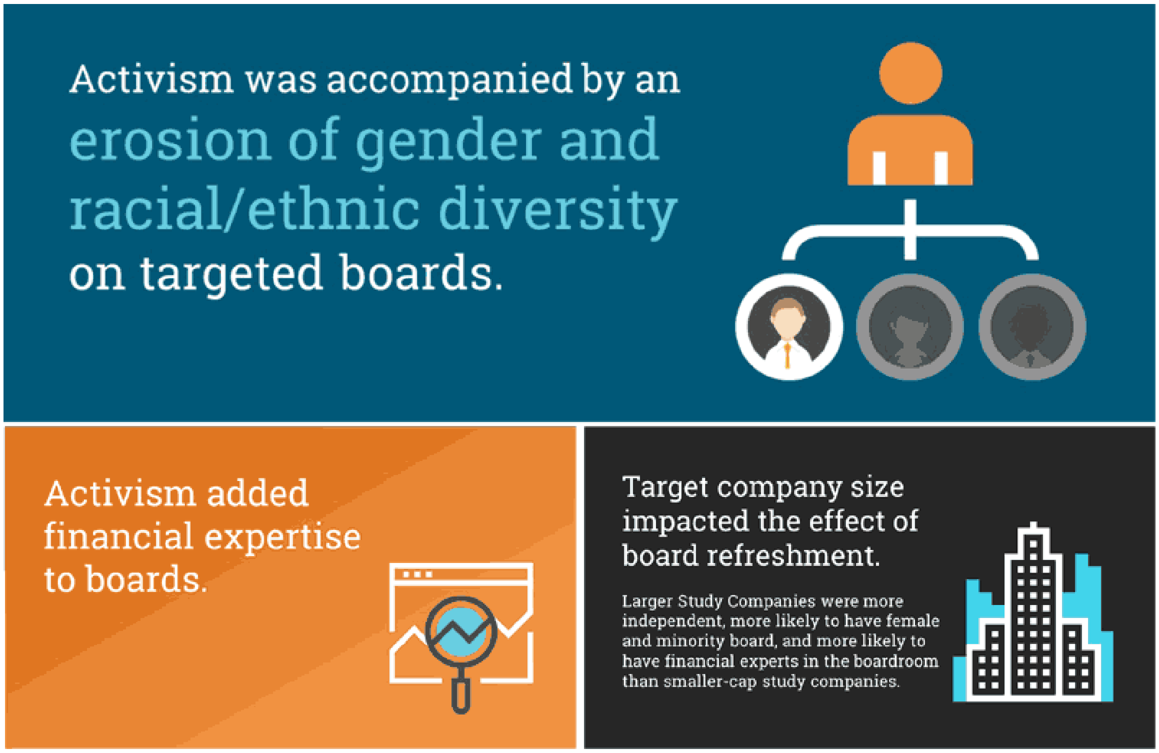
Prior boardroom experience is not required. Boardroom experience does not appear to be a prerequisite for contest candidates. More than half of Study Directors held outside board seats. While most of these directors sat on either one or two outside boards, a sizable minority pushed the over-boarded envelope. Six Study Directors served on four outside boards, four on five outside boards, and one on six outside boards. Many of these “busy” directors appear to be “go-to” nominees for individual activists. The serial nomination of favorite candidates raises questions about the “independence” of these individuals from their activist sponsors.

Investment professionals and sitting executives dominate the candidate pool for contested elections. Occupational data for the Study Directors demonstrates experience, qualifications, attributes, and skills (EQAS) preferences for nominees in contested situations. “Corporate executives” and “financial services professionals” were in a dead heat at the front of the pack. These favored occupations were not evenly distributed, as activists tended to select investors and incumbents tended to select executives. In fact, Dissident Directors were nearly three times more likely to be “financial services professionals” than Board Appointees, while Board Appointees were nearly twice as likely to be “executives” than Dissident Directors.

Part II: Board Profile



Snapshot: Public shareholder activism generally resulted in boards that are younger, shorter- tenured, slightly-larger, more independent, and more financially literate, but less diverse, than their pre-activism versions.



Activism-related turnover led to decreases in average director age and tenure at targeted boards. Dissident Directors averaged 53 years of age and Board Appointees averaged 56.3 years of age. Average director age decreased by 2.6 years to 59.6 years on Study Boards targeted by shareholder activists, while average director tenure decreased by 3.4 years to 6.1 years. For the broader S&P 1500 in 2015, average director age was 62.5 years and average tenure was 8.9 years.

Board size remained relatively steady despite membership changes. Although average board size at **Study Companies** increased from nine to 9.4 seats, less than half (41.9 percent) of the Study Companies experienced a post-activism boost in board size. 18.3 percent of Study Companies experienced a decline in board size following shareholder activism, while board size was unchanged at 39.8 percent of Study Companies.

Board independence levels increased in connection with activism campaigns. Average board independence at Study Companies increased from 79.5 percent to 83 percent. More than 60 percent of study companies experienced an increase in independence, 21.5 percent experienced a decrease, and 18.3 percent experienced no change. Average board independence in the S&P 1500 was 80.6 percent in 2015.

Other boardroom service was generally unchanged by activism-fueled refreshment. The average number of outside boards on which Study Company directors served remained virtually flat, increasing from 0.8 to 0.9. Of the 89 Study Companies, the number without a director who sat on more than one outside board decreased from four to two. There was a correlation between company size and outside board service, as directors at S&P 500 and S&P 400 study companies sat on a higher average number of outside boards than their counterparts at S&P 600 study companies.

Activism was accompanied by an erosion of gender and racial/ethnic diversity on targeted boards. Study Company boards were less likely to have at least one female director following an activism campaign than they were preceding one, decreasing from 87.1 percent to 82.8 percent. Similarly, Study Company boards were less likely to have at least one minority director following an activism campaign than they were preceding one, decreasing from 55.9 percent to 51.6 percent. According to *Board Refreshment Trends at S&P 1500 Firms*, the proportion of S&P 1500 companies with at least one female director increased from 72 percent in 2011 to 82.7 percent in 2015 and the portion of S&P 1500 companies with at least one minority board member increased through the course of the study period to 56.8 percent.

Activism added financial expertise to boards. The proportion of board seats at Study Companies occupied by "financial experts" increased from 22.6 percent (189 of 835) to 24.5 percent (214 of 874). The number of Study Companies with at least one, two, or three "financial experts" also increased. (At U.S. companies, ISS considers a director to be a "financial expert" if the board discloses that the individual qualifies as an "Audit Committee Financial Expert" as defined by the Securities and Exchange Commission under Items 401(h)(2) and 401(h)(3) of Regulation S-K. Under the SEC's rules, a person must have acquired their financial expertise through (1) education and experience as a principal financial officer (PFO), principal accounting officer (PAO), controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions, (2) experience actively supervising a PFO, a PAO, controller, public accountant, auditor or person performing similar functions; (3) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements or (4) other relevant experience.)

Target company size impacted the effect of board refreshment. Larger Study Companies were more independent, more likely to have female and minority board members (both pre- and post- activism), and more likely to have financial experts in the boardroom than smaller-cap study companies. Relative to their larger peers, smaller Study Companies generally experienced more pronounced declines in average director age and tenure, but experienced more significant increases in average board size.

The complete publication is available here.

Harvard Law School Forum on Corporate Governance and Financial Regulation

Dancing with Activists

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our study is available for download here.

A Second Bite at the Apple? Shareholder Activists and Tardy Director Nominations

Posted by Steve Wolosky, Andrew Freedman, and Ron Berenblat, Olshan Frome Wolosky LLP, on Wednesday, April 25, 2018

Editor's note: Steve Wolosky, Andrew Freedman, and Ron Berenblat are partners at Olshan Frome Wolosky LLP. This post is based on an Olshan publication by Mr. Wolosky, Mr. Freedman, and Mr. Berenblat.

Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); Dancing with Activists by Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

Now that we are midway into the 2018 proxy season, most deadlines for shareholder submissions of director nominations for upcoming annual meetings have come and gone. Nevertheless, shareholder activists who have missed a nomination deadline for whatever reason should be aware that in certain circumstances they may have a second bite at the apple. Where a company experiences a material change in circumstances set in motion by its board of directors after the passing of the nomination deadline, the shareholder may have grounds to compel the company to reopen the nomination window if the shareholder can demonstrate that the change in circumstances would have been material to its decision whether or not to nominate directors had it been known at such time. There is already case law in Delaware holding that it is inequitable for directors to refuse to grant a waiver of an advance notice deadline under such circumstances.

In his highly publicized campaign against Xerox Corp. ("Xerox"), Darwin Deason, the third largest shareholder of Xerox, recently commenced an action in New York State Supreme Court seeking to enjoin Xerox from enforcing its December 11, 2017 nomination deadline based on the Delaware standard on this issue. This post provides an overview of Deason's allegations and his legal claim seeking to compel Xerox to reopen the nomination window for him and all shareholders as a matter of New York law. This is a case of first impression in New York and the adoption of the Delaware holding by a New York court would be a major victory for shareholder activists. However, as a vast majority of corporations are incorporated in Delaware, this post is also intended to remind shareholder activists who desire to nominate directors after a deadline has passed that material developments triggered by a company's board that come to light after the deadline may give them grounds to request a waiver of the deadline.

Deason's Allegations in the Xerox Case

Deason is a long-time shareholder and outspoken critic of Xerox. In May 2017, almost seven months prior to Xerox's nomination deadline, Deason sent a private letter to Xerox expressing concerns regarding the company's relationship and contractual arrangements with Fujifilm Holdings Corporation ("Fuji") and Fuji Xerox, created by Xerox and Fuji in 1962 as a joint venture, and calling upon Xerox to explore its strategic alternatives with respect to Fuji. Deason claims the letter was ignored.

Deason alleges that later in the summer of 2017, he privately requested Xerox to provide copies of certain agreements relating to the Fuji Xerox joint venture that were entered into in 2001. Under one such agreement, Fuji obtained the exclusive rights to Xerox's intellectual property and the manufacture and sale of Xerox products in the burgeoning Asia and Pacific Rim markets—referred to by Deason as the "crown jewels" of Xerox. Deason alleges that Xerox refused to provide copies of the agreements unless he signed a non-disclosure agreement with a standstill provision. Deason refused to sign the agreement.

Approximately one month after the December 11, 2017 nomination deadline, rumors of a potential transaction between Xerox and Fuji were reported in the media. Shortly thereafter, on January 17, 2018, Deason sent his first public letter scolding Xerox for its lack of disclosure regarding its venture with Fuji that has left shareholders "speculating at the incredible materiality of its secret terms." Deason stated that in light of recent revelations of a potential alteration of the existing Xerox-Fuji relationship, the omission of the material agreements governing the relationship has left shareholders "guessing" as to how to evaluate a potential deal. Deason concluded by once again calling upon Xerox to publicly disclose the material agreements governing Fuji Xerox so that shareholders "can engage the Company, provide their views and make their investment and voting decisions with at least the minimum cards on the table."

On January 22, 2018, Deason and Carl Icahn, the largest shareholder of Xerox, announced that they formed a Section 13(d) group to solicit proxies for the election of a slate of four director candidates nominated by Icahn (prior to the nomination deadline) for election at the upcoming annual meeting. Deason alleges at that point in time he was still unaware of the full terms of the Fuji Xerox venture or the potential transaction between Xerox and Fuji and therefore "he had not yet determined that it was necessary to nominate his own slate of director candidates."

On January 31, 2018, Xerox and Fuji announced that they entered into a definitive agreement to combine Fuji Xerox with Xerox. Under the terms of the agreement, Fuji will own 50.1% of the combined company and Xerox shareholders will own 49.9% of the combined company and receive a special cash dividend of approximately $9.80 per share. Deason believes the transaction amounts to a scheme intended to allow Fuji to take control of Xerox without paying a "realistic control premium" while leaving Xerox shareholders "hostage and subject to abuse by Fuji."

On the same day the transaction was announced, Xerox also publicly disclosed the material agreements relating to the Fuji Xerox venture. Deason alleges that these agreements for the first time revealed the existence of a "crown jewel" lock-up right providing that if Xerox engages in a transaction with a specified competitor for more than 30% of the voting power of Xerox, Fuji has the right to terminate the main agreement governing Fuji Xerox, which in turn would strip Xerox of its decision-making authority with respect to the joint venture. However, Fuji would still retain the exclusive rights to Xerox's "crown jewels." Deason alleges that these provisions effectively gave Fuji a "blocking position on Xerox's ability to sell itself to anyone other than Fuji." Deason also alleges that the proposed deal contemplates making permanent Fuji's "crown jewel" lock-up right.

On February 26, 2018, Deason sent a letter to Xerox expressing his desire to nominate a full slate of directors at the company's upcoming annual meeting. Deason stated that while the December 11 nomination deadline had passed, he had the right to nominate directors at the annual meeting since the revelations regarding the proposed business combination and public disclosures regarding the existing joint venture agreements constituted a "material" change in Xerox's circumstances that was caused by the Xerox directors after the nomination deadline. Specifically, he asserted that the disclosure of the proposed business combination (that he believes would be detrimental to Xerox shareholders), the disclosure of the "crown-jewel" lock-up (that he believes restricts the company's strategic flexibility) and his belief that the lock-up and other rights under the joint venture agreements would become permanent "were highly material to the shareholders' decisions concerning potential nomination of directors." Deason requested a waiver of enforcement of the nomination deadline in order to allow him and other shareholders to nominate directors at the upcoming annual meeting. Xerox rejected Deason's waiver request.

Deason's Legal Claims and the *Hubbard* Case

On March 2, 2018, Deason filed a lawsuit against Xerox in New York State Supreme Court seeking a preliminary injunction enjoining enforcement of the nomination deadline and permitting Deason to nominate a full slate for election at the upcoming annual meeting. In his brief, Deason acknowledges the absence of controlling New York case law and asks the court to look to *Hubbard v. Hollywood Park Realty Enters., Inc.*, the leading Delaware Chancery Court case on this issue.

The 1991 *Hubbard* case involved a fascinating set of facts. Hollywood Park Realty Enterprises, Inc. ("Realty") and its sister company Hollywood Park Operating Company ("Operating") were the owners and operators of Hollywood Park Race Track near Los Angeles. R.D. Hubbard, a significant shareholder of Realty and Operating, filed suit against both companies after they refused his request to extend their respective nomination deadlines in order to allow him to submit nominations. After both companies denied his request, he submitted nominations prior to the deadlines and filed an action for a declaratory judgment that the advance notice bylaws were invalid. Nevertheless, shortly thereafter Hubbard and Realty entered into a settlement agreement under which Hubbard was elected to the board in return for Hubbard's agreement to drop his proxy contest. Under the settlement agreement, the Realty board also agreed not to waive the advance notice bylaw provisions to permit a shareholder to nominate an opposing slate at the upcoming annual meeting.

To everyone's surprise, once Hubbard joined the board, he quickly gained the support of a majority of the existing directors to alter the operational direction and management policies at the race track. The new management slate, including Hubbard and his new allies, were set to run uncontested at the upcoming annual meeting. The other directors who unexpectedly found themselves in the minority, including Merv Griffin, Aaron Spelling and John Forsythe, sought to nominate a competing slate based on a platform that the company be sold. Since the nomination deadline had already passed, the minority directors asked for a waiver. After determining that a sale of the company would not be in the best interest of shareholders, the board denied the waiver request.

The minority directors brought cross-claims in the lawsuit to enjoin enforcement of Realty's nomination deadline. They contended that the enforcement of the deadline would be inequitable because they had no reason to believe it would be necessary for them to run a dissident slate while the nomination window was open. Prior to the nomination deadline and the appointment of Hubbard, the minority directors believed the board was "united in their opposition to Hubbard" and had no reason to believe that after the deadline had passed, Hubbard would win over a majority of the existing directors or that the directors would contractually bind themselves not to waive the advance notice provision.

In granting the motion for preliminary injunction, the court stated:

> [T]his is a case where the Realty board itself took certain action, after the by-law nomination deadline had passed, that involved an unanticipated change of allegiance of a majority of its members. It was foreseeable that that shift in allegiance would result in potentially significant changes in the corporation's management personnel and operational changes in its business policy and direction. Such material, post-deadline changes would also foreseeably generate controversy and shareholder opposition. Under those circumstances, considerations of fairness and the fundamental importance of the shareholder franchise dictated that the shareholders be afforded a fair opportunity to nominate an opposing slate, thus imposing upon the board the duty to waive the advance notice requirement of the by-law.

Many years later, in *AB Value Partners, LP v. Kreisler Manufacturing Corp.*, the Delaware Chancery Court distilled the above holding into the following three questions that the court in *Hubbard* focused on in determining whether enjoinment of an advance notice nomination provision is warranted:

1. Did a change in circumstances occur after the nomination deadline?
2. Was the change "unanticipated" and "material"?
3. Was the change caused by the board?

In the Xerox case, Deason is relying heavily on the *Hubbard* principles. Deason asserts that the three-pronged *Hubbard* test has been satisfied as several weeks **after the nomination deadline** (prong 1), the **Xerox board** (prong 3) made a series of decisions and disclosures described above that were **highly material** (prong 2) to a shareholder's decision concerning the potential nomination of directors. By refusing to waive the nomination deadline, Deason claims that the Xerox board breached its fiduciary duty of loyalty to him and other shareholders and is "unjustly preventing Xerox shareholders from exercising their fundamental corporate voting rights or even considering whether to replace the Xerox Board responsible for the Transaction described above." Deason goes a step further by claiming that the Xerox board's refusal to waive the nomination deadline was primarily an entrenchment tactic. In addition to seeking to enjoin Xerox from enforcing the nomination deadline and allowing him to nominate a slate, Deason is also asking the court to declare that Xerox and its directors breached their fiduciary duties by refusing to grant the waiver.

Importance of *Hubbard* and Outcome of the Xerox Case

While the *Hubbard* decision is over 25 years old and has not been heavily cited by the Delaware Chancery Court, it is nevertheless controlling law on this issue. Interestingly, Deason's Section 13(d) cohort Carl Icahn was the last person to successfully invoke *Hubbard* in Delaware by convincing the court to grant his motion for an expedited proceeding in a lawsuit he filed against Amylin Pharmaceuticals, Inc. following its board's rejection of an acquisition proposal from Bristol-Meyers Squibb Co. after Amylin's nomination deadline had passed. Shareholder activists should become familiar with *Hubbard* and its three-pronged standard as it is not uncommon for companies to make highly significant decisions and disclosures right after a nomination deadline has passed. Resorting to a withhold campaign may not necessarily be the next best option for shareholder activists to pursue if they missed a nomination deadline.

As we are not aware of any state court outside Delaware that has adopted the *Hubbard* standard, a ruling by the New York State Supreme Court favorable to Deason that embraces the standard would be a great victory for shareholder activists. The Xerox case is currently ending the expedited discovery phase, with the parties having submitted a first round of additional briefing under seal, and a hearing on the preliminary injunction motion scheduled for April 26.

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CEOs and ISS' Proxy Contest Framework

Posted by Institutional Shareholder Services, Inc., on Wednesday, September 27, 2017

Editor's note: This post is based on a publication by Institutional Shareholder Services, Inc. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); and Dancing with the Activists by Lucian Bebchuk, Alon Brav, Wei Jiang and Thomas Keusch (discussed on the Forum here).

A pair of high-profile proxy contests currently underway—Trian's campaign to add Nelson Peltz to Procter & Gamble's board, and Pershing Square's effort to replace three members of Automatic Data Processing's board—reflect diverging paths in the ongoing evolution of activism. While the ADP contest may be seen, to some extent, as a continuation of this spring's trend toward increasingly contentious fights, Trian seems to be deliberately distancing itself from such hostilities. The outcome of these two contests, at the ballot box as well as reconfiguring the income statements of these corporations over the next few years, will likely have a lasting impact on the overall strategy and tone of future activist campaigns.

Direct attacks against sitting CEOs were prominent features of this year's proxy season, perhaps most notably because of Elliott's campaign at Arconic, the primary focus of which was removal of CEO Klaus Kleinfeld. Land & Buildings also directly targeted Taubman Centers' Chairman/CEO Robert Taubman for removal from the board; though Taubman was one of only two incumbent directors standing for reelection at the 2017 annual meeting due to the company's classified board structure, the dissident was not shy about blaming him for the company's governance missteps. In its contest at Buffalo Wild Wings, Marcato Capital did not directly target CEO Sally Smith for removal from the board, but the fund's intention to replace management was abundantly clear in its investor presentations; Smith announced her retirement shortly after the dissident's election victory. Trian was widely credited with prodding the GE board into pushing out Jeffrey Immelt out of the company's corner office in July.

Though the aforementioned situations attracted more media attention, this year's CEO-focused trend actually began earlier in proxy season, with the campaign by Alex Denner's Sarissa Capital to replace three of seven directors at Innoviva, including the company's CEO and its chairman. The trend even extended to smaller companies: At Rockwell Medical, dissident shareholder Richmond Group, which succeeded in replacing the only management nominee standing for election at the company's June 2017 annual meeting, began calling for the removal of Chairman/CEO Rob Chioini in late August. (The company has since countered that Richmond Group and its nominee have demanded a payment of nearly $1 million to avoid another proxy contest.)

Interestingly, this Queen of Hearts ("off-with-their-heads") strategy runs counter a slowdown in CEO exits across the broader economy. Outplacement specialist Challenger Gray & Christmas recently reported that 765 CEOs have announced their exits through the end of August, down 7.2 percent from the 825 CEOs who left their roles in the first eight months of 2016. Historically, dissidents have generally argued that providing them with board seats allows for a proper up-close assessment of whether CEO change is necessary, acknowledging that they "don't know what they don't know" from outside the board. The recent uptick in CEO attacks appears to dismiss any pretense that board change is a necessary precursor to CEO replacement.

That seismic shift has apparently been significant enough to prompt one leading law firm to suggest that ISS alter its analytical framework to "expressly account for whether a CEO is being targeted in a dissident's minority slate." While limiting ISS' ability to recommend against CEO directors as a matter of policy might impose greater discipline on dissidents to present a more compelling case, the notion that ISS does not already view the targeting of a CEO as an unusual and significant factor—and thus worthy of careful consideration in a short-slate fight—would be a misrepresentation of our framework.

ISS' proxy contest framework is broadly structured by design, reflecting our case-by-case approach to these analyses. Even when the CEO is not directly targeted for removal, ISS closely weighs the unintended consequences of any potential key-person change resulting from a contest. In the case of Cypress Semiconductors, for instance, ISS initially did not directly support the dissident slate—despite the fact that the dissident (founder and former CEO TJ Rodgers) had demonstrated a compelling case for change—given the downside risk related to the removal of the company's executive chairman, who was seen as a significant contributor to the company's strategic transition. ISS only reversed this recommendation in the face of material new information that, among other things, directly contradicted statements made by the executive chairman during his meeting with ISS.

The removal of a CEO from a board represents a vote of no-confidence that carries further-reaching consequences than the removal of most other directors. However, in instances of demonstrably poor execution, operational issues, or undue management influence over the board, such targeting may be appropriate—provided that the consequent risks have been properly assessed. Another consideration, as highlighted in the Taubman Centers contest, is whether a CEO, or any other director, should be insulated from accountability as a result of a staggered board structure.

At least at first glance, the path taken by Bill Ackman's Pershing Square can be seen as a continuation of this spring's trend. Though Pershing Square is not directly targeting ADP CEO Carlos Rodriguez for removal from the board, the fund's initial presentation is far from complimentary of his tenure. Ackman has publicly stated that a CEO change might in fact be necessary to effect the strategic shift that Pershing believes is needed. Like all campaigns critical of a chief executive, the ADP contest has unsurprisingly taken on a more antagonistic tone, including some much-publicized personal attacks on Ackman by Rodriguez himself.

Trian, conversely, has opted for a less traveled path, avoiding not only threats to replace the CEO, but direct attacks on any of P&G's current board members. In fact, Peltz has promised, if elected, to immediately propose the re-appointment of the displaced incumbent. Peltz's lone nominee approach also represents a marked departure from the “at least two” strategy favored by activists, who have traditionally felt that a sole dissenting voice is too easily squelched, and that at least two dissident directors are needed to advance any ideas within a challenged board. Of course, this “softer” approach raises other questions: assuming Trian can prove that change is indeed necessary, is one additional director really enough to address the changes needed? Also, if Trian is right about P&G having an insular corporate culture, can a shift in culture at such a giant company really be effected without an eventual CEO change?

A dissident’s burden of proof is undoubtedly going to be lower when he seeks a single board seat than if he demands a complete boardroom makeover or a CEO change. It would probably be inaccurate, however, to characterize such a surgical strike contest as a cost-free, “what’s the harm?” option, at least in a rhetorical sense that implies a dismissive view of potential risks. As in any contest, a thorough assessment of the risks of granting (or perhaps not granting) a dissident any board representation is always a relevant consideration.

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ISS and the Removal of CEOs: A Call for an Enhanced Standard

Posted by Richard Grossman, Skadden, Arps, Slate, Meagher & Flom LLP, on Friday, August 25, 2017

Editor's note: Richard Grossman is Partner at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden publication by Mr. Grossman, Gabrielle Wolf, and Kashira Patterson.

Recently, shareholder activists have been pursuing proxy contests seeking to prevent re-election of the CEO as a director, by proposing an alternative director nominee. When voting in proxy contests, many shareholders give significance to (or automatically follow) the recommendations of Institutional Shareholder Services Inc. (ISS). The analytical framework that ISS uses to determine whether it will recommend that shareholders support a dissident in a proxy contest depends on whether the dissident is seeking a minority or a majority position on the board, with the standard for a dissident seeking minority representation being significantly easier to meet than if control is sought. However, this framework does not expressly account for whether a CEO is being targeted in a dissident's minority slate.

Replacing the CEO as a company director can harm the company and shareholders. Typically, the CEO is the prime mover in developing and overseeing execution of the company's strategic plan as well as a myriad of other important corporate strategies, actions and relationships. This central leadership function is reinforced by the CEO's status as a director. Moreover, board membership enhances quality, two-way communication between the CEO and other directors. In short, the CEO-director is not "just another director"—and targeting the CEO for replacement on the board, which may well disrupt these key functions, implicates important additional considerations, ultimately bearing on shareholder value. For this reason, ISS should adopt an enhanced intermediate analytical framework in its review process that takes into account whether a dissident is targeting a CEO for replacement on the board.

Growing Trend of Targeting CEOs

According to FactSet, by May 1, 2017, there were nine activist campaigns this year targeting company CEOs for replacement on the board. Though such activity has been steadily increasing since 2011, the number of company CEOs targeted by May 1 of a given year has reached an all-time high.[1] This year, activists have successfully campaigned to replace CEOs on the boards of several major companies, including CSX Corp. and Pandora Media Inc.[2] In addition, on June 2,

[1] David Benoit, "Activist Investors Have a New Bloodlust: CEOs," *The Wall Street Journal* (May 16, 2017, 8:00 AM), https://www.wsj.com/articles/activist-investors-have-a-new-bloodlust-ceos-1494936001.

[2] Ronald Orol, "Activists Forced CEOs to Leave These Huge Companies This Year," The Street (July 8, 2017 8:48 AM), https://www.thestreet.com/slideshow/14215254/1/activists-forced-ceos-to-leave-these-huge-companies-this-year.html.

2017, Buffalo Wild Wings' CEO, Sally Smith (who was not targeted for replacement as a director), announced that she would step down at the end of 2017 following activist pressure.[3] Crucial to the success of an activist campaign is the support of ISS, whose influence is well documented. As an example, in the Buffalo Wild Wings campaign, following ISS' announcement of its recommendation in support of two dissident director nominees, the company's stock reacted with a more than 7 percent increase.[4] ISS recommendations are consistent with the ultimate outcome of a proxy contest a majority of the time.[5] As activist investors become more aggressive with their efforts to replace CEOs, it is incumbent on ISS to be more discerning in its voting recommendations in connection with these types of campaigns.

Current ISS Analytic Framework

There is precedent for ISS to use different analytical frameworks depending on the particular circumstances surrounding the proxy contest. The current analytical framework that ISS uses in proxy contests is twofold. First, ISS considers whether dissidents have made a compelling case that change is warranted at the company and, in particular, at the board level. The factors considered include the company's financial performance metrics (both absolute and relative to peers), management's history of executing its strategic plan, and total shareholder returns at different points on both an absolute basis and relative to a peer group. If ISS finds that the dissident has proven that change is warranted at the board, it will then ask whether the dissident nominees are more likely to effect that change than the incumbent directors. This inquiry considers factors such as the dissident nominees' skill level in the areas that need improvement.

ISS also considers whether the dissident is seeking minority or majority representation on the board. The standard for gaining support from ISS when seeking majority representation is more stringent than when seeking a minority of board seats. When minority representation is sought, ISS does not require that the dissidents put forth a detailed plan of action, nor are the dissidents required to prove that their plan is preferable to the company's plan. Rather, ISS requires that dissidents prove that change is preferable to the *status quo* and that their nominees are more likely to deliver that change than the targeted incumbent board members. However, when seeking control of the board, ISS requires the dissident to provide a well-reasoned and detailed business plan (including the dissidents' strategic initiatives), a transition plan that describes how the change in control of the company will be effected where management continuity may be an issue and the identification of a qualified and credible new management team.

Proposed Changes to ISS Analytic Framework

The identity and qualifications of the CEO are often critical factors in a company's success, and his/her selection by the board is one of the board's most important tasks and responsibilities. While shareholders should have the right to vote to replace a CEO/director on a board who is not performing at an acceptable level, the ISS standard for removing a CEO from the board should

[3] Kate Taylor, "Buffalo Wild Wings' CEO is leaving the struggling chain after an activist investor triumphed in a monthslong battle for the board," Business Insider (June 2, 2017 2:25 PM), http://www.businessinsider.com/buffalo-wild-wings-ceo-out-after-losing-battle-for-board-2017-6.

[4] Reuters, "ISS recommends activists nominees for Buffalo Wild Wings board," NASDAQ (May 24, 2017 12:16 PM).

[5] Glen T. Schleyer, Stephen M. Guynn, Korey R. Inglin, Tengteng Peng and Chenjing She, "Sullivan & Cromwell Reviews and Analyzes 2016 U.S. Shareholder Activism," Columbia Law School: CLS Blue Sky Blog (Dec. 15, 2016), http://clsbluesky.law.columbia.edu/2016/12/15/sullivan-cromwell-reviews-and-analyzes-2016-u-s-shareholder-activism/.

be higher than the “what’s the harm” approach that it applies in its analytical framework for minority representation. Under the current ISS framework, dissidents who target the CEOs of companies while seeking a minority position on the board may gain support from ISS without ever presenting a coherent strategic plan for the company’s future business or specifically stating why the CEO should not be a member of the board. Given its influence on the director election process, ISS should amend its current analytical framework for proxy contests in which the dissident targets the company’s CEO for replacement as a director. In such situations, ISS should require a dissident to provide, at minimum, the framework for any new strategic plan or proposed course of action (including any strategic initiatives being proposed) to ensure that the board and shareholders will have a reasonable understanding of the dissident’s thinking before shareholders act to replace the CEO on the board. Additionally, regardless of whether the dissident has identified a new CEO, the dissident should be required by ISS to set forth clearly the vision and initiatives that the current or new CEO will be urged to follow and the specific rationale for the change from the status quo.

I do not believe that the level of scrutiny applied to a dissident that targets a company’s CEO in a “short slate” fight should be raised to fully match the level of scrutiny applied to a control fight. However, ISS should require the dissident to present the framework for moving forward with a new CEO. Put differently, if a dissident seeking control of the board is required to present ISS with a “fully baked” plan, a dissident seeking a minority position along with removal of the CEO should put forth a written recipe with most of the ingredients that lay out a plan that is almost ready to be put in the oven. To require anything less would be a disservice to shareholders by allowing minority proxy fights that target replacement on the board of the company’s CEO—which, if successful, can have a major disruptive effect on the company’s leadership, internally and externally—to be influenced by the lower ISS standard that completely ignores this disruption risk.

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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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Activist Investors' Approaches to Targeting Boards

Posted by Jack "Rusty" O'Kelley III, Russell Reynolds Associates, on Monday, August 21, 2017

Editor's note: Jack "Rusty" O'Kelley III is a Managing Director at Russell Reynolds Associates. This post is based on a Russell Reynolds publication by Mr. O'Kelley. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

Clients who are anticipating or early in the process of an activist situation, and a potential proxy contest, often ask us two questions:

1. How do you know if an activist is going to seek to expand the board or target specific directors for replacement (and potentially escalate the situation to a proxy contest)?
2. If an activist chooses a board member replacement strategy, how can you predict which directors an activist may target?

Based on our experience working with corporate boards defending against activists (as well as our broader board search and effectiveness expertise), we have gathered insights regarding how activists analyze and target boards of directors. In response to client requests, we have developed this guide to help our clients proactively think through defensive measures regarding board composition and governance issues.

Activists generally will utilize against individual directors all current and historical negative press, statistics, and data that is publicly available, whether or not it is accurate, comprehensive, or fair. Boards should be ready for this tactic and be ready to take back control of the narrative about the board.

Russell Reynolds only works on behalf of corporations and their existing board and management teams. We urge our clients to take a proactive, "clear-eyed" activist view of their board to understand how an activist may attack their board. We have prepared this overview based on our experience and on the insights of several activist defense lawyers, investment bankers, and proxy advisors with whom we have worked. Additionally, we have talked with activist investors who were willing to share their approaches.

Expansion vs. Replacement

Anticipating an activist's approach to targeting board seats

Activists target a board to influence decision- making and increase value creation. While activists may take different approaches and specific tactics vary by activist and situation, key indicators can help identify their potential path.

Two of the most common activist approaches to maximizing influence on a board are either pressuring the company's board to expand the number of board members or targeting specific incumbent directors to be replaced. Both may be done by way of a proxy contest or by using the threat of such a contest to pressure the target board into a settlement that places activist-backed directors on the board. There is no strict methodology for predicting which tactic an activist will pursue, and activists' decisions are frequently determined by how companies react to the activists' ideas.

We have identified some key indicators that determine if activists are likely to look to expand a board or target specific board members.

Expansion

Activists often seek to expand a board in less contentious activist situations

We have observed that the earlier a company is in the process of engaging with an activist, the more likely it is that the activist will encourage the board to expand its size by adding activist-backed directors. The longer and more public the process, the more likely it is that the activist will target specific incumbent directors and consider conducting a proxy fight.

Board expansion usually occurs in several situations based on several factors, which include:

- The board has accepted the activist's investment thesis and acknowledges the validity of its recommendations
- The activist wants to monitor a situation or progress
- There is specific insight or expertise the activist and board feel is missing based on business strategy
- The board has classified terms (to get around limitations of a replacement strategy with staggered terms)

The first procedural step is for the board to look at its size in relation to its bylaws and peer benchmarks. As a general rule, relatively large boards make expansion less desirable. If the board is already at the maximum membership allowed by its bylaws, expansion is less attractive as the board may not want to change the bylaws to increase the number of directors. Board expansion will dilute the magnitude of activist influence (compared to replacement), and may face less resistance from the target board in a settlement.

For example, if an activist seeks to add 2 directors to a 10-member board, a board agreeing to expand the membership will net the activist 16% representation (2 of 12), as opposed to the 20% representation by replacing 2 sitting directors (2 of 10).

Board Expansion May Not Be the End of Activist Opposition

An activist and the board may agree to expand the board, but the activist may subsequently use their influence from their new board seats to later call for certain incumbent directors to step down in the following board election. Often, activists will look to break up groups of power on a board. They prefer to have at least two directors on a board to increase the number of voices and leadership for change. It is easier to dismiss one voice rather than two voices on an issue. Should the activist-backed directors seek to replace other directors likely targets could include:

- Directors with the poorest history of value creation
- The longest-tenured directors who approved the strategy to which the activist objected
- The chairman or the director(s) who led the campaign against the activist
- Activists usually do not target the CEO unless they create a "CEO referendum" evidenced by strong, public complaints about value creation (e.g., Arconic). Once an activist joins the board, the average CEO tenure is 15 months

Replacement

Activists often seek to replace board members in more contentious and drawn-out situations

Activists will spend the time and effort needed to win these contests to drive adoption of their perspective around major strategic/value creation issues when the financial returns will reward it. The director replacement strategy has the benefit (for the activist) of increasing the magnitude of the activist's influence on a board (compared to expanding the board).

Under U.S. securities law, activists may and usually identify, by name, the incumbent directors that they are targeting for replacement when submitting a proxy filing. Replacing directors sends the clearest message of an activist's desire to drive change in strategic direction to enhance value creation.

Activists usually go down this path the greater the disagreement between a company and an activist on strategies for value creation, and the less willing management is to implement the activist's ideas. We see a greater chance that an activist will seek to replace directors to demonstrate the need for dramatic change when:

- There are visible public disagreements about strategic or operational issues and value creation
- Increasingly public and "tougher" language
- Situations where the board is too large and cannot be expanded

Activists often are looking for directors who can provide specific insight or expertise about an industry and can act as change agents.

Identifying Incumbent Directors Activists May Target

Anticipating an activist's approach to targeting board seats

Activists have become very sophisticated in how they determine which directors to target in connection with a proxy contest. Activists will try to create the narrative around the full board and/or each director to advance the story that suits their goals. Activists will use time frames and benchmarks around total shareholder return and share price appreciation that paints management and board members in the worst possible light. While boards and directors may claim this is unfair or misleading (not taking into account the full facts or context), activists have the advantage of being on the offensive and using “facts” in a manner that benefits them. Activists look at a series of “filters” for each director. The record of value creation and relevance of each director’s skill set are critical. Unfortunately, a director with a great track record of value creation and with highly relevant skills can be targeted if there are publically available stories that raise questions about that director’s judgment or integrity.

Russell Reynolds recommends that boards conduct a proactive board and director activism defense review. To help prepare and defend against an activist targeting a board and individual directors, RRA uses five filters to analyze each incumbent director and identify those most likely to be targeted by an activist investor.

Our proactive board composition and performance audit review includes:

	Filter 1	Filter 2	Filter 3	Filter 4	Filter 5
	Value Creation Track Record (Target Company)	**Strategy-Linked Skills / Competencies**	**Value Creation Track Record** (Other Boards / Executive Positions)	**Governance Standards**	**Public Perception**
Activists will ask	Did the company become more (or less) valuable during the tenure of this director?	Does this director contribute experience, skills, and perspectives that help the company successfully execute its strategy?	When a person was a director or CEO at another company, did it become more (or less) valuable during that person’s tenure?	Does this director align with the governance standards and recommendations of proxy advisors and institutional investors?	What does the press have to say about this director? Has he/she done anything that would make the public question his/her business judgment?
RRA analyzes multiple factors	Review total shareholder return (TSR) over the course of the director’s tenure versus key benchmarks (the activist will select the benchmark that best proves their point)	Evaluation of director skills and experience in relation to strategy and expected activist strategy	Review TSR over the course of the director’s tenure on other public boards or as the CEO of a public company	Evaluate key board governance metrics/ areas of interest and each director’s commitments in relation to governance best practices (e.g., tenure, overboarding)	Review recent press around individual directors and the companies and organizations of which they are a part that could be used as a reflection of their business judgment

Summary

Scrutiny of public company boards from activists, institutional investors, and the media shows no signs of abating. Publicly and, what was once privately available information, continues to increase. New databases from ISS, Glass Lewis, Bloomberg, S&P and other information service providers increase the ability of activists and others to analyze multiple aspects of a board and individual directors’ performance, background, and governance standards. Boards need to prepare and be “clear-eyed” and objective in foreseeing the risks they may face should an activist or institutional investor initiate a review of the board.

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Top 5 Things Shareholder Activists Need to Know

Posted by Steve Wolosky, Andrew Freedman, and Ron Berenblat, Olshan Frome Wolosky LLP, on Friday, December 22, 2017

Editor's note: Steve Wolosky, Andrew Freedman, and Ron Berenblat are partners at Olshan Frome Wolosky LLP. This post is based on an Olshan publication by Mr. Wolosky, Mr. Freedman, and Mr. Berenblat. Related research from the Program on Corporate Governance includes Dancing With Activists by Lucian Bebchuk, Alon Brav, Wei Jang, and Thomas Keusch (discussed on the Forum here).

In re Investor Bancorp, Inc. Stockholder Litigation, issued by the Delaware Supreme Court on Dec. 13, 2017, may result in challenges to compensation awarded to directors pursuant to existing discretionary equity plans and is likely to affect the structure of future equity plans.

The Supreme Court, at the motion to dismiss stage, rejected the Court of Chancery's expansion of the application of the stockholder ratification defense to the granting of discretionary compensation to directors pursuant to equity plans that contain "meaningful limits" on awards. Reversing the decision below, the Supreme Court held that deferential business judgment review will *not* be available for (and the entire fairness standard of review will apply instead to) challenges to awards made under such equity plans if the plaintiff alleges facts that support an inference that the directors may have breached their fiduciary duties when determining the awards. The Supreme Court reasoned that when stockholders grant directors broad authority to use their discretion in making self-interested decisions, the stockholders do so knowing that the directors are subject to fiduciary standards in exercising that discretion; and that, therefore, there is a need for judicial oversight of the exercise of that discretion. The Supreme Court found in this case that the alleged facts sufficiently supported an inference of breach by the directors of their fiduciary duties for purposes of a motion to dismiss, as the awards granted appeared to have been "excessive" (based on their having been very significantly higher than the past compensation and the compensation at peer companies).

Pending further judicial development, it is uncertain how broadly the decision will be applied. In our view, notwithstanding the change in judicial course:

- ***With respect to an existing equity plan***, there should not be much risk of liability unless clearly excessive compensation was awarded under the plan (and/or there were other seriously problematic factors such as a flawed process or disclosure).
- ***With respect to future equity plans***, it should be possible to structure a plan to minimize the risk of liability by reducing the amount of (but not necessarily eliminating all) director discretion in determining awards under the plan. (See "Practice Points" below.)

Background

Investor Bancorp (which completed a bank mutual-company-to-stock conversion in 2014) accepted its Compensation Committee's recommendation and set 2015 compensation for its directors and officers at the same levels as in 2014. A few months thereafter, the board proposed a discretionary equity incentive plan (EIP) to provide "additional incentives." The EIP provided "meaningful limits" for awards—that is, a specified number of shares of common stock were reserved for restricted stock awards, restricted stock units, incentive stock options, and non-qualified stock options for the company's officers, employees, non-employee directors, and service providers. Sub-limits were provided for each category of award and each category of recipient. The non-employee directors were entitled to up to 30% of all of the reserved options and restricted stock shares, all of which could be granted in any calendar year. The number, types, and terms of the awards were subject to the board's discretion and would not be determined until after the stockholder approval of the EIP. Over 96% of the voting shares (which represented 79% of the shares outstanding) approved the EIP. Three days after the EIP was approved by the stockholders, the board held the first of four meetings during which, over the course of a month, they determined to issue to directors in 2015 (including the two executive directors, who were the CEO and COO) half of the available stock options and one-third of the available restricted shares, which had a total fair value of $51.7 million.

Discussion

The entire fairness standard of review will apply to challenges of discretionary awards under stockholder-approved equity compensation plans that include "meaningful limits"—if the facts pled indicate a possible breach of fiduciary duties by the directors. Due to directors' inherent self-interest when they determine discretionary equity awards for themselves, challenges to these awards have generally been subject to the entire fairness standard of review. However, when an equity plan approved by the stockholders provides for fixed awards, or when the specific awards made under a discretionary equity plan were ratified by the stockholders, then business judgment review has applied—based on ratification by the stockholders in a context where they "knew what they were approving." The Delaware Supreme Court long ago extended the stockholder ratification concept to discretionary equity plans that are "self-executing"—that is, where the awards are determined based on a formula, without further discretion by the directors.

Over the years, the Court of Chancery has extended the stockholder ratification concept further. While the Court of Chancery established that stockholder-approved discretionary equity plans with "generic" or "overall" limits on awards for directors and employees in the aggregate would *not* be entitled to business judgment review (*Calma/Citrix v. Templeton* (2016)), it has held that stockholder-approved equity plans with "meaningful limits" (*i.e.*, a specified cap applicable to the sub-group of non-employee directors) *would* be entitled to business judgment review (because stockholders approving the plan would know the contours of the awards that will be possible) (*3M Corp.* (1999), *Seinfeld v. Slager* (2012), and *Investor Bancorp* (Apr. 5, 2017)). In *Investor Bancorp*, the Supreme Court has now rejected that approach with respect to equity plans with "meaningful limits." Instead, in the event of a challenge to awards issued under such a plan, if the facts alleged indicate that it is reasonably conceivable that the directors breached their fiduciary duty when exercising their discretion in making the awards, then the directors will have to prove that the awards were entirely fair to the corporation.

The Supreme Court found that the alleged facts in this case as to the "excessive" nature of the awards sufficiently supported an inference (at the motion to dismiss stage) of a breach of fiduciary duties by the directors. The Court of Chancery had ruled that, although the awards were large in relation to the company's past compensation and peer group, they were within the equity plan's specified sub-limits and the plaintiffs had not established that they were so exorbitant as to constitute waste. The Supreme Court held, however, that the facts alleged indicated a possible breach of fiduciary duties, based on the awards having been "significantly" higher than the directors' past compensation and "inordinately" higher than directors' compensation at peer companies.

The Supreme Court's rationale for the change in course was a "need for continued equitable review of self-interested discretionary director self-compensation decisions." Justice Seitz wrote:

> When stockholders approve the general parameters of an equity compensation plan and allow directors to exercise their broad legal authority under the plan, they do so precisely because they know that that authority must be exercised consistently with equitable principles of fiduciary duty. The stockholders have granted the directors the legal authority to make awards. But, the directors' exercise of that authority must be done consistent with their fiduciary duties. Given that the actual awards are self-interested decisions not approved by the stockholders, if the directors acted inequitably when making the awards, their 'inequitable action does not become permissible simply because it is legally possible' under the general authority granted by the stockholders…. [Stockholder approval of an equity incentive plan] cannot be reasonably interpreted as a license [for the directors] to do whatever they [wish], unconstrained by equity. Rather, it is best understood as a decision by the stockholders to give the directors broad legal authority and to rely upon the policing of equity to ensure that that authority would be utilized properly.

In our view, directors are unlikely to have liability for awards issued under discretionary plans unless the awards were excessive and/or there are other significantly problematic factors (such as a flawed process or disclosure). Pending further judicial development, in our view, liability is not likely unless there is a highly negative factual context, as was alleged in this case, where:

- The average compensation paid to the Investor Bancorp non-employee directors in 2014 was $133,340—which was in line with the average at peer companies; whereas the average paid in 2015 (including under the EIP) was over $2 million—while the average at peer companies was less than $176,000.
- The CEO's total compensation package was seven times higher than in 2014, and the $16.7 million value of the stock options and restricted stock he was awarded under the EIP was alleged to be 1,759% higher than the peer companies' average compensation for executive directors (and 3,683% higher than the median award that peer companies granted their CEOs after mutual-to-stock conversions).
- The COO's total compensation package was nine times higher than in 2014, and his $13.4 million award under the EIP was alleged to be 2,571% higher than the peer companies' average compensation for executive directors (and 5,384% higher than the

median that peer companies paid to their second-highest paid executives after conversions).

- The plaintiffs alleged that the disclosure relating to the approval of the EIP was flawed. The stockholders were told that "by approving the [EIP], stockholders will give the Company the flexibility it needs to attract, motivate and retain highly qualified officers, employees and directors by offering a competitive compensation plan that is linked to the performance of the Company's stock." The plaintiffs alleged that this statement was "forward-looking"—that is, that stockholders would have understood that awards under the EIP would incentivize *future performance* , not reward past services. After stockholders approved the EIP, however, the board approved the a ward of about half of the stock options and one-third of the restricted shares available to the directors, vesting over five years—which, the plaintiffs alleged, rewarded *past efforts* in connection with the company's mutual-to-stock conversion.
- The plaintiffs also alleged that the directors' process for determining the awards was flawed. For example, according to the plaintiffs, the expert who had advised the Compensation Committee had not considered an appropriate list of companies when determining peer company averages; and the CEO allegedly had proposed the awards for himself and the COO and they had attended the meetings at which their awards were approved although the company had disclosed that they had not attended meetings at which their compensation was determined.

Practice Points

- **With respect to future director compensation plans**, there is a clear safe harbor in (a) having stockholders approve the specific equity awards or (b) adopting a "self-executing" equity plan. Alternatively, a company could consider whether there is a place on the continuum between "self-executing" equity plans and equity plans with "meaningful limits" where the court, under *Investor Bancorp*, would view the directors as having had sufficiently little discretion, and the stockholders as having had sufficient knowledge as to what they were approving, that business judgment review would apply. For example, the following could be considered:
  - An equity plan that provides that the awards are essentially "self-executing," by being determined based on a formula without further discretion by the directors other than potentially providing plan administrators (generally the board or a committee of directors) with the ability to use negative discretion under certain circumstances;
  - An equity plan that provides specific limits for each individual director rather than for directors in the aggregate—as the stockholders would, in effect, be approving for each director a specific award, up to the maximum set for that director;
  - An equity plan that provides more restrictive "meaningful limits" (such as not only sub-limits for each group but limits for each year) and/or provides very specific guidelines for setting awards (such as the award having to be within a specified range of peer companies' average compensation and/or other quantitative parameters)—so that the degree of director discretion involved is minimized and stockholders are provided with more specificity as to what they are being asked to approve; or,
  - An equity plan that combines a specific award piece, a self-executing piece, and a discretionary piece, with the discretionary piece subject to specific caps or

other mechanisms that limit the discretion (such as, detailed parameters or, possibly, determination of the discretionary piece by an independent consultant or a designated director who will not receive discretionary awards).

- **With respect to existing discretionary director compensation equity plans,** boards should take particular care when approving the grant of equity awards—from the perspective both of substance (*i.e.* , the amounts of the awards) and process, with the objective of minimizing the risk of excessive compensation claims. A board may also consider amending its existing discretionary director compensation equity plans (a) to make them “self-executing” or (b) to conform to one of the formulations described below. A board may wish to seek stockholder ratification of awards already made if a favorable outcome would be expected.
- **Importance of the process, the disclosure and the record.** When determining awards under an equity plan, the directors should establish a record that documents what principles they applied to determine the awards, as well as how the awards compare to past compensation and peer companies’ compensation and the business rationale for any differences. The disclosure relating to the approval of an equity plan should be accurate (including whether the awards will reward past performance or incentivize future performance) and consistent with the purpose and material provisions of the equity plan. We note that, based on the facts alleged, the process and disclosure in *Investor Bancorp* suggested possible duplicity on the directors’ part in terms of the timing of the setting of the awards (immediately after stockholder approval of the equity plan), and not disclosing to stockholders that the awards would relate to the directors’ efforts in connection with the mutual-to-stock conversion that had just been completed and would be very large.

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Activism's New Paradigm

Posted by Gregory Taxin, Spotlight Advisors; and Betsy Atkins, on Tuesday, September 26, 2017

Editor's note: Gregory Taxin is Managing Director at Spotlight Advisors and Betsy Atkins is a American business executive and entrepreneur. This post is based on a publication which originally appeared in *Corporate Board Member* magazine. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

Shareholder activism in the US has increased greatly over the past decade, measured not only in scope and the pools of capital dedicated to it but also in sophistication and in the range of tactics employed. There is currently more than $120 billion in dedicated activist funds at work, and these funds launched nearly 300 activist campaigns globally in 2016. Another 400 campaigns were launched by "occasional" activists. Indeed, a fair number of companies should expect a knock at their door soon-21% of the S&P 500 were approached publicly by an activist in 2016 according to FactSet (and many others received quiet, private overtures). Such activism will likely grow more prevalent, as it has proven to generate alpha (i.e. uncorrelated returns) for these funds' investors.

Activists and activism draw sharp emotional responses: some cheer activists as appropriate scolds of lazy and under-performing Boards; others paint activists as locusts focused solely on short-term strategies. Activism is a natural outgrowth of our market's structure and can be a force for good. All capital markets need a mechanism to "police" strategy selection and Board performance in those rare instances when the corporate governance system does not work.

For the most part, our system of corporate governance does work and Boards self-correct to put companies on the optimal strategic path. But the Board mechanism is not perfect: Not all boards are as independent as they ought to be and directors also have some interests, such as director fees and job continuity, that differ from shareholders.

For these reasons and others, activists can and do play an important role as last-resort overseers of the shareholders' interests, but as in every human endeavor, some perform better than others.

Activist techniques were once used only by specialist funds. Now, traditional, long-term investors are adopting (and adapting) activist techniques, increasing the volume of shareholder engagements. They've seen that engagement at companies with sub-optimal strategies or under-performing management teams can help generate alpha. It can also help justify the larger fees charged by active managers. At the same time, some specialized activist funds are taking a longer term view of performance.

All of these factors are driving a new wave of shareholder activism, with campaigns often reaching outside traditional targets. Companies of all sizes and types can have “opinionated” stockholders.

Today, in fact, even good stock performance does not immunize a company. Take the recent example of restaurant chain Buffalo Wild Wings. Over the 14 years since the company went public in 2003, the stock compounded shareholders· money by 24% per year, dramatically outperforming its casual dining peers. On operating metrics, the business also outperformed nearly all of its peers. In the three years before this spring’s proxy battle, the stock was up 18% in a difficult sector, where many of its peers had gone belly up. Yet, even strong performance like this did not protect Buffalo Wild Wings from Marcato Capital’s advances and demands.

Fundamental Drivers

What are the drivers of activist campaigns? Activists are, first and foremost, investors. They seek great returns and they propose changes that they believe will drive better future performance than the market expects. In this way, the driver of activist activity is really perceived suboptimal plans, not suboptimal past performance. The tactical focus is often on strategy, operations, the balance sheet, business configuration, the board, and M&A.

Activists are often extremely knowledgeable about the company, very invested in future outcomes, and equipped with analytical tools that can outstrip even a well-meaning board.

Ultimately an activist must be able to answer the question: why hasn’t the board adopted the proposed changes? And so, activists necessarily focus on perceived deficiencies in board composition or on a claim that the board is “stale.” Naturally, then, boards with longer average director tenure are significantly more vulnerable to campaigns. If there is a deficiency in strategy or business configuration and the Board is seen as “stale,” the activist can claim the staleness has led to the suboptimal choices.

Activist campaigns are remarkably successful, in part because activists get to pick their targets. In well over half of the campaigns, significant changes are driven by the activist. CEO tenures are shorter and, according to some academics, stock performance is better, once an activist appears.

A 2017 survey by FTI Consulting finds that settlements have become more prevalent and have come quicker than in the past. Nevertheless, more fights in absolute numbers went to a final vote in 2016 than at any time since 2010.

The increased number of companies facing activist campaigns has been driven by non-traditional activists. Mainstream, long-only institutional investors and first-time or “occasional” activists account for nearly all the increased volume in activism. Recent examples include campaigns by Neuberger Berman, T. Rowe Price, and PAR Capital Management, all three of which had been regarded as traditional investors that “vote with their feet” rather than vocally.

Activism is becoming a tactic deployed by all types of investors rather than a “strategy” that defines a fund. Along with its broader adoption, the practice of activism has professionalized, with a bevy of advisors that help both investors and companies to engage in these campaigns.

Given the willingness of more investors to use activist tactics, every public company may have “activists” in its shareholder base. The lurking activist may not have a familiar activist fund name: it may be your long tenured shareholder that wants to be heard. Some “activists” are hidden in plain sight.

Planning Strategically

For public company board members, these changes bring a new reality of engaged investors, with heightened reputational stakes for directors. Noisy, public campaigns challenge the judgment and composition of the board. And proxy fights are more distracting and expensive than is often imagined. In fact, it’s hard to overstate the all-consuming nature of such battles. Having been involved in more than fifty activist campaigns, we can tell you definitively that once embroiled in a proxy fight, the CEO. CFO, and board members will be forced to spend substantial time dealing with tough, daily decisions, and the costs often run between $4 million to $6 million for a full campaign at a mid-cap company. These costs have been escalating as campaigns go on longer and often involve many advisors: some protracted fights will cost a company well over $20 million. Obviously, some battles are worth fighting, but remember the odds: Companies very often lose-and will get stuck with the bill and distraction anyway.

The best defense is to make smart governance moves in times of peace. Since long-tenured boards have proven to be an easy wedge for activists, boards must proactively consider their refreshment, casting a critical eye on the mix of tenures and expertise. Think about setting a target “average tenure” for the board as a governance policy. It’s rare to find a well-composed, self-refreshing board come under successful attack from an activist.

Structural and strategic moves also help avoid activist campaigns before they begin. The board and management should lead an active, objective review and analysis of popular activist hot-button issues (e.g., capital allocation, capital structure, strategy, operational plans, executive compensation, business configuration, personnel, etc.). One good option is to bring in a third party to help the board “think like an activist” to provide fresh input and objective thinking and identify vulnerabilities (which can be opportunities for improvement) ahead of time.

Creative thinking on investor relations is also crucial. Consider “radical transparency” with investors about the roads taken and the roads not taken. Why did your company take a different path than peer companies? Directors must be prepared to provide rationales about choices made and differences in operating models, strategies, or performance.

Response Tactics That Work

Even with the above tactics, a surprise activist campaign involving your company is always possible. How do you respond? As a first step, the board should be immediately informed, ensure there is a response team, and designate a representative to liaison with the team.

Most companies turn to their corporate counsel first. And while counsel is critical in these situations, remember that an opinionated investor is not primarily a legal problem. Advisors can be helpful, but too many can be unwieldy.

It is critical to know where your other shareholders stand on the points raised by the activist. But, be cautious in assuming management knows the true feelings of your shareholder base. Investors don't always tell their true feelings to management.

The management team should actively engage with would-be activists to understand their thesis and points of view. At first, activists almost always seem friendly and express a desire to engage "constructively." Be wary. At the same time, always remember that being gracious pays off.

The company must contemplate its approach and words carefully, depending on the activist. Your board can prove a great asset in this engagement. Ensure that one or more directors are designated to speak to investors, should the need arise. (We recognize that many corporate advisers prefer to hide the board from investors. This approach, though common, has serious risks in our experience. Directors are shareholders' representatives and should be willing to meet with those whom they represent.) Whoever speaks for the company should know that there may be a tricky dance required to be both open and compliant with disclosure rules. This is especially true because activists often suggest things that are actively being considered or are under way, which makes for difficult conversations if the company's activities are not already public.

Six Questions You Should Address Before an Activist Does

1. Activists today are professionals who know your company inside and out-sometimes better than management. Here are six questions the board and management should answer Internally before they find themselves on the defensive with an activist.
2. How does the company's performance compare with its peers? How do valuation metrics compare, as well as executive compensation programs?
3. What does the buy side think of your strategy and operational prowess (not what you'd like to hope they think)?
4. What does the competition say, and what do its leaders think are your company's strengths and weaknesses?
5. How are your incumbent directors and management vulnerable?
6. What guidance has the management team provided that proved too optimistic?
7. What are impediments to board self-evaluation and refreshment?

In meeting with the activist, avoid defensiveness and a closed mind. Consider elements from an activist's agenda that you can adopt, leaving him or her with fewer complaints and suggestions.

Activist investors often have reasonable ideas worth considering, so be open to contemplating those ideas objectively.

The hardest "suggestions" usually are requests for changes to the board. As noted earlier, preemptive board refreshment is often the best medicine. Post-activist unilateral appointment of new directors is certainly not as good as preemptive board refreshment, but it's still better in many cases than remaining static with a board slate that is difficult to defend. Consider the options of agreeing to a third-party board candidate approved by both sides, setting a plan of refreshment, or appointing an alternative stockholder representative.

If you find yourself embroiled in a full, public proxy battle, early moves and press releases will set the tone and shape the future course, so contemplate them carefully with input from advisors.

We generally believe that canned press releases or attacks on the activist do not work. Today's capital markets are sophisticated about activism, and these tactics, along with ad hominem attacks or pro forma pledges of fidelity to shareholders, no longer help a company.

Moreover, tactics from a bygone era are usually received poorly by shareholders and likely will be counterproductive. Suing an investor, for example, is almost always a bad idea. Adopting a poison pill, changing advance notice provisions, or adopting last-minute bylaw changes to thwart a shareholder also generally backfire.

Shareholders now expect a substantive response to criticisms and suggestions. Respond to the shareholder on the merits.

Responses that work include the following:

- provide transparent, honest disclosures about the board's rationale for its decisions and actions;
- demonstrate recognition of performance challenges with a clear plan for fixing them; and
- show how value will be created with the current plan, capital structure, management, and incentives.

Careful analysis of your shareholder base can prove critical in knowing how to shape the message and win votes. Stock surveillance services can aid in watching trading to ensure management knows where the stock is.

Finally, be sure to use the independent directors' voice, especially if there is a strong history of board self-refreshment and shareholder board support. Use a director to sit down with shareholders and explain strategy (and paths not taken), operational performance, executive pay plan design and succession planning. Show the shareholders that the Board is thinking actively about all of these critical areas and working hard on behalf of shareholders.

Be Proactive and Vigilant

There's no doubt the past decade has seen enormous change in the relationship between shareholders, management teams.and boards. In this new era, more than ever, it is important for boards to be well composed, for companies to contemplate all value creation opportunities and for all capital market actors to recognize that good ideas can originate both inside and outside the company.

Smart corporations take the lead, shaking up their own strategies, boards, governance, and engagement rules before activists force them to.

A Director’s Perspective

by Betsy Atkins

I have served as a public company director at more than a dozen companies. I have faced an activist Investor approach at four of those companies, including from Starboard, Elliott Management and JANA Partners.

I have learned some important things during these engagements:

Get help. Boards are accustomed to seeking specialized, Independent assistance for executive compensation, cyber risk and litigation. Get help from an outside specialized when an activist shows up. These are not legal problems or purely financial ones. Turn to someone who knows shareholders, communications, capital markets, activist techniques and your company. At HD Supply, where I am Lead Director, we hired a firm to help us objectively review the activist’s suggestions and perspective: it has proven enormously valuable.

Speak. Many activist investors will listen. At Polycom, we had an open and constructive dialogue with Elliott. We explained why we did not believe their suggestion was the best direction at that time. We ultimately sold the company and everyone was happy.

Listen. At Chico’s (a clothing retailer), my co-author, Greg Taxin, was the activist. (That is where we met!) The Board was initially very defensive and reluctant to acknowledge the performance issues at the company. Eventually, we were convinced and changed the Board and the CEO. The company and stock then performed extremely well and was in the top 10% of all NYSE companies for four years.

Act. Activist investors are certainly not always right. But, they also are rarely entirely wrong. Some have short-term horizons and recommendations that serve their own interests and not the interests of others.

But activists are often well informed, thoughtful and well meaning. When you find such an activist, don’t be afraid to embrace the “free” advice. Had the Darden board done so, perhaps they would not have experienced such an overwhelming rebuke by shareholders.

Betsy Atkins has served on more than a dozen public company boards, is a three-time CEO, serial entrepreneur, and author of “Behind Boardroom Doors.” She currently sits on the boards of Cognizant, HD Supply, Schneider Electric, and private company Volvo.

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The Changing Face of Shareholder Activism

Posted by Paula Loop, Catherine Bromilow, and Leah Malone, PricewaterhouseCoopers LLP, on Thursday, February 1, 2018

Editor's note: Paula Loop is Leader, Catherine Bromilow is Partner, and Leah Malone is Director of the Governance Insight Center at PricewaterhouseCoopers LLP. This post is based on a PwC publication by Ms. Loop, Ms. Bromilow, and Ms. Malone. Related research from the Program on Corporate Governance includes Dancing with Activists by Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch (discussed on the Forum here); Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here); and The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here).

Activism is about driving change. Shareholders turn to it when they think management isn't maximizing a company's potential. Activism can include anything from a full-blown proxy contest that seeks to replace the entire board, to shareholder proposals asking for policy changes or disclosure on some issue. In other cases, shareholders want to meet with a company's executives or directors to discuss their concerns and urge action. The form activism takes often depends on the type of investor and what they want.

Institutional investors and hedge funds typically have the most impact. Individual investors may submit lots of shareholder proposals, but they usually lack the backing to drive real change.

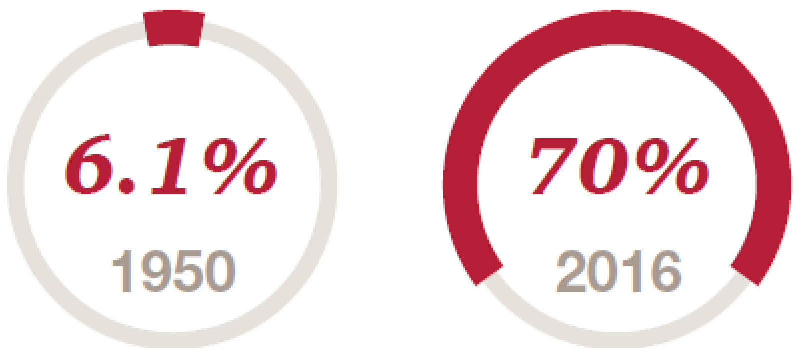
To prepare for—and possibly to even avoid—shareholder activism, companies and their directors need to understand today's landscape. Who are the activists? What are they are trying to achieve? When are activists more likely to approach a company? What tactics do they use? We break down the answers by the two main types of investors. Read on.

Institutional investors

These include pension funds, asset managers, mutual funds and insurance companies.

Balance of share ownership shifts heavily to institutional investors

Percentage of total outstanding US equities held by institutional shareholders

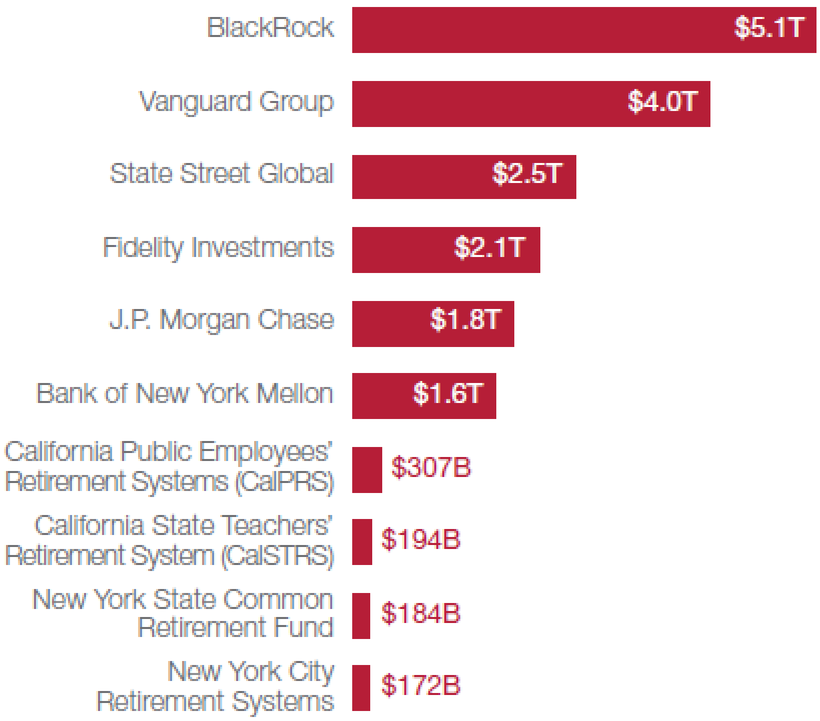


Sources: The Conference Board, *2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition,* November 2010; Broadridge and PwC, *ProxyPulse: 2017 Proxy Season Review,* September 2017.

Institutional investors are normally long-term shareholders. Many hold their shares in index funds, which are popular for their low fees. Institutions that provide index funds can't just sell a position if they think a stock is underperforming, or if they believe the company's governance practices hinder it's long- term value. And so they turn to activism. Through activism, they can bring attention to their concerns and drive the change that they believe will create long-term value—including through changes in corporate governance practices. Institutional investors such as Vanguard are vocal about their belief that companies with strong corporate governance practices can deliver better value in the long run.

Some of the biggest players

Assets under management (as of Dec. 31, 2016)



Sources: Pensions & Investments/Willis Towers Watson, *The World's 500 Largest Asset Managers*, October 2017; Pensions & Investments/Willis Towers Watson, *300 analysis: Year end 2016*, September 2017.

Index funds have become giants

42% of all US stock fund assets as of June 30, 2017 were held in index funds.

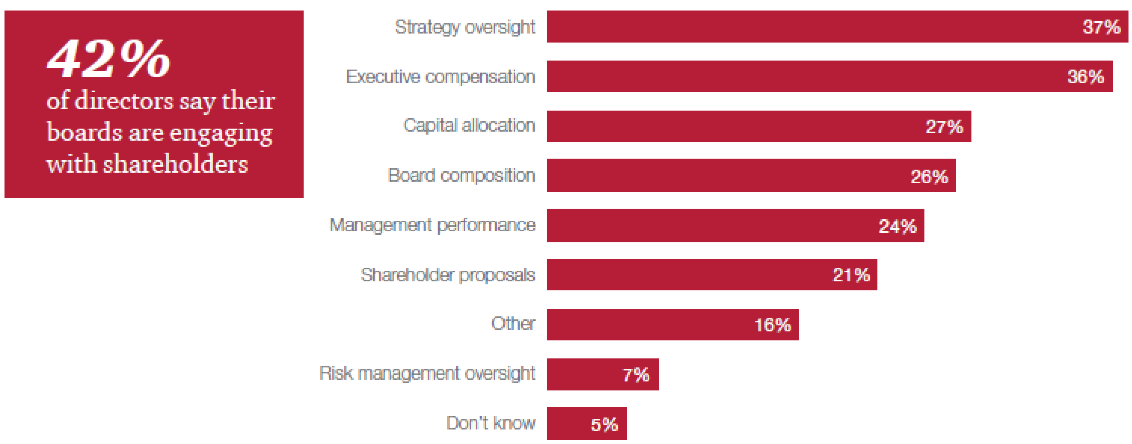
Source: Investment Company Institute

Shareholder engagement

When institutional investors have concerns, they often start by engaging one-on-one with the company. In prior years, engagement was mostly between the portfolio manager and the company's investor relations team or members of management, and focused largely on company performance. Today, investors' corporate governance teams are often driving the meetings—sometimes alone and sometimes in combination with portfolio managers.

At times shareholders ask to meet with directors. They may have identified issues in the company's executive compensation plans, its governance policies or practices, or its strategic plan. Other times, shareholders are looking to lay the foundation of an open dialogue with the directors. So when issues do arise in the future, they have an existing relationship upon which to build.

Directors are engaging with shareholders—often to discuss strategy



Shareholder proposals

In some cases, institutional investors submit—or indicate they plan to submit—a proposal if direct engagement with the company and its directors doesn't produce changes. Other investors view a shareholder proposal as a way to begin the conversation with a company.

These proposals often focus on governance practices or policies, executive compensation, or the company's behavior as a corporate citizen. Proponents watch how the major institutional investors are voting on issues, and have a sense of which shareholders may be likely to support their proposal going in. Investors also often reach out to other shareholders to encourage support for their measure. By the time a company even receives a shareholder proposal, its sponsor may already have a sense of whether it will pass.

Proxy access: a highly successful campaign

Proxy access *allows certain shareholders to include their director nominees in the company's proxy statement*

Institutional investors have been pushing for proxy access for years through shareholder proposals. In the 2012-2014 proxy seasons, these proposals got limited support. But in the fall of 2014, the New York City Pension Fund helped proxy access to take hold through its Boardroom Accountability Project. It targeted more than 70 major public companies with a coordinated, highly public effort. Most proposals passed, and companies started to implement proxy access bylaws. Efforts have continued since then, and by mid-2017, 60% of the S&P 500 had proxy access bylaws in place.

Why does this matter now? The New York City Pension Fund has launched version 2.0 of its Boardroom Accountability Project for 2018. This time, they are taking on board diversity and renewal, calling on companies to disclose the race, gender and skills of their directors in a standard matrix format.

Common shareholder proposals and their support in 2017 proxy season*

Type of shareholder proposal	Examples		Number of proposals		
			Submitted	Voted on**	Received majority support
Governance/ shareholder rights	• Board declassification • Majority voting standard	• Proxy access • Independent board chair	409	200	54
Social/political issues	• Climate change • Board diversity • Discrimination	• Human rights • Labor practices • Corporate political spending	453	194	6
Executive compensation	• Clawbacks • Pay ratio disclosure	• Required vesting terms for equity awards	97	50	0

* The 2017 proxy season refers to the period between January 1 and June 30, 2017.

** Many submitted proposals are either withdrawn through a negotiation process, or are removed due to technical failures.

Source: Alliance Advisors, *2017 Proxy Season Review*, August 2017.

"Vote no" campaigns

"Vote no" campaigns urge shareholders to withhold their votes from director candidates or to vote against a company's say on pay.

The vote doesn't actually have to fail for a vote no campaign to be a success. Overall shareholder support both for directors and for say on pay is typically above 90%. So if support levels fall to the 60s or 70s, it sends a stark message about shareholder dissatisfaction. It also generates media scrutiny, and can affect a director's reputation. Directors often serve on multiple boards, and low support levels at one company can affect how that director is viewed at his or her other companies as well.

A vote no campaign can send a strong signal about shifting shareholder priorities. Just as proxy season was beginning in 2017, State Street Global Advisors (SSGA) used the tactic to shine a spotlight on gender diversity. They announced they would start voting against nomination and governance committee chairs at companies that didn't have any women directors and weren't making efforts to add them. Indeed, SSGA voted against directors at over 400 companies in 2017, sending a clear signal.

Risk factors

Different types of shareholder concerns lead to different approaches. Although these methods can seem like escalation tactics, different investors simply prefer to start in different places and may adopt more than one approach on a given issue.

Risk factor	Commonly results in...		
	Request for engagement	Shareholder proposal	Vote no campaign
Underperforms peers in total shareholder return AND has features that aren't preferred governance practices (e.g., classified board, long average board tenure, lack of board diversity, combined CEO/chair position)	X	X (e.g., to declassify board)	
Low say-on-pay support with lack of subsequent changes; negative say-on-pay recommendation from a proxy advisory firm; significant off-market changes to compensation practices	X	X (e.g. changes to executive compensation policies)	X (against the members of the compensation committee or its chair, or against say on pay)
Majority-supported shareholder proposal has not been implemented by the board and appears to have been ignored			X (against the entire board, or directors viewed as responsible for failure to implement)
Director failed to receive support from a majority of shares voted but remained on the board (sometimes referred to as a "zombie director")	X	X (e.g., for majority vote policy)	X (against the zombie director or members of nominating and governance committee)
Significant media and/or analyst criticism about an acquisition, regulatory action or problematic product launch	X	X	
Board is considering or conducting a new CEO search	X	X (seeking, for example, separation of the CEO and chair positions)	
Perceived poor practices with respect to the environment (e.g., lack of preparedness for climate change), corporate social responsibility (e.g., labor, health or safety practices) or political spending/lobbying	X	X (e.g., request for a report on climate change)	
Lack of responsiveness to investors on key governance issues (e.g., failure to respond to a letter seeking information or dialogue on a governance practice)	X	X (e.g., related to the topic discussed in the letter)	
Material weaknesses in internal control over financial reporting, especially if they recur or if it appears the company is not taking appropriate action to remediate the issues			X (against the members of the audit committee)

Preparing for and responding to institutional investor activism

- ***Start a pattern of regular director engagement.*** Before the company receives a shareholder proposal or is targeted by a vote no campaign, start getting directors involved in discussions with major investors. Some investors view a shareholder proposal as a way to begin a conversation with the board. But if the lines of communication are already open, shareholders may not feel they need to resort to a shareholder proposal or other means.

- ***Respond directly to the investor.*** If you have received a shareholder proposal or been targeted for a vote no campaign, reach out to the investor. Discuss their specific concerns. When dealing with a shareholder proposal, the company and the shareholder may be able to agree on some action at the company in exchange for withdrawal of the proposal. Shareholders don't always insist on immediate action. They know change can take time, and often they are satisfied if the company demonstrates that it has a plan in place to address the issue. Communication might not put an end to a vote no campaign, but understanding the shareholder's perspective will help the company respond.

- ***Reach out to other shareholders.*** A shareholder proposal or a vote no campaign can be an opportunity to discuss the issue with other shareholders. Take the chance to articulate the company's view about why its current course is in the best long-term interests of the company and all of its investors. And consider disclosing the breadth of the company's shareholder engagement efforts in the proxy statement to give yourself credit for your outreach. For more on shareholder engagement, take a look at our paper *Director-shareholder engagement: getting it right*.

Blurring the lines—The future of institutional investor activism

Some institutional investors are moving beyond their traditional tactics. With many committed to long-term passive investments in a broad portfolio of companies, they are looking hard for ways to find untapped value at those companies—by encouraging governance changes, and otherwise. And so today, some are engaging in what has traditionally been thought of as hedge fund activism. Long-term institutional investors who previously never would have considered themselves "activists" are getting into the fray. Some are approaching hedge funds with a specific target in mind, backed by their own research, to suggest teaming up. Others are turning into "occasional activists" in their own right, without a hedge fund partner.

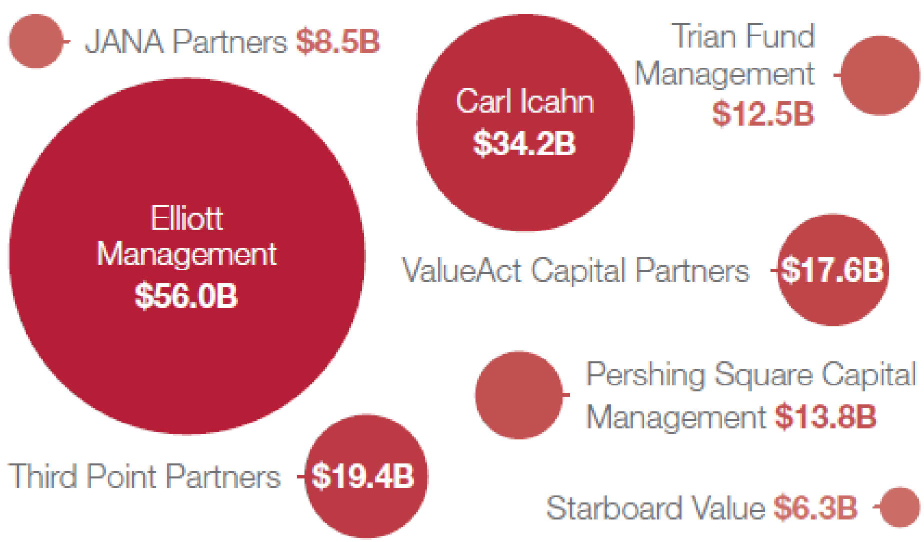
Hedge funds

Hedge funds attract big dollars from investors looking for above-average returns. So they are always looking for untapped value. Hedge fund activists often see that untapped value in the way a company is run, or the strategy it pursues. They see ineffective management, a stale board, or a company missing out on new opportunities. They see the potential for a new capital allocation strategy or changes in operations that will increase share value. And when their efforts to engage with executives or directors about these ideas fail, they often try to elect different directors.

Hedge fund activism today

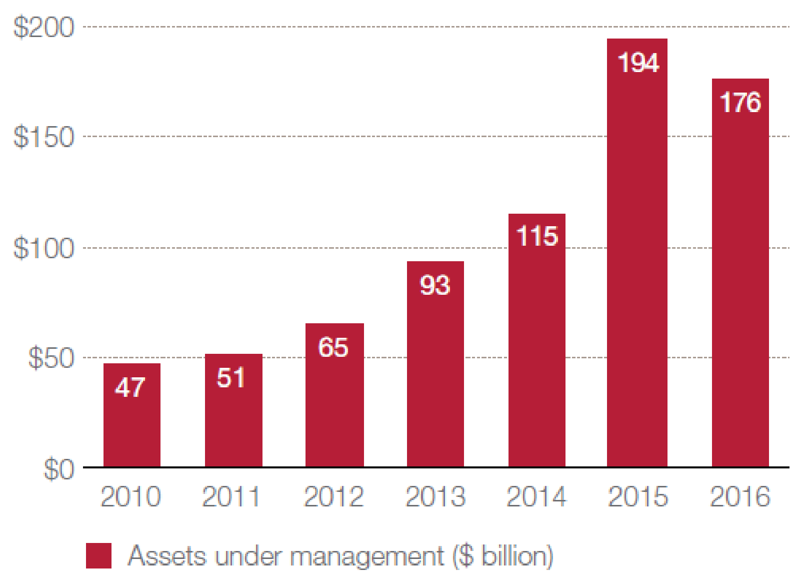
Hedge fund activists used to focus mostly on capital allocation issues, such as dividends and share buybacks. Many then began looking for company combinations and break-ups—mergers, carveouts and spin-offs. Now, there is a greater focus on operational activism, which has more of a long-term focus. Activists join the board (or appoint independent directors), replace members of management and help execute a new strategy. While many hedge funds had been thought of as being too focused on short-term gains, the longer-term operational activism has helped to shift that perception.

Major activist hedge funds



Source: Activist Insight, as of June 30, 2017.

Hedge fund assets under management booms, then slows

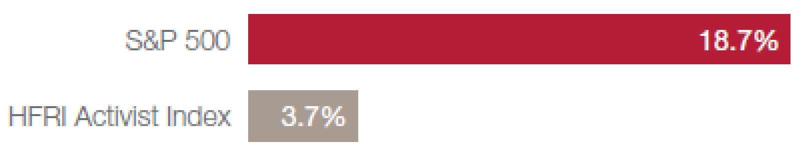


Source: Activist Insight, *Activist Investing: An annual review of trends in shareholder activism,* January 2017.

While a few hedge funds made significant profits for their investors in 2017, most have failed to outperform the S&P 500. For many investors, these returns don't justify the high related fees, and so some large institutional investors such as the California Public Employees' Retirement System (CalPERS) have pulled their investments out of hedge funds entirely. In 2016, hedge funds actually closed at the fastest rate since the 2008 financial crisis.

With competition for investments growing tighter, hedge funds are under greater pressure to post returns, which may be driving up activism even more.

Many hedge funds struggle to outperform index funds in 2017



Sources: S&P 500 research; Hedge Fund Research, Inc. (HFRI) Activist Index.

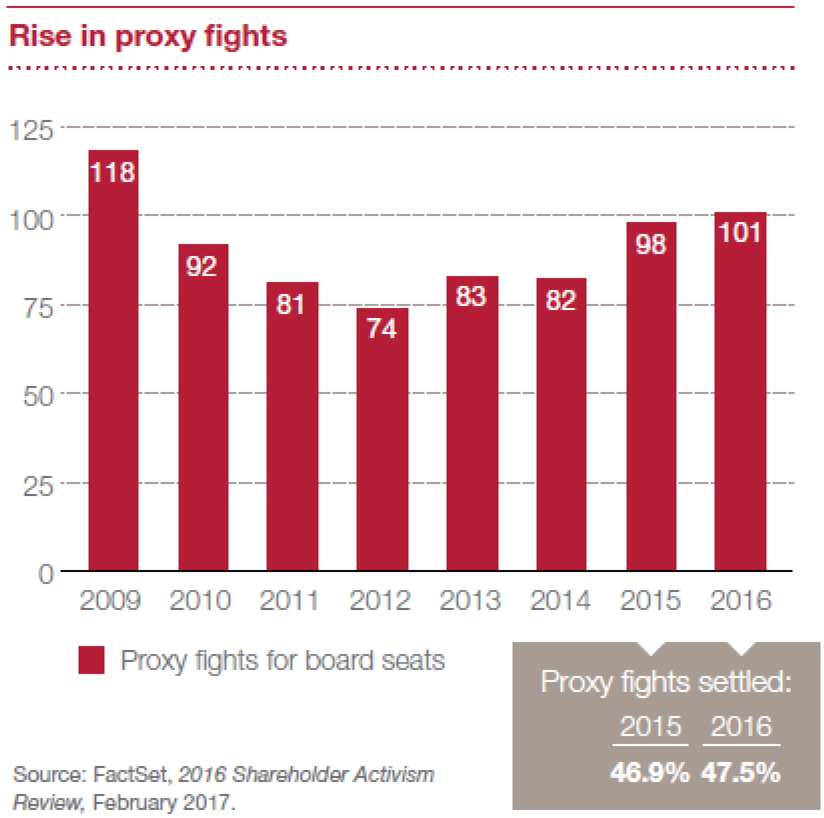
Activism tactics

Some activists follow a standard playbook. Many first spend time talking to the company, highlighting areas for improvement and value creation. If they can't negotiate a consensus around specific changes, they may move on to a proxy contest or a public media campaign.

Again, not all hedge funds follow this trajectory. Some move first to a media campaign or some other way of making a major splash. Whatever approach, hedge funds may also have spent time talking with some of the company's key shareholders to gauge their level of support for the campaign.

The number of proxy fights in 2016 reached its highest level since 2009, and companies are more willing to settle with activists than ever before. Proxy fights are long, expensive and draining for a company. There is greater recognition that the directors nominated by activists can sometimes add real value to the boardroom. So for many companies, it's just not worth the cost and distraction of a proxy fight.

Settlements have now become so common, in fact, that some institutional investors are concerned that companies are settling too easily. Before rushing to settle, they urge companies to at least reach out to their significant shareholders to solicit their views. Sometimes these investors might agree with the activist—and sometimes they might want the company to hold their ground against the activist.



Risk factors

Hedge fund activists use proprietary processes to identify their targets. But most targeted companies have some or many of these characteristics:

- Low market value relative to book value
- Disappointing company performance compared to peers
- Profitable with sound operating cash flows and return on assets
- Excessive cash on hand
- For multi-business companies: one or more significantly underperforming business lines or business lines with markedly different growth potential
- Board composition does not meet today's preferred governance practices (e.g., instead has long average board tenure, lack of board renewal, lack of diversity, lack of industry experience)

Before hedge fund activist campaigns occur

Companies can best anticipate, prepare for and respond to an activist campaign if they put themselves in an activist's shoes. Here are four key steps:

1. ***Rethink the information.*** Boards may get too much granular information that doesn't highlight underperforming assets. Reassess the type of information the board receives and revamp it so it gives the full picture.
2. ***Monitor shareholder positions and understand the activists.*** Ensure that the board is informed when an activist takes a significant position in the company or in an industry competitor. And make sure the board hears about broader activism trends that could affect the company in the future. Understanding what these shareholders may seek (i.e., understanding their "playbook") will help the company assess its risk of becoming a target and help it know what tactics to expect.
3. ***Evaluate and address your "risk factors."*** Look for the ways an activist might criticize the company and its board. Examine company strategy from an outside perspective, and then test whether it's working. Ask to hear from consultants, industry analysts or others from outside the company, to get a better understanding of how the company is seen by investors and potential activists and where its vulnerabilities are. Make sure they are giving their "unvarnished view"—one that has not been white-washed by management or by an unwillingness to give a frank evaluation.

If there are issues, take proactive steps to address them. This can reduce the chance of being an activist target and strengthen credibility with the company's shareholders. Even if the company chooses not make any changes, going through the critical process will help company executives and directors reaffirm and articulate why they believe the company is on the right course.

4. ***Launch an engagement plan.*** Once a company identifies areas that may attract activist attention, engaging with other shareholders around these topics can help prepare for—and in some cases may help to avoid—an activist campaign. Being transparent about the company's vulnerabilities and its strategic choices can help change a shareholder's view of the issue, and demonstrate that the board is fulfilling its oversight responsibilities. Other times, the engagement should be more about listening. We hear more and more about boards bringing portfolio managers or other investors in to share their thoughts on the company and ways they could improve—and possibly head off an activist.

Responding to a campaign

In responding to an activist, consider the advice that large institutional investors have shared with us: good ideas can come from anyone. Some circumstances may call for more defensive responses—such as litigation—to an activist's campaign. But in general, we believe the most effective response plans have three components:

1. ***Objectively consider the activist's ideas.*** Activists usually do extensive homework before they approach a company. Based on that research, they develop specific proposals for unlocking value—at least in the short term. And they have often discussed these ideas with other shareholders. Assume the company's institutional investors have already spent time evaluating the activist's suggestions. Investors will expect the company's executives and board to do the same—even when it's uncomfortable. And it often is. The changes activists propose are not easy and they are not uncontroversial. If they were, the company would have already done them. More often, they are recommending fundamentally restructuring the company or the go-forward strategy. They might be looking for changes in the boardroom, which may feel like a personal affront to

the directors around the table. Or they may be looking for a change in management, which will almost certainly feel like an attack on the CEO. But none of these ideas should be dismissed out of hand.

2. ***Look for ways to build consensus.*** More companies than ever are finding ways to work with activists. By doing so, they avoid the distraction and high cost of a proxy contest. Companies might agree to change their capital allocation, or even to add new directors to the board. Sometimes a brush with an activist gives a company a welcome opportunity to refresh its board.

Activists are also motivated to reach agreement. Proxy contests are expensive— for both sides. If given the option, most activists would prefer to spend less time and money to achieve their goals. Once they agree, the activist and the company enter into a standstill agreement that sets the terms of their relationship going forward.

3. ***Tell the company's story.*** Now is the time to reach out instead of hunkering down. As we've said, an activist will likely be engaging with other shareholders, so it's important these investors hear from management and the board as well. Ideally, the company already has an established relationship with those shareholders to build upon. If the company doesn't believe the activist's proposed changes are in the best long-term interests of the company and its owners, investors will want to know why—and just as importantly, how the company reached this conclusion. Often we hear that the suggestions activists make are ones that the company had already been considering.

If the activist and company are able to reach an agreement, investors will want to hear from executives and directors about why the changes are good for the company. Being seen as forward-thinking leaders, rather than victims of activism, can boost investor confidence.

Hedge fund activism is rarely "one and done"

When the annual meeting is over, and changes have been implemented, or the hedge fund has moved its attention to another target, it may feel like the storm is over. But the risk of additional activism doesn’t go away. The way the company responded to the activism, and the perception of the board’s independence and open-mindedness can make it a repeat target.

To get ahead of this, companies periodically refresh the four steps described earlier in the “Before hedge fund activist campaigns occur” section. By periodically assessing risk factors and engaging in a tailored and focused shareholder engagement program, the company can enhance its resiliency and strengthen its long-term relationship with investors.

Many companies are repeat activist targets

Approximately **20%** of company targets in 2017 had also been targeted in the previous five years.

Source: J.P. Morgan, *The 2017 Proxy Season*, July 2017.

Conclusion

As activism—by both institutional investors and hedge funds—continues to be strong, many think the number of campaigns could be on the upswing. These campaigns may also be more likely than ever to succeed. For companies, listening to and understanding shareholder concerns may be more important than ever.

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An Investor Consensus on U.S. Corporate Governance & Stewardship Practices

Posted by Michael McCauley, Florida State Board of Administration, on Wednesday, May 9, 2018

Editor's note: Michael McCauley is Senior Officer, Investment Programs & Governance, of the Florida State Board of Administration (SBA). This post is based on a publication from the Florida SBA by Mr. McCauley; Lindsey Apple, Senior Proxy Analyst at MFS Investment Management; Jacob Williams, Florida SBA Corporate Governance Manager; and Tracy Stewart, Florida SBA Senior Corporate Governance Analyst.

The ISG, as a private initiative wholly independent of any regulatory body, was formed to bring together all types of investors to establish a framework of fundamental standards of investment stewardship *and* corporate governance for U.S. institutional investor and boardroom conduct. The Investor Stewardship Group (ISG) is a collective of some of the largest institutional investors and global asset managers with the goal of establishing the first ever, broad-based U.S. Stewardship and Governance Code for companies and investors. Founding members include U.S. and international institutional investors with large investments in the U.S. equity market. Since its inception in late January 2017, membership in the ISG has grown significantly, with assets under management increasing to over $22 trillion.

The ISG published its 'Framework for U.S. Stewardship and Governance' which comprises both a set of six stewardship principles for institutional investors as well as 6 corporate governance principles for U.S. listed companies. (see graphic below) The principles capture fundamental corporate governance and stewardship elements that its members believe are essential to preserving and increasing long-term shareholder value. The corporate governance principles are not intended to be overly prescriptive or all-encompassing in their scope—allowing flexibility in their application. The Framework borrows from other governance codes outside the U.S., which are typically structured on a "comply-or-explain" basis, thereby avoiding concerns over strict compliance and "one-size-fits-all" criticism. The Framework also serves to improve alignment of U.S. corporate governance practices with those in other global markets. Although members of the ISG are supportive of the corporate governance principles, individual ISG members may (and often do) differ on specific standards regarding corporate governance practices that are expected of companies, as outlined in their own proxy voting policies and guidelines. The ISG members will evaluate companies' alignment with these principles, as well as any disclosure of alternative approaches that boards view as being in the company's best interests.

In September 2017, the ISG announced that it had partnered with the John L. Weinberg Center for Corporate Governance at the University of Delaware to serve as the home of the ISG and the ISG Framework. The Weinberg Center works with ISG on ISG's ongoing governance, administration, communications, and other related matters.

ISG Corporate Governance Principles espouse the adoption of annual director elections, boards comprised of a majority of independent directors, majority voting standards used for uncontested board elections, equal voting capitalization with a one-share, one-vote structure, and clear explanations why the board has chosen to adopt or maintain a variety of anti-takeover devices. The ISG Framework also takes the view that directors need to make the substantial time commitment required to fulfill their responsibilities and duties to the company and its shareowners. When considering the nomination of both new and incumbent directors, nominating committees should assess a candidate's ability to dedicate sufficient time to the company in the context of their relevant outside commitments.

In addition to the governance principles, the Stewardship Framework seeks to articulate a set of fundamental stewardship responsibilities for institutional investors. The framework serves to affirm investment managers' responsibility for engagement and proxy voting policies and decisions, regardless of how they may use services offered by third parties. As guidance, the rationales and expectations that underpin each principle have been articulated. For example, Stewardship Principle B-1 states, "Good corporate governance is essential to long-term value creation and risk mitigation by companies. Therefore, institutional investors should adopt and disclose guidelines and practices that help them oversee the corporate governance practices of their investment portfolio companies. These should include a description of their philosophy on including corporate governance factors in the investment process, as well as their proxy voting and engagement guidelines."

The ISG encourages institutional investors to be transparent in their proxy voting and engagement guidelines and to align them with the stewardship principles. These principles should not restrict investors from choosing to adopt more explicit and/or stronger stewardship practices. Notably, the Framework for U.S. Stewardship and Governance is *not* intended to replace or supersede any existing federal or state law and regulation, or any listing rules that apply to a company or an institutional investor. The Framework is also *not* intended to be static. The Framework is designed to be enduring, yet evolving. While the ISG does not anticipate frequent amendments to the Framework, it believes it should be evaluated periodically and amended to reflect commonly accepted governance and stewardship standards over time.

Goals of the ISG

The ISG Framework is likely to have a major impact on how U.S. companies govern themselves, and also improve how asset managers and owners conduct their fiduciary activities on behalf of clients. The Framework advocates constructive dialogue and engagement, practices which have been a work in progress for both investors and issuers. The members believe that the ISG Framework is likely to foster a collaborative reconciliation between a company's strategy and its governance protocol. While announced in 2017, the Framework went into effect January 1, 2018, which was timed to allow U.S. firms to review and adjust to ISG standards in advance of the 2018 proxy season. The ISG encourages companies to evaluate their alignment with the corporate governance principles and where and why they differ in approach. ISG members believe companies can best decide on how and where to disclose their alignment with the Principles, for example, investor relations, boards of directors or corporate governance websites, or in other investor outreach/engagement materials.

While the ISG is the first investor-led governance and stewardship framework developed for the U.S. market, it also aligns with other global stewardship guidelines, such as those espoused by the International Corporate Governance Network (ICGN).

In late March, the ISG announced the establishment of Steering, Governance, and Marketing and Communications committees to provide ongoing guidance and governance of the ISG. The ISG, under the leadership of the Steering and Governance Committees, has adopted an Amendment Process for the Framework that permits all members a means to participate.

The ISG's Framework for U.S. Stewardship and Governance

Stewardship Principles for Institutional Investors	Stewardship Principles for U.S. Listed Companies[1]
A. Institutional investors are accountable to those whose money they invest.	**1.** Boards are accountable to shareholders.
B. Institutional investors should demonstrate how they evaluate corporate governance factors with respect to the companies in which they invest.	**2.** Shareholders should be entitled to voting rights in proportion to their economic interests.
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.	**3.** Boards should be responsive to shareholders and be proactive in order to understand their perspectives.
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.	**4.** Boards should have a strong, independent leadership structure.
E. Institutional investors should address and attempt to resolve differences with companies in a constructive and pragmatic manner.	**5.** Boards should adopt structures and practices that enhance their effectiveness.
F. Institutional investors should work together, where appropriate, to encourage the adoption and implementation of these corporate governance and stewardship principles.	**6.** Boards should develop management incentive structures that are aligned with the long-term strategy of the company.

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How “Shareholder Value” is Killing Innovation

Posted by William Lazonick, University of Massachusetts Lowell, on Tuesday, August 8, 2017

Editor’s note: William Lazonick is Professor of Economics at University of Massachusetts Lowell. This post is based on his recent paper.

Conventional wisdom holds that the primary function of the stock market is to raise cash that companies use to invest in productive capabilities. The conventional wisdom is wrong. Academic research on corporate finance shows that, compared with other sources of funds, stock markets in advanced countries have in fact been insignificant suppliers of capital to corporations. What, then, is their function? If we are to understand employment opportunity, income distribution, and productivity growth, we need an accurate analysis of the role of the stock market in the corporate economy.

The insignificance of the stock market as a source of real investment capital exposes as fallacious the fundamental assumptions of the prevailing ideology that, for the sake of economic efficiency, a business corporation should be run to “maximize shareholder value” (MSV). As a rule, public shareholders do not invest in a corporation’s productive capabilities; they simply buy shares outstanding on the market, hoping to extract value that they have played no role in helping to create. And in practice, MSV advocates modes of corporate resource allocation that undermine innovative enterprise and result in unstable employment, inequitable incomes, and sagging productivity.

The most obvious manifestations of the corporate misbehavior that MSV incentivizes are the lavish, stock-based incomes of top corporate executives and the massive distributions of corporate cash to shareholders in the form of stock buybacks, coming on top of already-ample dividends. Indeed, with stock-based pay incentivizing senior executives to do stock buybacks—i.e., having a company repurchase its own shares to give manipulative boosts to its stock price—over the past three decades the stock market has had a negative cash function. On the whole, U.S. business corporations fund the stock market, not vice versa.

My INET paper, The Functions of the Stock Market and the Fallacies of Shareholder Value, provides an analysis of the evolving role of the stock market in the U.S. corporate economy over the past century. I ask how the changing functions of the stock market have influenced the processes of value creation (hence, the size of the economic pie), as well as the relation between value creation and value extraction (hence, the distribution of the economic pie). This essay is part of an ongoing project aimed at making “The Theory of Innovative Enterprise” central to an economic analysis that comprehends institutions’ and organizations’ roles in supporting or undermining stable and equitable economic growth.

The Theory of Innovative Enterprise posits that three social conditions of innovative enterprise—strategic control, organizational integration, and financial commitment—determine whether a business can generate goods and services that are higher quality and lower cost than those previously available. The process of value creation enabled by innovative enterprise enhances the performance of both the company and the economy of which it is a part. Once armed with a theory of innovative enterprise, we can analyze the relation between those who contribute to the processes of value creation and those who reap incomes through value extraction. We can discern how "predatory value extractors," who make little if any contribution to value creation, use their power to dominate the distribution of income.

In terms of the three social conditions of innovative enterprise: **Strategic control** gives decision makers the power to allocate the firm's resources to transform technologies and access new markets to generate higher-quality, lower-cost products**; organizational integration** creates incentives for people working together to engage in the collective learning that is the essence of the value-creation process; **financial commitment** secures funds to sustain the cumulative learning process, from the time when investments in productive capabilities are made until innovative products generate financial returns.

The functions of the stock market may support or undermine the social conditions of innovative enterprise. The functions of the stock market go well beyond "cash" to include four others, which can be summarized as "control," "creation," "combination," and "compensation." Historically, as the U.S. economy grew to become the world's largest and most powerful, the key function of the stock market was *control.* Specifically, the stock market enabled the separation of managerial control over the allocation of corporate resources from the ownership of the shares in the company.

Yet, assuming that the key function of the stock market is *cash,* academic economists known as agency theorists see this separation of control from ownership as the "original sin" of American capitalism. They argue that the evils of managerial control can be overcome by incentivizing or, if necessary, compelling corporate managers as "agents" to maximize the value of the stock possessed by corporate shareholders as "principals." The agency-theory mantra is that the key role of managers is to "disgorge" the "free" cash flow to shareholders in the forms of dividends and buybacks.

What is missing from the agency theory argument is a theory of how a firm creates value—that is, a theory of innovative enterprise. The functions of the stock market may support the types of strategic control, organizational integration, and financial commitment that can result in the generation of higher quality products at lower unit costs—the economic definition of innovation. It is possible, however, that the functions of the stock market may undermine the types of strategic control, organizational integration, and financial commitment that the innovation process requires.

Indeed, by following the prescriptions of agency theory—that senior executives should be incentivized by stock-based pay to "create value" for shareholders—corporate managers have undermined the conditions of innovative enterprise in U.S. corporations over the past three decades. Consider each of the three social conditions:

Strategic control: Senior executives who are willing to waste hundreds of millions or billions of dollars annually on buybacks to manipulate their companies' stock prices can lose the capacity to determine what types of organizational and technological investments are required to remain innovative in their industries. Instead, the current structure of stock-based executive remuneration—as prescribed by agency theory—creates incentives for senior executives to allocate resources in ways that boost stock prices and increase their take-home pay. The stock buyback is a powerful tool at the disposal of corporate executives for manipulating the stock market for their personal gain.

Organizational integration: Collective and cumulative learning about the technologies, markets, and competitors relevant to a particular industry is the foundation for generating the higher-quality, lower-cost goods and services that result in productivity growth. What I call "collective and cumulative careers" are essential for organizational learning, especially in industries that are technologically and organizationally complex. Organizational learning depends on a "retain-and-reinvest" regime. In such an arrangement, senior executives make corporate resource-allocation decisions that, by retaining people and profits in the company, permit reinvestment in the productive capabilities that can generate competitive (high-quality, low-cost) products. Our research supports the hypothesis that, as part of a corporate resource-allocation regime that downsizes the U.S. labor force and distributes corporate cash to shareholders, stock buybacks are done at the expense of investments in collective and cumulative careers. For working people who are the real value creators, the "disgorged" cash flow is far from "free."

Financial commitment: The cash flow that MSV calls "free" can deprive the business enterprise of the foundational finance for investment in innovative enterprise. Stock buybacks represent a depletion of internally-controlled finance that could be used to support investment in the company's productive capabilities. Every once in a while, a major company that has done massive buybacks over a period of years hits a financial wall. At that point the billions of dollars it wasted on buybacks are not available to support the restructuring needed for it to become innovative once again. The process of predatory value extraction that destroys innovative enterprise is irreversible. It must be stopped before it starts.

The complete paper is available for download here.

Are Buybacks Really Shortchanging Investment?

Posted by Jesse Fried (Harvard Law School) and Charles C.Y. Wang (Harvard Business School), on Monday, March 19, 2018

Editor's note: Jesse Fried is the Dane Professor of Law at Harvard Law School and Charles C.Y. Wang is the Glenn and Mary Jane Creamer Associate Professor of Business Administration. This post is based on a recent article authored by Professor Fried and Professor Wang, recently published in the *Harvard Business Review.*

In an article recently published in the *Harvard Business Review*, Are Buybacks Really Shortchanging Investment?, Charles Wang and I use data to challenge the widely-held view that U.S. firms distribute too much cash to shareholders through stock buybacks and dividends, reducing these firms' ability to innovate and invest for the long term.

Payout critics focus on the high volume of dividends and repurchases, often pointing to shareholder payouts routinely exceeding 90% of net income. For example, during the decade 2007-2016, S&P 500 firms distributed $7 trillion to shareholders, mostly via repurchases, totalling 96% of net income. These figures have led Larry Fink, CEO of Blackrock, to warn corporate leaders against seeking to "deliver immediate returns to shareholders, such as buy-backs… while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth." Vice-President Joseph Biden, reportedly mulling a run at the White House in 2020, claimed that the high level of buybacks "has led to significant decline in business investment" with "most of the harm …borne by workers." Biden's view is widely shared by prominent politicians in Washington, D.C. Just last week, Senate Democratic Leader Chuck Schumer, who claims buybacks "crowd out investment" that would benefit workers and firms, joined Senator Tammy Baldwin in introducing an amendment to the banking deregulation bill that gives the SEC the authority to block a stock buyback *it* deems to harm the corporation.

We begin by examining corporate investment levels. If shareholder payouts were excessive, corporate investment should be declining. However, across all S&P 500 firms, we find that the absolute amount of R&D spending ($274 billion in 2016) and R&D intensity (R&D spending as a percentage of revenues) are both at record highs. Similarly, a broader measure of investment, CAPEX plus R&D ($885 billion in 2016), has risen steadily over the past two decades. In fact, both in absolute and relative terms, CAPEX plus R&D are at levels not seen since the late 1990s boom period.

A payout critic might argue that investment in the S&P 500 would have been even higher if firms had retained more cash rather than distributing it to shareholders. But we find that corporate cash stockpiles are huge and growing. In 2007, S&P 500 firms held $2.8 trillion in cash plus cash-equivalent short-term investments. Over the next decade, they accumulated significantly more, ending up with $4.3 trillion in 2016—an increase of about 50%.

What accounts for the apparent disconnect between the large volume of shareholder payouts, on the one hand, and soaring investment and cash levels, on the other? The main reason is that buyback alarmists look at shareholder-firm capital flows going in only one direction: from firms to shareholders. They ignore capital flows going in the other direction, from shareholders to firms, via equity issuances. Across all S&P 500 firms, equity issuances from 2007 to 2016 totaled $3.3 trillion—about 79% of the $4.2 trillion in repurchases over this period. As a proportion of net income, shareholder payouts for the S&P 500 totaled 96%, but *net* shareholder payouts totaled a much more modest 50%.

A second reason for the disconnect is that, net income, against which shareholder payouts are often compared, is a poor measure of the income available for internal investment. It assumes the expenses deducted to arrive at net income are entirely unrelated to future-oriented investment, but one of these is R&D, which by its very nature is future oriented. At most, net income indicates the amount available for CAPEX and *additional* R&D. When we add R&D expenses (net of tax effects) back into net income to arrive at R&D-adjusted net income, and compare it to *net* shareholder payouts, the overall picture looks very different. From 2007 to 2016, net shareholder payouts by the S&P 500 constituted only 41.5% of R&D-adjusted net income. That left the S&P 500 with $5.2 trillion available for CAPEX, R&D, and other investments, which explains why investment levels can be at record or near-record highs while cash balances are increasing.

We also explain that buyback alarmism reflects a very myopic view of the U.S. economy, as it implicitly assumes that there is little economic activity outside S&P 500 firms and net shareholder payouts by these firms are thus wasted. But net shareholder payouts by the S&P 500 free up capital for productive use elsewhere, both in non-S&P 500 public firms and private firms. Consider non–S&P 500 public firms. In every single year of the 2007–2016 period, they experienced net shareholder *inflows* (that is, negative net shareholder payouts), absorbing capital to fuel investment, innovation, and job creation in those firms. Getting capital to private firms is even more important, as these firms account for more than 50% of nonresidential fixed investment, employ almost 70% of U.S. workers, generate nearly half of business profits, and historically have been important sources of innovation and job growth in the United States.

We also address the argument that stock buybacks increase income inequality by favoring wealthy executives and shareholders at the expense of middle-class workers. We explain why there is little reason to believe that shareholder payouts transfer value from workers to shareholders, or have much effect on nation-wide income inequality. Executives can and do sometimes use repurchases to improperly benefit themselves at the expense of shareholders, a real problem that should be addressed through better regulation of stock buybacks, but one that is unlikely to have a perceptible effect on income distribution in our society.

In short, buyback alarmists' claim that buybacks are draining public firms of investment capacity or causing other social ills does not stand up to the data.

The complete article is available here.

The data and the methodologies behind the analyses reported in the article can be found in the February 2018 version of our SSRN working paper, Short-Termism and Capital Flows.