Harvard Roundtable on Corporate Governance

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Tab I: Current Regulatory Proposals

Harvard Law School Forum on
Corporate Governance and Financial Regulation
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Would a Shift to Semiannual Reporting Really Affect Short-Termism?

Posted by Cydney Posner, Cooley LLP, on Friday, September 14, 2018

Editor's note: Cydney S. Posner is special counsel at Cooley LLP. This post is based on a Cooley memorandum by Ms. Posner. Related research from the Program on Corporate Governance includes The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here); Short-Termism and Capital Flows by Jesse Fried and Charles C. Y. Wang (discussed on the Forum here); and Stock Market Short-Termism's Impact by Mark Roe (discussed on the Forum here).

You remember, of course, that last month, the president, on his way out of town for the weekend, tossed out to reporters the idea of eliminating quarterly reporting. (See this PubCo post.) The argument is that the change would not only help to deter "short-termism," it would also save all public companies substantial time and money. But how meritorious is that idea? According to this article in the *WSJ*, if a change from quarterly reporting to semiannual reporting were actually implemented, smaller companies could experience significant cost savings, but large companies—not so much.

While it may be debatable whether a shift from quarterly to semiannual reporting would have any real effect on short-termism, there's not much question, the article asserts, that it would save time and costs, at least for some companies. The article maintains, however, that

> "size matters. The anticipated cost savings would benefit smaller public companies, but the change probably wouldn't make a substantial difference for larger firms…. Accelerated and large accelerated filers—companies that have earlier deadlines to file annual reports with regulators—paid audit fees of $541 per $1 million of revenue to their independent auditors in 2016, the latest full-year data available. By contrast, smaller reporting companies that recorded revenue in 2016, a group of 1,554 firms, paid $3,345 per $1 million in revenue, according to an analysis from consulting firm Audit Analytics conducted for *The Wall Street Journal*. The disparity reflects the fixed costs involved in performing annual audit and review work, as well as the economies of scale that can make large companies more efficient. For smaller companies, absolute costs matter more because they represent a greater share of potential profit."

Because the annual 10-K requires an audit, it accounts for a much greater proportion of the accounting costs, according to the article; review of the three quarterly reports together account for only 15% to 20% of the overall cost. But "eliminating two of those three reviews wouldn't slash two-thirds of the cost, [accountants] said, as the midyear review would be more robust and command higher fees." But there are also internal costs and time associated with closing the books (which, last year, took most companies 4½ days), preparation of related communications

and legal review. And, the article notes, “CFOs will be faced with a dilemma: Apply the time savings to financial planning, analysis and the improvement of operations. Or keep distributing the quarterly performance figures, which analysts and investors prize.”

In this article, professors from Wharton and Georgetown, discussing the issue of quarterly reporting, observed that companies have in the past decided to exceed the legal requirements. Case in point: the U.K., which, in 2007, had mandated quarterly reporting, changed back to semiannual reporting in 2014, “and Europe followed suit. As it turned out, companies in the U.K. and Europe continued to put out quarterly reports, egged on by investors, analysts and portfolio managers.” Of course, there’s no predicting whether U.S. companies would have the same reaction. After all, some business groups view the costs and pressures associated with quarterly reporting as one of the deterrents to going public and maintaining public company status. (See this PubCo post.)

The *WSJ* reminds us that, in 2016, the SEC issued a 341-page Concept Release on Business and Financial Disclosure Required by Regulation S-K, as part of its Disclosure Effectiveness Initiative, which requested comment on the frequency of interim reporting. The release observed that the type of industry or size of the company could make a difference, noting that the “costs of more frequent reporting may impose a disproportionate burden on smaller or less capitalized registrants. At the same time, smaller registrants may be more volatile and quarterly reporting may provide more timely disclosure of performance issues. Additionally, because smaller, capital-intensive companies may need greater or more frequent access to capital markets, more frequent reporting may provide greater investor confidence and a lower cost of capital for these companies.” Among other questions, the release asks whether quarterly reporting should be reconsidered for smaller or all companies. The article observes that, in response, EY suggested “scaling interim reporting requirements only in limited circumstances,” such as “for smaller reporting companies that are not listed on a national exchange.” Will that be the direction the SEC ultimately decides to go?

Keep Quarterly Reporting

The long-term benefits of semi-annual reporting are doubtful, while its costs are significant, say Robert Pozen and Mark Roe.

Robert C. Pozen and Mark Roe
August 27, 2018

On August 17, President Trump waded into another complex area by a short tweet. He had apparently asked several top business leaders how to "make business (jobs) even better in the United States." He then directed the Securities and Exchange Commission to study one business leader's reply: "Stop quarterly reporting and go to a six-month system."

Trump's tweet reflects the belief of many corporate executives and commentators that quarterly reporting pushes public companies away from attractive long-term investments. However, the long-term benefits of

Shifting company reports to every six months does not meet anyone's definition of the long-term. An extra three months to announce financial results would not induce American executives to take off the shelf the hypothetical stockpile of long-term, job-creating projects — now allegedly stymied by quarterly reporting.

For years, public companies like Amazon have achieved large market capitalizations by following long-term strategies, as investors waited patiently. Indeed, most biotechs go public successfully without any history of profits, so investors must be endorsing their plans for completing clinical trials and marketing their drugs.

Company executives who articulate a persuasive, multi-year business plan should not worry much about quarterly reporting. And if they are worried, moving to six-month reports will not help them.

Of course, the SEC could allow every public company to report their financial results with whatever frequency it chooses. However, that would make it very difficult for investors to compare companies in the same industry — a powerful tool for security analysis.

I. The Evidence

Our position is supported by empirical studies of the United Kingdom and more generally. During the last decade, the U.K. twice changed its reporting requirements for public companies. In 2007, the U.K. moved from semi-annual financial reporting to quarterly reporting. Yet, there was no significant decrease in capital or research expenditures over the next 3 to 6 years, according to a study commissioned by the CFA Institute Research Foundation.

Then, in 2013, the U.K. reversed direction by replacing the quarterly with a semiannual reporting requirement. Yet the same study did not find any significant increase in U.K. company spending on capital investment or research after the change.

We recognize that investments in property, plant, and equipment are down throughout the developed world since 1990. But this trend includes those countries that rely more on banks for corporate financing and that have fewer public firms than the U.S. has. Indeed, America's investment decline is less than that in the rest of the developed world.

Thus, it's a mistake to blame quarterly stock market reporting for reduced capital spending. Something else is operative — factors such as the movement to capital-light, technology-oriented economies; the rise of Asian manufacturing; and the weakness, until recently, of the economy overall.

While we don't believe that moving to a semi-annual reporting requirement would be beneficial, we do oppose the common practice of quarterly earnings guidance — when companies announce what they expect their earnings will be in the next quarter. Having put their reputations on the line by projecting earnings for the next quarter, some executives then scramble and distort their company's businesses to avoid reporting earning anything less.

But earnings guidance is optional, not required by the SEC, so companies could break this bad habit on their own, without a new or amended SEC rule. The practice of publicly predicting earnings has come under growing criticism, including a recent op-ed by Warren Buffett and Jamie Dimon. We note that Buffett and Dimon did not recommend doing away with quarterly reports.

Moving from quarterly to semiannual reporting would also have significant costs. With corporate results disseminated less frequently, stock prices would be less accurate as investors struggled to assess the financial effects of material developments without the company's numbers. Small bits of public information loom larger in stock price valuations when investors are in the dark as to the actual earnings implications of such bits.

When the SEC went from a semiannual to quarterly reporting requirement between 1955 and 1970, the cost of equity capital went down for U.S. public companies, according to a definitive empirical study. This result strongly suggests the investors highly value more frequent reporting because it reduces the risk of buying stocks based on currently available information.

Moreover, if results of U.S. companies were hidden for longer periods, more people — executives and advisers — would possess nonpublic information. The temptation and potential for insider trading would rise substantially.

II. A Better Reform

But as any public firm CFO knows, putting together a 10-Q is an arduous task, competing for time and resources that could be better spent elsewhere. While we believe that abolishing quarterly reports is unwise, the SEC should streamline quarterly reports — which now are too dense and long. Companies spend too many hours and dollars putting together what has become a thick tome that repeats too much old information.

For example, the SEC could require full company reports only at the end and middle of the fiscal year. In the two other quarters, company disclosures could be limited to their financial statements plus a concise summary of material developments since the last full report.

In addition, quarterly filings on form 10-Q arrive too late at the SEC — 7 to 10 days after a company issues a short press release summarizing its quarterly revenues and earnings. That press release is extensively discussed in an open conference call hosted by management for investors, who quickly respond to that information.

The SEC should therefore try to integrate those press releases with its quarterly filing requirements. Most investors read these timely summaries and trade in reaction to them, rather than the quarterly tomes later filed with the SEC. The appropriate direction is to coordinate the earnings releases with the 10-Qs to cover, in a timely manner, the important information for investors without undue repetition.

Such a reform agenda at the SEC would be more useful than pursuing the pipe dream of increasing long-term investments by shifting from quarterly to semiannual reporting of company results. Six months simply does not constitute the long term.

Robert C. Pozen, the former chairman of MFS Investment Management, is a senior lecturer at the MIT Sloan School of Management. Mark J. Roe is the David Berg professor of law at Harvard Law School.

A shorter form of this column originally appeared in *The Wall Street Journal*.

Harvard Law School Forum on
Corporate Governance and Financial Regulation
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The Regulation of Proxy Advisors

Posted by Steve Seelig and Puneet Arora, Willis Towers Watson, on Friday, August 3, 2018

Editor's note: Steve Seelig and Puneet Arora are regulatory advisors at Willis Towers Watson. This post is based on a Willis Towers Watson memorandum by Mr. Seelig and Mr. Arora.

Recently, the Senate Committee on Banking, Housing and Urban Affairs held a hearing on various legislative proposals aimed at improving corporate governance, including the Corporate Governance Reform and Transparency Act, H.R. 4015, that would regulate the activities of proxy advisory firms like Institutional Shareholder Services (ISS) and Glass Lewis.

This hearing is the latest step in the legislative process, following the House of Representative voting 238-182 on December 20, 2017 to send H.R. 4015 to the Senate for consideration. It is not yet clear that the Senate will move the legislation from the Committee to the full Senate, or whether the Committee will make significant amendments requiring a second vote from the House to endorse those changes, or some compromise to harmonize those differences. Moreover, any movement on H.R. 4015 in the near term seems unlikely, given the Senate's focus on confirming President Trump's nominee for the Supreme Court and on the mid-term elections.

According to a fact sheet published by Rep. Sean Duffy (R-Wis.), the House Bill's sponsor, "H.R. 4015 would require Proxy Advisory Firms to register with the SEC and disclose among other things, the procedures and methodologies to develop proxy voting recommendations and any conflicts of interests." The fact sheet also mentions that "In doing so it would grant companies sufficient time to respond to voting recommendations and require that firms demonstrate their capabilities to provide fair and accurate recommendations."

The fact sheet notes that proxy firms would need to meet several requirements to qualify for SEC registration that would include:

- Sufficient staffing to provide voting recommendations based on current and accurate information
- Establishment of procedures to permit companies an opportunity to provide meaningful comment on firm recommendations
- Policies and procedures to manage conflicts of interest
- Publicly available procedures and methodologies used in developing proxy recommendations and analyses
- Proxy advisory firms annually reporting to the SEC on the firm's recommendations, including the number of companies that are also consulting division clients

The legislation also would direct the SEC to withdraw two “no-action” letters issued by the SEC, which the fact sheet suggests “have led to overreliance on proxy advisory firm recommendations.”

The legislation appears to be widely supported by the business community, with the U.S. Chamber of Commerce and Business Roundtable sending letters of support to senators that recommend the bill moves forward in its current form. During the hearing, proponents of the legislation testified that lack of SEC oversight over these proxy advisory firms has allowed them to become too powerful. They took issue with the companies being hard-pressed to hire the consulting arm of a proxy advisory firm to assist with understanding the potential for a negative vote recommendation, stating their belief this is a clear conflict of interest. The testimony did not reflect how the proposed legislation itself would resolve these perceived conflicts through additional disclosures, although it appears that the proponents would be happy if proxy advisory firms simply curtailed their consulting business.

Opponents to the bill include the Council of Institutional Investors, the Consumer Federation of America, and many public sector pension fund managers. They argue that the legislation could impose additional costs for institutional investors passed on to them from proxy advisors required to beef up their internal compliance functions. They also noted that current law already provides recourse because proxy advisors can be sued by institutional investors for any errors leading to an unjustified voting recommendation. In addition, the opponents argued that the legislation would give companies too much control over the process by permitting them to delay vote recommendations, particularly as those may relate to executive pay-related issues.

Harvard Law School Forum on Corporate Governance and Financial Regulation

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The Conflicted Role of Proxy Advisors

Posted by Timothy M. Doyle, American Council for Capital Formation, on Tuesday, May 22, 2018

Editor's note: Timothy M. Doyle is Vice President of Policy and General Counsel at the American Council for Capital Formation (ACCF). This post is based on an ACCF publication by Mr. Doyle.

In an increasingly complicated investment and financial landscape, investors rely heavily on the services of data and analytics providers to support their investment-related decisions. Proxy voting is the process in which a vote is cast on behalf of a shareholder rather than that shareholder participating physically in a public shareholder meeting. The reliance on advisory services is readily apparent in the increased influence of proxy advisors like Institutional Shareholder Services ("ISS") and Glass, Lewis & Co. ("Glass Lewis"). Due to their increasing influence, these normally private and opaque proxy advisory firms have come under fire for issues such as conflicts of interest, undue influence, privacy concerns, and the investment value their recommendations provide.

Lest readers think this is an issue with limited impact or import, proxy advisors drive major policies at most publicly traded companies.[1] They provide analysis, recommendations, and consulting services to issuers and companies alike regarding how annual and special proxies should be voted. Recommendations are made on issues ranging from Board appointments to acquisitions to environmental and social issues.

Academics, trade associations, and other institutions educated on this topic have called for reform. As former Securities and Exchange Commission ("SEC") commissioner Daniel M. Gallagher remarked at a meeting of the Society of Corporate Secretaries & Governance Professionals in July of 2013:

> "I believe that the Commission should fundamentally review the role and regulation of proxy advisory firms and explore possible reforms, including, but not limited to, requiring them to follow a universal code of conduct, ensuring that their recommendations are designed to increase shareholder value, increasing the transparency of their methods, ensuring that conflicts of interest are dealt with appropriately, and increasing their overall accountability. I am not alone in raising these issues…what European policymakers and our own Congress have highlighted is that **changes need to be made so that proxy advisors are subject to oversight and accountability commensurate with their role."[2]**

[1] David Gelles, Lively Debate on the Influence of Proxy Advisory Firms, *The New York Times*.(Dec. 5, 2013), https://dealbook.nytimes.com/2013/12/05/lively-debate-on-the-influence-of-proxy-advisory-firms/

[2] Remarks at Society of Corporate Secretaries & Governance Professionals. U.S. Securities and Exchange Commission. (July 11, 2013), https://www.sec.gov/news/speech/spch071113dmghtm

In 2017, proposed legislation was brought to the floor aiming to bring a correction to the corporate governance and proxy advisor space: H.R. 4015—Corporate Governance Reform and Transparency Act of 2017 co-sponsored by Reps. Sean Duffy (R-WI) and Gregory Meeks (D-NY). The bill was proposed "to improve the quality of proxy advisory firms for the protection of investors and the U.S, economy, and in the public interest, by fostering accountability, transparency, responsiveness, and competition in the proxy advisory firm industry."[3]

Specifically, the bill would require proxy advisory firms like ISS and Glass Lewis to formally register with the SEC and comply with the applicable rules and regulations governing all financial institutions. Within their filings, proxy firms would be required to disclose their potential conflicts of interest and codes of ethics. They would also be required to make publicly available their methodologies for formulating proxy recommendations and analyses.

This legislation would require some of the same baseline standards regulators have for financial institutions and credit ratings agencies to proxy advisors. The House of Representatives passed the bill in December 2017, but is awaiting review in the Senate.[4]

The complete publication looks at the rationale for the proposed reform, first exploring the history of the proxy advisory firms—how they came to be, their evolving role in the investment ecosystem, and their conflicts of interest. The paper then evaluates the influence proxy advisor recommendations have on shareholder voting, as well as how a mechanism called robo-voting exacerbates that influence. The following section then evaluates their increasingly activist stances on social, political, and environmental issues, and how these are impacting companies.

Key Conclusions

Proxy advisors have immense influence over the way large institutions vote on corporate issues. This paper cites numerous academic studies that provide quantitative details on the impact of ISS and Glass Lewis recommendations on a company's proxy outcomes. Through an assessment of voting correlation data, this report also finds that institutions vote in-line with ISS and Glass Lewis recommendations the vast majority of the time—more than 80 percent of the time (on average) when the proxy advisors recommend in favor of a proposal, large institutional holders also vote in favor.

1. Proxy advisors have emerged as quasi-regulators with unchecked power. ISS and Glass Lewis have asserted themselves into a role of regulator, wielding the aforementioned influence to require disclosure across public companies, without any actual statutory requirements. A proxy advisory recommendation drawn from unaudited disclosure can in many cases create a new requirement for companies—one that has added cost and burden beyond existing securities disclosure.

2. While often characterized as "neutral" arbiters of good governance, these firms are very much for-profit enterprises. By design, proxy advisory firms are incentivized to align with the comments of those who pay them the most and to move targets and change policy to create a

[3] H.R.4015—Corporate Governance Reform and Transparency Act of 2017, United States Congress. (Dec. 2017), https://www.congress.gov/bill/115th-congress/house-bill/4015/text

[4] H.R.4015—Corporate Governance Reform and Transparency Act of 2017, United States Congress. (Dec. 2017), https://www.congress.gov/bill/115th-congress/house-bill/4015/tex

better market for their company-side consulting services. This problematic offering further complicates the role of proxy advisors and creates a problematic conflict of interest.

3. Shifting policy has costly impacts for companies. Consistent policy changes, which are influenced by a non-public annual comment process, move the goalposts for companies, creating burdensome and costly requirements not mandated by law—these burdens are amplified for small and mid-cap companies. While changes to ISS and Glass Lewis's policy recommendations may appear small at any given moment, taken in aggregate this constant evolution has significant ramifications for companies and often adds burden and cost.

4. Proxy advisors create particular challenges for smaller public companies. The quasi-regulatory authority creates a bias in favor of large-cap companies with the resources to comply or create a campaign to oppose. This, in turn. creates difficulty for small- and mid-cap companies.

5. Robo-voting in line with proxy advisor recommendations undermines fiduciary duty to investors. There are institutions, particularly in the quant and hedge fund space, that automatically and without evaluation rely on proxy firms' recommendations. In addition to potentially breaching fiduciary duty, this extends the power and impact of ISS and Glass Lewis policy recommendations and decreases the ability of companies to advocate for themselves or their businesses in the face of an adverse recommendation.

Ultimately, proxy advisory firms have become intricately woven into the investment landscape. These institutions have essentially become shadow regulators, with implications for the operations and disclosure requirements of companies. As increasing attention is brought by actual regulators and elected officials, it is worth examining the biases, conflicts, and activism of these powerful institutions.

The complete publication is available here.

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Corporate Governance Oversight and Proxy Advisory Firms

Posted by Ike Brannon and Jared Whitley, Capital Policy Analytics, on Monday, September 17, 2018

Editor's note: Ike Brannon is the President of Capital Policy Analytics (CPA) and a visiting Senior Fellow at the Cato Institute; and Jared Whitley is a senior communications consultant at CPA. This post is based on an article by Mr. Brannon and Mr. Whitley, recently published in *Regulation* magazine.

The Securities and Exchange Commission requires that investment management funds submit proxy votes for all companies in which they own shares. Because of the vast number of stocks held by the typical institutional investor, hedge fund, or mutual fund, most of these investors draw on the research of a proxy advisory firm, which provides them some guidance in their task and allows them to focus on managing their portfolio.

But while their clients want to maximize returns, the objectives of proxy advisory firms may not be completely aligned with theirs. The opacity with which these firms operate makes it difficult for investment management companies—and individual shareholders—to discern that alignment.

Proxies have become increasingly contentious in recent years as political activists have taken to leveraging shareholder proposals to pursue fashionable political goals in a variety of ways. Proxy advisors have themselves become more political in their support of some of these goals. Accordingly, these activities have been receiving closer scrutiny—especially from Congress, which is currently debating legislation to increase transparency at these proxy advisory firms. The SEC has also declared its concern with political activism in proxy voting and may pursue further action in this area.

These days, some investors perceive that the growing importance of proxy advisors to investment managers may be problematic, as the number of proxy votes multiplies. The worry many have is that political or social agendas that may be peripheral—or harmful—to long-run returns may be capturing undue priority, with potentially harmful ramifications for the interests of retail investors and other shareholders focused on value maximization. On such a basis, significant reform of the industry may be necessary.

Conflicts of Interest in Proxy Voting

Few individual investors are aware of the role that proxy advisors play in guiding the activities of institutional investors—or that they even exist, for that matter. But as the use of proposals for political advocacy accelerates, their role is growing in importance.

Ordinary-course management proxy items typically include the retention of existing board members, approval of new members, or the ratification of the CEO's pay package. However, companies are increasingly seeing proposals from shareholders that call on the company to take action on broader public policy proposals, both major and minor.

Proxy advisors are important because institutional investors—pensions, college endowments, and investment management companies—dominate shareholder voting. A recent analysis estimated that institutional investors control as much as 80% of the stock market. The SEC requires that institutional investors vote on corporate proxy matters, but permits them to use recommendations from third-party proxy advisory firms. These frequently call on the company to take additional actions on environmental and social causes. *The Economist* magazine reported that there were 459 shareholder proposals submitted by early April of this year, a high proportion of which concerned climate change, racial and gender diversity, pay, and political spending. Given the increasing frequency of shareholder proposals that are tangential to the core activities of the company, the recommendations of proxy advisors are becoming more important every year.

There is nothing inherently wrong with companies seeking guidance from a third-party source. The sheer number of proxy items makes it difficult for institutional investors to perform this activity themselves. However, three potential problems bedevil the proxy advisory industry.

The first is a lack of transparency on proxy firms' methods and accountability for their recommendations. Proxy advisory firms have become, in some respects, akin to a self-appointed regulatory body, capable of making demands on public companies but without any actual statutory authority.

The second problem is that many in the investment community view proxy advisory firms as neutral arbiters, akin to referees in a sporting event. But in fact, these firms are for-profit enterprises with the potential for conflicts of interest no different than any other professional service or consultant. Without robust oversight or copious disclosure, regular investors may not understand the costs they impose on their investments.

A third problem is a practice called "robo-voting." It is common for investment managers to simply and automatically heed the advice of a proxy advisory firm without giving the recommendations even a cursory review.

The Importance of Proxy Advisor Recommendations

No one could have predicted how powerful proxy advisor firms have become. For instance, earlier this year financial journalist Michelle Celarier wrote in *Institutional Investor* about the proxy advisor Institutional Shareholder Services (ISS):

That ISS has become the kingmaker in proxy contests between billionaire hedge fund activists and their multi-billion-dollar corporate prey is even more astonishing given that ISS itself is worth less than $1 billion and started out as a back-office support system, helping shareholders cast their ballots on what are typically mundane matters of corporate governance. Says one former ISS executive who now works at a hedge fund: "ISS sort of stumbled into this powerful role."

ISS's role now is so powerful the company and industry have drawn the attention of Congress. In May 2018, representatives from ISS and another advisory firm, Glass Lewis, sent letters to the Senate Banking Committee, which is considering legislation to address these longstanding concerns about their industry.[1] Both companies downplayed their influence and the weight their recommendations hold, arguing that it is incorrect to paint them as anything but neutral arbiters or "data aggregators"—rather than for-profit influencers with numerous potential conflicts of interest.

They emphasized that their task is to identify the priorities of their clients—with the client's assistance—in order to help them vote as they would if they had the time and resources to study the issue themselves. The crux of their argument is that if there's any deviation from investment companies maximizing shareholder returns, it's the fault of their clients. An industry trade group, the Council of Institutional Investors, explained it in a 2016 letter to the House Committee of Financial Services:

ISS and Glass Lewis tend to follow investors on governance policy, not lead them…. Their franchises are built on credibility with investors. As a result, advisors' views reflect those of many funds. Indeed, if there were a sharp divergence, we would expect to see advisors punished in the marketplace.

ISS claims that it plays only a marginal role in affecting the outcome of proxy votes, and that its recommendations only shift the vote by 6–10%. However, academic research suggests that the figure is more significant and may be as high as 25%. ISS also has its own corporate consulting arm, ICS Corporate Solutions, which is (somewhat opaquely) described on its website.

ISS leans heavily on its Registered Investment Advisor status to deflect criticism of its conflicts of interest, notes the Center on Executive Compensation. ISS argues that proxy advisory work constitutes "investment advice" under the Advisors Act, which would make the company a fiduciary and subsequently a "a disinterested fiduciary." This description diverges from Glass Lewis's view of itself in its letter to the Senate Banking Committee, which declares that it neither dispenses "investment advice" nor serves as a fiduciary.

The fact that ISS is registered as a fiduciary but Glass Lewis is not suggests a fundamentally different interpretation of their obligations and breeds confusion and uncertainty as to what the industry is and is not required to do. Given the SEC's ongoing efforts to ensure transparency in the markets and to protect the interests of retail investors through Regulation Best Interest and other requirements, it is possible that this difference of opinion may prove problematic.

Glass Lewis tries to distance itself from ISS, in part because (unlike ISS) it does not have a consulting arm. But Glass Lewis also fails to offer any substantive, transparent insight into its guidelines and methodologies.

While proxy advisory firms provide advice on standard proxies for well-managed companies, they have in the past regularly failed to identify major problems on the horizon for the firms they analyze. For instance, immediately prior to the recent Wells Fargo scandal involving the creation of fake customer accounts, which revealed a startling lack of management oversight, ISS recommended against removing any of the sitting board members even though most had been in place well beyond a time period normally considered prudent. Similarly, the company

[1] HR 4015, which has already passed the House of Representatives.

recommended a vote against a shareholder proposal to split the president and chairman of the board. ISS did subsequently recommend jettisoning incumbent board members, but not until well after the scandal came to light.

Efforts to push environmental, socially responsible, and good governance priorities via proxy battles are getting more traction these days. While the total number of votes pertinent to such issues have fallen slightly this year from 2017, the percentage scoring 50% approval doubled this year to 6%, and the percentage scoring 40% approval went from 12% last year to 19%.

Robo-Voting and its Implications

Institutional investors and large financial management companies have come to rely on the services of proxy advisors to help them decide how to vote on various shareholder resolutions. However, there is a moral hazard endemic in that decision-making process.

Certain investors—generally the largest ones—have sufficient personnel and resources to review the analysis and recommendations of their proxy advisors. But for most investment companies it is easier to simply concur without further review if both major proxy advisors make the same recommendation, a process referred to as “robo-voting.” The result is an overreliance on the recommendations of potentially understaffed and underqualified proxy advisor analysts.

Robo-voting is most common among smaller investors that lack the capacity or appetite to review individual reports and recommendations. Some of these investors have an arrangement with Glass Lewis and ISS that effectively dictates that they will automatically follow the recommendations provided, and that any deviation requires that a case be made to the internal investment committee. The extent to which these firms are effectively signing over their proxy recommendations has led some to question whether this might constitute a breach of fiduciary duty.

Given the number of clients they have (ISS claims over 1,900 institutional clients and Glass Lewis approximately 1,300) and the fact that many appear to have such arrangements in place, the two firms have significant influence on final voting outcomes. For example, institutions vote as directed by ISS and Glass Lewis more than 80% of the time, according to a study by the American Council for Capital Formation.

The Transparency Solution

The moral hazard that exists in the relationship between proxy advisors and investment management firms is the result of a government regulation mandating that they vote their proxies. That effectively coerces them into an over-reliance on firms whose influence exceeds their size, resources, and statutory authority.

Rep. Sean Duffy (R-WI) and Rep. Gregory Meeks (D-NY) introduced bipartisan legislation that would address many of these issues. The intent of HR 4015 is to enhance transparency in shareholder proxy systems, requiring proxy advisory firms to register with the SEC. Firms would also have to disclose potential conflicts of interest, codes of ethics, and methodologies for formulating recommendations and analyses. The House passed the bill in December 2017, but

the Senate Banking Committee has not yet considered it, although it held a hearing on the issue in June.

In testimony at that hearing, Thomas Quaadman, executive vice president for the Chamber of Commerce Center for Capital Markets Competitiveness, described ISS and Glass Lewis as “the de facto standard setters for corporate governance in the United States.” Given that position, he suggests that both operate with conflicts of interest and a lack of transparency. He further alleges that each has made significant errors when developing vote recommendations. He also suggests that because Glass Lewis is owned by two somewhat politically active institutions—the Ontario Teachers’ Pension Plan and the Alberta Investment Management Corporation—it creates an inherent conflict of interest. Quaadman pointed out that the company may be able to exploit its influence to advance a broader agenda at the expense of investors.

At the same hearing, Darla Stuckey, president and CEO of the Society for Corporate Governance, also refuted the notion that ISS and Glass Lewis have no influence on how clients vote. She described how these firms “own and control the software platforms that send investor votes to the tabulator for a shareholder meeting.”

The issue is entirely created by the requirement that financial managers vote their proxies. Given that in the past most have been manifestly uninterested in doing so and have found the most expedient answer to this requirement to be outsourcing it as much as possible, it is worth asking whether the requirement makes sense in this day and age. Removing the requirement would likely give individual investors more weight in any proxy vote, which we suggest would be superior to the status quo. Allowing investment managers to vote proxies when and where they choose might make them more engaged in these issues than they currently are.

The Costs of Activism Is Borne by Investors

There is recent precedent for government intervention when a perception develops that investors are being given short shrift. In 2015, the Obama Administration called for more stringent rules overseeing investment managers. The administration pointed out that even a small reduction in the long-run return on an investor’s portfolio resulting from higher management fees can result in a large reduction in the value of a portfolio over a sustained period of time. This reality, according to the administration, necessitated closer government scrutiny of the actions of these advisors.

This is particularly relevant given the conflicts of interest apparent in the situation. Regarding proxy firms’ professed neutrality; for instance, the Manhattan Institute’s James Copland noted:

ISS receives a substantial amount of income from labor-union pension funds and socially responsible investing funds, which gives the company an incentive to favor proposals that are backed by these clients. As a result, the behaviors of proxy advisors deviate from concern over share value, [suggesting] that this process may be oriented toward influencing corporate behavior in a manner that generates private returns to a subset of investors while harming the average diversified investor.

The actions of proxy advisors may be imposing a similar cost on investors, we submit. Given their conflicts of interest, shoddy guidance, and lack of certainty, they deserve the same scrutiny as fiduciaries, if not more.

Financial Regulation: Getting It Right

The federal government has painfully learned over the last two decades that effectively regulating corporate governance in financial markets is easier said than done. The pattern of legislative and regulatory action in this realm is best described as a punctuated equilibrium, with most activity taking place in direct response to a perceived change in the market environment.

The 2001 financial collapse of Enron brought the problem of shoddy corporate governance to the attention of Congress. By using accounting loopholes, special purpose entities, and myriad other tricks obscured by deficient financial reporting, the company's executives hid billions in debt and failed deals. It became the largest corporate bankruptcy in U.S. history. Reacting to this debacle, Congress passed the Sarbanes-Oxley Act in an attempt to prevent similar calamities in the future. While the legislation compelled companies to provide substantially more information to investors, it also increased compliance costs, which in turn reduced the number of Initial Public Offerings on American stock exchanges. That reduction still exists today.

In the aftermath of the 2008–2009 financial market crisis, Congress passed Dodd-Frank, a measure intended to prevent a similar disaster from occurring again. Dodd-Frank certainly has some merits: the increase in capital requirements and stricter regulatory oversight likely diminishes the odds of another major financial crash or at least blunts the damage such a crash could inflict. But the legislation has major downsides as well: by increasing compliance costs for banks, Dodd-Frank has contributed to a marked reduction in banks across the country, with over 1,000 having been acquired or otherwise disappeared since the act's passage. (See "Banking," p. XX.) That outcome, many believe, effectively made access to capital more difficult for smaller firms operating in smaller cities and rural communities where community banks tend to dominate the financial market landscape. Because of this, the law may have contributed to the growing economic gap between rural America and the prosperous cities along the coasts.

Again, retail investors were the victims of legislation intended to help them.

Addressing deficiencies in domestic financial markets in a way that mitigates the long-term economic effect on retail investors requires a measured, focused approach. Too little regulation can leave people out in the cold, while too much could exacerbate inequality, reduce economic growth, and make U.S. capital markets less competitive. The lessons that Congress and regulators have taken from 21st century financial incidents—act sooner rather than later, and do so judiciously but decisively—may apply to the current status of proxy advisors as well.

The potential conflicts of interest, factually inaccurate guidance, and lack of transparency that can arise from a reliance on proxy advisory firms tend to dilute the focus on stock price performance and maximizing returns in favor of other special interests. This ultimately hurts investors. Ending the requirement that investment funds vote their proxies would reduce the potential cost of this moral hazard problem.

The complete article is available for download here.

Readings

"Bank Consolidation and Merger Acquisition Following the Crisis," by Michal Kowalik, Charles S. Morris, and Kristen Regehr. *Economic Review* (Federal Reserve Bank of Kansas City) 2015(Q1): 31–49 (Summer 2015).

"Politicized Proxy Advisers vs. Individual Investors," by James Copland. *Wall Street Journal*, Oct. 7, 2012.

"Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings," by Joseph Piotroski and Suraj Srinivasan. *Journal of Accounting Research* 46(2): 383–425 (May 2008).

"The Conflicted Role of Proxy Advisors," by Timothy Doyle. *American Council for Capital Formation*, May 2018.

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ISS Senate Hearing Statement

Posted by Gary Retelny, Institutional Shareholder Services, Inc., on Thursday, July 12, 2018

Editor's note: Gary Retelny is President and CEO of Institutional Shareholder Services, Inc. This post is based on an ISS statement addressed to the Chairman and a Ranking Member of the U.S. Senate Committee on Banking, Housing and Urban Affairs.

July 6, 2018

The Honorable Michael Crapo
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown:

Thank you for holding the hearing on June 28, 2018 on "Legislative Proposals to Examine Corporate Governance." Institutional Shareholder Services Inc. (ISS) thanks the Committee for its commitment to ensuring that corporate governance in the United States is robust and works to support our nation's capital markets and economy. To this end, ISS respectfully submits this statement, as well as the enclosed document, for inclusion in the hearing record in order to help clarify misconceptions and to correct misinformation about ISS and the proxy advisory industry that were raised during last week's hearing.

FACT: ISS is a Registered Investment Adviser (RIA) and is subject to strict SEC oversight

Contrary to the suggestions oft made in the hearing, ISS is a Registered Investment Adviser ("RIA") and is therefore subject to the Investment Advisers Act of 1940 ("Advisers Act") and the rules and regulations that the U.S. Securities and Exchange Commission ("SEC") has promulgated thereunder. The Advisers Act and related SEC rules provide a mature and comprehensive regulatory regime that covers virtually every aspect of our business and that subjects ISS to the SEC's continuing oversight and examination authority.

As an RIA, ISS is required to implement and maintain a comprehensive compliance program, including a mandatory requirement for a Code of Ethics, which is publicly available on our

website.[1] The RIA regime also dictates that we provide clients with transparency about our internal operations, including how potential conflicts of interest are addressed. Indeed, ISS is already subject to and complying with rigorous federal legal requirements.

FACT: Proxy advisory firms, including ISS, have a fiduciary obligation to their clients

As an RIA, ISS has a fiduciary obligation to our investor clients, which means ISS and our employees must carry out our duties solely in the best interest of clients and free from any compromising influences and loyalties.

Further, we note that in 2010, the SEC confirmed that proxy advice is a form of investment advice subject to the Advisers Act and the rules and regulations thereunder.[2] The SEC restated this view just last month in a proposed interpretive release on investment adviser standards of conduct.[3]

FACT: Proxy advisory firms *do not* set or regulate corporate governance disclosure standards, *do not* set shareholder meeting agendas, *do not* put forward shareholder proposals, and *do not* advocate for shareholder proponents, and *do not* vote proxies.

ISS' *only* job is to analyze proxy statements and provide informed research and vote recommendations based on the policies and guidelines that our institutional investor clients have selected, and in many cases developed, themselves. We are an independent provider of data, analytics and voting recommendations to support our clients in their own decision-making. Indeed, it is proxy advisory firms' clients who control both their voting policies and their vote decisions.

Federal statutes and state law dictate most of the items that appear on proxy statements to be voted upon by shareholders. The remaining agenda items, including the selection of nominees for election to the Board, are overwhelmingly put forward by corporate management, or sometimes by a company's shareholders.

Further, as a disinterested fiduciary, ISS has no financial stake in the outcome of a particular vote. ISS does not choose the ballots or agenda items on which we render advice. Rather, at a client's direction, we are asked by our clients to analyze and provide a voting recommendation for each agenda item related to every equity security held in our clients' portfolios. In fact, we are agnostic as to whether clients support a proposal, reject the proposal or abstain from voting altogether. Indeed, ISS will recommend contradictory votes on the same issue if individual clients' policies conflict. We are similarly indifferent as to whether clients choose to follow an ISS vote recommendation or not.

[1] Available at: https://www.issgovernance.com/file/duediligence/iss-regulatory-code-and-exhibits-june-2017.pdf

[2] Concept Release on the U.S. Proxy System, IA Release No. 3052 (July 14, 2010) ("Proxy Concept Release") at 110.

[3] Proposed SEC Interpretation Regarding Standard of Conduct for Investment Advisers, IA Release No. 4889 (April 18, 2018) ("IA Interpretive Release")

FACT: ISS' report error rate is minor, and what's often classified by the issuer as an error is in fact a fundamental disagreement in corporate governance philosophy.

ISS is committed to ensuring the accuracy and quality of our reports. As an RIA and a fiduciary, we have adopted a number of policies and procedures designed to ensure the integrity of our data collection and research process, upon which our reports are founded. We have robust systems and controls designed to ensure that research reports and vote recommendations include high-quality, relevant information; are accurate; are correctly based on policies selected or developed by the client; and are reviewed by appropriate personnel prior to publication. ISS commissions regular SSAE 16 audits, conducted by a third-party auditor, to ensure compliance with our internal control processes, including our research process.

ISS' research team does, infrequently, identify or receive notice of material factual errors in research reports that have already been published to our clients. ISS tracks such occurrences, which are rare. In 2017, for example, ISS covered over 6,400 meetings in the United States and the error rate was approximately 0.76% as measured by post-publication "Proxy Alerts" to clients notifying them of a material error within our benchmark proxy research that resulted in a change of a vote recommendation.

It is therefore particularly disconcerting that during the hearing Mr. Tom Quaadman, Executive Vice President at the U.S. Chamber Center of Capital Markets Competitiveness, mischaracterized our engagement with Abbott Laboratories ("Abbott"). In fact, it is false that ISS "refused to meet with Abbott Labs or… correct the report." We are enclosing with this submission a letter which ISS sent to Abbott in response to their filing. As the letter explains, after sharing a draft report with Abbott, receiving Abbott's written comments and prior to publishing our final report, ISS, in fact, modified its report and corrected two minor factual inaccuracies: the date Abbott entered into an agreement to acquire Alere and the start year of Abbott's audit firm.

Further, even before Abbott published its proxy statement, ISS considered arguments made by Abbott that ISS should change its selection of "comparable corporations" (or peers) for purposes of evaluating Abbott's executive compensation program. After consideration of the merits of Abbott's comments and consistent with ISS' policy approach, ISS subsequently removed an ISS selected peer to instead include a company suggested by Abbott. This resulted in even greater overlap – 12 out of 16 corporations – between the final peer group used by ISS and Abbott's self-selected peers. In presenting the information to our clients in our report and consistent with our normal approach, we outlined in *side-by-side* fashion the peers selected by Abbott Labs and the ISS-selected peers.

Following this engagement, Abbott requested a meeting, a request which ISS acknowledged and to which it responded. Consistent with our stated engagement policies, and considering the proxy season had already begun, ISS responded the same day to let Abbott know that the company's comments were being reviewed, that we would reach out to Abbott if we had any questions, and asked Abbott to let us know if it had any additional comments. Our records show no other requests for engagement were received from Abbott in 2018 prior to the delivery of the draft ISS Report to Abbott for factual review.

This process and the change made based on Abbott's feedback clearly demonstrate the extent to which ISS does engage with, and take into account, the input of the companies that it covers. While differences in approach and opinion may still exist, that is a far cry from the suggestion that the underlying analysis or vote recommendation results from a mistake or error.

Finally, we reiterate the findings of a 2007 GAO Report, which concluded that our clients trust us to provide "reliable, efficient services."[4] The GAO's follow-up report in 2016 addressed this further, stating "Both corporate issuers and institutional investors [the GAO] interviewed said that the data errors they found in the proxy reports were mostly minor…"[5]

FACT: Proxy advisory firms do not "control" shareholder votes.

Proxy advisory firms' clients control both their voting policies and their vote decisions. As noted by the Council of Institutional Investors (CII), a leading nonpartisan and nonprofit association of public, corporate and union employee benefit funds and state and local entities with combined assets exceeding $3.5 trillion: "Proxy advisory firm influence is exaggerated by analyses that confuse correlation with causation. ISS and Glass Lewis tend to follow investors on governance policy, not lead them….Their franchises are built on credibility with investors. As a result, advisors' views reflect those of many funds."[6] Indeed, as Ms. Darla Stuckey, President and CEO of the Society for Corporate Governance, acknowledged during the hearing, "proxy advisory firms…serve institutional investors."

We note that this is consistent with the results of a 2012 survey of asset managers by Tapestry Networks that found proxy advisory firms' "role as data aggregators" has become increasingly important to asset managers, and that even if smaller managers are more reliant on such advisory firms, they still acknowledge that responsibility for voting outcomes lies with investors.[7]

We also point you to the myriad of opposition letters to H.R.4015, "The Corporate Governance Reform and Transparency Act," in which institutional investors, pension funds, state retirement systems, as well as state treasurers and comptrollers reiterate their opposition to the assertion that they are uninformed buy-side investors who outsource their investment and proxy voting decisions.

FACT: ISS discloses all perceived and real conflicts of interest, and transparently complies with relevant SEC requirements. ISS is not aware of any instance in which a proxy research report or a vote recommendation was compromised by a conflict of interest.

As an RIA, ISS takes its fiduciary duty of loyalty very seriously. We place primary importance on conducting our business in a transparent and responsible manner, and have developed a

[4] Jones, Y. D. (2007). *Issues Relating to Firms that Advise Institutional Investors on Proxy Voting.* (GAO-07-765). Washington, DC: Government Accountability Office (hereafter, "2007 GAO Report"), note 1 at 13.

[5] Clements, M. (2016). *Proxy Advisory Firms' Role in Voting and Corporate Governance Practices.* (GAO-17-47). Washington, DC: Government Accountability Office at 29.

[6] June 13, 2016 letter from the Council of Institutional Investors to Rep. Hensarling, Chair of House Committee on Financial Services.

[7] Bew, Robyn and Fields, Richard, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers (June 2012) at 2. Available at SSRN: http://ssrn.com/abstract=2084231. ("Across the board, participants in our research said they value proxy firms' ability to collect, organize, and present vast amounts of data, and they believe smaller asset managers are more reliant on those services. Nonetheless, participants emphasized that responsibility for voting outcomes lies with investors").

comprehensive program to manage potential conflicts of interest as required by the Advisers Act and related SEC rules. Moreover, ISS has adopted a significant relationship disclosure policy and took robust steps to enhance transparency following the promulgation of SLB 20.

As required by the Advisers Act's compliance program rule,[8] ISS has implemented, maintains and periodically updates a program designed to eliminate, or manage and disclose, conflicts of interest. This program includes appointing a chief compliance officer, establishing comprehensive compliance policies and procedures, and testing the adequacy of those policies and procedures and the effectiveness of their implementation on an ongoing basis, ISS has also adopted, as mentioned earlier, a comprehensive Code of Ethics as the Advisers Act regulatory regime also requires.[9]

Separate and apart from our compliance protocols, ISS addresses conflicts, in part, by being a transparent, policy-based organization, with research and voting recommendations based on publicly-disclosed information available to all shareholders. Contrary to Mr. Quaadman's claim, ISS provides our clients (and other stakeholders) with an extensive array of information to ensure that they are fully informed of our policies to manage conflicts of interests, and of any potential conflicts and the steps ISS has taken to address them. Among other things, ISS supplies a comprehensive due diligence compliance package, publicly available on our website, so that our clients (and other stakeholders) can confidently and fully assess the reliability and objectivity of our voting recommendations.

One measure that ISS has historically taken to ensure transparency is the disclosure of instances where a relationship between ISS and a party exists that may present a conflict of interest. This includes potential conflicts with ISS Corporate Solutions, Inc. ("ICS"), which is the subsidiary of ISS that provides governance tools and services to corporate issuer clients. ISS' standard institutional client contract contains specific disclosure regarding the work of ICS, ensuring our clients have full visibility into any significant relationships that may exist between ISS and the subjects of our proxy research reports.

ISS' institutional clients can readily identify any potential conflict of interest through ISS' primary client delivery platform, ProxyExchange (PX), which provides information about the identity of ICS clients, as well as the types of services provided to those issuers and the revenue received from them. Similarly, each proxy analysis and research report issued by ISS contains a legend indicating that the subject of the analysis or report may be a client of ICS. This legend also advises institutional clients about the way in which they can receive additional, specific details about any issuer's use of products and services from ICS, which can be as simple as emailing our Legal/Compliance department via disclosure@issgovernance.com.

One of the most important components of the ISS compliance program is the firewall maintained between the core institutional business and the ICS business. This firewall includes the physical and functional separation between ICS and ISS, with a particular focus on the separation of ICS from the ISS Global Research team. A key goal of the firewall is to keep the ISS Global Research team from learning even the identity of ICS' clients, thereby ensuring the objectivity and

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[8] *See* Advisers Act Rule 206(4)-7

[9] *See*. Advisers Act Rule 204A-1.

independence of ISS' research process and vote recommendations. The firewall mitigates potential conflicts via several layers of separation:

- ICS is a separate legal entity from ISS.
- ICS is physically separated from ISS, and its day-to-day operations are separately managed.
- The ISS Global Research team works independently from ICS.
- ICS and ISS staff are forbidden to discuss the identity of ICS clients.
- ISS' institutional analysts' salaries, bonuses and other forms of compensation are not linked to any specific ICS activity or sale.

Yet another element of the conflict mitigation procedures is the "blackout period," pursuant to which ICS staff may only have limited interactions with issuers or their representatives when a "live" voting issue is pending for review by ISS. The "blackout period" runs from immediately after definitive proxy materials are filed with the appropriate regulatory body through the date of the issuer's shareholders' meeting. During this period, interactions between ICS and its corporate clients are limited. During the blackout period, ICS is precluded from providing advisory services to, or otherwise interacting with, issuers with respect to matters that are "live" or pending on the issuer's proxy statement. In addition, during the blackout period, ICS does not engage in marketing or selling efforts to issuers (whether they are existing ICS clients or prospects).

Moreover, ICS explicitly tells its corporate clients, and also indicates in their contracts that ISS will not give preferential treatment to, and is under no obligation to support, any proxy proposal of an ICS client. Contrary to Ms. Stuckey's statement, neither ISS nor ICS "help you to draft your proxy if you're an issuer." ICS further informs its clients that ISS' Global Research team prepares its analyses and vote recommendations independently of, and with no involvement from, ICS.

Finally, ISS is not aware of any instance in which a proxy research report or a vote recommendation was compromised by a conflict of interest, nor any instance where a regulatory body has reached that conclusion. We are heartened by the fact that the most vocal critics of ISS on this point are those who speak on behalf of corporate management, and not the investors who rely on ISS' research and vote recommendations. We see this as a strong indication that we are managing this potential conflict extremely well.

Furthermore, provisions of HR4015 would be in fact undermine the firewall between these two firms.

FACT: Proxy advisory industry is competitive and there are no artificial barriers to entry

There are no artificial barriers to entry into the proxy advisory industry in the United States. We operate in a competitive market and, as Mr. Quaadman himself stated during the hearing, we have seen entrants come and go within the industry. Moreover, institutional investors are not required to purchase our services. In the free market, institutional investors purchase our services because they choose to do so, and find value in the products we provide.

ISS is indeed an industry leader and has earned its market share by virtue of the quality of its work and the level of service it has provided for more than a quarter century. The GAO report entitled "Issues Relating to Firms that Advise Institutional Investors on Proxy Voting" concluded as much when it wrote that ISS has "gained a reputation with institutional investors for providing reliable, comprehensive proxy research and recommendations."[10] While we have seen the widely circulated conjecture that two firms "control" 97% of the proxy advisory industry, this is not a statistic we have verified or can confirm.

Ultimately, as noted at the hearing by Harvard Law Professor John Coates, no one is required by law or regulation to consult a proxy advisor. Similarly, there is no requirement to follow our vote recommendations. The ultimate voting decision for each resolution at a company meeting remains the responsibility of our clients, the owners of the corporation, as we believe it should. Our clients are sophisticated institutional investors who owe a fiduciary duty to their plan beneficiaries.

With regard to H.R.4015 and any similar legislation, we agree with many of the concerns about the negative impacts of this legislation that were raised during the hearing. We believe the litmus test for any federal intrusion into the free market is whether it targets a proven problem and seeks to address it cost-effectively. The proposed bill does not pass either test. Further, we have not heard from any institutional investor who supports H.R.4015 or the underlying arguments upon which the legislation is founded.

The investors who use proxy advisory services do not see the "problem" the proposed legislation purports to address. In fact, as Mr. Silvers stated, institutional investors are concerned that the legislation, as written, seeks to "impose a new regulatory scheme designed to make [proxy advisory firms] disloyal to their clients" and would "essentially defeat the corporate governance system."

In conclusion, ISS appreciates this opportunity to set the record straight and underscore the rigorous regulatory system and internal compliance program under which we operate. If there is any additional information I can provide or if you have any follow-up questions, please do not hesitate to contact me.

Sincerely,

Gary Retelny, President and Chief Executive Officer

CC: Members, Committee on Banking, Housing and Urban Affairs, U.S. Senate

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[10] Jones, Y. D. (2007). *Issues Relating to Firms that Advise Institutional Investors on Proxy Voting.* (GAO-07-765). Washington, DC: Government Accountability Office (hereafter, "2007 GAO Report") at 13.

Regulating Proxy Advisors is Anticompetitive, Counterproductive, and Possibly Unconstitutional

Posted by Nell Minow, ValueEdge Advisors, on Friday, March 2, 2018

Editor's note: Nell Minow is Vice Chair of ValueEdge Advisors. This post is based on recent publication authored by Ms. Minow.

A party line vote in the House of Representatives approved H.R. 4015,[1] titled, with typical Capitol Hill oxymoronic newspeak the "Corporate Governance Reform and Transparency Act of 2017." said in a statement that while proxy-advisory firms play an important role in advising clients. This bill is not just stupid and completely contrary to its stated purpose of promoting competition; it is probably unconstitutional.

The proxy advisory firms, led by ISS (which I helped to found in 1986 as its first general counsel, ran for one year and then left in 1990) and Glass-Lewis, analyze public company proxy issues like executive compensation and board effectiveness and make recommendations to their clients, large institutional investors like mutual funds and pension funds, suggesting votes for or against the proposals on the proxy card from corporate management and sometimes from other investors. I have observed this industry from the beginning, but left it 28 years ago. Since then, I have been a proponent and dissident who has failed to gain the support of the ISS analysts more often than I have been successful, and I have had the opportunity to develop some objectivity.

No one is required to use their services and many institutional investors do not. No one is required to vote according to their recommendations and the data show that the more complex and controversial the issue, like contested business combinations, the less likely the clients will follow their recommendations, though they do read and appreciate the underlying analysis.

So, what we have is the most sophisticated institutional investors in the world, with access to the greatest resources for researching portfolio companies ever assembled, making a free market decision to pay for outside, objective analysis, no different from other securities analysis reports they may purchase, to help them better understand their holdings and better meet their obligation as fiduciaries for the people whose money they are investing to respond to corporate initiatives appropriately. There is no monopoly and no requirement to buy these services; they can buy from one, all, or none. There could not be a better example of market efficiency or a worse argument for government interference. And yet, here we are.

Rep. Sean Duffy, R-Wis., sponsor of the bill, says it is necessary because the proxy firms are "susceptible to conflicts of interest."[2] Financial Services Committee Chairman Jeb Hensarling, R-

[1] https://www.congress.gov/bill/115th-congress/house-bill/4015/committees.
[2] Pensions & Investments, December 21, 2017 "House moves to regulate proxy-advisory firms," http://www.pionline.com/article/20171221/ONLINE/171229979/house-moves-to-regulate-proxy-advisory-firms

Texas, said in the same statement that his panel discovered "numerous instances whereby the two largest proxy-advisory firms (Institutional Shareholder Services and Glass Lewis) have issued vote recommendations to shareholders that include errors, misstatements of fact and incomplete analysis."

Assuming arguendo that both statements are true, that is still no basis for government intervention, especially from conservatives who are supposed to be ultra-sensitive to intrusive action by government that restricts or impedes the free market. It should be left to the consumers to decide whether the product is not reliable, though carelessness or conflicts.

The bill requires proxy firms to register with the Securities and Exchange Commission, disclose potential conflicts of interest and codes of ethics, and make public their methodologies for formulating proxy recommendations and analyses. Again, this should be left to the market, and certainly the government has no right to tell a business that it has to disclose its proprietary methodologies. The bill would also require the proxy advisory firms to submit their analyses to the companies before sending them to clients and, if the company objects to the analysis, to include its rebuttal in the report.

ISS developed the proxy advisory business because as we were trying to sell another product entirely institutional investors kept telling us that what they wanted was an independent assessment of management and shareholder proposals. At the time, many of them subscribed to the IRRC reports, which analyzed proposals but did not give recommendations. They wanted advice that was knowledgeable and objective, and so that was the product we developed.

When I left ISS in 1990, both our employees and our clients were in the low two digits. The fact that it became such a powerful international presence in the two decades that followed demonstrates just how badly its customers wanted those products. The fact that other substantial competitors have entered the market shows that there are very low barriers to entry. The firms often disagree with each other. They are transparent and highly competitive about their different approaches, and each does not hesitate in sales calls to explain in detail why their product is superior. Most clients choose the firm that best suits their own policies the rest prefer to do business with more than one and compare the recommendations to assist them in arriving at their own decision. This is exactly what markets do best and there is no reason to interfere.

Corporate executives claim that these firms are too influential, a strange objection to make when they support management recommendations in the overwhelming majority of cases. In the small fraction where they recommend against management recommendations, it is important not to confuse correlation with causation. Clients follow because they agree that in those instances the executives are proposing matters that are not in the shareholders' interest.

There is no evidence that sophisticated institutional investors are abdicating their obligation as professionals and fiduciaries to consider these issues as carefully as they do their buy-sell-hold decisions, also based in part on the opinions of independent analysts. Just as two investors can look at the same data and make different conclusions about whether to buy, sell, or hold, they can look at a proxy advisory recommendation and make a different decision about whether to vote yes, no, or abstain.

Corporate executives and Republican Congressional representatives seem stung to discover that investors may not believe management is acting in their best interests and believe that the answer is not to change their behavior or improve their communication but to smother outside analysis of their proposals. If executives object to the recommendations made by the proxy advisory firms, the answer is for them to respond directly and substantively in their communications with their shareholders, not to cut off outside assessment.

The core founding principle of our democracy is freedom of expression. The recent Citizens United decision by the Supreme Court emphasized the importance of unfettered speech, justifying corporate participation in the political process explicitly through its accountability to investors because shareholder objections raised through the procedures of corporate democracy can be more effective today because modern technology makes disclosures rapid and informative (citation omitted). The core founding principle of our economy is to allow the market to determine the value of goods and services. Infringement of either free expression or the free market should only be done in the most extreme circumstances and no such justification is present here.

Most significantly, consideration of this bill included no assessment of any kind of its potential for unconstitutional infringement of First Amendment freedom of speech and of the press. The proxy advisory firms publish reports that include facts, data, analysis, and opinion along the lines of a newspaper or magazine. No one is required to buy their reports or follow their recommendations. The bill's requirement that these reports include rebuttals from the corporations they are analyzing would be allowing the government to direct the content of their publications, like requiring the New York Times to publish op-eds by the individuals in their news stories.

A pending Supreme Court case may cast some light on this issue. *National Institute of Family and Life Advocates v. Becerra* concerns a requirement imposed on "crisis pregnancy" (anti-abortion) clinics. The California Reproductive FACT Act provides that staff of these facilities must inform the women who consult them that state-funded prenatal care, family planning, and abortion services are available by calling the county health department. If the Court rules that this exceeds permissible disclosure requirements like ingredient and nutritional labels on food or financial disclosures and warnings in securities filings, it would be likely to apply to this substantive content as well.

SEC No-Action Letters on Investment Adviser Responsibilities in Voting Client Proxies and Use of Proxy Voting Firms

Posted by Steve Wolosky, Andrew Freedman, and Ron Berenblatt, Olshan Frome Wolosky LLP, on Tuesday, September 18, 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 memorandum by Mr. Wolosky, Mr. Freedman, and Mr. Berenblat.

As reported in our prior Client Alert, the Securities and Exchange Commission ("SEC") issued a statement in July announcing that it will host a roundtable regarding the U.S. proxy process. The roundtable, expected to be held in November, will give the SEC an opportunity to discuss with market participants various topics, including the hotly debated role of proxy voting firms. On September 13, 2018, the Division of Investment Management of the SEC (the "Staff") issued an Information Update stating that in developing the roundtable agenda, the Staff has been considering whether prior SEC guidance on the responsibilities of investment advisers with regard to voting client proxies and retaining proxy voting firms should be "modified, rescinded or supplemented." As part of this process, the Staff announced that it has revisited no-action letters it issued in 2004 to Egan-Jones Proxy Services ("*Egan-Jones*") and Institutional Shareholder Services ("*ISS*") that provided guidance regarding the reliance of investment advisers on the recommendations of proxy voting firms and determined to withdraw these letters effective immediately.

Background

Under Rule 206(4)-6 of the Investment Advisers Act of 1940 ("Rule 206(4)-6"), it is fraudulent and deceptive for investment advisers to exercise voting authority with respect to client securities unless, among other things, they adopt and implement written policies and procedures designed to ensure they vote the securities in the best interests of the clients, which procedures must include how the advisers address conflicts between them and their clients. In the adopting release for Rule 206(4)-6, the SEC stated that investment advisers have a fiduciary duty of care and loyalty to their clients with respect to proxy voting and emphasized that their policies and procedures must address how they resolve material conflicts of interest with clients before voting their proxies. The release goes on to state that an investment adviser could demonstrate that a vote of client securities was not a product of a conflict of interest if it voted, in accordance with a pre-determined policy, based upon the recommendations of an "independent" third party.

Egan-Jones and *ISS*

In *Egan-Jones*, the Staff provided guidance on the circumstances under which a third party, such as a proxy voting firm, may be considered "independent" under Rule 206(4)-6 and the steps an investment adviser should take to verify that the third party is in fact independent in order to cleanse the vote of any conflict. The Staff specifically addressed whether a proxy voting firm would be considered independent if it receives compensation from a company for providing advice on corporate governance issues. The Staff stated that "the mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser." However, the investment adviser must first ascertain whether the proxy voting firm has the "capacity and competency" to analyze proxy issues and can make recommendations in an impartial manner and in the best interests of the clients. In addition, the investment adviser should have procedures requiring the proxy voting firm to disclose "any relevant facts concerning the firm's relationship with an Issuer, such as the amount of the compensation that the firm has received or will receive from an Issuer."

In *ISS*, the Staff was specifically asked by Institutional Shareholder Services to agree with its view that an investment adviser may determine that a proxy voting firm can dispense voting recommendations in an impartial manner and in the best interests of the adviser's clients based on the procedures implemented by the firm to insulate the firm's voting recommendations from its relationships with companies rather than a review of the firm's relationship with individual companies on a case-by-case basis. The Staff agreed that

> "a case-by-case evaluation of a proxy voting firm's potential conflicts of interest is not the exclusive means by which an investment adviser may fulfill its fiduciary duty of care to its clients in connection with voting client proxies according to the firm's recommendations."

Without taking a position regarding Institutional Shareholder Services' specific conflicts policies and procedures, the Staff stated that the steps taken by an adviser to fulfill this fiduciary duty to clients may include a "thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation" and provided guidance on how investment advisers should examine and assess a proxy voting firm's conflict procedures.

Over the years, investment advisers have embraced a view that their reliance on the voting recommendations of proxy voting firms, in accordance with the guidance provided by the Staff in *Egan-Jones* and *ISS* and subsequently issued guidance, will insulate their client voting decisions from any conflicts of interest while allowing them to discharge their fiduciary duty of care and loyalty to their clients with respect to proxy voting.

Reactions and Implications

The withdrawal of the no-action letters has been reported by the media as a "win" for Republicans in Congress, the U.S. Chamber of Commerce and corporate lobbyists who believe proxy voting firms such as Institutional Shareholder Services and Glass Lewis have too much influence over corporate voting decisions, are not adequately held accountable for their recommendations and should be more heavily regulated.

However, it may be premature for critics of proxy voting firms to claim victory. SEC guidance issued in 2014 (Staff Legal Bulletin No. 20) regarding investment advisers' responsibilities in voting client proxies and retaining proxy voting firms is still in effect. In response to the announcement, Steven Friedman, General Counsel of Institutional Shareholder Services, stated that "Corporate lobbyists have created a mythology surrounding these letters" and that their withdrawal "does not change the law, does not change the manner in which institutional investors are able to use proxy advisory firms, nor does it change the approach that institutions need to take in performing diligence on their proxy advisory firms."

SEC Commissioner Robert Jackson was similarly critical of the announcement, stating that the questions suddenly raised by the Staff are "long-resolved" and that the laws governing the use of proxy voting firms have not changed. He also expressed concern that the SEC's efforts to address "proxy plumbing" issues "will be stymied by misguided and controversial efforts to regulate proxy advisors." According to Commissioner Jackson, "Regulating proxy advisors has long been a top priority for corporate lobbyists, who complain that advisors have too much power. There is, of course, little proof of that proposition, and the empirical work that's been done in the area makes clear that that claim is vastly overstated."

The impact the withdrawal of the no-action letters will have on shareholder activism is unclear. While large institutional investors are becoming less dependent on proxy voting firms, the influence wielded by the voting recommendations of these firms on the outcomes of contested elections is not insignificant. Investment advisers may now face uncertainty as to whether their continued reliance on these voting recommendations is contrary to their fiduciary duty of care and loyalty to their clients. A statement released by SEC Chairman Jay Clayton concurrently with the announcement that SEC staff guidance is non-binding and does not create enforceable legal rights or obligations may add to this uncertainty.

We will continue to monitor developments relating to the role of proxy voting firms and other "proxy plumbing" topics that will be reviewed during the SEC roundtable in November.

Glass Lewis Response To SEC Statement Regarding Staff Proxy Advisory Letters

Posted by Nichol Garzon, Glass, Lewis & Co., on Wednesday, September 19, 2018

Editor's note: Nichol Garzon is Senior Vice President and General Counsel at Glass, Lewis & Co. This post is based on a Glass Lewis memorandum by Ms. Garzon.

The proxy advisor no-action letters, issued in 2004 to Egan-Jones and ISS, described the duty of investment advisers to ensure their proxy advisor(s) have the capacity and competency to adequately analyze proxy issues. While the SEC withdrew these no-action letters yesterday, the law in this area has not changed. Indeed, it has always been the law that an investment adviser, as a fiduciary to its clients, is required to take steps to avoid having a conflict of interest influence its decisions on behalf of clients.

Investment advisers who vote proxies on behalf of their clients generally follow policies and procedures that address how to vote proxies when the adviser has a conflict, and they are required to disclose these policies to their clients, such as:

- The adviser may abstain from voting, and give the power to vote to the client;
- The adviser may follow a predetermined voting policy that dictates how the adviser shall vote on particular matters;
- The adviser may appoint an independent third party to cast the vote on its behalf; or
- The adviser may vote in accordance with the recommendation of an independent third party.

SEC Staff Legal No. 20 (June 30, 2014) provides the most current view of the SEC regarding investor and proxy advisor responsibilities related to proxy voting.

Glass Lewis provides robust disclosures and audit capabilities that enable our investment adviser clients to demonstrate compliance with SLB 20. A full description of relevant processes, procedures and disclosures is available in the Glass Lewis Statement of Compliance to the Best Practice Principles for Providers of Shareholder Voting Research & Analysis. The Best Practice Principles ("BPP") were developed and launched in advance of the 2015 proxy season by the world's leading proxy advisors, under the direction and with the support of the European Securities and Markets Authority. Glass Lewis applies the Best Practice Principles to its activities globally and provides an annual update on its compliance with the BPP.

As described in our June 1, 2018 response to a request for information from Sen. Dean Heller (Rep.), Chairman of the U.S. Senate Subcommittee on Securities, Insurance & Investment,

Senate Committee on Banking, Glass Lewis complies with the interpretation given by the SEC in SLB 20 with respect to what does and does not constitute a solicitation of proxies.

While Glass Lewis works with each client to implement the client's respective proxy voting policy on Glass Lewis' Viewpoint vote management platform, the formulation of the actual policy is at the sole discretion of the client. Glass Lewis does not have the discretion to deviate from a client's instructions or to determine a vote that is not consistent with the policy specified by the client.

Further, the SEC's guidance does not explicitly state or suggest that an investment adviser must manually vote all the proxies it receives, or that it must reiterate its voting policies after each proxy statement it receives. Such a requirement also would conflict with the SEC Staff's response to Question 1 in SLB 20.

In that question, the SEC was asked what steps an investment adviser could take to demonstrate that its proxies were being cast in accordance with the adviser's proxy voting policies and in the best interests of the adviser's clients. The SEC answered by suggesting that the adviser periodically review a sample of the proxies voted to see whether they complied with the adviser's policies. This supports the common practice among institutional investors of casting ballots in accordance with a predetermined client-specific voting policy. The pre-population of voting instructions on a ballot by Glass Lewis' Viewpoint platform is merely an administrative, ministerial task that strictly adheres to each client's specific voting instructions and involves no discretion on the part of Glass Lewis.

The Viewpoint platform alerts each Glass Lewis client when preliminary ballots are ready for review, and clients have all the disclosures and other information they need at their fingertips to review and evaluate the matters up for a vote. Clients can choose to restrict the submission of a ballot until after specified client personnel have reviewed and approved the votes. Clients can, and do, make changes to the preliminary ballot before signing off, and can even change their vote and resubmit it, assuming the voting deadline has not passed. Clients also have direct access to robust reporting and audit capabilities that allow them to audit Glass Lewis' compliance with their voting policies on a regular basis.

In addition, there is another exemption from the federal proxy rules that proxy advisory firms can rely on, and which was discussed in SLB 20.

Rule 14a-2(b)(3) of the Securities Exchange Act of 1934 contains an exemption that extends to the provision of proxy voting advice by any person to another person with whom it has a business relationship provided certain conditions are met. In order for the exemption to apply, the person giving the proxy voting advice must: (i) give financial advice in the ordinary course of business; (ii) disclose to the recipient of its advice any significant relationship with the issuer, its affiliates, or a security-holder proponent of the matter on which advice is given, as well as any material interest it may have in the matter to be voted on; (iii) not receive any special commission or remuneration for furnishing the advice from any person other than the recipient of the advice and others who receive similar advice; and (iv) not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

Glass Lewis meets all the above criteria and thereby relies on this exemption as well.

Specifically, as described in further detail in our annual BPP Statement of Compliance, Glass Lewis provides sufficient disclosure on the face of its Proxy Paper reports to enable its clients to: (i) understand the nature and scope of any potential conflict it may have with the issuer, its affiliates, or a security-holder proponent of a matter on which advice is given, as well as any material interest it may have in such matter; and (ii) make an assessment about the reliability or objectivity of the recommendation.

Glass Lewis strongly believes that investors and issuers are both better served by preserving the independence of proxy advisory firms through the avoidance of undue influences. As such, Glass Lewis does not provide consulting services to issuers. Glass Lewis is committed to ensuring that in its role as a proxy advisor, institutional investors can comply with the fiduciary duties they owe to their respective clients, and companies are entitled to a fair, reasonable and independent assessment.

Instead of providing consulting services to issuers, Glass Lewis maintains an online resource center designed specifically for the issuer community, whereby companies can (i) arrange a free engagement meeting with Glass Lewis outside of the solicitation period (which begins on the date the notice of meeting is released and ends on the date of the meeting); (ii) submit company filings or supplementary publicly-available information; (iii) suggest that a particular topic be discussed through a Proxy Talk, a recorded open forum intended to help company representatives, dissidents or shareholder proposal proponents engage with Glass Lewis' clients and provide detail on specific issues; (iv) request a free copy of the company's Issuer Data Report (IDR)—a fact-based report that includes the key data used by Glass Lewis to the company's research report, so as to allow the issuer to notify Glass Lewis of any issues prior to Glass Lewis completing and publishing its analysis to its investor clients; (v) notify Glass Lewis of a purported factual error or omission in a research report; and (vi) purchase a copy of its own research report upon publication to Glass Lewis' investor clients.

In addition, Glass Lewis has robust policies and procedures to help manage all other potential conflicts of interest that may arise in the course of its business, including from its ownership structure, business partnerships, clients, employees and outside advisor relationships. In situations where a conflict is unavoidable, Glass Lewis provides specific, prominent disclosure of the potential conflict on the cover of the relevant research report, and a description of the exact nature of the conflict in the appendix of such report (http://www.glasslewis.com/conflict-of-interest/).

Glass Lewis intends to continue to fully engage with the SEC and other market participants on the role of proxy advisory firms in the industry, which includes participating in the upcoming Roundtable on the Proxy Process announced by SEC Chairman Jay Clayton earlier this year.

U.S. Senator Elizabeth Warren,
EHF18429: The Accountable Capitalism Act

The Senate of the United States, [excerpt, p.7–9]
Aug. 15, 2018

1 (1) IN GENERAL.—An entity that is organized
2 as a corporation, body corporate, body politic, joint
3 stock company, or limited liability company in a
4 State shall obtain a charter from the Office as fol-
5 lows:
6 (A) If the entity is a large entity with re-
7 spect to the most recently completed taxable
8 year of the entity before the date of enactment
9 of this Act, the entity shall obtain the charter
10 not later than 2 years after the date of enact-
11 ment of this Act.
12 (B) If the entity is a large entity with re-
13 spect to any taxable year of the entity that be-
14 gins after the date of enactment of this Act, the
15 entity shall obtain the charter not later than 1
16 year after the last day of that taxable year.
17 (2) FAILURE TO OBTAIN CHARTER.—An entity
18 to which paragraph (1) applies and that fails to ob-
19 tain a charter from the Office as required under
20 that paragraph shall not be treated as a corporation,
21 body corporate, body politic, joint-stock company, or
22 limited liability company, as applicable, for the pur-
23 poses of Federal law during the period beginning on
24 the date on which the entity is required to obtain a

1 charter under that paragraph and ending on the
2 date on which the entity obtains the charter.
3 (b) RESCISSIONS.—
4 (1) IN GENERAL.—An entity that has obtained
5 a charter as a United States corporation and, with
6 respect to a subsequent taxable year of the entity,
7 is not a large entity may file a petition with the Of-
8 fice to rescind the charter of the United States cor-
9 poration.
10 (2) DETERMINATION.—Not later than 180 days
11 after the date on which the Office receives a petition
12 that an entity files under paragraph (1), the Office
13 shall grant the petition if the Office determines that
14 the entity, with respect to the most recently com-
15 pleted taxable year of the entity preceding the date
16 on which the petition was filed, was not a large enti-
17 ty.
18 **SEC. 5. RESPONSIBILITIES OF UNITED STATES CORPORA-**
19 **TIONS.**
20 (a) DEFINITIONS.—In this section:
21 (1) GENERAL PUBLIC BENEFIT.—The term
22 "general public benefit" means a material positive
23 impact on society resulting from the business and
24 operations of a United States corporation, when
25 taken as a whole.

1 (2) SUBSIDIARY.—The term ''subsidiary''
2 means, with respect to a person, an entity in which
3 the person owns beneficially or of record not less
4 than 50 percent of the outstanding equity interests
5 of the entity, calculated as if all outstanding rights
6 to acquire equity interests in the entity had been ex-
7 ercised.
8 (b) CHARTER REQUIREMENTS.—
9 (1) IN GENERAL.—The charter of a large entity
10 that is filed with the Office shall state that the enti-
11 ty is a United States corporation.
12 (2) CORPORATE PURPOSES.—A United States
13 corporation shall have the purpose of creating a gen-
14 eral public benefit, which shall be—
15 (A) identified in the charter of the United
16 States corporation; and
17 (B) in addition to the purpose of the
18 United States corporation under the articles of
19 incorporation in the State in which the United
20 States corporation is incorporated, if applicable.
21 (c) STANDARD OF CONDUCT FOR DIRECTORS AND
22 OFFICERS.—
23 (1) CONSIDERATION OF INTERESTS.—In dis-
24 charging the duties of their respective positions, and
25 in considering the best interests of a United States

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Will Warren's Accountable Capitalism Act Help? The Answer is No.

Posted by Denise Kuprionis, The Governance Solutions Group, on Monday, September 10, 2018

Editor's note: Denise Kuprionis is President of The Governance Solutions Group (GSG). This post is based on a GSG memorandum by Ms. Kuprionis, originally published on The Conference Board's Governance Center blog.

U.S. Sen. Elizabeth Warren has proposed legislation that would require all companies with more than $1 billion in annual revenue to secure a charter from a newly established Office of United States Corporations. It's hard to think of a sillier idea. I don't disagree with her proposition that we "need to end the harmful corporate obsession with maximizing shareholder returns ***at all costs***." However, I believe federalization of all large corporations, which would likely morph into all corporations, will not accomplish this goal, will not improve corporate governance and will not make our country better for middle class Americans, her target group of beneficiaries.

Sen. Warren said in an August 15, 2018 *Mad Money* interview on CNBC with Jim Cramer that all stakeholders should be rewarded (when companies are successful), not just shareholders. Agreed. Successful companies treat employees, customers and vendors fairly and with respect. The boards of directors and management at these companies understand the value of listening, hearing and reacting to employee and community concerns. They also know the importance of sustainability and thinking long-term.

Each individual corporation determines for itself how it will best do its work and how it will spend its money. As governance experts often say, there is not one right governance structure. How will an Office of United States Corporations determine if a company is making the country better by working toward a "public good?" Just as individuals each have their own preferences for "doing good," so do companies. I might like using Uber to save on fuel and help cut down on traffic congestion and do less damage to our air quality. You might think that's hogwash but want to contribute to the NRA where I might not. That's the benefit of a free society. I determine where and how I divert resources. Corporations do the same in our free market.

In the same *Mad Money* interview, Sen. Warren said she believes in the market, but the market needs rules. Agreed. Every public company CEO I know will tell you that he or she operates within rules—NYSE listing rules, SEC rules, the tax code, EPA regulations, just to name a few. Even if it were true that companies at one time operated by only one rule—increase shareholder value—an array of events, including the Enron and WorldCom scandals, the 2008 financial crisis and the passage of the Sarbanes Oxley and Dodd-Frank acts, caused directors to reassess how they do their work. Perhaps we could do a better job of enforcing rules and promoting good governance practices, but we don't need more rules.

Yes, there is that occasional corporate scandal (albeit, sometimes it seems like there's a new one every other week), and some companies have done things wrong. However, most companies do most things right. Management and directors look at what's in the best interest of employees, customers, partners, and the communities where they do business.

Let's look a little more closely at what Sen. Warren's legislation would require.

Companies with more than $1 billion in annual revenue would be required to obtain a federal charter. The charter would obligate the company's directors to, when making any decision, consider the interests of a variety of stakeholders, not just stockholders.

This idea is not new. It's a form of governance based on the for-profit benefit corporation model, which 33 states already sanction. This model is voluntary and if chosen, companies adopt a mission that includes making a positive impact on society and the environment. When making decisions, these companies are required to consider the impact on all stakeholders, i.e. shareholders, employees, customers, suppliers, communities.

Further, the idea behind the idea is already in play. Corporations consider many different perspectives in decision making:

- Today there is increased focus on Environment, Social, and Governance (ESG), more specifically on the E&S matters. As evidence, read BlackRock CEO Larry Fink's 2018 letter to CEOs in which he highlights BlackRock's view that boards are central in the oversight of companies' long-term strategic direction and what he believes is a connection between companies' management of ESG risk factors and long-term value creation.
- The debate over whether companies should be required to report quarterly earnings or report every six months is ongoing with both camps agreeing that companies focused on the long-term out-perform short-term players.
- Boards of directors and CEOs understand longer-term sustainable growth requires an investment in people. Compensation committees are focused on talent development and succession planning, with many renaming the committee, "Compensation and Management Development."

Sen. Warren says her legislation "restores the idea that giant American corporations should look out for American interests." Just one question here, how does she define American interests? Does it mean companies hire more immigrants, or less? Does it mean we support marijuana legalization, or we don't?

Requiring corporations to secure a federal charter puts the federal government in charge of corporations—not investors, not the board, not management. Does anyone believe the government could effectively and efficiently run corporate America?

The new ACA (this time, instead of the Affordable Care Act, it's the Accountable Capitalism Act) will be successful only in creating board governance chaos. Instead of dealing with the occasional corporate scandal, American business will deal with more gridlock on the hill, and long, complex rules that will take companies lots of time and money to understand. This could turn into a reason for companies to choose not to be a U.S. company or to leave for somewhere else.

* * *

The federal government would be permitted to revoke a company's charter if it has engaged in repeated and egregious illegal conduct.

Today, state attorneys general are authorized to revoke a corporation's license or registration, so this seems to be covered.

In recent history, we've witnessed companies shut down because of illegal behaviors so revoking a charter hardly seems necessary.

Sen. Warren argues that for much of US history corporations succeeded in the marketplace and recognized their obligations to employees, customers and the community, and everyone was "happy." She then suggests that in the late 20th century this changed, and business became driven by a single rule, "maximize shareholder wealth." As described above, there is no need for the federalization of corporations because successful companies are indeed measuring shareholder "value" not only as a dollar value, but also considering sustainability and good governance.

Perhaps a better answer than the ACA is to better promote benefit corporations as an option for companies. Then to determine and highlight the accountabilities in that model—and perhaps incentivize with some form of tax break. And for those companies that don't opt for the benefit corporation model, to better enforce the rules that are on the books today and to encourage good governance practices.

Bottom line, Sen. Warren's proposition that we "need to end the harmful corporate obsession with maximizing shareholder returns at ***all costs***" is true. However, most directors and managers understand the imperative of increasing long-term shareholder value, which means nurturing corporate culture and valuing the well-being of all employees. This formula translates into stronger customer and vendor relationships—which in turn creates better communities.

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Further to the Warren Bill, The New Paradigm and a Better Way

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Thursday, August 23, 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 memorandum by Mr. Lipton.

I've received a number of comments essentially raising the question, "If you are such a strong supporter of stakeholder corporate governance, how can you not favor Senator Warren's Bill?" As I said in both of my previous memos, *Corporate Governance; Stakeholder Primacy; Federal Incorporation, August 15, 2018* (discussed on the Forum here), and *Corporate Governance—The New Paradigm—A Better Way Than Federalization, August 17, 2018* (discussed on the Forum here), I reject federalization of all large corporations as too high a price to pay for stakeholder governance—particularly when it would do little to deter attacks by activist hedge funds. There are innumerable advantages to continued state incorporation and state corporate law that should not be sacrificed. My solution is the private sector solution advocated by the World Economic Forum, *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth.* Growing support for *The New Paradigm*, as noted in my August 17 memo, would lead to it being *the* solution.

If a federal legislative solution is needed, I would prefer to promote a focus on the fundamental "Purpose" of the corporation (ESG, long-term sustainability and stakeholder interests) through legislation that does not effect state corporate law or state corporate governance jurisprudence. I would focus not on the corporation, but on the investor. The true power over corporate strategy, operations and management is in the investor and not the corporation. The vast majority of the S&P 500 corporations are majority-or near-majority owned by roughly 20 investors, with approximately 10% to 15% of the shares held by the three indexers, BlackRock, State Street and Vanguard. Almost all of the significant investors in the S&P 500 and other major public corporations are subject to filing and disclosure requirements pursuant to the Investment Company Act, the Investment Advisers Act and Section 13(f) [Form 13-F report] of the 1934 Exchange Act. Each of these Acts could be amended to require that each investor subject to any one of the Acts (1) disclose its policy with respect to Purpose, (2) explain each vote with respect to Purpose, and (3) explain any vote contrary to the recommendation of management—in effect a variation of the British "comply or explain" approach to governance and stewardship. By including stakeholder corporate governance in Purpose, this approach would also facilitate a corporation's ability to obtain approval of a charter amendment similar to the stakeholder provision in the Warren Bill and similar provisions in state stakeholder laws. While this approach would not eliminate attacks by active hedge funds, it would very substantially diminish their strength by

reducing support from other investors. Importantly, it would not inhibit investors from engaging with corporations and seeking changes in strategy or management.

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Trump and Warren are Both Wrong

Posted by Jesse M. Fried, Harvard Law School, on Thursday, September 6, 2018

Editor's note: Jesse Fried is the Dane Professor of Law at Harvard Law School. This post was authored by Professor Fried. Related research from the Program on Corporate Governance includes Short-Termism and Capital Flows by Professor Fried and Charles C. Y. Wang (discussed on the Forum here).

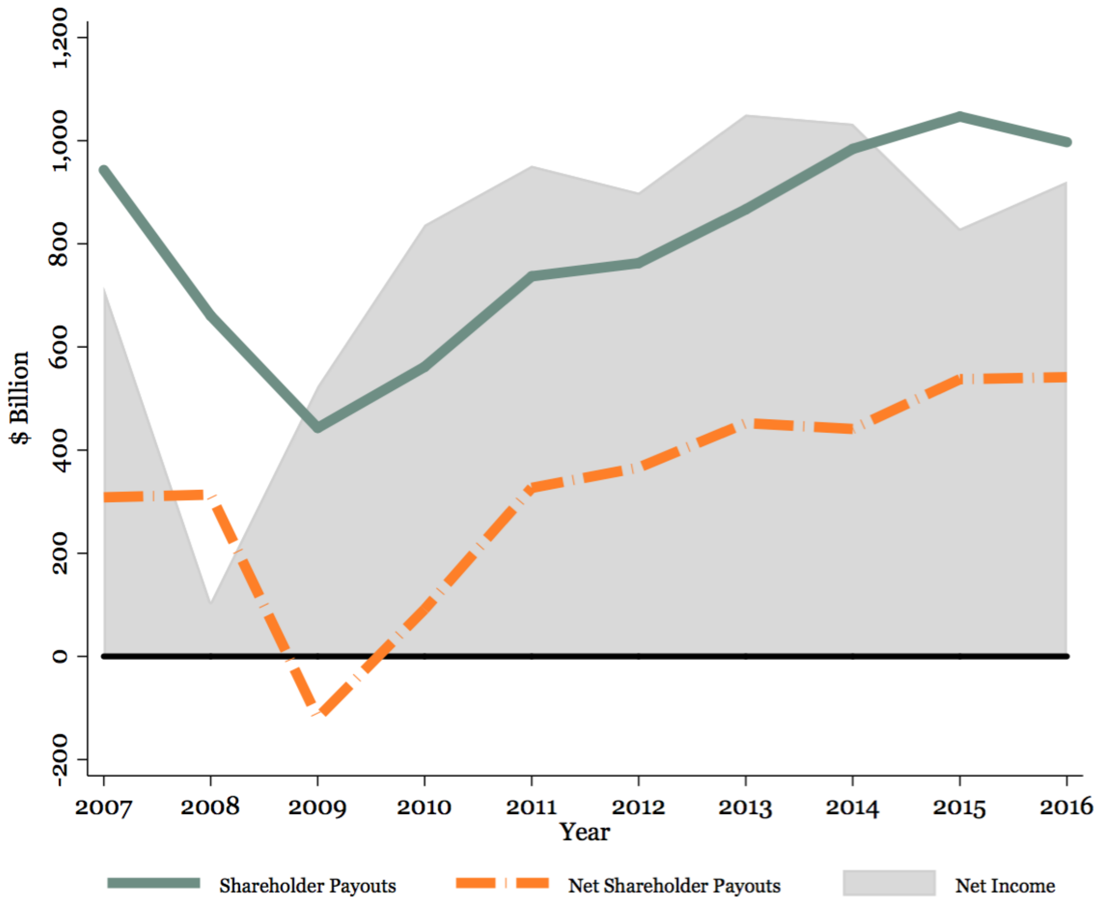
President Donald Trump and Senator Elizabeth Warren rarely see eye-to-eye on policy, and frequently attack each other personally. But they have finally found common ground: both seem to believe that investors in public firms are too powerful, and the solution is to better insulate corporate directors from shareholders.

In August, each offered a proposal aimed at shielding boards from investor pressure. Senator Warren introduced legislation—the Accountable Capitalism Act—that would federalize corporate law and force all U.S.-domiciled firms with revenues exceeding $1 billion to hand over at least 40% of board seats to employees. The Act would also alter fiduciary duties to require directors to consider all stakeholders, not just shareholders. President Trump, in turn, asked the Securities and Exchange Commission to study the possibility of eliminating quarterly reporting for public firms and allowing boards to share the information with investors only semi-annually.

Bipartisanship is generally a good thing, especially in this era of hyper-polarized politics. But the consensus view that public shareholders are distorting firm behavior—a phenomenon often labelled "quarterly capitalism" or "short-termism"—is very wrong-headed. And the remedies emerging from this consensus, particularly Senator Warren's, could profoundly damage the U.S. economy.

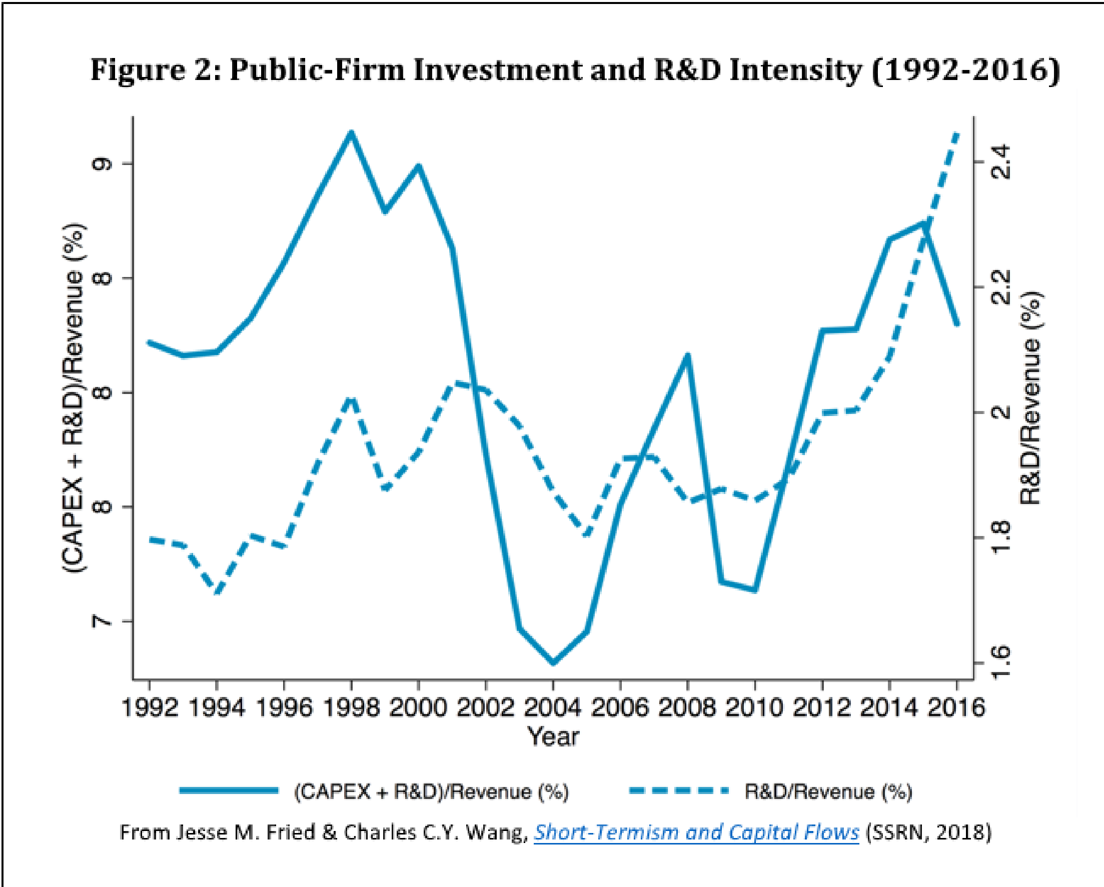
In the absence of any solid evidence that shareholders harm firms, the case for weakening investors has been based on myths, misconceptions, and misleading figures. For example, the press release for Senator Warren's Accountable Capitalism Act recycles the erroneous claim that America's biggest companies dedicate 93% of their profits to shareholders—funds that supposedly would have gone to workers or long-term investment.

But as my research with Charles Wang shows, the 93% payout figure is *gross*—it includes dividends and stock repurchases, but excludes equity issuances that move capital in the opposite direction. *Net* shareholder payouts are much lower. **Figure 1** below displays both shareholder payouts (dividends and repurchases) and *net* shareholder payouts (dividends and repurchases, less issuances) for all public firms during 2007-2016, against a backdrop of net income. As **Figure 1** makes clear, *net* shareholder payouts are only about 40% of shareholder payouts during the period. (Our research focuses on 2007-2016 but the results are almost identical for 2008-2017, the latest decade for which data are available.)



Another problem with this 93% figure is that the denominator—net income or profits—reflects what's left after the firm has allocated a portion of its income to deductible expenses, including wages and R&D. For understanding the effect of net shareholder payouts on investment capacity, a better denominator is "income available for investment": net income plus a firm's after-tax R&D costs. Across all public U.S. firms, our research shows, net shareholder payouts during the period 2007-2016 were only about 33% of income available for investment, leaving approximately $7 trillion for that purpose.

In fact, my research with Charles Wang shows that much of this $7 trillion has gone into long-term investment. As **Figure 2** below illustrates, the overall investment intensity at public firms, as measured by the ratio of capital expenditures (CAPEX) and R&D to revenue, was higher during 2012-2016 than during any other five-year period since the late 1990s boom. R&D intensity, the ratio of R&D to revenue, ended the period at an all-time high.



Nor are public firms financially constrained from engaging in additional investment; they had ample dry powder. Indeed, cash balances climbed from about $3.3 trillion in 2007 to about $5 trillion at the end of 2016. The misleading 93% figure and others like it paint a picture of shareholders starving firms of capital, crippling their ability to invest; the real figures do not.

Decisions about how to deploy capital in public firms—whether to invest it, store it for the future, or pay it out to investors—occur within the context of a market-based system. Investors provide capital to corporate managers under an agreed-upon allocation of decision-making power. If managers have a credible plan for long-term investment, investors can sit patiently as the firm spends years running up losses (such as Amazon, in its early years). When a firm can't profitably deploy capital, investors want the cash returned to them so it can be invested in other firms, public and private. Overall, the market generally works, allocating financial resources to where they are most needed.

The ironically-titled Accountable Capitalism Act would endanger this system by making corporate insiders accountable to nobody but themselves. When 40% of a firm's board consists of managers or their direct or indirect reports, outside investors would need to win almost every other seat to wrest control from incumbents. While this feat would be difficult even under existing arrangements, the Act's new stakeholder-oriented fiduciary duties could make it all but impossible—by justifying directors' use of extreme anti-takeover defenses to protect their board

seats. And even if investors could gain a majority of board seats, these fiduciary duties could be used to prevent the investors from rationally allocating firm capital from inside the boardroom.

The Act's effects can easily be predicted: capital would be trapped in cash-rich firms and mis-spent, the flow of capital from larger public firms to smaller public and private firms would dry up, and wealth would be transferred from public investors to corporate insiders. Firms looking to raise cash would find it harder. After all, why would investors hand funds over to unaccountable directors? Over time, capital would flee the country, followed by jobs. To be sure, employees of existing firms may feel more secure, at least in the short run. But there will be fewer opportunities in the U.S. for their children.

Of course, some firms may succeed in escaping the Act's reach, either by domiciling outside the U.S. or by splitting themselves into smaller pieces. But these circumventions would give rise to other costs to the American economy, such as reduced operational efficiencies and a transfer of corporate tax revenues to other jurisdictions.

The Act could also be expected to lead to additional distortions down the road. Once corporate law is federalized, Congress will be tempted to use its foot-hold in corporate governance to add more mandates and restrictions, ostensibly to address other "problems" in corporate America, but actually to benefit key voting constituencies and campaign financiers. In short, the Act would put American crony capitalism on steroids.

President Trump's proposal—which he tweeted after chatting with CEOs at his golf course—would also reduce corporate accountability, but through a different channel: by depriving shareholders of up-to-date information needed to monitor management. The CEOs whispering in Trump's ear apparently told him that moving from quarterly to semi-annual disclosures would encourage boards to focus more on long-term investment. But, as my research with Charles Wang shows, R&D is at a record high and overall investment spending by public firms appears quite robust. Thus, it's far from clear such encouragement is needed. In any event, evidence from the U.K. suggests that a reduction in disclosure frequency does not increase investment.

For most firms, the main effects of moving to semi-annual reporting will be profoundly negative: investors will find it harder to assess management and the value of their shares, and corporate insiders—and their tippees—will have more non-public information on which to trade. As a result, stock prices will be lower and firms going public will find it harder to raise capital.

To be sure, there could be certain public firms where *both* managers and outside investors prefer semi-annual over quarterly reporting, because the costs of more frequent disclosures exceed the benefits. Thus, the SEC should consider permitting firms to adopt semi-annual reporting after managers obtain approval by outside investors or at the IPO stage. But the CEOs pushing for semi-annual disclosures want the SEC to let them *unilaterally* reduce reporting frequency, even when it would hurt investors.

Perhaps President Trump and Senator Warren offered these ideas during the summer doldrums to rally their bases, or to provide material for Twitter, without actually expecting them to go anywhere. But there is a growing bipartisan consensus that excessive shareholder power is a critical problem facing America—notwithstanding the absence of any compelling evidence. This

consensus creates a real risk that one or both of their policy proposals could be adopted, either in this administration or the next one.

Harvard Law School Forum on Corporate Governance and Financial Regulation

SUPPORTED BY:

Stock Buyouts and Corporate Cashouts

Posted by Robert J. Jackson, Jr., U.S. Securities and Exchange Commission, on Wednesday, June 13, 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 public statement, 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 Program research includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here); The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008 by Lucian Bebchuk, Alma Cohen, and Holger Spamann (discussed on the Forum here); Insider Trading Via the Corporation by Jesse Fried (discussed on the Forum here); and Short-Termism and Shareholder Payouts: Getting Corporate Capital Flows Right by Jesse Fried and Charles Wang (discussed on the Forum here).

Thank you so much, Neera, for that very kind introduction. I've long admired all that you and everyone here at the Center for American Progress do to promote a progressive economic agenda. And I share your commitment to making sure our markets are safe and efficient—and fair for all Americans. So it's a real honor to be with you here today.[1]

I also want to thank my friend Andy Green, who in addition to being Managing Director of Economic Policy here at CAP, has been a critical source of wisdom for me since my swearing in at the Commission back in January.

Today [June 11, 2018], I'd like to share a few thoughts about corporate stock buybacks—and some research produced by my staff that raises significant new questions about this activity. As Neera mentioned, I'm a recovering researcher. Before I was appointed to the SEC, I was a law professor who spent most of my time thinking about how to give corporate managers incentives to create sustainable long-term value. I'd often ask my students: are we making sure that executive pay gives managers reason to invest in the long-term development of their workforce and their communities? Or are we paying executives to pursue short-term stock-price spikes rather than long-term growth?

Little did I know that, so soon into my tenure, I'd have a sobering case study to put these questions to the test. That's because the Trump tax bill, promising to bring overseas corporate

[1] Commissioner, United States Securities and Exchange Commission. I am, as always, grateful to my SEC colleagues Bobby Bishop, Caroline Crenshaw, Marc Francis, Satyam Khanna, Prashant Yerramalli, and Jon Zytnick for their invaluable counsel. Professor Jesse Fried of the Harvard Law School also provided insights that significantly deepened my thinking about these matters. The views expressed here are solely my own, and do not necessarily reflect those of the Staff or my colleagues on the Commission, though I hope someday they will.

cash home, became law last December.

Now, we all know what happened the last time a Republican-controlled government pushed through a corporate tax holiday in 2004. As that bill's sponsors hoped, American companies repatriated billions of dollars of overseas cash.[2] But corporations didn't invest most of that money in innovation. They didn't invest it in retraining their workforce or raising wages. Instead, executives largely used the influx of fresh funds for massive stock buybacks.[3]

So when I first took this job, I worried that 14 years later history would repeat itself, and the tax bill would cause managers to focus on financial engineering rather than long-term value creation. Sure enough, in the first quarter of 2018 alone American corporations bought back a record $178 billion in stock.[4] On too many occasions, companies doing buybacks have failed to make the long-term investments in innovation or their workforce that our economy so badly needs.[5] And, because we at the SEC have not reviewed our rules governing stock buybacks in over a decade, I worry whether these rules can protect investors, workers, and communities from the torrent of corporate trading dominating today's markets.[6]

Even more disturbing, there is clear evidence that a substantial number of corporate executives today use buybacks as a chance to cash out the shares of the company they received as executive pay.[7] We give stock to corporate managers to convince them to create the kind of long-term value that benefits American companies and the workers and communities they serve. Instead, what we are seeing is that executives are using buybacks as a chance to cash out their compensation at investor expense.

Executives often claim that a buyback is the right long-term strategy for the company, and they're not always wrong. But if that's the case, they should want to hold the stock over the long run, not

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[2] *See* American Jobs Creation Act, Pub. L. No. 108-357, 118 Stat. 1418-1660 (2004).

[3] Although the *degree* to which corporations used the proceeds of the 2004 holiday for buybacks is debatable, *whether* they did so—even though the statute prohibited such uses—is not. *Compare* Dhammika Dharmapala, C. Fritz Foley, and Kristin J. Forbes, *Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act*, 66 J. Fin. 753 (2011) *with* Thomas J. Brennan, *Where the Money Really Went: A New Understanding of the AJCA Tax Holiday* (Northwestern Law and Economics Working Paper) (2014). What's worse, "the temporary holiday conditioned firms to anticipate future holidays and to change their behavior by placing more earnings overseas than ever before." Thomas J. Brennan, *What Happens After a Holiday? Long-Term Effects of the Repatriation Provisions of the AJCA*, 5 Nw. J. L. & Soc. Pol'y 1 (2010).

[4] Talib Visram, *Tax Cut Fuels Record $200 Billion Stock Buyback Bonanza*, CNN.com (June 5, 2018); *see also* William Lazonick, *Stock Buybacks: From Retain-and-Reinvest to Downsize-and-Distribute*, Brookings Initiative on 21st Century Capitalism (April 2015), at 2 ("Over the decade 2004-2013, 454 companies in the S&P 500 Index in March 2014 that were publicly listed over the ten years did $3.4 trillion in stock buybacks, representing 51 percent of net income.").

[5] Savvy market observers also worry that the magnitude of this year's buyback spree reflects a troubling trend in corporate investment. *See, e.g.*, Matt Egan, *Goldman Sachs Warns Against Falling in Love with Stock Buybacks*, CNNMoney.com (April 26, 2018) (noting a recent equity research report describing the perhaps-unsurprising result that, since the 2016 presidential election, "Goldman Sachs's collection of stocks that are focused on capital spending and research and development soared 42% … besting the S&P 500's 24% gain").

[6] For an exceptionally clear demonstration as to how buybacks can harm investors while benefiting insiders, see Jesse M. Fried, *Insider Trading Via the Corporation*, 162 U. Pa. L. Rev. 801, 805 (2014) (referring to stock buybacks as "indirect insider trading" and noting that such "trading likely imposes considerable costs on public investors in two ways. First, just like 'ordinary' direct insider trading, indirect insider trading secretly redistributes value from public investors to insiders…. Second, the use of the corporation as a vehicle for insider trading can lead insiders to waste economic resources.").

[7] In these remarks, I focus on executives' use of buybacks to cash out shares granted as part of compensation packages otherwise designed to link executive pay with long-term performance. There are, of course, circumstances where managers who founded the firm or are otherwise large shareholders seek liquidity for those holdings using buybacks. Those cases, too, should be addressed if the SEC chooses to reevaluate its rules in this area. But here I focus on cases where executives use buybacks to cash out shares granted as stock-based pay.

cash it out once a buyback is announced. If corporate managers believe that buybacks are best for the company, its workers, and its community, they should put their money where their mouth is. That's why I'm here today to call on my colleagues at the Commission to update our rules to limit executives from using stock buybacks to cash out from America's companies.

And I am also calling for an open comment period to reexamine our rules in this area to make sure they protect employees, investors, and communities given today's unprecedented volume of buybacks.

Stock Buybacks and Executive Pay

Basic corporate-finance theory tells us that, when a company announces a stock buyback, it is announcing to the world that it thinks the stock is cheap.[8] That announcement, and the firm's open-market purchasing activity, often causes the company's stock price to jump, so the SEC has adopted special rules to govern buybacks.

Those rules, first adopted in 1982, provide companies with a safe harbor[9] from securities-fraud liability if the pricing and timing of buyback-related repurchases meet certain conditions.[10] After experience proved that buybacks could be used to take advantage of less-informed investors,[11] the SEC updated its rules in 2003, though researchers noted that several gaps remained.[12]

In the meantime, the use of stock-based pay at American public companies has exploded.[13] Although these pay programs present many challenges, the one that I've spent much of my career thinking about is how to make sure that corporate management has skin in the game—that is, how to keep top executives from cashing out stock they receive as compensation.[14]

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[8] *See, e.g.*, George Constantinides & Bruce Grundy, *Optimal Investment with Stock Repurchase and Financing as Signals*, 2 Rev. Fin. Stud. 445 (1989) (providing a theoretical model on the role of repurchases when a firm is undervalued).

[9] Among other reasons, a safe harbor is necessary because firms often pursue buybacks under informational circumstances that might lead to securities-law liability in other contexts. *See* Fried, *supra* note 5, at 813-814 ("The SEC takes the position that Rule 10b-5 … applies to a firm buying its own shares.").

[10] Securities and Exchange Commission, Final Rule: Purchases of Certain Equity Securities by the Issuer and Others, Release Nos. 33-8335, 34-48766, 17 C.F.R. Pt. 228 *et seq.*

[11] For example, because these rules permitted firms to announce a buyback—generating a stock-price spike—and then choose not to buy back any stock at all without disclosing that fact to investors, commentators and the SEC worried that managers opportunistically used buyback announcements to manipulate share prices. *See, e.g.*, Jesse Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 Cal. L. Rev. 1323, 1336-40 (2005); *see also* Final Rule, *supra* note 8 ("Studies have … shown that some issuers publicly announce repurchase programs, but do not purchase any shares or purchase only a small portion of the publicly disclosed amount.").

[12] *See* Final Rule, *supra* note 8. Among other things, commentators have pointed out that the SEC's still-lax disclosure rules regarding buybacks give corporate insiders "a strong incentive to exploit [those] rules in order to engage in indirect insider trading: having the firm buy and sell its own shares at favorable prices to increase the value of the insiders' equity." Fried, *supra* note 8, at 804. Indeed, there is important evidence that the limited tightening of disclosure rules in this area have had some benefits in addressing opportunistic buyback activity. *See* Michael Simkovic, *The Effect of Mandatory Disclosure on Open-Market Stock Repurchases*, 6 Berkeley Bus. L. J. 98 (2009). That evidence makes the case for revisiting these rules now all the more compelling. Indeed, the Commission issued a proposal to update these rules in 2010, *see* Proposed Rule, Purchases of Certain Equity Securities by the Issuer and Others, Release No. 34-61414 (2010), but to date has taken no action on the proposal.

[13] *See, e.g.*, Kevin J. Murphy, *Executive Compensation: Where We Are and How We Got There*, *in* George Constantinides, Milton Harris, and Rene Stulz, Eds., Handbook on Economics and Finance 211 (2013).

[14] *See, e.g.*, Robert J. Jackson, Jr., *Stock Unloading and Banker Incentives*, 112 Colum. L. Rev. 951 (2012); Robert J. Jackson, Jr. & Colleen Honigsberg, *The Hidden Nature of Executive Retirement Pay*, 100 Va. L. Rev. 479 (2014); Robert J. Jackson, Jr. & Jonathon Zytnick, *The Effects of a Tax Notch on CEO Golden Parachute Contracts and Option Exercises* (working paper 2018).

You see, the theory behind paying executives in stock is to give them incentives to create long-term, sustainable value.[15] Because executives who receive shares rather than cash demand higher levels of pay, the use of stock-based compensation has led to eye-opening pay packages for top executives. In the trade, investors—and the economy as a whole—tie executives' fortunes to the growth of the company.

But that only works when executives are required to hold the stock over the long term. Researchers have long worried that executives, who always prefer cash to stock, will try to sell rather than hold their shares, eliminating the incentives they were meant to produce.[16] So it's no surprise that, in the years leading up to the financial crisis, top executives at Bear Stearns and Lehman Brothers personally cashed out $2.4 billion in stock before the firms collapsed.[17] And it's no wonder that sophisticated investors have for decades strictly limited executives' freedom to cash out their shares.[18]

In the wake of the financial crisis, Congress realized the importance of keeping executives' skin in the game, so the Dodd-Frank Act included several provisions designed to give investors more information about whether and how managers cash out.[19] Unfortunately, as you all know too well, those rules have still not yet been completed, keeping investors in the dark about executives' incentives.

Nearly eight years since that landmark legislation, it is completely unacceptable that the SEC has still not promulgated these and other rules required by law. But it's not just that the regulations haven't been finalized. It's that the problem itself keeps getting worse. You see, the Trump tax bill has unleashed an unprecedented wave of buybacks, and I worry that lax SEC rules and corporate oversight are giving executives yet another chance to cash out at investor expense.

How Executives Use Buybacks to Cash out

That's why, when I was sworn in a few weeks after the Trump tax bill took effect, I asked my staff to take a look at how buybacks affect how much skin executives keep in the game. I was worried that lax corporate practices and SEC rules might lead to buybacks that give executives yet another chance to cash out at investor expense.

[15] *See, e.g.*, Kevin Murphy, *Executive Compensation*, *in* Orley C. Ashenfelter & David Card, Eds., 3B Handbook of Labor Economics 2485 (1999).

[16] *See* Lucian A. Bebchuk, Jesse Fried, and David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. Chi. L. Rev. 751 (2002); *see also* Lucian A. Bebchuk & Jesse Fried, *Paying for Long-Term Performance*, 158 U. Pa. L. Rev. 1915, 1921 (2010) (describing concerns related to "ensuring that, whatever equity incentives are used [in executive pay, executives'] payoffs are primarily based on long-term stock values rather than on short-term gains that may be reversed.").

[17] Lucian A. Bebchuk, Alma Cohen, and Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 Yale. J. Reg. 257 (2012).

[18] Robert J. Jackson, Jr., *Private Equity and Executive Compensation*, 60 U.C.L.A. L. Rev. 638, 640 (2013) ("[T]he pay-performance link is much weaker in public companies than in companies owned by private equity investors. Borrowing from their private equity counterparts, public company boards seeking to strengthen the link between pay and performance should restrict CEOs' freedom to unload.").

[19] *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 953(a), 954, 955, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (requiring the SEC to adopt rules requiring disclosure of the pay-performance link, public companies' policies related to the clawback of erroneously awarded compensation, and policies related to insider hedging of public companies' stocks, none of which has been finalized).

So we dove into the data, studying 385 buybacks over the last fifteen months.[20] We matched those buybacks by hand to information on executive stock sales available in SEC filings.[21] First, we found that a buyback announcement leads to a big jump in stock price: in the 30 days after the announcements we studied, firms enjoy abnormal returns of more than 2.5%.[22]That's unsurprising: when a public company in the United States announces that it thinks the stock is cheap, investors bid up its price.

What *did* surprise us, however, was how commonplace it is for executives to use buybacks as a chance to cash out. In *half* of the buybacks we studied, at least one executive sold shares in the month following the buyback announcement. In fact, *twice as many companies* have insiders selling in the eight days after a buyback announcement as sell on an ordinary day.[23] So right after the company tells the market that the stock is cheap, executives overwhelmingly decide to sell.[24]

And, in the process, executives take a lot of cash off the table. On average, in the days before a buyback announcement, executives trade in relatively small amounts—less than $100,000 worth. But during the eight days following a buyback announcement, executives on average sell more than $500,000 worth of stock each day—a fivefold increase. Thus, executives personally capture the benefit of the short-term stock-price pop created by the buyback announcement:

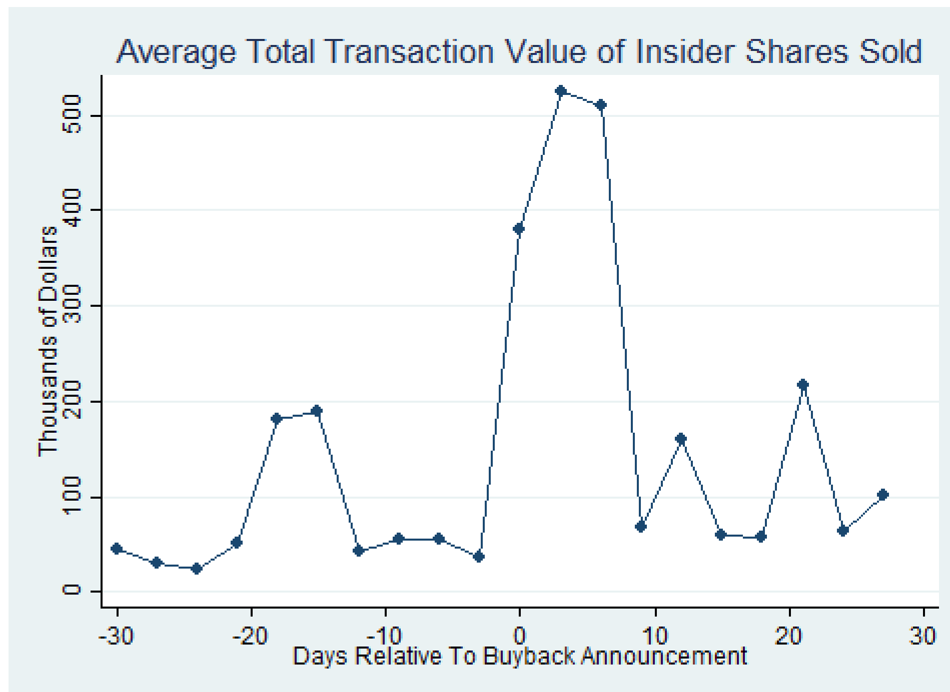
[20] We drew information on buybacks from the Securities Data Company (SDC) database, using transactions identified by SDC as buybacks with announcements in the year 2017 and the first three months of 2018. For consistency in treatment across the sample, we identify an initial sample of 708 repurchases and retain only the first repurchase announcement by each company—and only those repurchases not followed by a subsequent repurchase announcement within 60 days. We merged those data with information from the Center for Research on Securities Prices (CRSP) database, leaving a sample of 385 public company buybacks.

[21] We used data from Form 4 filed pursuant to Section 16. *See* Securities and Exchange Commission, Ownership Reports and Trading By Officers, Directors and Principal Securities Holders, 56 Fed. Reg. 7,242 (Feb. 21, 1991); *see also* Securities and Exchange Commission, Mandated Electronic Filing and Web Site Posting for Forms 3, 4 and 5, 68 Fed. Reg. 25,788 (May 13, 2003).

[22] That finding is consistent with the longstanding finance literature on the effects of these announcements on stock prices. *See, e.g.*, David Ikenberry, Josef Lakonishok, and Theo Vermalen, *Market Underreaction to Open Market Share Repurchases*, 39 J. Fin. Econ. 181 (1995); Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. Chi. L. Rev. 421 (2000).

[23] On an average day, between 3 and 4 percent of corporate insiders trade in the company's stock, but we found that, during the eight days following a buyback announcement, more than 8 percent do. We direct the interested reader to the data appendix to this speech, where you can learn more about our methodology and analysis.

[24] Investors receive a mixed signal from a buyback announcement that is accompanied by insider selling. Indeed, as we explain in our data appendix, we observe statistically significantly lower returns during the ten- and thirty-day window following buyback announcements with executive selling than we do in buybacks where executives hold their shares for the long term.



Now, let's be clear: this trading is not necessarily illegal. But it is troubling, because it is yet another piece of evidence that executives are spending more time on short-term stock trading than long-term value creation. It's one thing for a corporate board and top executives to decide that a buyback is the right thing to do with the company's capital. It's another for them to use that decision as an opportunity to pocket some cash at the expense of the shareholders they have a duty to protect, the workers they employ, or the communities they serve.

More importantly, policymakers, advocates, investors and corporate boards have spent decades, and billions of dollars of shareholder money, trying to tie executive pay to long-term corporate performance. But the evidence shows that buybacks give executives an opportunity to take significant cash off the table, breaking the pay-performance link. SEC rules do nothing to discourage executives from using buybacks in this way. It's time for that to change.

The Path Forward

There are two steps we can and should take right away to address the practice of executives using buybacks as a chance to sell their shares. First, as I mentioned earlier, the SEC last revised its rules governing buybacks in 2003. Those rules give companies a so-called "safe harbor" from liability when pursuing buybacks. But there are no limits on boards and executives using the buyback—and the safe harbor—as an opportunity to cash out.

I cannot see why a safe harbor to the securities laws should subsidize this behavior. Instead, SEC rules should encourage executives to keep their skin in the game for the long term. That's

why our rules should be updated, *at a minimum*, to deny the safe harbor to companies that choose to allow executives to cash out during a buyback.[25]

And that's why today I'm also calling for an open comment period to reexamine our rules in this area to make sure they protect American companies, employees, and investors given today's unprecedented volume of buybacks.[26]

Second, corporate boards and their counsel should pay closer attention to the implications of a buyback for the link between pay and performance. In particular, the company's compensation committee should be required to carefully review the degree to which the buyback will be used as a chance for executives to turn long-term performance incentives into cash. If executives will use the buyback to cash out, the committee should be required to approve that decision and disclose to investors the reasons why it is in the company's long-term interests. It is hard to see why a company's buyback announcement shouldn't be accompanied by this kind of disclosure.[27]

Executives who can't sell their holdings in the short term—but instead have to create real value over time—have far fewer incentives to manage to quarterly earnings and pursue the kind of short-term thinking that dominates our economy today. The esteemed experts on our next panel will, I'm sure, offer broader policy proposals that can help us address those problems. But at the SEC, it's time for our rules to require corporate managers who say they want to manage for the long term to put their money where their mouth is. At the very least, our rules should stop giving executives incentives to use buybacks to cash out.

* * *

The increasingly rapid cycling of capital at American public companies has had real costs for American workers and families. We need our corporations to create the kind of long-term, sustainable value that leads to the stable jobs American families count on to build their futures. Corporate boards and executives should be working on those investments, not cashing in on short-term financial engineering.

Each day when I arrive at work, I'm reminded that the SEC's mission is to protect investors, ensure a level playing field in our financial markets, and encourage capital formation. Updating our rules to reflect the effects of buybacks on executives' incentives to create long-term value would serve all three of those goals.

Investors deserve to know when corporate insiders who are claiming to be creating value with a buyback are, in fact, cashing in.[28] A level playing field requires that shareholders selling into a

[25] The precise way in which the safe-harbor could be restructured to disfavor the use of buybacks for insider sales is beyond the scope of my remarks—and, in all events, well within the expertise of our exceptional Staff. Suffice it to say that, if the Commission were so inclined, our Staff would have little difficulty making sure that our rules are not used in a way that encourages corporate executives to use buybacks to sell their shares.

[26] We should also use this opportunity to review other problems with Rule 10b-18 and related rules—including the fact that they require only quarterly disclosure of the amount of shares a company has actually repurchased, leaving investors largely in the dark about corporate trading in their own shares. For an exceptionally thoughtful proposal in this respect, *see* Fried, *supra* note 5.

[27] Except, of course, the fact that our rules let them. *See* Final Rule, *supra* note 8; *but see* Schnell v. Chris-Craft Industries, Inc., 285 A.2d 437, 444 & n.15 (Del. 1971) ("Inequitable action does not become permissible simply because it is legally possible.").

[28] It's true, of course, that investors *eventually* receive disclosure of executives' selling on Form 4, which is how we were able to conduct this study. But those disclosures come *after* the executive has already sold—too late for

buyback know what managers are doing with their own money. And investors who feel assured that buybacks won't be used as a chance for insiders to cash in will be more willing to fund the kinds of long-term investments our economy needs.

All of you here at CAP have provided essential leadership in developing policies that produce growth for all Americans—and favor long-term value creation over financial engineering. That's why I'm so proud to be here today. I'm very much looking forward to your questions. And I so look forward to working with you to ensure that the SEC's policies create the kinds of markets that American families need—and deserve.

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shareholders to price the executive's decision into their own determination whether to sell their shares. *See* Fried, *supra* note 5.

Harvard Law School Forum on
Corporate Governance and Financial Regulation
SUPPORTED BY:

Taking Stock: Share Buybacks and Shareholder Value

Posted by Ric Marshall, Panos Seretis, Agnes Grunfeld, MSCI Inc., on Sunday, August 19, 2018

Editor's note: Ric Marshall is Executive Director of ESG Research, Panos Seretis is Head of ESG Research, and Agnes Grunfeld is Vice-President at MSCI Inc. This post is based on a MSCI memorandum by Mr. Marshall, Mr. Seretis, and Mr. Grunfeld.

Related research from the Program on Corporate Governance includes The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here); Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay, by Jesse Fried (discussed on the Forum here); and Short-Termism and Capital Flows by Jesse Fried and Charles C.Y. Wang (discussed on the Forum here).

Executive Summary

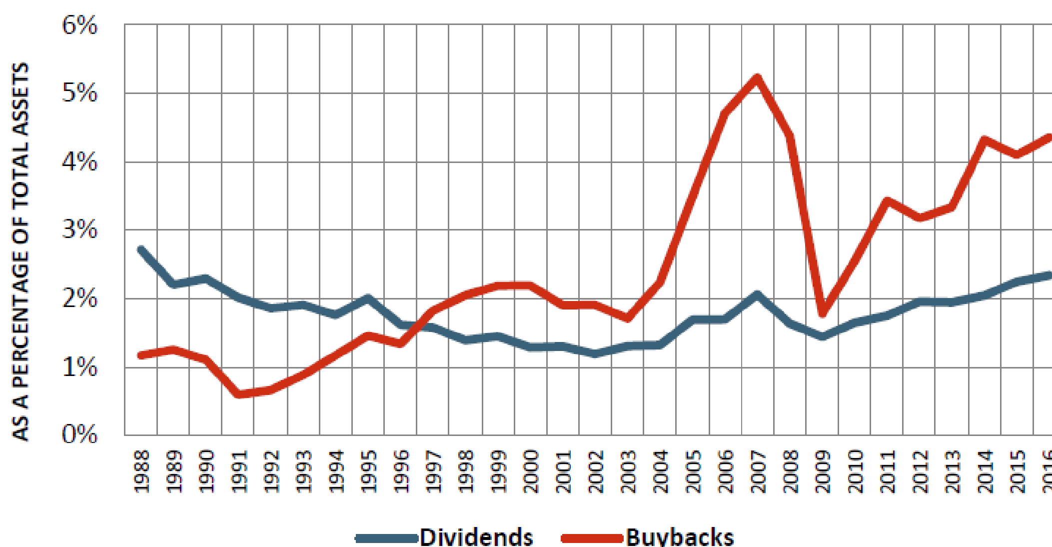
1. Share buybacks have become the favored means for distributing cash to investors among large-cap S. companies, exceeding cash dividends every year since 1997 at 388 of the 610 companies (63.6%) we studied.
2. A majority of the companies we observed bought back shares when prices were high rather than low, as buybacks have replaced dividends as the dominant way of returning cash to investors at many companies.
3. Contrary to concerns expressed by many observers, we found no compelling evidence of a negative impact from share buybacks on long-term value creation for investors overall. In each of the areas we examined, beginning with MSCI ESG Ratings but also including CAPEX, R&D, new debt issues, and, most importantly, value creation, the companies that were most actively distributing cash to their investors were also the strongest companies.
4. Companies where index investors were the largest shareholders included a much wider range of buyback impacts, good and bad, than companies where the largest shareholders were buy-and-hold investors: total returns for the buy-and-hold investor companies were 18% higher, on average, than for the index investor companies from 2007 to 2016.

Background

Prior to 1982, share buybacks were virtually non-existent in U. S. equity markets due to regulations aimed at limiting the potential for share price manipulation. The U.S. Securities and Exchange Commission reconsidered its position in 1982, adopting Rule 10b-18, which established a safe harbor for companies wishing to distribute cash to investors via share buybacks. Both the frequency and amount of share buybacks began to rise almost immediately, eventually superseding dividends as the primary means of distributing corporate profits to

investors. At the 610 MSCI USA Index constituents[1] we studied, total buybacks have exceeded total dividend payments every year since 1997.

Exhibit 1: Dividends and Buybacks 1988-2016



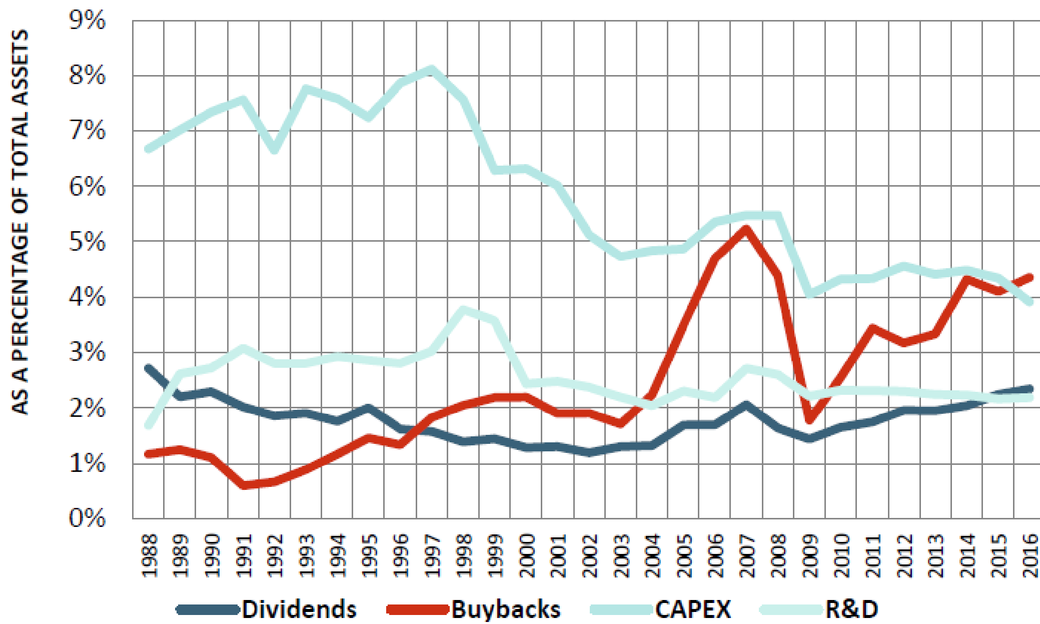
Annual cash dividends and share buybacks as a percentage of total assets for 610 constituents of the MSCI USA Index as of Dec. 31, 2016. Source: MSCI ESG Research, based on Thomson Reuters data.

The decision to buy back shares is one of the most important strategic decisions a corporate board can make. Share buybacks are an integral part of a company's overall capital management, which requires the continual balancing of operating costs, capital expenditures (CAPEX) and research and development (R&D) against revenues and tax obligations. Buybacks are a key element of a company's corporate governance, i.e., the primary means by which a company may create and preserve value on behalf of its investors.

As a means for returning value to investors, buybacks offer companies and investors greater flexibility than dividends: Companies can more easily manage their tax liabilities and market expectations on both the timing and amount of buybacks. Investors may also prefer buybacks over dividends because they can facilitate more frequent reallocation of existing capital. But some investors worry that companies might prioritize buybacks over either long-term capital investments or R&D.[2] In fact, both CAPEX and R&D spending at our sample companies has declined in almost every year since 1997, with total buybacks exceeding total CAPEX for the first time in 2015.

[1] As of Dec. 31, 2016.
[2] "Share Buybacks and their Governance Implications." (2017). International Corporate Governance Network.

Exhibit 2: Dividends and Buybacks versus CAPEX and R&D

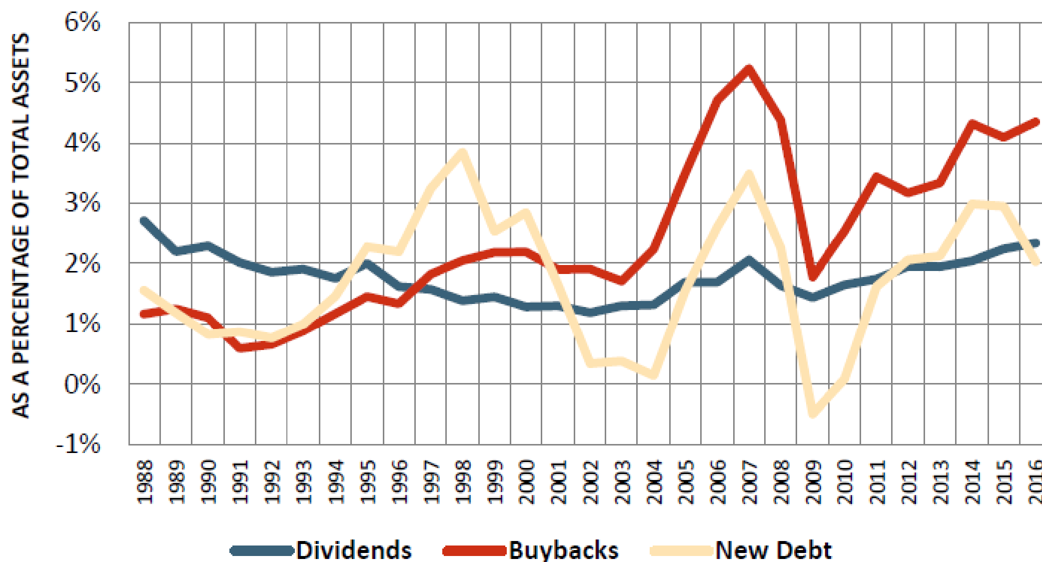


Annual cash dividends and share buybacks vs. CAPEX and R&D as a percentage of total assets for 610 constituents of the MSCI USA Index as of Dec. 31, 2016. Source: MSCI ESG Research, based on Thomson Reuters data.

Of these 610 companies, 554 (91%) bought back shares at some time during our study period, while 499 (82%) paid cash dividends. Eighty-nine bought back shares but paid no dividends, while 34 paid dividends but did not buy back shares.

Some companies have also borrowed to buy back shares, raising concerns that some firms might over-leverage their balance sheets. Among the companies we studied, aggregate new debt issues appear to have closely tracked aggregate share buybacks since about 2003, as shown in Exhibit 3.

Exhibit 3: Dividends and Buybacks vs. New Debt Issues



Annual cash dividends and share buybacks vs. new debt issues as a percentage of total assets for 610 constituents of the MSCI USA Index as of Dec. 31, 2016. Source: MSCI ESG Research, based on Thomson Reuters data.

Some observers fear that the corporate embrace of share buybacks reflects a dearth of new ideas among CEOs and boards,[3] or favors short-term gains over long-term sustainability.[4]

Others have lamented the possible use of share buybacks by CEOs to enhance their own equity-based pay gains, particularly at those companies where pay has not always been well aligned with long-term investment returns.[5]

Surprisingly, there has been very little pushback from investors regarding the growing use of share buybacks. Further, buybacks have continued to rise even as many of these companies were achieving record high valuations, contradicting the long-standing assertion that companies should buy back shares only when their shares are under-valued.[6] A majority of these companies have repeatedly bought back shares at prices that reflected possible over- rather than under-valuation,[7] and in addition to rather than as a substitute for cash dividends.

Brav et al. (2005),[8] who surveyed 384 corporate financial executives, wrote that "…many of those firms that pay dividends wish they did not, saying that if they could start all over again, they would

[3] Ayres, R. and M. Olenick. (2017). "Secular Stagnation (Or Corporate Suicide?)." INSEAD Working Paper.

[4] Lazonick, W. (2014). "Profits Without Prosperity." *Harvard Business Review.*

[5] Edmans, A., V.W. Fang and K. A. Lewellen. (2017). "Equity Vesting and Investment." *The Review of Financial Studies*, Vol. 30, No. 7, pp. 2229–2271.

[6] For one of the more frequently cited versions of this advice, see Buffet, W. E. (2012). "Annual Letter to Berkshire Hathaway Shareholders." Berkshire Hathaway.

[7] See Liu, H. and E. P. Swanson. (2016). "Is Price Support a Motive for Increasing Share Repurchases?" *Journal of Corporate Finance*, Vol. 38, pp. 77-91, for an examination of one possible explanation for this behavior, which is beyond the scope of the current analysis.

[8] Brav, A., J. R. Graham, C. R. Harvey and R. Micaely. (2005). "Payout Policy in the 21st Century." *Journal of Financial Economics,* Vol. 77, No. 3, pp. 483-527.

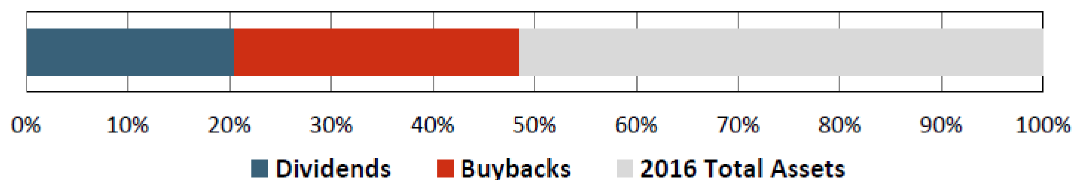
not pay as much in dividends as they do … many of these firms would prefer to pay out in the form of buybacks."

We looked to the U.S. to better understand buyback activity. While we found evidence of share buyback activity in virtually every market globally between 1988 and mid-2017, the dollar value totals in the U.S. market (particularly among U.S. large caps) dwarfed other markets.[9] Global dividend and buyback activity is shown in Appendix 1 of the complete publication (available here).

We ultimately identified 610 companies for deeper analysis. All of these companies were constituents of the MSCI USA Index as of Dec. 31, 2016. We then narrowed our focus to the most recent 15-year period (ending December 2016) for which sufficient buyback and other financial data was available.

Over this 15-year period, these 610 MSCI USA constituents paid over $3.86 trillion in cash dividends, and repurchased just under $5.19 trillion of their own shares. Excluding financial companies, which report total assets differently, the combined total payout was equal to 48.6% of total 2016 constituent assets, or $3.2 trillion in dividends, and $4.4 trillion in buybacks, as shown in Exhibit 4.

Exhibit 4: Cumulative Dividends and Buybacks 2002-2016 vs. 2016 Total Assets

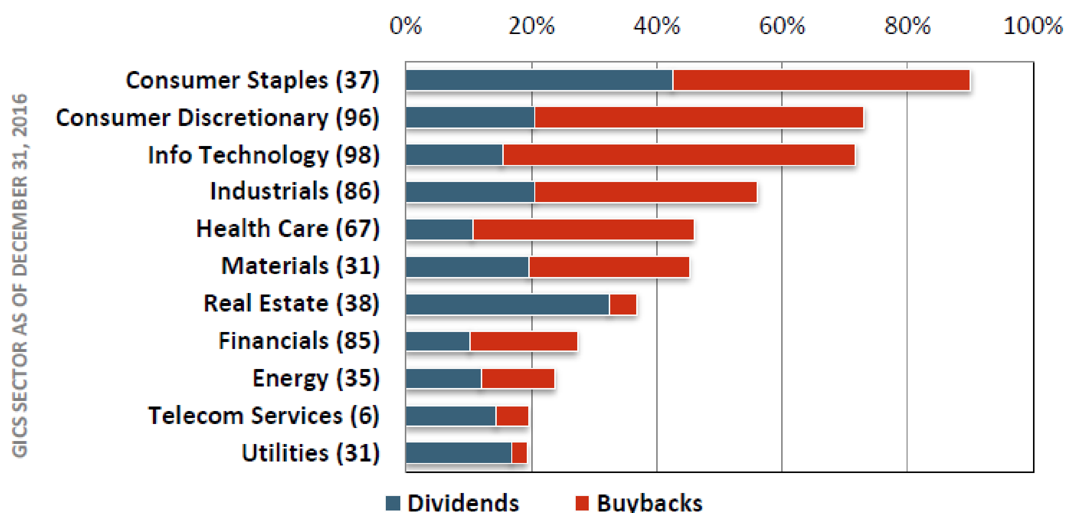


Total cumulative cash dividends and share buybacks vs. 2016 total assets for 525 constituents of the MSCI USA Index as of Dec. 31, 2016, excluding GICS Financials. Source: MSCI ESG Research, based on Thomson Reuters data.

During this period, 140 of these companies paid out the equivalent of more than 50% of their total 2016 assets on buybacks; 53 of these companies repurchased shares equivalent to more than 100% of their 2016 assets. In comparison, only 37 companies paid out more than 50% of 2016 assets in dividends, while 24 paid no dividends at all.

[9] Unless otherwise noted, all financial reporting figures used in this report were obtained from Thomson Reuters.

Exhibit 5: Dividend and Buyback Variations by GICS sector



Total cumulative cash dividends and share buybacks as a percentage of total assets for 610 constituents of the MSCI USA Index as of Dec. 31, 2016, by GICS sector. The number of companies per sector group is shown in parentheses. Source: MSCI ESG Research, based on Thomson Reuters data.

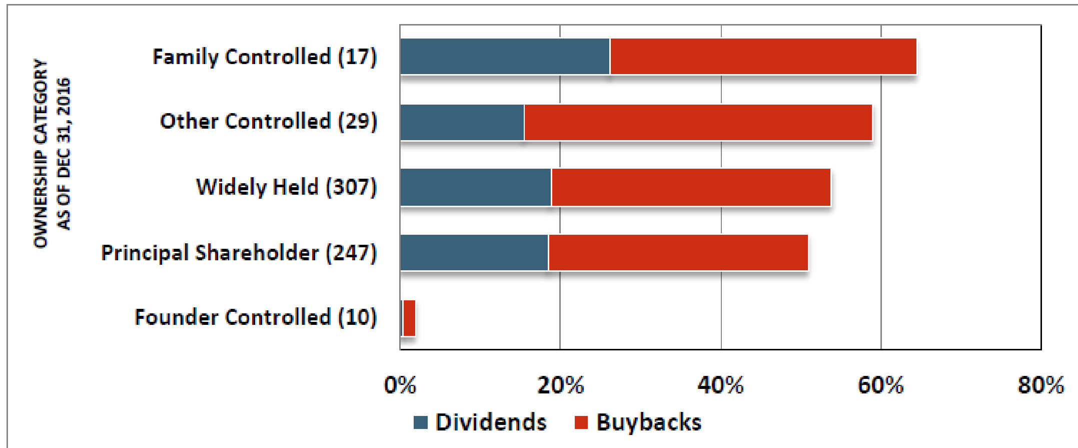
As shown in Exhibit 5, both dividends and buybacks varied considerably between GICS®[10] sectors: Buybacks were highest among info tech and consumer discretionary/staples sectors, and lowest among telecom, real estate and utilities. Such differences were even greater at the GICS industry group level, with three groups (food & restaurants, specialized finance and household products) on average exceeding 100% of 2016 assets in total payouts.[11] These differences were not surprising, as some industries were simply more profitable during this period, while others struggled to such a degree that even dividends could only be funded using borrowed capital, leaving little scope to repurchase shares.

We also found differences when we looked at company ownership. Family-controlled firms paid more in cash dividends than other ownership groups, on average, though they also participated heavily in share buybacks, as did nearly all other controlled companies. But founder-controlled companies, such as Alphabet, Inc. or Facebook, Inc., allocated very little capital to either, as shown in Exhibit 6.

[10] The GICS industry classifications system is maintained jointly by MSCI and S&P Global.

[11] The GICS classification uses four levels of increasing specificity: sector, industry group, industry and sub-industry.

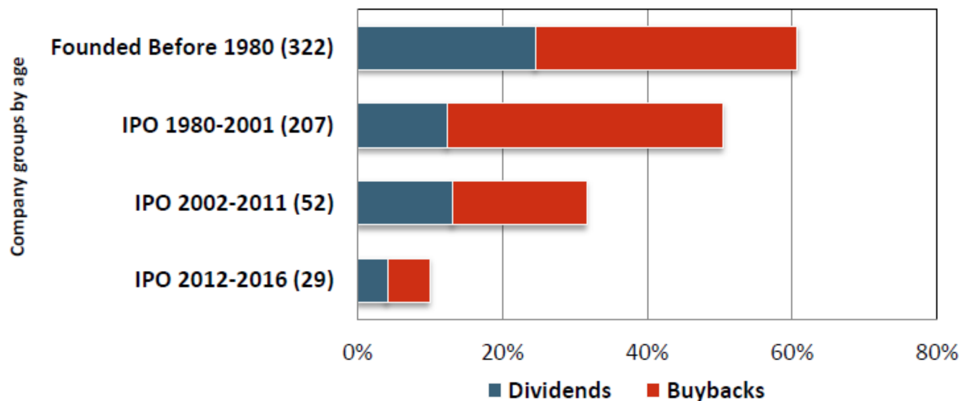
Exhibit 6: Dividend and Buyback Averages by Ownership Category



Total cumulative cash dividends and share buybacks as a percentage of total assets for 610 constituents of the MSCI USA Index as of Dec. 31, 2016, by MSCI ownership category. The number of companies per ownership group is shown in parentheses. Source: MSCI ESG Research, based on Thomson Reuters data.

These sector- and ownership-based differences were closely related, and in many cases overlapping. So were the differences we observed based on company age and maturity. The most active repurchasers were companies that first listed from 1980 to 2001; such older, more established companies paid more in dividends, on average, while still actively buying back shares, which resulted in even higher total payouts. These differences are shown in Exhibit 7.[12] [13]

Exhibit 7: Dividend and Buyback Averages by Company Age and Maturity



Total cumulative cash dividends and share buybacks as a percentage of total assets for 610 constituents of the MSCI USA Index as of Dec. 31, 2016, by company age. The number of companies per group is shown in parentheses. Source: MSCI ESG Research, based on Thomson Reuters data.

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[12] Nearly half of the companies we studied (48%) were first listed after 1980, and 13.5% were first listed after 2002.

[13] While it was not included in our sample, our own firm, MSCI, Inc. has actively engaged in share buybacks since 2008, and paid dividends since 2014.

Statement Announcing SEC Staff Roundtable on the Proxy Process

Posted by Jay Clayton, U.S. Securities and Exchange Commission, on August 1, 2018

Editor's note: Jay Clayton is Chairman of the U.S. Securities and Exchange Commission. This post is based on Chairman Clayton's recent public statement, available here. The views expressed in this post are those of Mr. Clayton and do not necessarily reflect those of the Securities and Exchange Commission or its staff.

Shareholder engagement is a hallmark of our public capital markets, and the proxy process is a fundamental component of that engagement. In 2010, the Commission issued a concept release seeking public comment on whether the U.S. proxy system as a whole operates with the accuracy, reliability, transparency, accountability, and integrity that shareholders and companies should expect.[1] In light of the many changes in our markets, technology, and how companies operate since then, SEC staff will host a roundtable this fall to hear from investors, issuers, and other market participants about whether the SEC's proxy rules should be refined.

The SEC's rules governing the proxy process are at the center of investor participation in, and influence over, corporate governance at U.S. public companies. For example, our proxy rules specify the requirements for information companies must provide to shareholders and how votes may be solicited. Since the 2010 concept release, we have seen a dramatic increase in the number of U.S. companies reporting shareholder engagement, with 72% of S&P 500 companies reporting engagement with shareholders in 2017, compared to just 6% in 2010.[2] The scope of topics subject to shareholder engagement also has increased. Consistent with the Commission's mission, we must regularly review whether our existing rules are achieving their objectives effectively in light of changes in our marketplace. The SEC staff roundtable is intended to facilitate that type of assessment with respect to the proxy process and shareholder engagement.

SEC staff will announce the roundtable agenda items shortly. As they develop that agenda, I have asked that staff consider the topics outlined below.

Potential Topics for Consideration

Voting Process

[1] *Concept Release on the U.S. Proxy System*, Release No. 34-62495 (July 14, 2010) [75 FR 42982 (July 22, 2010)]. The comment letters received in response to the 2010 concept release are *available at* https://www.sec.gov/comments/s7-14-10/s71410.shtml.

[2] *See* Ernst & Young 2017 Proxy Season Review (June 2017), *available at* https://webforms.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-review/$File/ey-2017-proxy-season-review.pdf.

Accuracy, transparency, and efficiency in the proxy system can inspire confidence in the proxy voting process for both companies and investors. Areas that may warrant particular attention include:

- Potential for over-voting and under-voting of securities by broker-dealers, the reasons this may occur, and ways to address it. In addition, the extent to which "empty voting" (e.g., acquiring voting rights over shares but having little or no economic interest in the shares) is of concern to market participants and the regulatory steps, if any, that should be taken to address those concerns.
- Practical difficulties in confirming whether an investor's shares have been voted in accordance with the investor's instructions. For example, challenges could be attributable to the number of participants that may be involved in the process, including issuers, transfer agents, third-party administrators, vote tabulators, securities intermediaries, and proxy service providers.
- Costs and challenges associated with distributing proxy and other materials to beneficial owners who hold in "street name," as well as the costs and other challenges of communicating with such shareholders more generally. In particular, concerns have been expressed about the ability and expense for issuers to communicate with street name holders through securities intermediaries, regardless of whether the shareholder is an "objecting beneficial shareholder" or "non-objecting beneficial shareholder."

Retail Shareholder Participation

In the 2017 proxy season, retail shareholders voted approximately 29% of their shares, while institutional investors voted approximately 91% of their shares.[3] In this regard, it may be useful to better understand:

- Reasons for this relatively low retail participation rate and whether better communication and coordination among proxy participants, increased use of technology, changes to our rules, or investor education could increase participation.
- How existing rules or market practices affect the ability of individuals who invest in the public markets through investment vehicles such as mutual funds and pension funds to participate in the governance of public companies in which they have an interest. For example, some have suggested that fund shareholders should have a means of providing input into how the fund adviser votes its portfolio securities.
- And, more generally, the extent to which relatively low retail investor participation should be of concern and should inform analysis of existing regulation.

Shareholder Proposals

The shareholder proposal process is a channel for shareholders to engage with the U.S. public companies in which they invest on specific topics. All shareholders, as the ultimate owners of the company, bear the costs associated with management's consideration of a proposal and its inclusion in the proxy statement. And, those same shareholders may benefit from the engagement and potential for enhanced performance brought about by consideration of a

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[3] *See* ProxyPulse, 2017 Proxy Season Review (September 2017), *available at* https://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-proxypulse-2017-proxy-season-review.pdf.

shareholder proposal. Many market participants believe this dynamic has enhanced company performance. Many market participants also believe that the costs of this process could be significantly reduced without limiting (and potentially increasing) the benefits of shareholder engagement. In this vein, it often is noted that a small group of shareholders submits a significant percentage of the total number of shareholder proposals each year.[4]

Areas of the shareholder engagement process that may warrant particular attention include:

- Whether the current thresholds for minimum ownership (e.g., shares held and length of time) to submit a proposal to be included in the company's proxy statement[5] appropriately consider the interests of all shareholders, taking into account the potential benefits to shareholders of a proposal (or resubmission) being considered or adopted, as well as the costs associated with the inclusion of a proposal (or resubmission) in the proxy statement.
    - Further, whether rules that allow companies to omit resubmitted proposals that received less than 3%, 6%, or 10% of the vote, depending on how many times the subject matter has been voted on in the last five years,[6] are appropriate.
- Whether meaningful ownership in the company can be demonstrated by factors other than the amount invested and the length of time shares are held.
- Whether the voices of long-term retail investors (who invest directly and indirectly through mutual funds, ETFs, and other products) are appropriately represented in the shareholder proposal process and in the shareholder engagement dynamic more generally.

Proxy Advisory Firms

Proxy advisory firms provide a number of services related to proxy voting, which include aggregating and standardizing information, providing platforms for managing votes, and providing voting recommendations. Areas that may warrant particular attention include:

- Whether various factors, including legal requirements, have resulted in investment advisers to funds and other clients relying on proxy advisory firms for information aggregation and voting recommendations to a greater extent than they should, and whether the extent of reliance on these firms is in the best interests of investment advisers and their clients, including funds and fund shareholders.
- Whether issuers are being given an appropriate opportunity to raise concerns if they disagree with a proxy advisory firm's recommendations, including, in particular, if the recommendation is based on erroneous, materially incomplete, or outdated information.
- Whether there is sufficient transparency about a proxy advisory firm's voting policies and procedures so that companies, investors, and other market participants can understand how the advisory firm reached its voting recommendations on a particular matter, and

[4] *See* Gibson Dunn, Shareholder Proposal Developments During the 2018 Proxy Season (July 12, 2018), *available at* https://www.gibsondunn.com/wp-content/uploads/2018/07/shareholder-proposal-developments-during-the-2018-proxy-season.pdf (one proponent, and shareholders associated with him, submitted or co-filed 24% of all proposals in the 2018 proxy season).

[5] Shareholders must own either $2,000 or 1% of a company's stock for one year. 17 CFR 240.14a-8(b).

[6] 17 CFR 240.14a-8(i)(12).

whether comparisons of recommendations across similarly situated companies have value.

- Whether there are conflicts of interest, including with respect to related consulting services provided by proxy advisory firms, and, if so, whether those conflicts are adequately disclosed and mitigated.
- The appropriate regulatory regime for proxy advisory firms and whether prior staff guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms[7] should be modified, rescinded, or supplemented.

Technology and Innovation

The use of technology is implicated in all areas of the proxy process. As such, it may be appropriate to consider the following:

- As technology continues to evolve, whether it can be used to make the proxy process more efficient and effective for participants.
- The potential benefits and consequences that could result from further reliance on, and changes in, technology. For example, whether technology, such as "blockchain" or distributed ledger technology, could be used to streamline or create more accountability in the proxy process.

Other Commission Action

In 2016, the Commission proposed amendments to the proxy rules to require the use of universal proxy cards that would include the names of all nominees in contested board of directors' elections.[8] Under existing rules, nominees must consent to including their names on a proxy card. This means that in an election contest, a dissident may not include the other party's nominees unless it receives consent, which in my experience has rarely been provided. A consequence of this current rule is that, if a shareholder wants to vote for a combination of directors (e.g., some from the management slate and some from the dissident slate), he would have to attend the shareholder meeting in person.

Roundtable Details

The roundtable date, agenda items, panelists, moderators, and logistical information will be made public as they are finalized.

[7] *See* SEC Staff Legal Bulletin No. 20, Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms (June 30, 2014); Institutional Shareholder Services, Inc. SEC Staff Letter (Sept. 15, 2004); Egan-Jones Proxy Services, SEC Staff Letter (May 27, 2004). The guidance states that investment advisers should ascertain whether a proxy advisory firm has the capacity and competency to adequately analyze proxy issues, including the robustness of its policies and procedures identifying and addressing any conflicts of interest. In addition, the guidance addressed the availability and requirements of two exemptions from the federal proxy rules that are often relied upon by proxy advisory firms. SEC Staff Legal Bulletin No. 20 (June 30, 2014).

[8] *Universal Proxy*, Release No. 34-79164 (October 16, 2016) [81 FR 79122 (November 10, 2016)]. The comment letters received in response to the 2016 proposing release are *available at* https://www.sec.gov/comments/s7-24-16/s72416.htm.

Members of the public who wish to provide their views on the proxy process, either in advance of or after the roundtable, may submit comments electronically or on paper.[9] Please submit comments using one method only. Information that is submitted will become part of the public record of the roundtable and posted on the SEC's website. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

Electronic Comments:

Use the SEC's Internet submission form or send an email to rule-comments@sec.gov .

Paper Comments:

Send paper comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, D.C. 20549-1090.

All submissions should refer to File Number 4-725, and the file number should be included on the subject line if email is used.

[9] Comments on the use of universal proxy cards should be submitted to the rulemaking file for the 2016 Universal Proxy release using the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml) or via email to rule-comments@sec.gov(please include File Number S7-24-16 on the subject line).

Harvard Law School Forum on
Corporate Governance and Financial Regulation
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Legislative Threat to Shareholder Rights

Posted by Dimitri T.G. Zagoroff, Glass, Lewis & Co., on Thursday, June 14, 2018

Editor's note: Dimitri T.G. Zagoroff is Content Manager and Internal Consultant at Glass, Lewis & Co. This post is based on his Glass Lewis publication.

Shareholder rights are once again under legislative threat.

Introduced May 10, HR 5756 would require the SEC to adjust resubmission thresholds for shareholder proposals. The language mirrors that of the Financial CHOICE Act in calling for substantial increases to the level of support required for proposals to stay on the ballot: the threshold for first-year submissions would double from 3% to 6% support; more than double from 6% to 15% for second-year, and treble from 10% to 30% in the third-year.

Like last year's HR 4015, which sought to regulate proxy advisors, the bill was proposed by Rep. Sean Duffy (R-WI). Like HR 4015, the bill effectively recycles provisions of the CHOICE Act, itself stalled in the Senate, on a standalone basis. And like HR 4015, HR 5756 marks an attempt to push back against investors amid a rising swell of shareholder activism.

Shareholder proposals play an important role in ensuring that owners get a say in how their companies are run, and in setting the broader agenda across the market. Making it harder for shareholder proposals to be resubmitted from year to year would make it that much harder for proponents to refine their ideas and build a coalition of support. This often takes several years, both to generate interest in the underlying topic, and to convince other shareholders that the specific proposal offers the appropriate means of addressing the topic.

In recent years, issues like climate change and the gender pay disparity at tech companies have been brought to the fore after investors requisitioned proposals demanding that their boards take action—and kept pushing those proposals, even if they initially received low levels of support. Those advocating for a review of submission thresholds argue that the 3% requirement is too low: in 2017, of the 498 SHPs that went to a vote, only 24 got under 3%. However, increasing second and third-year thresholds by up to 3x, to 15% and 30% respectively, sets the bar extremely high and may serve to stifle discussion on key issues before they can gain traction. Moreover, for companies with dual-class share structures (like Tyson, Google and Facebook, all of which have seen shareholder proposals recently), 30% support from independent shareholders is effectively impossible to achieve.

With elections looming and the CHOICE Act still outstanding, it's unclear whether anything will come of this latest bill. Regardless, coming off another proxy season marked by increasing support for shareholder proposals, investors should keep an eye on HR 5756, and any other CHOICE Act provisions that find new life in standalone bills.

The Universal Proxy Gains Traction: Lessons from the 2018 Proxy Season

Posted by David Whissel, MacKenzie Partners, Inc., on Wednesday, September 19, 2018

Editor's note: David Whissel is Senior Vice President and Director of Corporate Governance at MacKenzie Partners, Inc. This post is based on a MacKenzie Partners memorandum by Mr. Whissel. Related research from the Program on Corporate Governance includes Universal Proxies by Scott Hirst (discussed on the Forum here).

Despite recent reports that it has been shelved as an item on the SEC's agenda, the universal proxy card, which makes it easier for shareholders to pick-and-choose from a combination of management and dissident nominees in a proxy contest, found new life this year as it was used for the first time in a proxy contest involving a US-listed company, and was on the verge of being implemented in at least two other contests that were settled prior to the proxy being mailed.

The universal proxy card has long been a topic of discussion among regulators and industry practitioners, and it looked like the initiative had gained sufficient traction in October 2016 as then-SEC Chair Mary Jo White proposed a new rule on the issue. However, the new SEC administration had reportedly put the universal proxy on the back burner and shifted its attention towards other rulemaking initiatives. It is somewhat surprising, then, that the private ordering that occurred this year primarily emanated from issuers rather than activists, who have historically been more outspoken in their support of the universal proxy.

Most notably, in June 2018, a universal proxy card was used by SandRidge Energy in its proxy contest with Carl Icahn—a first for a US-listed company. In that case, SandRidge developed a unique card that offered up both its own five nominees and Icahn's seven nominees as potential choices, but, crucially, recommended that shareholders vote only for its five nominees and two of the three other nominees that were deemed independent of Icahn. The move received praise from various constituencies, including the Council of Institutional Investors, which wrote a letter to the company's board expressing its support. And while the company ultimately ceded five board seats to the Icahn nominees in a last-minute settlement agreement, it should be noted that, had the company used a traditional proxy card, it is highly likely that even more shareholders would have used Icahn's gold proxy card to vote for some or all of his nominees, increasing the possibility that Icahn would have won control of the entire board.

The universal proxy was also proposed, though not ultimately used, in two other situations: first, at Cars.com, and second, at Mellanox Technologies. Coincidentally, both companies were targeted by activist investor Starboard Value, and in both cases, Starboard was nominating directors that would have comprised at least half of the board. In the case of the latter, the company actually submitted the issue of whether or not to use a universal proxy to a shareholder vote at a special meeting that preceded the annual meeting at which the directors were to be

elected. The universal proxy received overwhelming support from shareholders at Mellanox's special meeting, and although both campaigns settled prior to the ultimate shareholder vote, they provided further evidence of the extent to which the universal proxy is a viable option for corporate issuers in a proxy contest.

In the absence of private ordering, with the current SEC administration, there are questions over whether the universal proxy will ever become standard practice. However, with the issue having gained a considerable amount of momentum over the past five years, shareholders appear to be eager to test out the universal proxy on an expedited timeline. During our experiences with the universal proxy card this past spring, the feedback we received from investors was overwhelmingly positive. And, importantly, the universal proxy did not lead to any unexpected results or insurmountable logistical challenges in any of the three contests in which it was used in 2018.

For those advocating for the widespread adoption of the universal proxy, however, a glimmer of hope arrived in August 2018, when the SEC announced plans to convene a roundtable to discuss the proxy process. Though the release indicates that the focus of the discussion will be predominantly on the "plumbing" of the voting system, it did make relatively brief mention of the 2016 proposed universal proxy amendments to the proxy rules. The logistical information regarding this roundtable has yet to be released, but the proposed agenda should provide some indication as to whether the universal proxy will be a focal point or merely a side issue.

For the time being, however, the spread of the universal proxy is likely to be ad hoc, driven by private ordering rather than legislative initiative. This is not necessarily a bad thing; the fact that the universal proxy remains something that is privately negotiated rather than mandated can give the parties to a proxy contest some flexibility in creating a body of acceptable "best practices" around the universal proxy, which could encourage its further use and may even provide a template for a future SEC rulemaking initiative. Nonetheless, the proxy contest at SandRidge Energy provided a much-needed "case of first impression," demonstrating the universal proxy's usefulness as a tool to facilitate shareholder franchise.

The complete publication is available here.

The SEC and Mandatory Shareholder Arbitration

Posted by Cydney Posner, Cooley LLP, on Thursday, February 22, 2018

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

Depending on your point of view, you may have experienced either heart palpitations or increased serotonin levels when you heard, back in July 2017, that SEC Commissioner Michael Piwowar had, in a speech before the Heritage Foundation, advised that the SEC was open to the idea of allowing companies contemplating IPOs to include mandatory shareholder arbitration provisions in corporate charters. As reported, Piwowar "encouraged" companies undertaking IPOs to "come to us to ask for relief to put in mandatory arbitration into their charters." (See our earlier post on the Forum.) As discussed in this PubCo post, at the same time, in Senate testimony, SEC Chair Jay Clayton, asked by Senator Sherrod Brown about Piwowar's comments, responded that, while he recognized the importance of the ability of shareholders to go to court, he would *not "prejudge" the issue.* According to some commentators at the time, to the extent that these views appeared to indicate a significant shift in SEC policy on mandatory arbitration, they could portend "the beginning of the end of securities fraud class actions." Then, in January of this year, the rumors about mandatory arbitration resurfaced in a Bloomberg article, which cited "three people familiar with the matter" for the proposition that the SEC is "laying the groundwork" for this "possible policy shift." But in recent Senate testimony, Clayton reportedly put the kibosh on these signals.

As discussed here, the concept of mandatory arbitration of shareholder claims has been run up the flagpole a few times in the past. The idea took hold in the late 1980s, when SCOTUS concluded that stock brokers could enforce mandatory arbitration agreements with customers. However, in subsequent encounters, the SEC has not been particularly receptive to the idea. When a private equity fund sought to go public in 2012 with a provision in its partnership agreement requiring mandatory individual arbitration of any disputes, including disputes under the federal securities laws, Corp Fin advised that it would not accelerate effectiveness of its registration statement, and the provision was withdrawn. Then, in an interesting turn of events, binding shareholder proposals were submitted at several companies seeking to amend their bylaws to *include* mandatory shareholder arbitration provisions. (If this seems a bit curious, the argument submitted by the proponent was that the costs of frivolous class action litigation were ultimately borne by the shareholders, and preventing these suits would therefore benefit shareholders.) Some of these companies, attempting to *exclude* the proposals from their proxy statements, contended that they should be excludable under Rule 14-8(i)(2)—on the basis that implementation would cause the company to violate applicable law—because implementation would violate Section 29(a) of the Exchange Act. Section 29(a) declares void any provision "binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder…." Since the bylaw prohibited claims subject to arbitration from being brought in a representative capacity, that is, in class actions, the company argued, the provision effectively

waived shareholders' abilities to bring claims under Rule 10b-5. The SEC allowed exclusion of the shareholder proposal, agreeing that there was some basis for the view that implementation of the proposed bylaw amendment would cause the company to violate the federal securities laws.

The impetus for the recent reemergence of the concept of mandatory arbitration in the context of IPOs seems to be the continued hand-wringing over the dearth of IPOs. Commissioner Michael Piwowar has previously observed that, "since 2000, the average annual number of IPOs is 135—less than one-third the average annual number of IPOs—457—in the 1990s…. In the 1980s and 1990s, IPOs with proceeds of less than $30 million constituted approximately 60 percent and 30 percent, respectively, of all IPOs. In fact, some of the most iconic and innovative U.S. companies…entered the public market as small IPOs. This trend reversed in the 2000s. IPOs with proceeds less than $30 million accounted for only 10 percent of all IPOs in the period 2000-2015. By comparison, large IPOs have increased from 13 percent in the 1990s to approximately 45 percent of all IPOs since then."

SideBar

Not everyone agrees that the fretting over the decline in IPOs is appropriate. According to EY, what happened—largely the result of acquisitions and delistings—happened primarily by 2002; it's not just a recent phenomenon. And much of the decline may reflect the popping of the dot-com bubble in the first years of the new millennium. Accordingly, some would argue that a number of those companies should not have gone public in the first place and that measuring against the height of the bubble is wrong-headed. (For more discussion regarding the decline in IPOs and public companies, see this PubCo post, this PubCo postand this PubCo post.)

More recently, a Treasury report, A Financial System That Creates Economic Opportunities—Capital Markets, issued in October last year, asserted that concerns about becoming the target of securities class actions may discourage companies from going public. To make matters worse, the report observed, the number of class actions has recently increased from 151 in 2012 to 272 in 2016, with 317 filed in the first nine months of 2017 (although still below the peak of 498 actions in 2001). The level of class actions was particularly striking in light of the decline in the number of public companies. However, most cases settled; according to the report, only "21 cases since the adoption of the Private Securities Litigation Reform Act of 1995 have gone to trial." The report also observed that some commentators view class actions as useful tools for accountability and deterrence of wrongdoing. At the end of the day, however, the report did not advocate mandatory arbitration; instead, it recommended that both the states and the SEC "investigate the various means to reduce costs of securities litigation for issuers in a way that protects investors' rights and interests, including allowing companies and shareholders to settle disputes through arbitration." (See this PubCo post.)

But according to an article in Pensions & Investments, in testimony regarding ICOs before the Senate Banking Committee on Tuesday, February 6, Clayton indicated that barring shareholder securities fraud litigation was not in the offing. In questioning, Senator Elizabeth Warren, referring to the news report cited above that the SEC was considering allowing companies to adopt mandatory arbitration provisions, asked whether Clayton would support this "enormous change." According to the article, "Mr. Clayton said that while he could not dictate whether the issue comes before the Securities and Exchange Commission, he is 'not anxious to see a change in this area.'" In addition, he observed, "'If this issue were to come up before the agency, it would take a

long time for it to be decided, because it would be the subject of a great deal of debate. In terms of where we can do better, *this is not an area that is on my list of where we could do better,*' Mr. Clayton told the committee." [Emphasis added.]

Harvard Law School Forum on
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The Legality of Mandatory Arbitration Bylaws

Posted by Andrew Rhys Davies, Allen & Overy LLP, on Wednesday, September 12, 2018

Editor's note: Andrew Rhys Davies is a partner at Allen & Overy LLP. This post is based on an Allen & Overy memorandum authored by Mr. Rhys Davies originally published in the *New York Law Journal*.

There has been renewed interest in whether the SEC should allow a U.S. company to conduct a registered initial public offering if its bylaws require shareholders to arbitrate federal securities claims. In April 2018, SEC Chair Jay Clayton said that resolving this knotty issue is not a priority for the Commission, but the Supreme Court's May 2018 pro-arbitration decision in *Epic Systems Corp. v. Lewis*, 138 S. Ct. 1612 (2018), may embolden an IPO candidate to force the issue.

In *Epic Systems*, the Supreme Court held that the Federal Arbitration Act (FAA) requires a court to enforce an employment agreement that requires an employee to bring federal employment claims in a bilateral arbitration against the employer, and to dismiss a federal class action brought in violation of such an agreement. As the Supreme Court reaffirmed, a plaintiff faces a "stout uphill climb" to show that some other federal statute (in this case, the National Labor Relations Act) overrides the FAA and guarantees the right to litigate in court or to bring class claims in arbitration. *Id.* at 1264. Indeed, over the last thirty years, the Supreme Court has rejected "*every*" attempt to "conjure conflicts between the [FAA] and other federal statutes." *Id.* at 1627 (emphasis in original).

There are genuine policy arguments on both sides of the debate over whether federal securities claims should be arbitrable. Those in favor argue that this will eliminate vexatious securities litigation and maybe even help reverse the long-term decline in IPOs. But securities litigation is not quite as vexatious as in years past. Together, the Private Securities Litigation Reform Act of 1995 (PSLRA) and Securities Litigation Uniform Standards Act of 2002 direct all class claims to federal court, where cases filed around the country can be consolidated for efficient pretrial management, and where entirely meritless claims should not survive long.

Federal Rule of Civil Procedure 23(f) permits interlocutory appellate review of class certification orders. And when a federal class action is settled, the defendant can secure class-wide peace. Not all of those features of federal court litigation are readily available in arbitration, so registrants should be careful before assuming that arbitration is preferable in every respect.

Opponents argue that shutting the courthouse doors to investors will impair the effective enforcement of the securities laws. And if only institutional or wealthy investors can afford to bring arbitrations, there may well be a danger that retail investors go unprotected. But here, too, things are not entirely one-sided. Ultimately, it is investors who bear the costs of meritless litigation. And if investors truly value the right to litigate in a federal class action, then the market should be

willing to pay more for shares that include that right, thereby incentivizing registrants to keep offering them.

Moreover, allowing federal securities claims to be arbitrated would hardly stop the development of the law in its tracks, as some have suggested. To be sure, private civil securities actions have yielded many important precedents, including cases limiting the territorial reach of the securities laws, *see Morrison v. Nat'l Australia Bank Ltd*., 561 U.S. 247 (2010), and defining what it means to "make" a misstatement, *see Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), and for fraud to be "in connection with" a securities transaction, *see Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006).

But civil and criminal cases brought by the SEC and Department of Justice, too, have given us important case law, including decisions that tell us what a security is, *see S.E.C. v. W.J. Howey Co*., 328 U.S. 293 (1946), and that describe scienter, *see Aaron v. SEC*, 446 U.S. 680 (1980), and the contours of insider trading, *see United States v. O'Hagan*, 521 U.S. 642 (1997). In any event, the Supreme Court has long endorsed the arbitrability of claims under the federal antitrust, labor, and antiracketeering laws without any concern for the impact that would have on the availability of judicial decisions to elucidate the law. It is not immediately obvious why that concern should bear any greater weight in the context of the federal securities laws.

SEC Blocks Carlyle Group IPO in 2012

The last time it confronted the issue, in 2012, the SEC effectively blocked the IPO of a U.S. company, Carlyle Group, whose governing documents required the arbitration of federal securities claims. The SEC did that by declining to exercise its authority under § 8(a) of the Securities Act of 1933, 15 U.S.C. § 77h(a), to accelerate the effective date of the registration statement. The issue was not litigated in 2012, but if it ever were, it is not at all clear that § 8(a) actually permits the SEC to block an IPO based on its dim view of arbitration (as opposed to its view as to whether the arbitration requirement is properly disclosed to investors).

And the SEC was surely wrong to suggest in 2012 that the FAA is overridden by the anti-waiver provisions in the securities laws, 15 U.S.C. §§ 77n, 78cc(a). In the context of permitting securities brokers to require their customers to arbitrate, the Supreme Court long ago held that those anti-waiver provisions only block waivers of the *substantive* protections of the securities laws. *See Rodriguez de Quijas v. Shearson/American Express, Inc.,* 490 U.S. 477 (1989); *Shearson/American Express, Inc. v. McMahon,* 482 U.S. 220 (1987).

A registrant that is truly motivated to press the arbitration issue would seem, therefore, to have real arguments to challenge any future attempt by the SEC to block its IPO. It is not clear that any registrant would want to begin its life as a public company litigating against the SEC, nor that such a fight would attract underwriters and investors. But if the SEC were to change course and affirmatively endorse arbitration, or even if it punted on the issue by simply letting the registration statement become effective, the arbitrability issue would be ripe as soon as an investor filed a federal class action and the registrant moved to dismiss in favor of arbitration.

The *Epic Systems* decision makes clear that debates about the wisdom or not of arbitrating securities claims should play little role in resolving the question. Under the FAA, all federal statutory claims are subject to arbitration unless Congress has said otherwise. Some have

suggested that the PSLRA reflects a Congressional judgment that securities claims should be litigated as class actions in federal court. But to displace the FAA, Congress must speak with a good deal more "clarity" than it did in the PSLRA. *See CompuCredit Corp. v. Greenwood*, 565 U.S. 95, 103-04 (2012). Congress knows how to displace the FAA for particular claims, as it did when it expressly invalidated agreements that require arbitration of whistleblower claims. *See* 18 U.S.C. § 1514A(e)(2). And in any event, the PSLRA was intended to rein in abusive securities class actions, not to exalt them above all other forms of dispute resolution.

Opponents have also suggested that the FAA does not require enforcement of arbitration provisions set forth in a company's bylaws because corporate bylaws do not qualify as a written "contract" to arbitrate for purposes of the FAA, *see* 9 U.S.C. § 2. But state law generally determines whether there is an agreement to arbitrate, *see, e.g., Volt Information Services, Inc. v. Bd. of Trustees of the Leland Stanford Junior University*, 489 U.S. 468, 475-76 (1989), and Delaware law, which governs the constitutional documents of many U.S. companies, treats corporate bylaws as contracts between the company and its shareholders, *see Hill Int'l, Inc. v. Opportunity Partners L.P.*, 119 A.3d 30, 38 (Del. 2015).

One other thing is clear from the *Epic Systems* opinion. Even assuming the continued viability of the *Chevron* doctrine, the Supreme Court is likely to pay little heed to the SEC's views on whether federal securities claims are subject to mandatory arbitration. According to the Supreme Court, an agency like the SEC has no relevant expertise to bring to bear on the question of whether the statute it administers can be reconciled with the Arbitration Act. *See Epic Systems*, 138 S. Ct. at 1629. And the SEC's views are likely to command even less deference if it changes its position on that question. *See id.* at 1630.

Mandatory Arbitration: An Illusory Remedy for Public Company Shareholders

Posted by Rick A. Fleming, U.S. Securities and Exchange Commission, on Tuesday, February 27, 2018

Editor's note: Rick A. Fleming is an Investor Advocate with the U.S. Securities and Exchange Commission. This post is based on Mr. Fleming's recent remarks at the *Practising Law Institute*. The views expressed in this post are those of Mr. Fleming and do not necessarily reflect those of the Securities and Exchange Commission or its staff.

Today [February 24, 2018] is a special day for the Office of the Investor Advocate. I started this job four years ago today, and because I am the first Investor Advocate that is also the day the Office of the Investor Advocate came into existence. During the past four years, through the efforts of the talented and dedicated individuals who have joined my Office and work so hard to advocate for investors, we have helped to elevate the Commission's thinking about the needs of today's investors. And we continue to make progress in some important areas. For example, the SEC Ombudsman, Tracey McNeil, has recently launched an electronic Ombudsman Matter Management System (OMMS) to make it easier for investors to let us know of any concerns about the SEC or a self-regulatory organization. An electronic OMMS form is available at the Ombudsman's website, www.sec.gov/ombudsman, and we encourage investors to check it out.

This morning, I would like to share some of my views on the issue of mandatory arbitration and, more specifically, on efforts to force public company shareholders to forego class action lawsuits and seek recovery individually through arbitration. This has been a matter of concern to investors recently,[1] after commentators have suggested that U.S. IPO issuers should consider including arbitration provisions in their articles or bylaws.[2]

The idea of forced arbitration has been promoted as a way to reduce costs of securities litigation for public companies and thereby remove a perceived disincentive for companies to be public. Reportedly, it is too easy for plaintiffs' firms to bring dubious cases and win settlements,[3] and some have argued that class action lawsuits, even meritorious ones, fail to compensate harmed investors in any meaningful way.[4]

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[1] *See* Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to William H. Hinman, Dir., Div. of Corp. Fin., SEC (Jan. 29, 2018), http://www.cii.org/files/issues_and_advocacy/correspondence/2018/January%2029%202018%20letter%20to%20Mr_%20Hinman%20on%20forced%20arbitration%20(final).pdf.

[2] *See, e.g.,* Stephen Bainbridge, *The SEC Should Authorize Mandatory Arbitration of Shareholder Class Action Lawsuits*, (Jan. 30, 2018, 2:21 PM), http://www.professorbainbridge.com/professorbainbridgecom/2018/01/the-sec-should-authorize-mandatory-arbitration-of-shareholder-class-action-lawsuits.html.

[3] *See* Sara Randazzo, *Companies Face Record Number of Shareholder Lawsuits*, Wall St. J., (Aug. 22, 2017, 5:30 AM), https://www.wsj.com/articles/why-lawsuits-targeting-stock-drops-are-on-the-rise-1503307800.

[4] *See* Hal S. Scott & Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 Harv. J. L. & Pub. Pol'y 1187, 1194 (2013).

There may be some validity to these concerns. But stripping away the right of shareholders to bring a class action lawsuit seems to me draconian and, with respect to promoting capital formation, counterproductive. Let me explain why.

If we take a step back and look at the big picture, there are some very good reasons why shareholders have been given private causes of action. In the United States, the government has traditionally played a limited role in policing our markets, as evidenced by the fact that only 4,600 SEC employees oversee approximately $72 trillion in securities trading each year, as well as the disclosures of more than 8,100 public companies and the activities of more than 26,000 registered entities.[5] Because of the limited scope of the SEC's resources, investors themselves have typically borne a large share of the responsibility for policing the markets and rooting out misconduct. Over the years, Congress,[6] the Supreme Court,[7] and former SEC Commissioners[8] have recognized the importance of private suits in helping to protect investors and deter wrongdoing.

The SEC, itself, continually reminds investors of its constraints in advocating for their individual interests. Consider how many times every day an investor is told by the SEC staff that we cannot give them legal advice or represent their individual interests. For good reasons, nearly every SEC Investor Alert and hotline phone call includes a disclaimer to the effect that the reader or caller should consult with an attorney who specializes in securities law.[9] In fact, I have personally communicated this to investors many times over the course of my career. When I was a state regulator, I frequently cautioned investors that they should retain private counsel, because even though the interests of victims were generally aligned with the interests of the State of Kansas, those interests could diverge—for example, it might be in the best interest of the state to take away a license, which may decrease the likelihood that a victim would be repaid.

[5] *Examining the SEC's Agenda, Operations, and Budget: Hearing Before the H. Committee on Financial Services*, 115th Cong. (2017) (statement of Jay Clayton, Chairman, U.S. Securities and Exchange Commission), https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-jclayton-20171004.pdf.

[6] Notably, Congress affirmed the importance of preserving the federal securities class action when enacting the Private Securities Litigation Reform Act of 1995, legislation which purported to weed out frivolous suits through a variety of procedural and other measures. Joint Explanatory Statement of the Committee of Conference on H.R. 1058 at 31, *reprinted in* 2 U.S.C.A.A.N. 730 (104th Cong., 1st Sess. 1995) ("The private securities litigation system is too important to the integrity of American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits. Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.").

[7] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 345 (2005) ("The securities statutes seek to maintain public confidence in the marketplace…. They do so by deterring fraud, in part, through the availability of private securities fraud actions."); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) ("While this language [in Exchange Act §14(a)] makes no specific reference to a private right of action, among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result."); Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988) ("Judicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of §10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act's requirements.").

[8] *See, e.g., Securities Investor Protection Act of 1991: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing and Urban Affairs*, 102d Cong. 15-16 (1991) (quoting then-Chairman Richard C. Breeden as saying "private actions…have long been recognized as a necessary supplement…and an essential tool in the enforcement of federal securities laws. Because the Commission does not have adequate resources to detect and prosecute all violations of the federal securities laws, private actions perform a critical role in preserving the integrity of our securities markets.").

[9] *See, e.g.*, Office of Investor Education and Advocacy, Investor Alert: Credit Cards and Investments—A Risky Combination (Feb. 14, 2018), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_riskycombination.

In addition, investors have remedies that may not be available to regulators, the most important of which is the ability to seek full restitution of their losses instead of merely disgorging the bad actor's ill-gotten gains. Resource constraints can also make regulators pick and choose among cases, which means that the government may decline to pursue many viable cases. In short, our regulatory framework assumes that investors themselves will serve an important role in policing the markets.

Advocates for mandatory arbitration suggest that arbitration provides a sufficient way for investors to seek redress, even if investors are denied the right to pursue class action lawsuits. But, as a practical matter, unless a class-wide remedy is available there is often no other recourse for investors with small holdings.[10] Cases involving accounting irregularities or other corporate misdeeds are usually far more complex than the typical dispute involving a consumer contract, or even a dispute against a broker or investment adviser that involves the investor's personal account. For individual investors who suffer losses in a widespread fraud, the costs of bringing claims individually in arbitration may well exceed the amount of the likely recovery. And, unless their losses are sizable, victims will struggle to find attorneys to represent them, much less experts to establish elements such as materiality, reliance, loss causation, and damages. This can lead to a collective action problem, where each investor lacks the economic incentive to bring an individual case, even though the collective losses of multiple investors would justify the costs of the litigation.[11]

Some have observed that class actions generally result in "institutional shareholders effectively suing themselves," paying high costs for the defense while giving plaintiffs' attorneys a large share of any settlement.[12] But institutional investors, who presumably have the economic incentives and resources to pursue individual arbitration, have been vocal in their opposition to forced arbitration. In a recent letter to the SEC, the Council of Institutional Investors expressed its view that these clauses represent a potential threat to principles of sound corporate governance that balance the rights of shareholders against the responsibility of corporate managers to run the business.[13] In my view, there is considerable value in seeing companies held accountable for wrongdoing, even if the compensatory mechanism is imperfect.

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[10] The available evidence from other types of forced arbitration provisions bear this out. In the commercial contract context, studies show that far fewer claims are pursued when would-be plaintiffs are limited to arbitration and banned from bringing a class action. For example, a *New York Times* analysis found that in the United States between 2010 and 2014, only 505 consumers went to arbitration over a dispute of $2,500 or less. During that five-year time period, three cell phone and cable TV providers with a combined customer base of nearly 200 million people faced only 78 consumer arbitrations. The *Times* concluded that once people were blocked from going to court as a group, most dropped their claims entirely. Jessica Silver-Greenberg and Robert Gebeloff, *Arbitration Everywhere, Stacking the Deck of Justice*, N.Y. Times, Oct. 31 2015, https://www.nytimes.com/2015/11/01/business/dealbook/arbitration-everywhere-stacking-the-deck-of-justice.html.

[11] *See* Christopher R. Leslie, *The Significance of Silence: Collective Action Problems and Class Action Settlements*, 59 Fla. L. Rev. 71, 73 (2007).

[12] *See supra* note 5 at 1194.

[13] *See supra* note 2. In an amicus brief submitted by CalPERS and CalSTRS, the two California public pension funds averred that the ability of investors injured by securities fraud to recover through class actions is essential to the integrity of the securities markets and that "[e]viscerating the class action mechanism in securities cases would have disastrous consequences for the amici and their beneficiaries." *See* Brief of the Cal. Pub. Employees' Ret. System et al. as Amici Curiae Supporting Appellees, Conn. Ret. Plans & Tr. Funds v. Amgen Inc., 660 F.3d 1170 (9th Cir. 2011) (No. 09-56965), 2010 WL 4316250. In an amicus brief submitted by several public pension funds in the 2004 Dura Pharmaceuticals v. Broudo Supreme Court case, the institutional investors averred that, notwithstanding the oversight of regulators such as the Commission, "the ability of investors to seek to redress corporate wrongdoing through class and individual actions brought under the Securities Act of 1933 and the Securities Exchange Act of 1934 is an important mechanism to deter improper conduct and to recoup losses that investors have suffered as a result of fraud and other misconduct." *See* Brief of City of N.Y. Pension Funds et al. as Amici Curiae Supporting Respondents, Dura Pharms. Inc. v. Broudo, 544 U.S. 336 (2005) (No. 03-932), 2004 WL 2652613 (statutory citations omitted).

There are other downsides to relying upon individual arbitration as the sole means of recourse. For example, disputes that go to arbitration rather than the court system generally do not become part of the public record, which diminishes their deterrent effect.[14] And, while arbitration is often touted as an efficient means for resolving disputes, it seems terribly inefficient to require multiple plaintiffs to prove up the same claims in separate proceedings.[15] Arbitration also lacks procedural rules that require written opinions or decisions explaining the reasoning for an award, and the grounds for appeal tend to be extremely narrow.[16] As a result, the evolution of case law can be hindered.

Consider, for a moment, how different the federal securities laws would be in the absence of civil litigation. How would we define an investment contract in various fact-specific contexts without the cases that have become our guideposts? Would investors even be able to pursue claims under Rule 10b-5?

As a legal matter, I believe the Commission has been on solid footing when objecting to companies forcing shareholders into arbitration. Securities Act Section 8(a) allows the Commission to refuse to accelerate the effective date of an issuer's registration statement upon considering, among other things, the facility with which the rights of the issuer's securities holders can be understood, the public interest, and the protection of investors. If an issuer chooses to file a registration statement with a forced arbitration provision, I would urge the Commission and staff to make use of Section 8(a).

More broadly, Securities Act Section 14 and Exchange Act Section 29(a) state that any condition that would bind a person to waive compliance with those laws is void. The Supreme Court has upheld the validity of arbitration clauses in brokerage customer agreements, but, for the reasons I've already stated, I would suggest that arbitration is not a viable option for investors—particularly small investors—in cases involving fraud on the market or other corporate misconduct. In my view, if private remedies are an important part of the enforcement mechanisms for the '33 and '34 Acts, and forced arbitration provisions would render those remedies illusory for public company shareholders, then those arbitration provisions are void because they would undermine the enforcement of substantive provisions of the Acts.

Admittedly, there are legal arguments to be made on the other side. The law in this area is messy, particularly in the context of an offering that is reviewed by the SEC, and this specific issue has not been addressed by the Court. But, before public companies push this issue and try to go down this road, it's worth considering where it may ultimately lead. For instance, if investors are blocked from seeking redress in an egregious case, it is not difficult to imagine calls for the SEC to receive greater resources and expanded enforcement powers (such as the ability to seek full restitution) to make up for the loss of private causes of action.

Or, perhaps more likely, investors may pursue other avenues to deter the use of forced arbitration. Not long ago, investors were outraged when a company went public with non-voting

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[14] *See supra* note 14.

[15] For example, there is no *stare decisis* or *collateral estoppel*—no legal precedents, and no questions that have been asked and answered. This is an inefficient use of resources because it provides no guidance to other shareholders in virtually identical disputes against the same company, to other companies looking for guidance on their conduct, or to shareholders in other companies.

[16] *See* Jennifer J. Johnson & Edward Brunet, *Critiquing Arbitration of Shareholder Claims*, 36 Sec. Reg. L. J. 181, n. 89 and accompanying text (2008).

shares, and they turned to the index providers for a market solution that would prevent passive investors from being forced to buy the shares. If a company strips away the ability of investors to seek class actions, investors could go down that same road and ask the index providers to keep the company off the index. Before long, if the SEC fails to act, the index providers could step into that vacuum and become the de facto regulators of corporate governance in this country.

Let me close by saying that I hope the Commission does not actually have to confront this issue again in the near future. In my view, the Commission's time would be better spent on matters that address more urgent needs of issuers and their investors. Chairman Clayton, to his credit, has indicated that he is not anxious to expend Commission resources on this issue,[17] and I hope companies are not anxious to push it. For those of you who advise companies that may be curious about adopting mandatory arbitration clauses, I encourage you to talk to them about the downsides and the likely resistance they would encounter from investors and their advocates, including me.

Thank you.

[17] *See* Tom Zanki, *SEC Chief 'Not Anxious' to Deter Post-IPO Class Actions*, Law360 (February 6, 2018, 4:42 PM) https://www.law360.com/articles/1009613/sec-chief-not-anxious-to-deter-post-ipo-class-actions (referring to remarks given by SEC Chairman Jay Clayton at a Senate hearing).

State Treasurers' Opposition Against Forced Arbitration or Class Action Waivers in Shareholder Agreements

Posted by John Chiang, California State Treasurer; Michael Frerichs, Illinois State Treasurer; Michael I. Fitzgerald, Iowa State Treasurer; Tobias Read, Oregon State Treasurer; Joe Torsella, Pennsylvania State Treasurer; and Seth Magaziner, Rhode Island State Treasurer, on Friday, July 13, 2018

Editor's note: John Chiang is California State Treasurer; Michael Frerichs is Illinois State Treasurer; Michael I. Fitzgerald is Iowa State Treasurer; Tobias Read is Oregon State Treasurer; Joe Torsella is Pennsylvania State Treasurer; and Seth Magaziner is Rhode Island State Treasurer. This post is based on their recent joint letter to the SEC.

Dear Chairman Clayton:

As a bipartisan coalition of State Treasurers from across the country, we recognize the dire fiscal matters that face our nation and understand the pitfalls that imperil the financial security of American investors. As institutional investors ourselves, we observe the critical importance of rigorous enforcement of the state and federal securities laws. That's why we write to express our serious concern with reports that the SEC may be considering a fundamental shift in policy that would—for the first time—allow publicly traded companies to block shareholder lawsuits through the use of forced arbitration clauses in IPO filings.[1] We write to express our support for your previous statements indicating you would prefer not to take up the issue[2] and to urge you, should the issue arise in circumstances you do not control, to preserve the Commission's long-standing policy barring public companies from adopting forced arbitration clauses.

State Treasurers serve as custodians of state resources and ensure the prudent oversight and safekeeping of entrusted public funds. As our states' chief financial officers, one of our significant responsibilities is the prudent management and, in many states, the investment of both public taxpayer funds and some private savings. These investments include not just government resources not immediately used for operating expenses, but also college tuition savings accounts, investment accounts for disabled individuals, and—in some cases—pension funds. An essential aspect of our obligation to prudently manage public funds is ensuring that investment managers entrusted with public funds make investment decisions with a full understanding of the potential for financial frauds and abuses on the part of the companies we invest in. As investors,

[1] On July 17th, in a speech before the Heritage Foundation, SEC Commissioner Michael Piwowar strongly supported changing SEC policy to allow companies to place language into their initial public offering paperwork that would force shareholders to resolve claims through forced arbitration rather than in court as well as permitting class action waivers to be placed in the same documentation. See https://www.reuters.com/article/us-usa-sec-arbitration/u-s-secs-piwowar-urges-companies-to-pursue-mandatory-arbitration-clauses-idUSKBN1A221Y.

[2] Hazel Bradford, "SEC chairman says he's not ready to force arbitration," Pensions & Investments, Feb. 7, 2018. See http://www.pionline.com/article/20180207/ONLINE/180209852/sec-chairman-says-hes-not-ready-to-force-arbitration.

we are interested in preserving the ability to redress diminished public funds through private shareholder litigation when violations of the state and federal securities laws occur. Forced arbitration directly threatens our ability to meet these responsibilities.

We want Americans to save for a better life for themselves and their families. Private savings can enhance quality of life and increase opportunities for the citizens of the states we serve, and private savings can also reduce the need for state resources and public assistance.[3] Targeted, private enforcement of state and federal securities laws furthers these goals by empowering Americans to directly combat financial misconduct, and get back their hard-earned investment dollars.

Forced arbitration provisions and class action waivers do just the opposite. Possessing the experience and responsibility of prudently investing billions of public dollars as State Treasurers, we are uniquely qualified to express significant reservations about the proposal to permit forced arbitration provisions. Unfortunately, individual police and firefighter pensioners, teachers and municipal workers, and other individual and retail investors simply do not possess the financial size or scale to contest the inclusion of a forced arbitration clause or class action waiver in a company charter or corporate bylaw. The choice is either to forego any reasonable hope of accountability in the wake of securities fraud, or to forego the investment entirely. We can all support concepts of individual choice and freedom of contract without sacrificing our commitment to ensure that such investment choices and contractual relationships are informed and not predatory.

Moreover, forced arbitration, by its very nature, helps to keep corporate misconduct and financial fraud secret by preventing such cases from reaching the light of public U.S. courtrooms. More specifically, arbitration clauses typically prohibit the disclosure of any information about proceedings. Bans on shareholder class actions (“waivers”) prevent investors from banding together to seek redress for widespread investor harms, leaving over-stretched regulators to try to fill this role on their own. Taken together, this spells immunity for many financial actors, even the very worst. Without private shareholder litigation to police U.S. capital markets and make investors whole, investor confidence in our markets suffers, public participation diminishes, and your stated goal of attracting more companies to go public[4] will ultimately fail. In short, such a proposal hurts both investors and the companies in which they invest.

We come from a diverse coalition of states and perspectives, yet we share a common underlying core financial belief: American investors must be protected. Allowing public companies to adopt forced arbitration clauses and class action waivers at initial public offerings to deny shareholders reasonable ability to redress grievances threatens that protection. We encourage you to continue to resist this proposal and instead to uphold the Commission’s longstanding policy of prohibiting forced arbitration clauses and class action waivers.

Thank you for the opportunity to share our views.

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[3] See http://patreasury.gov/pdf/Impact-Insufficient-Retirement-Savings.pdf.

[4] In June 2017, SEC Chairman Jay Clayton, in a speech, noted that one of his goals is for more companies to go public. See https://www.reuters.com/article/us-usa-sec-ipo/new-sec-chair-clayton-wants-more-companies-to-go-public-speech-idUSKBN19D1S2.

Sincerely,

John Chiang
California State Treasurer

Michael Ferichs
Illinois State Treasurer

Michael I. Fitzgerald
Iowa State Treasurer

Tobias Read
Oregon State Treasurer

Joe Torsella
Pennsylvania State Treasurer

Seth Magaziner
Rhode Island State Treasurer

Tab II: Managing Crisis and Overseeing Culture

CEO Pay Trends

Posted by Alex Knowlton, Equilar Inc., on Friday, September 14, 2018

Editor's note: Alex Knowlton is a Senior Research Analyst at Equilar Inc. This post is based on an Equilar memorandum by Mr. Knowlton, Amit Batish, Courtney Yu, Elizabeth Carroll, Hailey Robbers, and Joseph Kieffer.

With Say on Pay now a regular part of the executive compensation landscape, companies have a clear understanding of how shareholders view chief executive pay. Since the implementation of Say on Pay in accordance with the enactment of Dodd-Frank, over three-fourths of large-cap companies have received at least 90% of shareholder approval, while chief executive officer (CEO) compensation has continued to increase with each passing year.

However, despite the overall increase in total CEO compensation, the composition of CEO compensation, especially equity, has seen updates to reflect the modern pay landscape. Say on Pay provides shareholders an outlet to voice opinions on CEO compensation, and companies, for the most part, listen. For example, compensation tied to specific performance goals became increasingly prevalent with each passing year, evidenced by almost 90% of Equilar 500 CEOs receiving an award tied to some performance metric in 2017. As awards have more often than not hinged upon some performance metric, time-based awards, specifically option awards, continually decreased in prevalence. Additionally, plan-based bonuses and performance incentives have seen a higher, widespread usage, while discretionary bonuses still remain few and far between.

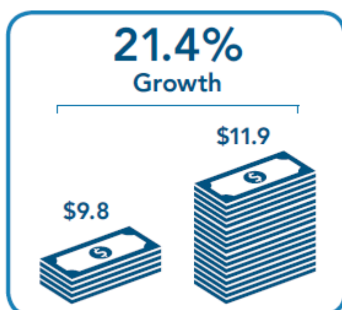
Furthermore, as the voices of activists and institutional investors have become louder and more pronounced, pressure has continually mounted upon boards to align the pay of CEOs with the long-term company strategy, as well as the interests and returns of shareholders. As a result, a majority of large-cap companies highlight some form of shareholder engagement in the annual proxy statement, with discussions on executive pay a principal engagement topic.

This 2018 edition of the Equilar CEO Pay Trends report contains information on trends and changes of CEO compensation, in addition to the breakdown of pay package components, chiefly: cash, equity, time-based and performance-based vehicles. A review of these trends over the five year period provides insight into how boards have positioned pay to balance the combination of executive talent, company strategy and shareholder concerns over the years.

Total Compensation Nearly $12 Million in 2017

The median total reported compensation for Equilar 500 chief executive officers was $11.9 million in 2017, the highest of the five years in the study, and a 3.5% increase from the previous year, though not as large as the increase between 2015 and 2016. Additionally, with generally

consistent growth throughout the years included in the study, the median total compensation has increased 21.4% from 2013 to 2017. That being said, both the 25th percentile and 75th percentile for Equilar 500 total compensation actually saw decreases from 2016 to 2017 of 9.8% and 0.6%, respectively.



Breaking down median total compensation by sector allows for a more in-depth analysis across industries and provides for more specific trends. The healthcare sector, despite remaining constant around $15 million from 2015 to 2017, had the highest median total compensation in all three years. The basic materials sector was the only other sector to have median total compensation for CEOs of at least $13 million, while the financial sector had the lowest median total CEO compensation at $10.2 million.

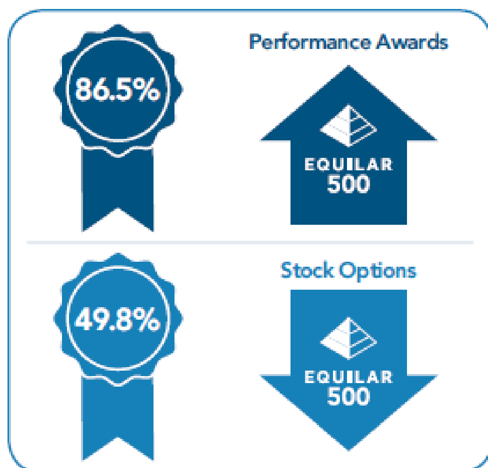
Stock Continues to Represent Majority of CEO Compensation

Stock, which is the summation of both restricted stock and units, increased steadily over each year in the study and had a peak median value of $5.4 million in 2017, more than $3 million of the median value of any other pay component. With all other pay components remaining relatively constant in value from 2013 to 2017, the increase in median CEO pay can be attributed almost exclusively to the increase in median stock value. Though stock also represented the largest value for median pay components in every sector, the basic materials and technology sectors sported the highest median values, with both sectors' median stock values surpassing $6.9 million.

While value provides one avenue of pay component analysis, the makeup of median total compensation also allows for deliberation between each CEO pay component. For example, on average, nearly half of the median total compensation—48.5% to be exact—for an Equilar 500 CEO was comprised of stock. Annual bonus was the second most prevalent component, with almost a quarter of median compensation represented in the form of a bonus. The makeup of total compensation also provides for a detailed look at compensation structure between the sectors. Utilities employed both stock and salary the most on average, while granting CEOs the fewest options and "other" compensation, which is comprised of benefits and executive "perks." Conversely, the consumer goods and services sectors spread the components of CEO pay out the most across multiple vehicles.

Long-Term Incentives Highlight Performance

While the aforementioned stock was the most prevalent component of median total compensation for Equilar 500 CEOs, performance-based was the most common vehicle by which long-term incentives (LTI) were delivered. In fact, 86.5% of companies granted an incentive award with a performance condition in 2017, compared to only 49.8% of companies awarding time-based options. On top of that, performance award prevalence at Equilar 500 companies increased by 20% from 2013 to 2017, while time-based option usage decreased by 16.3% over that same time frame. Over 90% of technology companies granted awards with a performance-based vehicle, and all sectors had at least 82% of companies follow suit.



The median long-term incentive package granted to an Equilar 500 CEO in 2017 consisted of a 54.6% performance-based and 45.4% time-based mix. While this may seem somewhat of an equal breakout, when compared to previous years the numbers begin to paint a vibrant, performance-based picture. Since 2015, performance-based LTI has seen an increase of 14.2%, and an even larger increase of 23.8% since 2013. The utilities and financial sectors both showcased a performance-based LTI mix of nearly 60% of the median incentive award. Moreover, technology, though almost 90% of companies in the sector utilized a performance award, was the sector with the least performance-based LTI mix, with the breakout barely a majority of 51.2% in terms of performance.

Of all Equilar 500 companies in 2017, 30% utilized both restricted stock and performance awards as vehicles in long-term incentive awards for chief executive officers, a 92.3% increase for the same combination in 2013. Granting just options was the least prevalent LTI vehicle in 2017, at 2.1% of companies. Additionally, companies granting options as the only vehicle were even less prevalent than companies that granted no equity at all in the most recent year. In fact, throughout all five years in the study, time-based vehicles with no performance supplement—options or restricted stock alone, or a combination of the two—were never featured by more than 9% of companies each, exhibiting the mass push towards performance since the enactment of Dodd-Frank.

Methodology

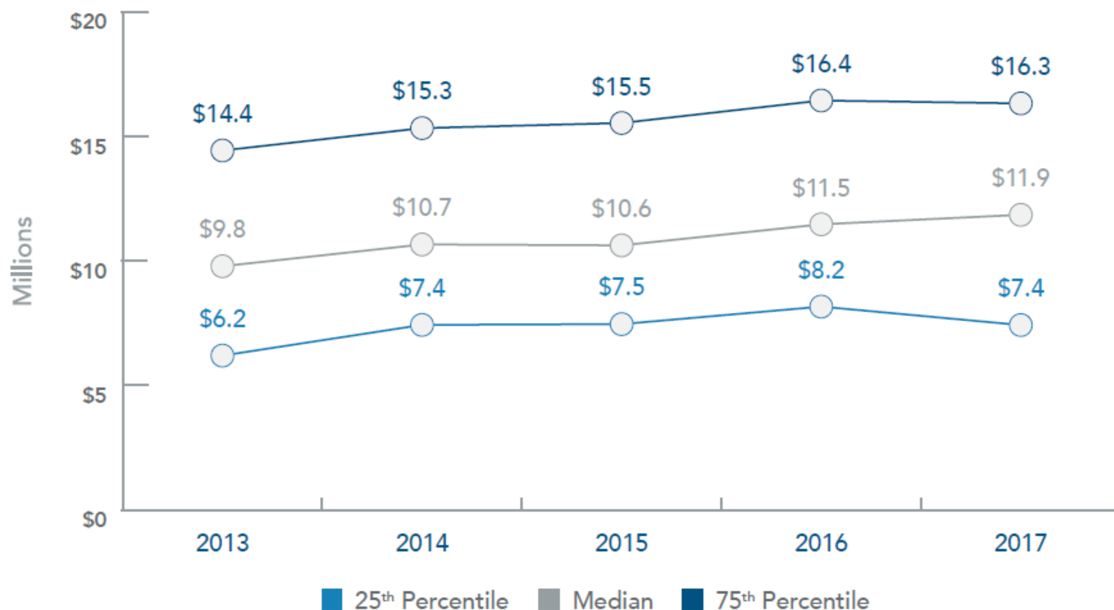
CEO Pay Trends, an Equilar publication, analyzes the compensation data of chief executive officers at Equilar 500 companies over the last five fiscal years. The Equilar 500 is comprised of the 500 largest, by reported revenue, U.S.-headquartered companies that trade on one of the major U.S. stock exchanges (Nasdaq, NYSE or NYSE American), with adjustments to compare to the sector mix of similar large-cap indices. Fiscal year one is defined by companies that filed their most recent proxy statement (DEF 14A or DEFC 14A) or compensation information in a 10-K amendment (10-K/A) between May 2, 2017 and May 1, 2018. Additionally, CEOs that did not serve in the position for a full fiscal year were excluded from the analysis.

Total compensation is defined as the total sum of salary, bonus, non-equity incentive plan compensation, stock awards, option awards and all other compensation as reported in the summary compensation table (SCT). As a way to eliminate actuarial value changes, nonqualified deferred compensation and changes in pension value were excluded from the summation of total compensation. The term “options” includes both options as well as stock appreciation rights (SARs). Similarly, “stock” refers to all full-value shares, including both restricted stock units and restricted stock awards. Performance awards are defined in the report as all long-term incentive compensation vehicles that are linked to a performance metric in some way. Industry sectors for companies in the Equilar 500 are based on the Yahoo! Finance classifications. Though excluded from the sector analysis, companies with the designation of conglomerate were still included in the overall figures.

The data points and figures captured in the report highlight trends in the compensation of chief executives and how companies award that compensation. Meridian Compensation Partners has provided independent commentary to help illustrate how compensation awards are structured and paid to Equilar 500 CEOs.

Key Findings

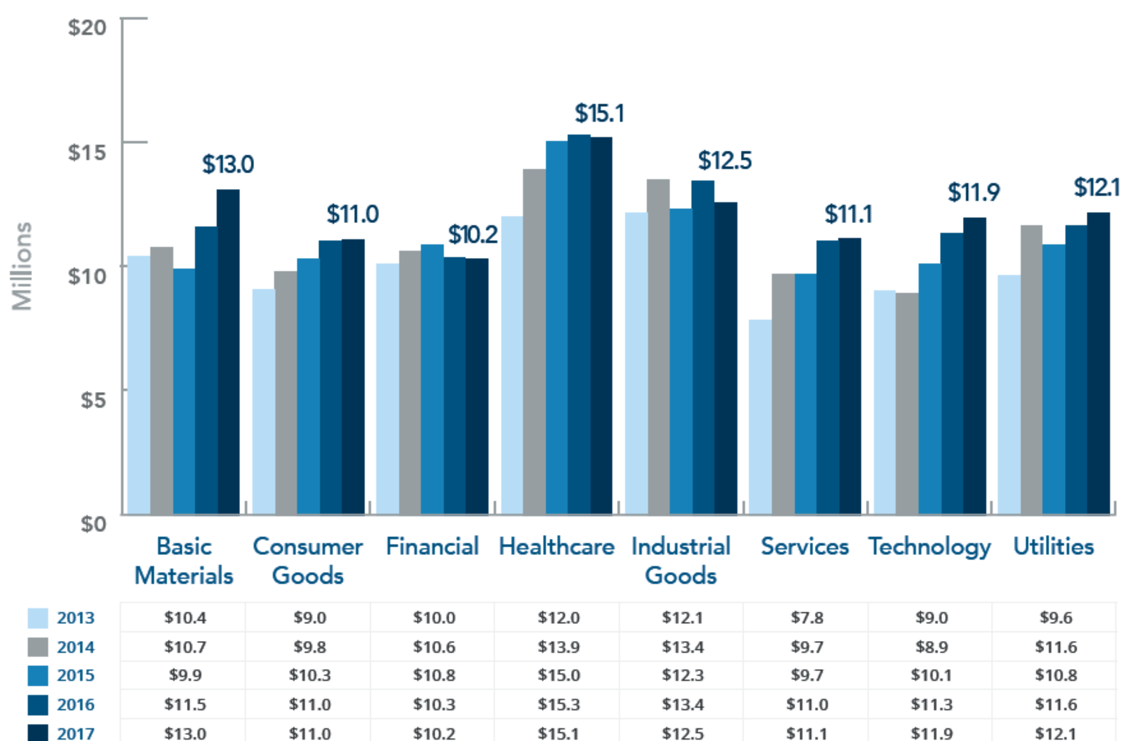
1. Median reported total compensation for Equilar 500 chief executive officers was $11.9 million in 2017, $400,000 more than the previous year's median and a 4% increase from 2013, the first year in the study.
2. Despite remaining constant around $15 million the past three years and even slightly decreasing from 2016 to 2017, median total compensation of CEOs in the healthcare sector was the highest of all sectors. The median total compensation of basic materials chief executives was the only other sector to reach at least $13 million, while the financial sector saw the lowest median at $10.2 million in 2017.
3. On average, nearly half of the reported pay mix for CEOs in the Equilar 500, 5%, is represented in the form of stock. Conversely, barely 3% of the pay mix is made up of "other" compensation, such as benefits and perquisites.
4. 86.5% of Equilar 500 CEOs received an award with a performance condition in 2017, while only 49.8% of the same group was granted an award with time-based options.
5. At the median, 6% of the reported LTI mix for the Equilar 500 was performance-based in 2017. Additionally, financial and utilities companies reported a high of 59.7% performance-based LTI mix, while technology had the lowest median with only 51.2% of LTI mix as performance-based.
6. 30% of all companies in 2017 utilized both restricted stock and performance vehicles in awards, the combination resulting in the most prevalent of all grant vehicles.



Data Points

- From 2013 to 2017 the median total compensation of CEOs increased by 21.4%. The largest increase, $0.9 million, occurred from 2013 to 2014 and 2015 to 2016 (Fig. 1)
- Average total compensation surpassed $13 million in 2017 for first time in the five years included within the study
- The 25th percentile of total compensation for chief executives at Equilar 500 companies decreased by $800,000 between 2016 and 2017 (Fig. 1)
- As was the case from 2014 to 2016, healthcare was the sector with the highest median total compensation, despite seeing a drop of $0.2 million from 2016 to 2017 (Fig. 2)
- Between the two most recent fiscal years, CEOs in the basic materials sector saw the highest increase in pay at $1.5 million (Fig. 2)

Figure 2 Equilar 500 Median Reported Total Compensation by Sector



	Basic Materials	Consumer Goods	Financial	Healthcare	Industrial Goods	Services	Technology	Utilities
2013	$10.4	$9.0	$10.0	$12.0	$12.1	$7.8	$9.0	$9.6
2014	$10.7	$9.8	$10.6	$13.9	$13.4	$9.7	$8.9	$11.6
2015	$9.9	$10.3	$10.8	$15.0	$12.3	$9.7	$10.1	$10.8
2016	$11.5	$11.0	$10.3	$15.3	$13.4	$11.0	$11.3	$11.6
2017	$13.0	$11.0	$10.2	$15.1	$12.5	$11.1	$11.9	$12.1

Meridian Compensation Partners Commentary

There are several factors that lead to higher or lower CEO compensation rates by industry. The most obvious and direct factors are the size and complexity of the organization and the related experience and skill level required by the CEO. Actual performance of the company, and the executive, will materially impact annual bonus and long-term performance-based incentive payout levels. The overall market demand for talent within the certain industry, in comparison to the supply of well-qualified executives, will also have an impact on pay levels.

For example, healthcare is typically in the lead when it comes to CEO compensation. CEOs in this industry often possess a very specific set of skills when it comes to identifying and integrating strategic acquisitions to build value. The high level of M&A activity in this industry means there is relatively higher risk. CEOs typically demand a market premium in pay to offset this risk.

Technology, on the other hand, has seen some of the strongest gains. This appears to be related to the high demand for talent in this space. It's not just from within the technology sector—most companies in all industries are transforming to be more "tech-oriented" or "tech-enabled" and therefore recruiting executive talent away from the technology sector. With higher demand, technology companies are forced to pay higher wages to retain their talent.

* * *

The complete memorandum is available here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation
SUPPORTED BY:

Growth in CEO Pay Since 1990

Posted by Joseph Bachelder, McCarter & English LLP, on Wednesday, September 19, 2018

Editor's note: Joseph Bachelder is special counsel and Andy Tsang is a senior financial analyst at McCarter & English LLP. This post is based on a McCarter & English memorandum by Mr. Bachelder and Mr. Tsang. Related research from the Program on Corporate Governance includes The Growth of Executive Pay by Lucian Bebchuk and Yaniv Grinstein and The CEO Pay Slice by Lucian Bebchuk, Martijn Cremers and Urs Peyer (discussed on the Forum here).

The following chart sets forth CEO pay at large U.S. companies for 1990, 2000, 2010 and 2016. In addition, the chart projects CEO pay for 2020.

Median CEO Pay at Large U.S. Companies		
Year	**$ Millions**	**Change from 1990**
1990	**$2.2**	**0%**
2000	**$9.4**	**317%**
2010	**$9.9**	**341%**
2016	**$12.1**	**438%**
2020 (Projected)	**$13.8**	**514%**
Note: Dollar amounts shown in the chart were adjusted for inflation, reflecting 2018 dollars. For detail regarding the surveys on which the chart is based see Attachment A to this Bulletin.		

For purposes of the chart, CEO pay is based on proxy statement reporting. It includes:

1. Salary (reported for the year in which earned)
2. Annual bonus (reported for the year in respect of which awarded)
3. Long-term incentive compensation. This includes:
    a. Stock-based incentive awards such as
        - Stock options (and stock appreciation rights)
        - Shares of restricted stock (and restricted stock units)
        - Performance shares (and performance share units)
          (Stock-based incentive awards are generally reported based on grant-date values.)

b. Cash-based incentive awards. (These are generally reported for the year of earn-out.)

CEO pay (again, reflecting proxy statement reporting) also includes provision of perquisites and welfare benefits and annual accruals of pension benefits. As noted in Attachment A (Paragraph 1) to this Bulletin, the chart reflects an upward adjustment to the median CEO pay for 1990 from that shown in the applicable survey. The adjustment for 1990 was made because perquisites, benefits and certain forms of long-term incentive compensation were not included in that survey.

Over the same periods of time, the Gross Domestic Product (GDP), the Consumer Price Index (CPI) and the S&P 500 Index increased (or, in the case of 2020, are projected to increase) as follows:

Year	**GDP**		**CPI**		**S&P 500 Index**	
	$ Trillions	**Change from 1990**	**Index Value**	**Change from 1990**	**Index Value**	**Change from 1990**
1990	**$9.4**	**0%**	**131**	**0%**	**645**	**0%**
2000	**$13.1**	**40%**	**172**	**32%**	**2,089**	**224%**
2010	**$15.6**	**67%**	**218**	**67%**	**1,317**	**104%**
2016	**$17.7**	**89%**	**240**	**84%**	**2,199**	**241%**
2020 (Projected)	**$19.2**	**105%**	**256**	**96%**	**3,095**	**380%**

Note: For each of the years 1990, 2000, 2010 and 2016 the sources of information are as follows:

- For GDP: U.S. Bureau of Economic Analysis. (GDP numbers are inflation-adjusted.)
- For CPI: U.S. Bureau of Labor Statistics. (The reference base period is 1982-1984 (100).)
- For S&P 500 Index: Yahoo! Finance. (Index value for a year represents the average daily S&P 500 Index value for that year adjusted for inflation.)

Projected values for 2020 were calculated using the average compound annualized growth rates for the GDP, CPI and S&P 500 Index, respectively, for the period from 2010 to 2016.

Factors Causing Increase in CEO Pay

Following are factors that have contributed to the steady rise in CEO pay since 1990.

1. Public disclosure of CEO pay.

The purpose in the proxy statement disclosure of CEO pay, starting in the 1930s, has been to inform stockholders of the levels of top management pay at their respective companies. It has enabled them to compare the pay of the top management at the company they own with that of top management at other companies. At the same time, it has enabled members of top management to see what members of top management at other companies are being paid. This has led to pressure on companies, including their boards of directors, to "keep up with the Jones," with a "ratcheting up" effect on CEO pay generally.

2. Growth in size and complexity of public companies and the jobs of running them.

As a business enterprise grows in size and complexity so does the CEO job. There is a correlation between the size of a business and the pay associated with the CEO position. According to an article by Professor Kevin F. Hallock of Cornell University, "for a 10-percent increase in company size, CEO pay goes up by about 3 percent." Hallock, Kevin F., "The Relationship Between Company Size and CEO Pay," *Workspan Magazine* (February 2011). Thus, if a company doubles in size, an increase of approximately one-third in the CEO's pay could be reasonably expected.

As the enterprise grows the risks and opportunities associated with the CEO's decisions grow. The scalability of this risk/opportunity decision-making has been commented on by Professor Alex Edmans of the London Business School:

> "A CEO's actions are scalable. For example, if the CEO improves corporate culture, it can be rolled out firm-wide, and thus has a larger effect in a larger firm. One percent is $20 million in a $2 billion firm, but $200 million in a $20 billion firm. In contrast, most employees' actions are less scalable. An engineer who has the capacity to service 10 machines creates, say, $50,000 of value regardless of whether the firm has 100 or 1,000 machines. In short, CEOs and employees compete in very different markets, one that scales with firm size and one that scales less." Edmans, Alex, "Why We Need to Stop Obsessing Over CEO Pay Ratios," *Harvard Business Review* (February 23, 2017).

3. Growth in stock market values.

CEO pay reflects a "custodial" pay factor. To an extent, CEO pay resembles the pay of a trustee or other custodian whose fees are tied to the values of the assets under management. Among other things, the CEO is managing the value of the company, as reflected in the case of a public company in its stock market value. CEO pay, expressed as a percentage of a company's stock market value, does not ordinarily reach the levels customary for trustee fees expressed as a percentage of value of assets being managed. Annual fees equal to one or two percent of assets under management plus additional fees for income and gains realized are not unusual fees for bank trustees. The annual pay of a CEO, generally, is much less than 1 percent of the market cap of the company being managed.

4. The increasing proportion of CEO pay tied to long-term incentive awards.

Compared to CEO pay in 1990, CEO pay today is much more tied to long-term incentive awards. See, for example, the research paper by Edmans, Gabaix and Jenter, entitled "Executive Compensation: A Survey of Theory and Evidence" (cited in Attachment A (Paragraph 2) to this Bulletin). The shift in CEO pay toward long-term incentive awards not only means delayed receipt of the compensation but increased risk that the executive may not receive it (or may receive only a portion of the target award). The risks include market risk for equity awards, performance risk for performance-based awards and risks that the CEO's employment may be terminated under circumstances in which the award is forfeited. It is likely that the delay in payment and the increased risks have resulted in awards being larger than they would have been if the awards, for example, had been simply time-vested over a one-year or two-year period. The award values reported in proxy statements generally do not take into account the delay and risk factors noted. For a discussion of how the factors noted may have impacted the values of incentive awards to executives receiving the awards, see the article by the author, "What Is the Real Value of an Incentive Compensation Award When It Is Made?", published in the *New York Law Journal* September 23, 2016.

5. CEO turnovers

According to an article published by Equilar, for S&P 500 companies the median CEO tenure in 2017 was 5.0 years (a drop from 5.1 years in 2015 and 2016, 5.6 years in 2014 and 6.0 years in 2013). Marcec, Dan, "CEO Tenure Drops to Just Five Years," *Equilar* (January 19, 2018). When companies appoint a new CEO they often pay the new CEO more than they paid the departing CEO. This is especially so if the new CEO comes from outside the company. Thus, CEO turnover itself becomes a factor in increasing CEO pay.

Conclusion

For the period 1990 through 2016 median CEO pay grew by over 400 percent. If annualized CEO pay growth thus far in the current decade continues for the rest of the decade, the end-of-decade median CEO pay level will have increased by more than 500 percent over the median CEO pay in 1990. Median CEO pay has grown at a rate faster than the indices noted at the beginning of this Bulletin. As also noted in this Bulletin, numerous factors have contributed to this. The most important probably is the proxy statement disclosure of CEO pay starting in the 1930s. The increasing portion of long-term incentive awards as part of annual CEO pay and the decade-by-decade growth of the stock markets also have been significant factors. Such factors are likely to cause continuing increase in CEO pay for the foreseeable future

* * *

Attachment A

Notes to the Chart entitled "Median CEO Pay at Large U.S. Companies"

The data shown in the chart is derived from three different surveys: One survey reported the 1990 data, a second reported on 2000 and 2010 and a third reported on 2016. While the three surveys

covered many of the same companies, there were differences in some of the companies covered and in the size of the samples.

1. Subject to an adjustment noted in the next sentence, the median CEO pay shown for 1990 is based on the median CEO pay for 1990 shown in a research paper by Hall, Brian J. and Liebman, Jeffrey B., “Are CEOs really paid like bureaucrats?” (Quarterly Journal of Economics (1998), Vol. CXIII, 653–691), reflecting median CEO pay for the largest U.S. companies (approximately 400 companies). The chart makes adjustment to the median CEO pay shown in the research paper because the paper shows CEO pay as the sum of salary, bonus and grant-date values of stock options only. The paper does not reflect other long-term incentives or other compensation elements. The author of the Bulletin applied a factor of 1.2 to the paper’s median CEO pay for 1990 to take this into account.
2. The median CEO pay figures shown for 2000 and 2010 are based on median CEO pay figures for 2000 and 2010, respectively, shown in a research paper by Edmans, Alex, Gabaix, Xavier and Jenter, Dirk, “Executive Compensation: A Survey of Theory and Evidence” (Handbook of the Economics of Corporate Governance (2017), Vol. 1, Chapter 7, 383-539 (edited by Hermalin, Benjamin E. and Weisbach, Michael S.)). The CEO pay figures, in turn, are based on ExecuComp data, reflecting median CEO pay for S&P 500 companies.
3. The median CEO pay for 2016 is based on a report by Tonello, Matteo, Hodgson, Paul and Reda, James F., “CEO and Executive Compensation Practices—2017 Edition,” (published by the Conference Board in collaboration with Arthur J. Gallagher & Co. and MyLogIQ in August 2017), reflecting median CEO pay for S&P 500 companies.
4. The projected median CEO pay for 2020 was calculated using the average compound annualized growth rate of median CEO pay values for the period from 2010 to 2016.

Effects of Executive Pay Levels on Say on Pay

Posted by Austin Vanbastelaer and Charles Gray, Semler Brossy Consulting Group, LLC, on Saturday, July 28, 2018

Editor's note: Austin Vanbastelaer and Charles Gray are consultants at Semler Brossy Consulting Group, LLC. This post is based on a Semler Brossy memorandum by Mr. Vanbastelaer, Mr. Gray, Todd Sirras, Kayla Dahlerbruch, and Justin Beck. Related research from the Program on Corporate Governance includes the book Pay without Performance: The Unfulfilled Promise of Executive Compensation and Executive Compensation as an Agency Problem, both by Lucian Bebchuk and Jesse Fried.

CEO pay gets most of the attention for the Say on Pay vote. It's less clear how shareholders interpret and evaluate pay levels for the other named executive officers excluding the CEO ("NEOs") and to what degree these values impact Say on Pay outcomes. We looked at S&P 500 Say on Pay results from the past three years to understand how NEO compensation influences Say on Pay voting and made four key observations:

1. Shareholder support typically decreases as CEO or NEO pay increases, particularly when high pay is not aligned with company size.
2. Voters are more responsive to CEO pay than to pay for a company's other NEOs.
3. However, pay levels for a company's other NEOs also impact vote results.
4. High pay for an entire executive team and/or diverging pay between a CEO and NEOs within an executive team can negatively impact vote results.

Exhibit A: CEO Pay and NEO Pay

3-Year Average Say on Pay Result for CEO and NEO Pay Quartiles

CEO Pay	Average Vote by CEO Pay		NEO Pay	Average Vote by NEO Pay		Overall S&P 500 Average Vote
Lowest Quartile *(< 25th P)*	94.8%		Lowest Quartile *(< 25th P)*	94.0%		91.6%
(25th-50th P)	93.9%		*(25th-50th P)*	93.5%		91.6%
(50th-75th P)	91.8%		*(50th-75th P)*	91.8%		91.6%
Highest Quartile *(> 75th P)*	85.9%		Highest Quartile *(> 75th P)*	87.1%		91.6%

> *Top quartile CEO and NEO pay has resulted in lower vote support among S&P 500 companies in the past three years*

Shareholder support typically decreases as CEO or NEO pay increases, particularly when high pay is not aligned with company size

Top quartile CEO and NEO pay has resulted in lower vote support among S&P 500 companies in the past three years. Average Say on Pay support for all S&P 500 companies over the past three years was 91.6% (Exhibit A). By comparison, average vote support was 570 basis points lower among the highest quartile CEO pay group and 450 basis points lower among the highest quartile NEO pay group.

Additional context about company size is needed to fully capture the dynamic between executive pay levels and Say on Pay outcomes. Since we know CEO and NEO pay are largely driven by company size, we divided the S&P 500 companies into quartiles based on pay and revenue. Measuring pay and revenue allows us to assess whether executive pay levels align with company size, and to what degree relative pay levels affect Say on Pay.

Exhibit B: CEO Pay vs Revenue

Average Say on Pay Result by Company Revenue and CEO Pay Quartiles Over Past 3 Years

		Company Revenue			
		Lowest Quartile *(< 25th P)*	*(25th-50th P)*	*(50th-75th P)*	Highest Quartile *(> 75th P)*
CEO Pay	Lowest Quartile *(< 25th P)*	94.4% n=189	95.2% n=104	94.8% n=41	96.6% n=9
	(25th-50th P)	93.1% n=101	94.2% n=132	94.7% n=82	93.2% n=30
	(50th-75th P)	87.6% n=46	91.3% n=74	92.3% n=142	93.5% n=93
	Highest Quartile *(> 75th P)*	79.1% n=23	81.0% n=30	86.6% n=72	87.0% n=214

Shaded region highlights the group of highly paid CEOs where Say on Pay results are significantly lower than the overall average

Exhibit C: NEO Pay vs Revenue

Average Say on Pay Result by Company Revenue and NEO Pay Quartiles Over Past 3 Years

Average NEO Pay	Company Revenue: Lowest Quartile (< 25th P)	(25th-50th P)	(50th-75th P)	Highest Quartile (> 75th P)
Lowest Quartile (< 25th P)	93.6% n=181	94.5% n=114	94.2% n=40	94.3% n=7
(25th-50th P)	93.1% n=103	94.4% n=110	93.4% n=104	91.8% n=28
(50th-75th P)	88.7% n=54	91.3% n=81	92.7% n=107	92.6% n=112
Highest Quartile (> 75th P)	84.3% n=20	84.9% n=36	88.1% n=85	87.3% n=200

Shaded region highlights the group of highly paid NEOs where Say on Pay results are significantly lower than the overall average

Voters are more responsive to CEO pay than to pay for a company's other NEOs

As CEO pay magnitude outpaces company size, Say on Pay support declines. Among the S&P 500's highest paid CEOs, companies in the lowest revenue quartile received 79.1% average Say on Pay support, compared to 87.0% among companies in the highest revenue quartile. Vote results in Exhibit B support the common notion that shareholders are critical of highly paid CEOs, particularly when pay is misaligned with company size. But to what degree do shareholders look beyond the CEO to evaluate pay for the rest of the executive team?

> *Competitive CEO pay alone does not always provide companies with a free pass in Say on Pay voting*

Pay levels for a company's other NEOs impact vote results

Media and proxy advisor focus on CEO pay creates a perception that NEO pay is not relevant to Say on Pay. However, three-year vote history for the S&P 500 tells us that Say on Pay is not just about CEO pay. Shareholders are responsive to how companies pay their entire executive team. Similar to the findings for CEO pay, average Say on Pay support was lowest among companies where average NEO pay (excluding the CEO) outpaces company size.

Vote patterns suggest that NEO pay has less of an impact on Say on Pay support, but investors will still criticize outliers that pay in the top quartile. In particular, the smaller companies in the top quartile NEO pay group received lower vote support than the larger companies. It's important that a company maintains pay levels for the rest of its NEOs that don't go too far beyond other similarly sized companies—competitive CEO pay alone does not always provide companies with a free pass in Say on Pay voting.

High pay for an entire executive team and/or diverging pay between a CEO and other NEOs can negatively impact vote results

Exhibit D illustrates the relationship between a company's CEO and average NEO pay and to what degree relative pay within a team affects Say on Pay. CEO and NEO pay positioning are typically aligned—over half the S&P 500 pays its CEO and NEOs in the same quartile. Among these companies, there is a strong inverse relationship between executive pay and Say on Pay outcomes. However, we also observe that voters are responsive to CEO and NEO pay alignment within an executive team. Although very few companies pay their CEOs in the bottom quartile and pay their NEOs in the top quartile, or vice versa, vote history suggests that vote support declines as pay for one outpaces the other. Among companies with bottom quartile CEO pay, Say on Pay support declines significantly for those that pay NEOs above median. And among companies with bottom quartile NEO pay, Say on Pay support declines significantly for those that pay CEOs above median. Executive pay should be aligned with the company's size, as well as with pay for the company's other executives. Companies open themselves up to shareholder scrutiny during Say on Pay voting if pay for their CEO or NEOs goes above a competitive range relative to size or relative to other executives on the team.

Exhibit D: CEO Pay vs NEO Pay

Average Say on Pay Result by CEO and NEO Pay Quartiles Over Past 3 Years

Average NEO Pay	CEO Pay: Lowest Quartile *(0th-25th P)*	*(25th-50th P)*	*(50th-75th P)*	Highest Quartile *(75th-100th P)*
Lowest Quartile *(0th-25th P)*	95.0% n=237	93.2% n=82	87.2% n=20	82.4% n=4
(25th-50th P)	95.3% n=85	94.0% n=158	92.2% n=86	87.0% n=18
(50th-75th P)	90.7% n=24	94.6% n=84	91.9% n=169	88.7% n=75
Highest Quartile *(75th-100th P)*	- n=0	92.5% n=19	92.2% n=79	85.0% n=243

Shaded region highlights all companies that payed their CEO and other NEOs in the same quartile in the last three years

Pay levels for the entire executive team should be carefully evaluated

Our study suggests that shareholders consider NEO pay in addition to CEO pay when making Say on Pay votes, as vote results are lower when CEO or NEO pay is misaligned. CEO pay receives a majority of the attention from proxy advisors and media and has a greater impact on Say on Pay outcomes, but it's important to make sure that pay for all NEOs is being carefully evaluated.

Differentiation in roles and levels of responsibility, as well as considerations around succession planning, drive pay dynamics for all NEOs. It's common that companies will pay above market for premium talent that they see as a prospective future leader for their business. However, the rationale behind such decisions should be defensible and explained in the proxy. Pay magnitude for all executive positions tends to reflect company size, and companies should be cognizant that investors will be wary if pay for the entire executive team is too high relative to company size.

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Executive Pay at Public Corporations After Code §162(m) Changes

Posted by Joseph Bachelder, McCarter & English LLP, on Saturday, April 6, 2018

Editor's note: Joseph E. Bachelder is special counsel in the Tax, Employee Benefits & Private Clients practice group at McCarter & English, LLP. The following post is based on a column by Mr. Bachelder which first appeared in the *New York Law Journal*. Andy Tsang, a senior financial analyst with the firm, assisted in the preparation of this post.

Internal Revenue Code §162(m) imposes limitations on the deductibility of executive pay by public corporations. The new tax law, Public Law No. 115-97 (the "Tax Cuts and Jobs Act" (TCJA)), makes a number of changes in Code §162(m). These changes generally take effect for taxable years commencing after Dec. 31, 2017 (exceptions noted below). This post discusses these changes, how the changes might impact on different forms of executive pay and some of the steps public corporations need to take in light of these changes.

Part I. Code §162(m) Before and After TCJA

A. Pay Subject to the Deduction Limitation

Prior to TCJA. Since its enactment in 1993, Code §162(m) has imposed a limit of $1 million per taxable year on the deductibility by a "publicly held corporation" of remuneration paid for such year to each "covered employee." ("Covered health insurance providers" have been, and continue to be, subject to special provisions under Code §162(m) that are not covered in the following discussion.)

Prior to its amendment, Code §162(m) excepted from the deduction limit remuneration that constituted "qualified performance-based compensation." See pre-TCJA Code §162(m)(4)(C) and Treas. Reg. §1.162-27(e). (It also excepted "commissions," which are not covered in the following discussion.) For this purpose, Treasury regulations have treated stock options and stock appreciation rights (SARs) as if they were qualified performance-based compensation, whether or not they are subject to performance targets, provided that such stock options and SARs meet the requirements of Treas. Reg. §1.162-27(e)(2)(vi).

After TJCA. TCJA removes the exception just noted for qualified performance-based compensation, making it subject to the $1 million deduction limit for taxable years commencing after Dec. 31, 2017. (It also removes the exception for "commissions" which, as noted, are not included in the following discussion.)

B. "Covered Employees"

Prior to TCJA. Under Code §162(m), as previously in effect, "covered employee" meant any employee (i) who, as of the close of the taxable year, was the chief executive officer (CEO) of the corporation (or was an individual acting in such capacity) or (ii) whose compensation was "required to be reported to the shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the 4 highest compensated officers for the taxable year" (other than the CEO). (In its Notice 2007-29, the Internal Revenue Service reduced the number of executives required by clause (ii) from 4 to 3 and excluded the chief financial officer (CFO) for purposes of determining the executives in clause (ii) as modified. This notice no longer applies due to the changes discussed in the next paragraph.)

After TCJA. TCJA modifies the definition of "covered employee" to include any employee (i) who at any time during the taxable year was the "principal executive officer" or "principal financial officer" of the corporation (or was an individual acting in such capacity); (ii) whose compensation "is required to be reported to the shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the three highest compensated officers for the taxable year" (other than any individual described in the preceding clause (i)); or (iii) who "was a covered employee of [the corporation] (or any predecessor) for any preceding taxable year beginning after December 31, 2016." As a result of this new definition, over time the number of individuals included in the "covered employee" group will expand.

C. "Publicly Held Corporation"

Prior to TCJA. A "publicly held corporation" meant an issuer of equity securities required to be registered under §12 of the Securities Exchange Act of 1934 (the Exchange Act).

After TCJA. TCJA extends the definition of "publicly held corporation" to include any corporation that is (i) an issuer of securities required to be registered under §12 of the Exchange Act or (ii) an issuer required to file reports under §15(d) of the Exchange Act. This new definition includes not only corporations with publicly traded equity (as previously) but now includes those with publicly traded debt. The Joint Explanatory Statement of the Committee of Conference for the tax bill that became the TCJA states that this new definition also includes "foreign companies publicly traded through ADRs" and that it "may include certain additional corporations that are not publicly traded, such as large private C or S corporations." (Quoted language in the preceding sentence appears at page 344 of the Joint Explanatory Statement.)

D. TCJA's "Grandfather" Clause

TCJA provides that the new provisions described above do not apply to "remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date." Grandfathering should apply to future awards if they are made pursuant to a "written binding contract" (e.g., an employment agreement) in effect on Nov. 2, 2017. (See discussion in Part III.B. below on protecting the "grandfathered" status of certain arrangements in effect on Nov. 2, 2017.)

Part II. Potential Impact of Code §162(m) Changes on Executive Pay

A. Short-Term Pay

(1) Salary. It is unlikely that public companies will shift, to any significant degree, from performance-based pay to salaries as a result of the §162(m) changes. Some large U.S. public corporations may have kept salaries of their top executives lower than those salaries might have been, relative to other components of such executives' pay, in order to maximize the amount of pay (performance-based awards, stock options, etc.) eligible for the former exemption under Code §162(m). Some of those employers now may increase the salary levels of such executives to make them more proportionate to the other elements of such executives' pay.

(2) Annual Bonus. Payouts under most senior-level annual bonus programs of public companies will continue to be tied to achievement of performance targets. In part, this is because the plans pursuant to which such awards are made contain provisions requiring performance targets in order to qualify for the former exemption under Code §162(m). (These provisions should be carefully reviewed, as noted in Part III.A. below, by public companies to determine whether they want to continue provisions previously required to qualify for the §162(m) exemption.)

It is likely that many annual bonus programs will be revised (subject to shareholder approval if required by the applicable plan) to provide Compensation Committees (as to grants made after 2017) with discretion to adjust bonus payments from those based strictly on the performance targets. Before the enactment of Code §162(m), public company annual bonus programs generally provided such discretion to Compensation Committees.

B. Long-Term Incentive Awards

(1) Performance-Based Awards. For purposes of this discussion, a "long-term performance-based award" means an award as to which payout is conditioned upon the achievement of one or more pre-determined long-term performance targets. A performance period of three years is typical. (This definition of "long-term performance-based award" is not the same as the definition of "qualified performance-based compensation" contained in Treas. Reg. §1.162-27(e). That regulation, issued pursuant to pre-TCJA Code §162(m)(4)(C), contains the technical requirements that must have been met in order for performance-based compensation to be excepted, as previously provided, from the deduction limit under Code §162(m).)

It is expected that public companies will continue to use long-term performance-based awards as a major part of their executive pay programs.

Some public companies may consider giving the Compensation Committee discretion to adjust payouts from those that would result from performance based strictly on pre-determined long-term performance targets. Careful attention should be given to the accounting consequences that might follow from giving Compensation Committee such discretion. These consequences may differ according to the nature of the award and other circumstances.

(2) Stock options and SARs. As discussed in Part I above, stock options and SARs, like performance-based awards, previously were exempted from the $1 million deduction limit under Code §162(m), provided they met the requirements of Code §162(m) and regulations thereunder.

Due to accounting changes, adverse stock markets and other factors, the use of stock options and SARs declined in the 2000s. The changes in Code §162(m) are not likely to cause significant further reduction in the use of stock options and SARs.

(3) Restricted Stock/Restricted Stock Units (RSUs). Public companies may shift to some extent from long-term performance-based awards to restricted stock/RSUs as a result of the changes in Code §162(m). Restricted stock involves less complexity in design and administration than performance shares or other performance-based awards. Employers that shift to restricted stock may extend the vesting period for future grants of restricted stock. The intention of extending time vesting for a longer period for future awards would be, as a corporate governance matter, to counterbalance the elimination of performance risk.

C. Deferred Compensation

Some companies, if faced with non-deductibility because of the $1 million cap under Code §162(m), may choose to defer a portion of compensation otherwise payable currently in order to bring annualized amounts below the $1 million cap.

D. Severance Pay

As just noted in connection with deferred compensation, in order to bring annualized amounts below the $1 million cap, some companies may extend severance payments over a period longer than that over which they might otherwise be paid.

Part III. Other Considerations

A. Need to Review Documentation of Executive Pay Arrangements and Summaries in Proxy Statements of Those Arrangements

Careful attention should be given to current documentation of executive pay arrangements to be sure such documentation is consistent with changes in Code §162(m). References to Code §162(m) may, in some cases, have been intended to comply with the §162(m) requirements for exemption from the $1 million deduction limit and are not applicable to grants made in taxable years commencing after 2017. Care must be taken not to make changes in documents (including awards themselves) that, as noted in Subpart B. below, could “de-grandfather” a plan or award. (As noted above, an amendment to a plan may require stockholder approval.)

In addition to review of documents embodying plans, programs and awards, proxy statements must be reviewed to determine whether changes need to be made in descriptions of the arrangements noted. These include changes that may be needed in proxy statement references to Code §162(m). Employers generally will want to continue references to pre-existing §162(m) provisions applicable to previously granted awards as to which grandfathered status applies.

B. Protecting Grandfathered Status of Certain Agreements/Awards in Effect on Nov. 2, 2017

The exemption from the $1 million deduction limit under Code §162(m) will continue to apply, as noted in Part I.D. above, to written binding agreements in effect on Nov. 2, 2017 provided they

are "not modified in any material respect on or after such date." Careful attention should be given to any modification that might cause loss of grandfathered status. For example, extending the term of an award could result in loss of its grandfathered status. In the case of plans, it may be advisable to adopt a new plan rather than modify an existing one. Presumably these points will be covered in rulings and/or regulations to be issued by the Treasury.

C. Avoiding Adverse Consequences Under Other Sections of the Code

Besides the potential loss of grandfathered status, a modification of a plan or award may trigger adverse consequences under another Code provision. For example, Code §409A has complicated provisions regarding deferred compensation that must be complied with in order for such compensation to be "qualified" under that section. Failure to comply with these requirements could result in a 20 percent excise tax and other penalties being imposed on the service provider.

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Elon Musk's Compensation

Posted by Joseph Bachelder and Andy Tsang, McCarter & English LLP, on Wednesday, May 23, 2018

Editor's note: Joseph Bachelder is special counsel and Andy Tsang is a senior financial analyst at McCarter & English LLP. This post is based on an article by Mr. Bachelder and Mr. Tsang originally published in the *New York Law Journal*.

Related research from the Program on Corporate Governance includes How to Tie Equity Compensation to Long-Term Results, and Paying for Long-Term Performance (discussed on the Forum here), both by Lucian Bebchuk and Jesse Fried.

On January 21, 2018, Tesla, Inc. (Tesla), the electric car manufacturer (also in the business of sustainable energy generation and storage), granted its Chairman and Chief Executive Officer, Elon Musk, an option, subject to shareholders' approval, to acquire 20,264,042 shares of Tesla (representing 12 percent of the then outstanding shares). Tesla's shares are traded on NASDAQ. As of the grant date of the option, the market cap of Tesla was approximately $59 billion.

The grant-date value of the option, according to the proxy statement for the special meeting noted below, was approximately $2.6 billion, based on a so-called "Monte Carlo" option pricing model, a mathematical model used to provide an estimate for the fair value of an option at the time of grant. The option exercise price is $350.02 per share, the January 19 closing price for a share of Tesla stock. To the author's knowledge, this is the largest stock option ever granted by a public company to an executive. According to the same proxy statement, Mr. Musk "will receive no salary, no cash bonuses and no time-based equity awards that vest solely through the passage of time (that is, simply by continuing to show up for work)."

The grant of the $2.6 billion option was approved by shareholders at a special meeting held March 21, 2018. Approximately 73 percent of votes cast, excluding votes of shares owned, directly or indirectly, by Mr. Musk (owning beneficially approximately 22 percent of Tesla's shares) and his brother Kimbal Musk (owning less than 1 percent), voted in favor of the option grant.

Musk Option Features

The following discussion addresses a number of unique features of the option grant to Mr. Musk.

1. Performance Targets.

The option is comprised of 12 equal "tranches," each tranche representing 1 percent of Tesla's shares. A tranche vests only upon (a) the achievement by Tesla stock of the market cap level

assigned to that tranche and (b) the achievement by Tesla of either one of two operational targets at levels discussed below.

(a) Achievement of Market Cap Targets. Each of the 12 tranches is assigned a market cap target. The market cap targets range from $100 billion to $650 billion, in $50 billion increments. A market cap target is achieved at the close of the trading day on which the average market caps for both the six-month period and the 30-day period ending on that day exceed the applicable target for the tranche. Once reached, the market cap target is considered achieved even if the market cap subsequently drops below that target level. The market cap targets are subject to adjustments to take into account transactions, including acquisitions, divestitures and spin-offs, that are considered material to the achievement of the targets.

(b) Achievement of Operational Targets. There are two sets of operational targets: revenue targets and EBITDA targets. (EBITDA is adjusted by removing any charge for stock-based compensation.)

i. Revenue: The revenue targets range, in 8 increments, from $20 billion to $175 billion. A revenue target is achieved when revenue equals or exceeds that target for four consecutive quarters.
ii. Adjusted EBITDA: The EBITDA targets range, also in 8 increments, from $1.5 billion to $14 billion. An EBITDA target is achieved when EBITDA, adjusted as described above, equals or exceeds that target for four consecutive fiscal quarters.

Like the market cap targets, the operational targets are subject to adjustments to take into account transactions, including acquisitions, divestitures and spin-offs, that are considered material to the achievement of the targets.

(c) Matching Achieved Market Cap Targets With Achieved Operational Targets. When a market cap target for an option tranche, as described above, is achieved it can be matched with either an achieved revenue target or an achieved EBITDA target, as described above. When that “match” occurs the tranche (representing 1/12 of the option) vests.

Following are three characteristics of the operational targets that should be noted:

i. The two types of operational targets are not linked (they are simply two sets of targets) and an achieved target in either category can be “matched” with an achieved market cap target.
ii. (An achieved revenue target or an achieved EBITDA target, until used as a “match” for vesting purposes, continues to be available for matching even if revenues or adjusted EBITDA, as the case may be, subsequently fall below the achieved target level.
iii. Once an achieved revenue target or an achieved EBITDA target is matched with an achieved market cap resulting in vesting it cannot be used again.

(d) Example. Assume that the market cap target of $100 billion is met and that the operational targets of $20 billion in revenues and $1.5 billion in adjusted EBITDA also have been met. The achieved market cap target can be matched with either of the two achieved operational targets—in this assumption either the achieved revenue target of $20 billion or the achieved EBITDA target of $1.5 billion. As a result, Tranche 1 becomes vested. Note that one of the two achieved

operational targets was not needed in order to have a “match” for vesting purposes and will be available for matching with a market cap target achieved in the future. For example, achievement of a market cap target of $150 billion could then be matched with such achieved but unused operational target to result in vesting of a tranche.

2. Consequences of a Termination of Employment or Cessation as Chief Company Executive.

If, for any reason, Mr. Musk’s employment terminates or if he ceases to be the Chief Company Executive he will forfeit tranches of the option that are not yet vested. Chief Company Executive is defined in the award agreement as service as either (i) the Chief Executive Officer or (ii) the Executive Chairman and Chief Product Officer.

Upon any termination of employment, Mr. Musk will have one year (or, if it occurs sooner, the date on which the original 10-year term of the option expires) to exercise any portion of the option that is vested and unexercised at the time of such termination. Upon cessation as Chief Company Executive, for so long as Mr. Musk remains employed with Tesla he will have until the option expiration date to exercise any portion of the option that is vested and unexercised.

3. Consequences of a Change in Control.

Upon a change in control:

- the operational targets are disregarded and the achievement of the market cap targets is determined by using the greater of (x) the market cap immediately before the change in control and (y) the total value received by Tesla shareholders in connection with the change in control;
- Mr. Musk will forfeit tranches of the option that are not yet vested and do not otherwise vest, as discussed in the bullet point above, upon the change in control; and
- any vested and unexercised portion of the option will be exercisable until the option expiration date, whether or not Mr. Musk continues to be employed with Tesla.

4. Required Holding Period for Acquired Shares.

Shares acquired upon the exercise of the option must be held for five years following their acquisition. Shares used for cashless exercise and shares used to satisfy tax withholding obligations are not considered dispositions for this purpose.

Non-Deductibility of Option

Under Internal Revenue Code § 162(m) Tesla is limited to a maximum deduction of $1 million for compensation provided in respect of a taxable year to a “covered employee.” (Mr. Musk is a covered employee.)

Before the Tax Cuts and Jobs Act (TCJA), stock options were exempted from the Code § 162(m) limitation. TCJA removes that exemption and, as a result, for taxable years commencing after December 31, 2017, amounts realized by a covered employee upon exercise of a nonqualified

stock option will be included in the compensation of such employee that is subject to the Code § 162(m) limitation.

A binding written contract entered on or before November 2, 2017 is grandfathered from the new rule. Since the Musk option was granted on January 21, 2018 it will not be grandfathered and thus will be subject to the Code § 162(m) limitation.

Conclusion

The Musk option, like many of Mr. Musk's achievements, is extraordinary. This is so whether measured, on the date of grant, by a traditional option valuation model (e.g., Monte Carlo, $2.6 billion) or by the value of the Tesla shares subject to it ($7.1 billion). If all targets are met (achievement of all 12 market cap targets and 12 of the 16 operational targets) the market cap of Tesla would be at least $650 billion. This is in the range of the market caps of companies with the largest market caps today (e.g., Apple, Alphabet and Amazon). At a market cap of $650 billion, Tesla estimates that the spread of the option would be approximately $55.8 billion (without taking into account adjustments for certain dilutions that might occur in the future).

Is this extraordinary option reasonable compensation for Tesla to be providing Mr. Musk? Would he produce the same results for Tesla without it? Or with something less? As noted above, the option was approved by well over a majority of Tesla shareholders (excluding Mr. Musk and his brother) who voted at the special meeting held to approve it in March. In a recent Delaware case, *In re Tesla Motors, Inc. Stockholder Litigation*, C.A. No. 12711-VCS (Del. Ch. Mar. 28, 2018), the Delaware Court of Chancery held that approval by a majority of Tesla shareholders of an acquisition by Tesla of another corporation, SolarCity Corporation, owned in part by Mr. Musk, did not prevent review by the Court of the transaction under the "entire fairness" doctrine. The majority vote was reached without taking into account the vote of Mr. Musk. The Court of Chancery concluded that "it is reasonably conceivable that Musk, as a controlling stockholder, controlled the Tesla Board in connection with the Acquisition." For this purpose, citing Delaware authority, the Court states that a "controlling stockholder" includes one who exercises control over the corporation's business affairs notwithstanding being a minority stockholder. Thus, the Court held that the majority shareholder vote did not eliminate the need for court review of the fairness of the transaction.

It should also be noted that Mr. Musk currently is serving in leadership roles at other companies, including as chief executive officer at a rocket company, SpaceX, and at two recent start-ups, The Boring Company (a tunnel-construction company) and Neuralink (a company in the business of artificial intelligence).

Mr. Musk has prodigious talents. We extend our best wishes to Mr. Musk and Tesla for results at Tesla that will produce full vesting of Mr. Musk's option and extraordinary value for the shareholders of Tesla, including Mr. Musk.

Performance Awards and Say on Pay

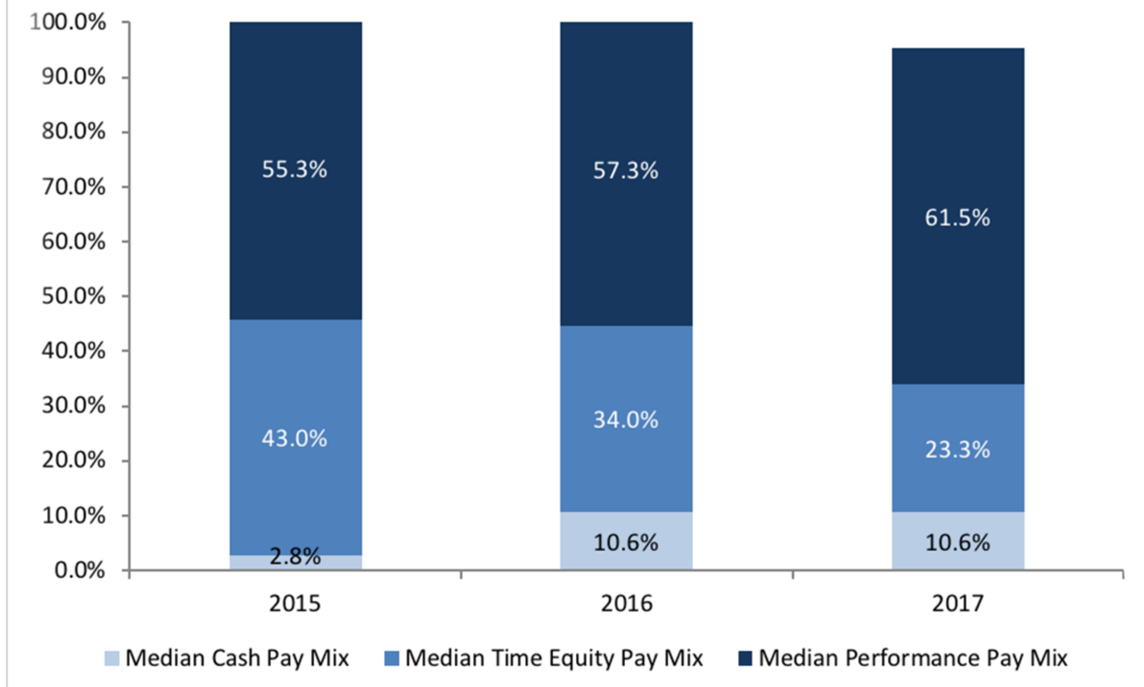
Posted by Elizabeth Carroll, Equilar, Inc., on Monday, August 27, 2018

Editor's note: Elizabeth Carroll is a Senior Research Analyst at Equilar, Inc. This post is based on an Equilar memorandum by Ms. Carroll. Related research from the Program on Corporate Governance includes the book Pay without Performance: The Unfulfilled Promise of Executive Compensation, by Lucian Bebchuk and Jesse Fried.

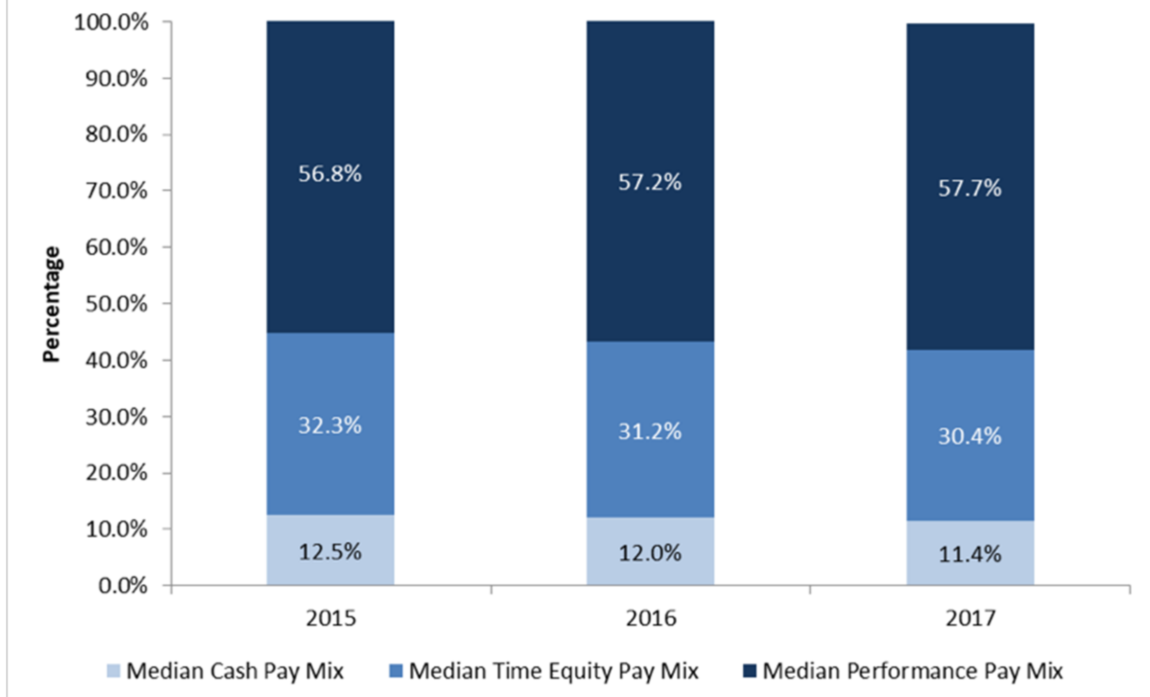
With most annual shareholder meetings concluded, a majority of shareholders have had the opportunity to vote on 2018 compensation packages. While companies are not legally bound by their Say on Pay results, there are still plenty of incentives, such as shareholder confidence in the board and management, to motivate them to work towards a passing score. However, designing a pay package that can attract and retain talented executives, while still pleasing shareholders, can prove to be a challenge for compensation committees.

A new Equilar study examined the mix of compensation provided to CEOs—cash (consisting of base salary and bonus), time-vested equity, and performance awards (consisting of both cash and equity performance targets)—broken down by shareholder approval of these compensation packages over the past three years.

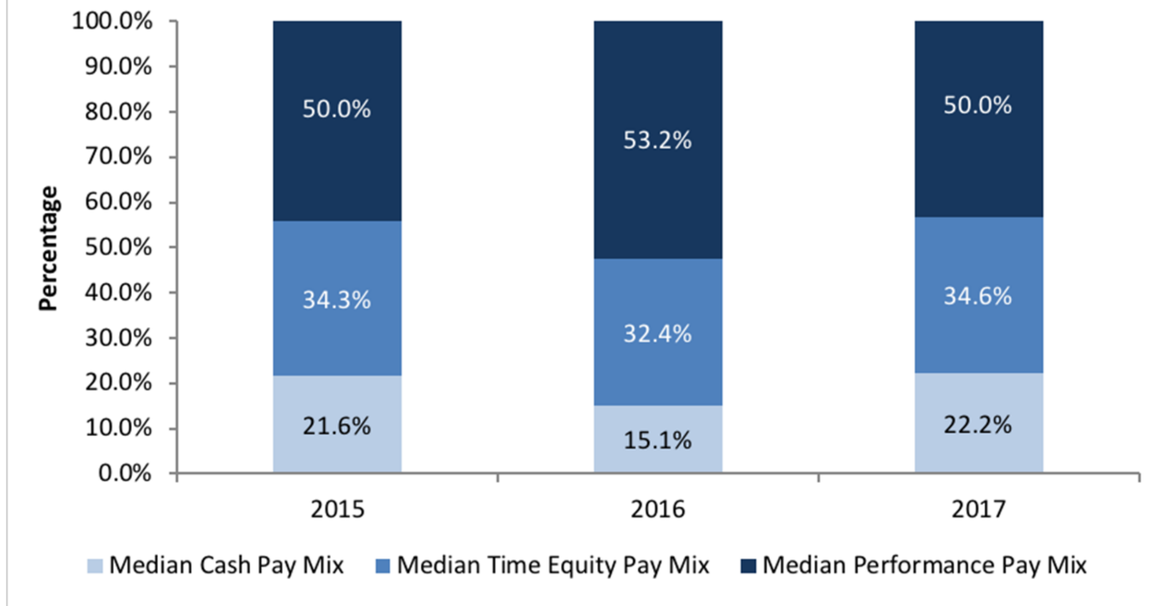
The share of cash compensation awarded to CEOs within the Equilar 500 whose companies achieved at least 70% Say on Pay approval has decreased slightly each year, declining from 13% in 2015 to 12% in 2016, and again to 11% in 2017. At the same time, the share of time-vested equity compensation has also decreased, while performance-based awards have increased slightly from 57% to 58%, representing an increase of $585,563 at the median. Though these changes to median pay mix are small, they show a clear trend—companies who receive approval from their shareholders regarding compensation are shifting their pay packages to rely more heavily on performance awards.



A similar but more dramatic trend occurs at companies that passed their Say on Pay vote but received less than 70% shareholder support. Cash compensation at these companies has remained steady at 11% since 2015. Additionally, these companies have seen a significant reduction in the percentage of total compensation allotted to time-based equity, from 47% in 2015 to 30% in 2017. Meanwhile, the percentage of total compensation granted in the form of performance awards increased by 34.8%, from just 46% prevalence in 2015 to 62% in 2017—which is notably higher than the companies in the 70%-100% Say on Pay approval range. Conversely, at companies who failed Say on Pay (receiving less than 50% approval from shareholders), the median cash compensation has risen from 3% in 2015 to 11% in 2017. Though time-based equity has also decreased steadily, the share of performance-based compensation has fluctuated—from 55% in 2015 to 66% in 2016, and back down to 61% in 2017. In both 2016 and 2017, the median share of compensation in the form of performance awards was actually higher for companies that failed Say on Pay than for companies who passed with more than 70%, suggesting that perhaps a failing Say on Pay vote may depend on more than just compensation alone.



The Russell 3000 tells a similar story. In the 70% to 100% range, median cash compensation has decreased slightly, while median performance-based compensation saw a small increase from 2015 and 2017. At the same time, the median share of time-based equity did not change. Similar to the Equilar 500, these changes are small, which indicates that in a given year, pay mix at companies that have a high Say on Pay approval percentage remains more or less constant, with a slight shift towards performance-based pay. In that same vein, Russell 3000 companies who failed Say on Pay shared similarities with failing Equilar 500 companies—these companies have varying pay mixes with less of a clear trend, which again indicates that other factors may play into a failing Say on Pay vote.



In 2017, all three categories of Russell 3000 companies had 50% of pay packages comprised of performance awards. Contrarily, in 2015, only the companies who failed Say on Pay had 50% performance mix at the median, while all passing companies had less than a majority made up of performance. The companies that failed also had a higher percentage of time-based equity at the median than those that passed with 70% or more positive votes.

Companies and boards must account for many factors when designing a pay package for chief executives. In addition to feedback from shareholders, compensation committees must take into account market conditions, past company performance and the need to retain their executives. Additionally, shareholders may vote according to metrics rather than strictly compensation itself, such as company performance and compensation levels relative to peers. This leaves room for compensation committees to exercise their own judgment, rather than simply following a formula. Ultimately, there is not a correct way to design a CEO pay package. Compensation committees, management and shareholders must find an equilibrium that aligns well with their company.

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What Does the CEO Pay Ratio Data Say About Pay?

Posted by Ben Burney, Exequity, LLP, on Tuesday, September 4, 2018

Editor's note: Ben Burney is Senior Advisor at Exequity, LLP. This post is based on an Exequity memorandum by Mr. Burney. Related research from the Program on Corporate Governance includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

Our analysis finds company size as measured by employee count is the primary driver of the CEO Pay Ratio; company revenue and market capitalization are secondary drivers. Deeper analysis uncovers industry trends that may provide companies additional context as they compare their CEO Pay Ratios to those of their peers. Ultimately, despite some interesting trends uncovered, analysis of the CEO Pay Ratio data provides little actionable intelligence for companies and questionable, if any, value for investors. More concerning, we find potential avenues for critics of executive pay to manipulate the data to serve their interests or constituencies. The purpose of this post is to provide guidance on what the data says—and what it doesn't.

What Drives the CEO Pay Ratio?

A common question related to the CEO Pay Ratio is: Does CEO pay or median employee pay[1] have a greater impact on the CEO Pay Ratio? We note, this question is akin to asking whether the value of an investment is more influenced by the stock price or the number of shares. As much as the number of shares and the stock price both impact the value of an investment, both CEO pay and median employee pay impact the CEO Pay Ratio.

But what about the key drivers of CEO pay and median employee pay? As is well known, CEO pay is most heavily influenced by revenues and market cap—the two primary determinates compensation committees use when making decisions on setting target pay levels. Median employee pay bears little relation to either revenues or market cap but, as our research uncovers, is highly, though inversely, correlated with employee count, i.e., higher employee counts are correlated with lower median employee pay. With these facts in mind, the more important question is: What is the impact of *company size* on the CEO Pay Ratio?

To explore impacts on CEO Pay Ratio and to generate potential insights, we gathered available CEO Pay Ratio data from 372 S&P 500 companies and performed statistical analyses. To analyze the data collected, we calculated correlations[2] between CEO pay, median employee pay,

[1] Median employee pay is defined in Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act as "the median of the annual total compensation of all employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer."

[2] Correlation is a measure of how two variables relate to one another and range in value from -1.00 to +1.00. A correlation of -1.00 means the two variables move perfectly in opposite directions, whereas a correlation of +1.00 means

CEO Pay Ratio, and company size, as measured by revenues, employee count, and market capitalization. Our analysis finds:

- Employee count is strongly and positively correlated with the CEO Pay Ratio, 0.58, meaning the more employees a company employs, the higher the CEO Pay Ratio.
- Median employee pay is strongly and inversely correlated with the CEO Pay Ratio, -0.74, meaning the lower the median pay, the higher the CEO Pay Ratio; (though we would note, median employee pay is also an input to the CEO Pay Ratio, so this finding is less meaningful than the relationship between employee count and the CEO Pay Ratio).
- CEO pay correlates well with the CEO Pay Ratio, 0.53, but ranks below median employee pay and employee count (again noting that CEO pay is an input to the CEO Pay Ratio).
- Revenues correlate well with CEO pay, 0.46, but bear little relation to median employee pay, -0.07.
- Employee count is inversely correlated with median employee pay, -0.46, and positively correlated with CEO pay, 0.28; this is notable because it means higher employee counts are associated with *both* lower median employee pay and higher CEO pay.
- Employee count is strongly correlated with revenues, 0.79.
- Market cap is weakly correlated with both median employee pay, 0.15, and the CEO Pay Ratio, 0.19.

Table of Correlations

	CEO Pay	Median Employee Pay	Employees	Revenues	Market Cap
Median Employee Pay	0.17				
Employees	0.28	-0.46			
Revenues	0.46	-0.07	0.79		
Market Cap	0.48	0.15	0.49	0.70	
CEO Pay Ratio	**0.53**	**-0.74**	**0.58**	**0.38**	**0.19**

This table displays correlations between observed variables. Variables are identified in the top row and leftmost column. For example, the correlation between CEO Pay and Median Employee Pay is 0.17 and the correlation between CEO Pay Ratio and Market Cap is 0.19.

The most notable finding is that in the aggregate and excluding the pay figures, CEO Pay Ratios are driven primarily by the number of employees at a company. This finding is significantly more meaningful than whether CEO pay or median employee pay have a greater impact on the CEO Pay Ratio because employee count is not an input in the CEO Pay Ratio itself (as the pay figures are).

Since employee count is much more associated with median employee pay, however, we sought to answer a logical follow-up question: Does including revenues or market cap to the calculation materially increase the overall correlation with the CEO Pay Ratio? What is the combined impact? To find the answer, we calculated the multiple correlation coefficients[3] of these variables with the

they move perfectly in tandem. A correlation of 0.00 means the two variables are statistically unrelated, i.e., when one moves up, the other is no more likely to move up than down.

[3] A multiple correlation assesses the combined impact two variables have on a single other variable (i.e., two independent x variables compared to a dependent y variable).

CEO Pay Ratio. Interestingly, the combined impact of other size variables only marginally increases the overall correlations with employee pay.

Multiple Correlation Table

y Variable	Pay Ratio	Pay Ratio	Pay Ratio	Pay Ratio	Pay Ratio
x_1 Variable	Employees	Employees	Employees	Revenues	Employees
x_2 Variable	N/A	Revenues	Market Cap	Market Cap	Revenues
x_3 Variable	N/A	N/A	N/A	N/A	Market Cap
Correlation	**0.58**	**0.60**	**0.59**	**0.51**	**0.60**

Including pay variables in the mix improves correlations, but the fact remains that company size alone is nearly as strongly correlated with the CEO Pay Ratio as median employee pay—one of the CEO Pay Ratios' two components.

y Variable	Pay Ratio	Pay Ratio	Pay Ratio	Pay Ratio	Pay Ratio
x_1 Variable	Revenues	CEO Pay	Median Pay	CEO Pay	Median Pay
x_2 Variable	Employees	Employees	Employees	Revenues	Revenues
Multiple Correlation	**0.60**	**0.70***	**0.79***	**0.65***	**0.81***

* Denotes that correlation includes the impact of a pay variable and less meaningful than coefficients excluding pay variables.
***Note**: When CEO pay and median employee pay are the x variables, the multiple correlation with the CEO Pay Ratio is 1.00. Comparisons with market cap are not included in this table because it has less overall impact on the CEO Pay Ratio than revenues and/or employee count.*

The more complicated data analysis reinforces the initial finding: CEO Pay Ratios are defined largely by employee count. In our view, this is evidence supporting the notion that the CEO Pay Ratio disclosure provides investors with little, if any, meaningful information they can use to make investment decisions.

Industry Observations

Observers have noted CEO Pay Ratios within certain industries are lower due to largely higher median employee pay. We would also note the employee counts of companies in certain industry sectors such as Consumer Discretionary and Consumer Staples often have substantially higher employee counts relative to most other sectors. Employees in certain industries, particularly Energy and Utilities tend to have workforces with higher median employee pay levels, due to the nature of work performed by their median employees in comparison to those at companies in other industries. Such industry differences may be of

interest when comparing one company's CEO Pay Ratio against "industry peers," though we note even within industry sectors (and also compensation peer groups), there are commonly significant business models rendering comparisons of limited use.

Industry Detail by GICS Sector

Sector	Sample Size	CEO Pay ($000)	Median Employee ($000)	Pay Ratio	Employee Count	Revenues ($000,000)	FYE Market Cap ($000,000)
Consumer Discretionary	59	$11,854	$30	428	55,500	$11,811	$13,386
Consumer Staples	15	$15,349	$48	313	35,900	$19,494	$63,960
Industrials	55	$11,504	$62	172	35,000	$10,425	$15,810
Financials	60	$13,320	$69	157	17,650	$10,642	$26,844
Healthcare	47	$15,325	$70	209	26,000	$12,274	$35,218
Materials	19	$12,933	$73	158	14,000	$7,409	$14,131
Information Technology	27	$10,895	$79	151	13,400	$7,011	$26,809
Real Estate	29	$9,969	$81	116	1,565	$2,474	$16,067
Utilities	27	$11,530	$122	91	12,512	$11,074	$20,604
Energy	30	$12,838	$126	103	3,878	$8,764	$19,241

Notably, within these industries, trends identified from among the broader data set generally hold true: employee count is typically equivalently or more positively correlated with the CEO Pay Ratio and negatively correlated with median employee pay. Industrials companies, however, buck the trend. For these companies in aggregate, employee count is less strongly correlated with the CEO Pay Ratio

and unlike most other industries, median employee pay is *positively* correlated with employee count. The reason may be the mix of companies represented in Industrials, which range from airlines to manufacturing companies to business services. Employee population of these companies are very different, resulting in notable dispersions in median employee pay. For Industrials, as with other industries, CEO pay follows the broader trend (bigger size, higher pay).

Industry Detail by GICS Sector—Correlations

Sector	CEO Pay Ratio			Median Employee Pay			CEO Pay		
	EE Count	Revenues	FYE Market Cap	EE Count	Revenues	FYE Market Cap	EE Count	Revenues	FYE Market Cap
Consumer Discretionary	0.44	0.09	0.15	-0.49	0.02	0.06	0.01	0.15	0.27
Consumer Staples	0.68	0.56	0.49	-0.55	-0.34	-0.17	0.49	0.49	0.51
Industrials	0.27	0.22	0.29	0.25	0.38	0.38	0.42	0.45	0.52
Financials	0.59	0.64	0.49	-0.27	-0.02	0.16	0.44	0.66	0.62
Healthcare	0.75	0.59	0.18	-0.63	-0.23	0.22	0.34	0.56	0.48
Materials	0.70	0.31	0.28	-0.39	0.12	0.09	0.62	0.78	0.67
Information Technology	0.62	0.44	0.20	-0.54	-0.19	0.10	0.33	0.50	0.48
Real Estate	0.57	0.21	0.27	-0.68	0.00	-0.06	0.03	0.31	0.32
Utilities	0.52	0.57	0.44	0.21	0.21	0.33	0.64	0.68	0.62
Energy	0.64	0.45	0.31	-0.25	0.03	0.11	0.68	0.71	0.58

Manipulating CEO Pay Ratio Data

As noted earlier, one of the primary rationales labor unions and other critics of executive compensation put forth in support of the then-pending Dodd-Frank rule was one of investors

being more fully informed. The implication is that CEO Pay Ratios may impact or be associated with corporate performance—similar to how observers and critics of executive compensation often selectively compare pay and performance data to draw conclusions about disparities between pay and performance. To support the notion that CEO Pay Ratios impact performance, we expect some observers may attempt to draw misleading comparisons between CEO Pay Ratios and company performance to find headline-grabbing conclusions.

For demonstrative purposes, we analyzed CEO Pay Ratios, CEO pay, and median employee pay in relationship to 1-, 3-, and 5-year total shareholder return (TSR). Observers searching for meaning in the data, such as proponents of CEO Pay Ratio, could make the following claim:

> 2018 CEO Pay Ratio data show that companies with high median employee pay and/or low CEO Pay Ratios outperform those with low median employee pay and/or high CEO Pay Ratios. This proves that paying your workers more and your CEOs less results in better stock price performance.

This would be a startling claim. On its face, it could seemingly validate the usefulness of the CEO Pay Ratio—and with cherry-picked statistics, it is not technically inaccurate. In isolation, median 5-year TSR[4] for companies with the highest decile median employee pay is 117% versus 91% for the lowest decile median employee pay. For companies with the lowest decile CEO Pay Ratios, median performance was 95% versus those with the highest decile, 87%.

However, statistics can be cherry-picked both ways. It would also be possible to make the claim that higher CEO Pay Ratios result in better short-term performance because on a 1-year TSR basis, the companies with the higher CEO Pay Ratios outperformed (at the median of each decile) those with the lowest CEO Pay Ratios.

A more fulsome analysis would involve segmenting the full dataset, for example into quartiles, and calculating correlations between the variables to determine whether the data is meaningful. And in fact, the data is not meaningful. Correlations between median employee pay, the CEO Pay Ratio and 1-, 3-, and 5-year performance range from -0.05 to 0.03, meaning there is no meaningful relationship between median employee pay and performance or the CEO Pay Ratio and TSR. Segmenting the data into quartiles by each measure reinforces the fact that there appears to be no relationship between the CEO Pay Ratio and TSR performance. Therefore, drawing any affirmative conclusions about the “impact” of CEO Pay Ratios or median employee pay on performance is grossly misleading.

The decile analysis presented below is an example of how an observer could use data in isolation to draw startling, but misleading, conclusions using CEO Pay Ratio data.

[4] TSR figures presented here are not annualized.

Decile Analysis

	CEO Pay ($000)	Median Employee ($000)	Pay Ratio	1-Year TSR	3-Year TSR	5-Year TSR
Top Decile Median Pay	$15,154	$158	91	14%	23%	117%
Bottom Decile CEO Pay Ratio	$5,600	$106	61	15%	34%	95%
Bottom Decile Median Pay	$11,070	$15	685	19%	22%	91%
Top Decile CEO Pay Ratio	$15,468	$19	737	18%	21%	87%

***Note**: All statistics represent the medians of each isolated decile. TSR data is not annualized.*

The quartile analysis below demonstrates how more robust analyses that do not cherry pick CEO Pay Ratio data. A close inspection of the data reveals no discernable relationship between CEO Pay Ratio or median employee pay and performance.

Quartile Analysis

	Quartile	CEO Pay ($000)	Median Employee ($000)	Pay Ratio	1-Year TSR	3-YearTSR	5-Year TSR
Median Employee Pay	Top	$13,827	$134	99	15%	30%	100%
	2nd	$12,933	$83	151	19%	35%	95%
	3rd	$11,396	$60	201	20%	41%	109%
	4th	$11,052	$35	378	19%	29%	89%
CEO Pay Ratio	Top	$16,760	$41	428	21%	35%	93%
	2nd	$14,727	$66	215	21%	38%	119%
	3rd	$10,518	$76	133	16%	38%	96%
	4th	$8,808	$116	83	13%	28%	86%

***Note**: All statistics represent the medians of each isolated decile. TSR data is not annualized.*

Discussion

One of the key rationales which proponents of the CEO Pay Ratio cited was how the new disclosure

would provide investors with relevant information they could use to evaluate Say-on-Pay proposals and/or make investment decisions. However, even before companies were required to begin publishing the CEO Pay Ratios in their proxy statements, most reasonably dispassionate observers indicated they would be hesitant to draw conclusions, judging the figures to be of little use. Our analysis confirms there are few, if any, actionable insights arising from the data—and industry trends may be worthy of note, but they are not instructive. Ultimately, the CEO Pay Ratio is what we thought it is: A datapoint requiring disproportionately more effort to produce than will ever be realized in value to investors.

The Search for Meaningful Director Compensation Limits

Posted by Rebecca Burton and Michael Bowie, Willis Towers Watson, on Thursday, September 13, 2018

Editor's note: Rebecca Burton is a lead associate and Michael Bowie is a senior associate at Willis Towers Watson. This post is based on a Willis Towers Watson memorandum by Ms. Burton and Mr. Bowie. Related research from the Program on Corporate Governance includes The Growth of Executive Pay by Lucian Bebchuk and Yaniv Grinstein and Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

Total pay for non-employee directors continues to grow at a modest but steady rate, driven by increases to the annual cash retainer and the value of annual equity grants. Not all aspects of director compensation and corporate governance remain predictable, however. Annual compensation for directors continues to be a hot topic for shareholders and boards alike, precipitated by the ongoing attention to shareholder lawsuits that allege "excessive" pay for board members. This mutual interest has prompted boards to look for ways to mitigate exposure to lawsuits involving director pay programs; the most visible result is the swift action taken in adopting annual compensation limits specific to directors.

Willis Towers Watson's Global Executive Compensation Analysis Team (GECAT) reviewed 300 publicly-owned companies from the 2018 *Fortune* 500 list with proxies filed by June 30, 2018 for this director compensation trends analysis and compared results to data from the same companies reported in 2017. (For our previous director pay trends report, see "Balanced pay adjustments fuel growth in Fortune 500 outside director pay," *Executive Compensation Bulletin*, July 27, 2017.) *Figures 1* and *2* provide an overview of the range and prevalence of all elements of director pay.

Figure 1. Outside director compensation—percentile values[1]

	25th	Median	75th	Average	Prevalence
Sales ($ millions)	$7,381	$11,565	$22,063	$27,279	
CASH					
Board cash retainer	$80,000	$100,000	$110,000	$95,984	97%
Board meeting fee	$1,500	$2,000	$2,000	$2,092	10%
Committee cash retainer	$7,500	$10,000	$12,500	$10,458	30%
Committee meeting fee	$1,500	$1,500	$2,000	$1,671	15%
Committee chair extra retainer	$11,875	$15,000	$20,000	$15,691	92%
Annual Cash Compensation[2]	**$97,250**	**$107,500**	**$122,813**	**$109,339**	**97%**
ANNUAL/RECURRING STOCK					
Expected Value:					
Common stock ($)	$129,519	$150,008	$180,012	$157,809	15%
Deferred stock and phantom stock ($)	$129,965	$144,969	$180,000	$152,734	18%
Restricted stock ($)	$120,011	$146,815	$180,000	$154,164	65%
Full-value stock ($)[3a]	$125,033	$150,000	$180,008	$157,144	96%
Stock options ($)	$80,000	$95,004	$150,835	$125,986	7%
Annual/Recurring Stock Compensation ($)[3,4]	**$130,000**	**$150,005**	**$184,981**	**$162,956**	**98%**
Total Direct Compensation[5]	**$235,737**	**$267,512**	**$302,001**	**$270,050**	**100%**
ONE-TIME STOCK	$68,037	$110,000	$163,752	$152,739	10%
One-time stock grants annualized[6]	$8,505	$13,750	$20,469	$19,092	10%
Total Compensation (with one-time stock)	**$236,148**	**$269,950**	**$305,305**	**$271,959**	**100%**

Figure 2. Median outside director compensation

	2016	2017	% change	Prevalence
Sales ($ millions)	$10,898	$11,565	6%	
CASH				
Board cash retainer	$95,000	$100,000	5%	97%
Board meeting fee	$2,000	$2,000	No change	10%
Committee cash retainer	$10,000	$10,000	No change	30%
Committee meeting fee	$1,500	$1,500	No change	15%
Committee chair extra retainer	$15,000	$15,000	No change	92%
Annual Cash Compensation[2]	**$102,979**	**$107,500**	**4%**	**97%**
ANNUAL/RECURRING STOCK				
Expected Value:				
Common stock ($)	$140,000	$150,008	7%	15%
Deferred stock and phantom stock ($)	$137,497	$144,969	5%	18%
Restricted stock ($)	$139,991	$146,815	5%	65%
Full-value stock ($)[3a]	$140,004	$150,000	7%	96%
Stock options ($)	$93,060	$95,004	2%	7%
Annual/Recurring Stock Compensation ($)[3,4]	**$145,000**	**$150,005**	**3%**	**98%**
Total Direct Compensation[5]	**$259,744**	**$267,512**	**3%**	**100%**
ONE-TIME STOCK	$100,016	$110,000	10%	10%
One-time stock grants annualized[6]	$12,502	$13,750	10%	10%
Total Compensation (with one-time stock)	**$260,163**	**$269,950**	**4%**	**100%**

The average pay mix for a director stayed constant at 43% cash and 57% equity, with restricted stock remaining the equity vehicle of choice with a prevalence of 65%. Variable cash elements did not change in value at the median, even as the prevalence of per-meeting fees for attendance

[1] The sample consisted of 300 publicly-owned companies in the 2018 *Fortune* 500 that filed their fiscal year 2017 proxy statements by June 30, 2018.

at board and committee meetings fell from 13% to 10% and from 20% to 15%, respectively. Though usage of meeting attendance fees decreased, the prevalence of flat cash retainers for committee member service remained at 30%.

Total direct compensation rose to approximately $267,500 this year, compared to last year's $259,750. This 3% growth occurred because 40% of companies made changes to the core elements of their director pay programs. Annual cash compensation increased 4% at the median, from $103,000 to $107,500, bolstered by a 5% increase to the annual cash retainer. Total stock compensation grew by $5,000 at the median, an uptick of 3%.

One-half of the companies that made changes to their annual pay programs adjusted both the cash retainer and stock grant. However, companies that made a change to only one of these two components were nearly three times more likely to modify the annual equity award rather than adjust the board cash retainer. More than a third (38%) of companies changed only their equity component compared to 13% that changed solely cash. The median value of increases to the annual cash retainer was $10,000, while the median stock value increase was $15,000.

Annual compensation limits

The percentage of companies implementing an annual compensation limit continues to grow, as 61% of the group (previously 55%) now have a limit, including 17 which were newly-established this year. Several shareholder lawsuits alleging that "excessive" board-approved stock grants had been made to directors first pushed annual award limits into the spotlight. The claims made by shareholders in these lawsuits were not dismissed because the company's stock plan did not contain a "meaningful" limit for directors. Since the "meaningful" standard is not explicitly defined, companies are taking a practical approach to interpreting this criteria and are focusing on the form and scope of the limits. As shown in *Figure 3*, fixed-value limits are more prevalent than those based on a fixed number of shares (78% and 22%, respectively), as they offer a more clearly defined pay ceiling. Furthermore, limits continue to go beyond covering only annual stock grants: 32% of annual compensation limits now cover both stock and cash compensation, compared to 29% in this group last year. The direct cause of this shift is that the majority of newly-adopted limits in this sample (59%) incorporated both cash and equity.

Figure 3. Director–specific annual compensation limits: 2017

	Fixed number of shares	Fixed value
Prevalence	22%	78%
Minimum	1,000	$102,500
Median	27,500	$600,000
Average	56,838	$702,940
Maximum	700,000	$5,000,000

Compensation review

Nearly half (49%) of companies review their non-employee director pay program at least annually. Conversely, just 6% of companies disclosed either a biennial or triennial frequency of a compensation review, while 29% used less defined terminology such as "periodically" or "from

time to time." The responsibility of spearheading this review generally lies with either the compensation committee (55% of the group) or the nominating and corporate governance committee (36%). (The responsibility at the remaining 9% were divided among various committees, overseen by the board, or otherwise not disclosed.) Companies may want to review their pay structures more frequently to avoid becoming an outlier considering the increased attention recent shareholder lawsuits have brought to board compensation.

Board leadership

Figure 4. Pay for board leadership positions

	Non-executive board chair		Lead director	
	Total incremental compensation	Total chair pay relative to typical director	Total incremental compensation	Total lead director pay relative to typical director
25th percentile	$123,966	148%	$25,000	109%
Median	$160,000	162%	$30,000	111%
75th percentile	$200,000	176%	$40,000	114%
Average	$189,566	172%	$37,427	113%

Forty-nine percent of the companies in our sample separated the positions of board chair and chief executive officer, up from 47% in the prior year. These stand-alone board chairs served largely in a non-executive capacity, with 71% (or 35% of the entire group) serving as non-executives, up from 68% last year. The overwhelming majority (95%) of companies provided additional pay above what is paid for services as a director to individuals serving as a non-executive board chair, the median value of the incremental additional compensation is $160,000 (*Figure 4*). Nine out of 10 non-executive chairs receive an extra cash retainer as all or part of their incremental compensation, while just 33% of board members serving in this leadership role are granted an additional equity award.

In contrast to the rise in the number of standalone board chairs, the prevalence of companies identifying a lead or presiding director decreased from 73% to 70%. However, the recognition that this should be a paid role is increasingly ubiquitous, as 84% of companies paid an additional fee for serving as a lead director, compared with 79% last year.

Ninety-seven percent of companies compensated their lead director with an extra cash retainer; only one out of eight were granted an additional stock award. While cash and equity values each rose marginally at the median, total additional compensation for the lead director remained unchanged at $30,000.

Share ownership and retention

Stock ownership guidelines and retention requirements are nearly universal, with 94% of companies in this sample having one or both. Eighty-four percent of companies have equity ownership guidelines based on a multiple of the annual retainer (*Figure 5*), while the majority (55%) of retention requirements mandate a holding period which lasts until the stock ownership guidelines are met.

Figure 5. Stock ownership guidelines for directors

	Type of stock ownership guideline			Total guideline value
	Multiple of retainer	Fixed number of shares	Fixed-dollar value	
Prevalence	84%	6%	10%	
25th percentile	5	5,000	$375,000	$400,000
Median	5	10,000	$490,000	$500,000
75th percentile	5	15,000	$500,000	$575,000

Define and refine pay

Non-employee director pay rose moderately this year, buoyed by measured increases to cash and equity which resulted in a static pay mix. However, pay program design remained relatively the same, as compensation continued to be delivered primarily through fixed-value components. As more companies implement director-specific annual compensation limits, it will be interesting to see if, and how, these mandates will affect how companies structure their director pay programs.

Endnotes

[1] Annual cash compensation is calculated as follows:

1.
   i. Values reported for fees earned or paid in cash in the Director Summary Compensation Table are identified for each director.
   ii. Directors who did not serve the entire fiscal year, as well as directors in leadership positions receiving supplemental compensation (e., board chair and lead director) and chairs of the three primary committees (audit, compensation and nominating/governance) are removed.
   iii. The median value is identified for the remaining directors to determine the total cash compensation for “typical” directorial duties.
   iv. The value of the retainer is eliminated from the total cash compensation for the “typical” director to determine the value, if any, of total variable cash fees.
   v. Annual cash compensation is the combined value of the annual cash retainer and the median value of variable cash fees.

[2] Stock compensation is determined using ASC 718 values reported in company proxy statements.

a. Full-value stock represents the combined value of all full-value grants, regardless of the form of the award.

[3] All board/committee meeting fees and retainers that are paid in stock are included under annual/recurring stock compensation.

[4] Total direct compensation includes annual cash compensation plus annual/recurring stock compensation.

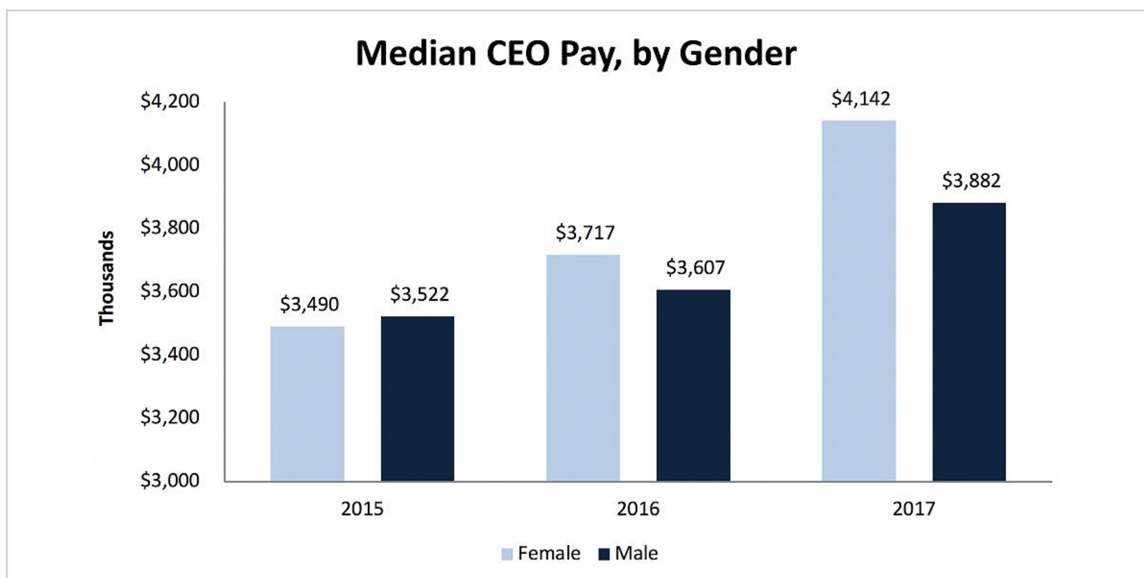
[5] One-time stock includes initial and discretionary stock-based grants. The values reflect the incremental additional value above that of the annual grant.

Dissecting C-Suite Gender Pay Disparity

Posted by Lyla Qureshi, Equilar, Inc., on Wednesday, August 1, 2018

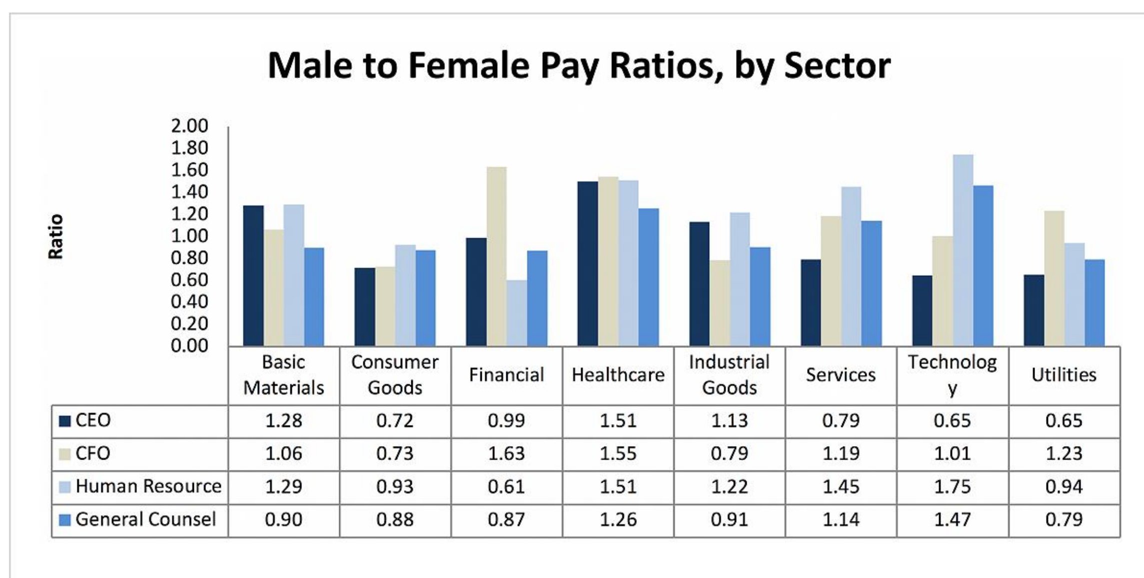
Editor's note: Lyla Qureshi is a Research Analyst at Equilar. This post is based on an Equilar memorandum by Ms. Qureshi.

April 10th marked Equal Pay Day 2018 in the United States. This particular date was chosen to highlight the occasion because it represents the amount of time—approximately 100 days into 2018—women must work to achieve the same pay that men earned in 2017. To further shed light on this topic, Equilar examined the gender pay equity ratio of specific executive levels. To understand the gender pay equity ratio as it stands today, Equilar calculated the ratio by analyzing the total compensation (base salary paid, incentive awards valued at target, grant date fair value of equity awards) received by male and female executives, particularly those who occupy the positions of chief executive officer, chief financial officer, human resources executive and general counsel at companies classified in the Russell 3000 market index over the last three years.



In 2015, the median male CEO earned approximately 1% more than the median female CEO, while in 2016 the gap reversed with female CEOs earning approximately 3% more than their male counterparts. The most recent year in the study saw the gap increase further in favor of women, with female chief executives making 6.3% more for the same-level job performed by the median male CEO. While these statistics may be positive indicators for those striving for gender pay equity, they should be viewed with caution due to the vast difference in the sample size between female and male CEOs. In 2017 there were 135 female CEOs, leading to a more volatile median

number in terms of total compensation for females. In light of this uneven sample population of male and female CEOs, the pay differentials between three other executive positions, namely CFOs, HR executives and GCs were analyzed.



	Basic Materials	Consumer Goods	Financial	Healthcare	Industrial Goods	Services	Technolog y	Utilities
CEO	1.28	0.72	0.99	1.51	1.13	0.79	0.65	0.65
CFO	1.06	0.73	1.63	1.55	0.79	1.19	1.01	1.23
Human Resource	1.29	0.93	0.61	1.51	1.22	1.45	1.75	0.94
General Counsel	0.90	0.88	0.87	1.26	0.91	1.14	1.47	0.79

For the role of CFO, men earned consistently more than women from 2015 through 2017, with their pay differential resting at 11.2% in 2017. Human resources executive was the position that witnessed the greatest change in gender pay ratio in the past three years, with the male-to-female pay ratio rising by 28.1 percentage points in favor of men. Between 2015 and 2017, female executives who served as general counsels made less money than men who performed the same job, with the difference rising from 4.3% in 2016 to 7.0% in 2017. Thus, during the timeline of this study, apart from CEOs, all other executives saw an increase in gender pay disparity. However, merely observing the overall numbers does not paint the entire picture. To gain a deeper insight into gender pay equity, Equilar examined the differences in pay with respect to sector. Any ratio of more than 1.0 indicates that the median male compensation was higher than the median female compensation at a given position.

Breaking down CEO pay by sectors for 2017 tells us that women tend to earn more than men in the consumer goods, financial, services, technology and utilities industries. On the flipside, the sector with the greatest disparity in terms of CFO pay is financial, while for HR executives, the largest gap can be found in the technology sector. In fact, the table above illustrates that consumer goods was the only sector in which women received more money than men in all four executive positions analyzed in this study. Conversely, men earned exceptionally more than women across all executive positions in the healthcare sector.

For the most part, the findings of this study are not entirely surprising. The *New York Times*, *Wall Street Journal* and CNBC have all published stories recently about the implications of the gender pay gap, or lack thereof, across the C-suite at public companies. While the gender pay gap as examined in this article, in particular the results found at the CEO level, may not necessarily be earth-shattering, the rise in overall NEO gender pay disparity between the years of 2016 to 2017 stands out. This widening of the gap goes hand in hand with trends recorded in a report issued by the World Economic Forum which found that gender parity has shifted in reverse for the first time

since 2006. Additionally, another finding of note involved the persistent gender pay equity gap in the healthcare sector, between both the median male and female at all executive positions in the study. One factor that might help explain this difference is the lack of space available for women to negotiate their salaries.

“Few women make it to those jobs where they’re making hundreds of millions of dollars, so they’re really seen as the exception, rather than the rule, and so that impacts their ability to negotiate,” Anna Beninger, Senior Director of Research at Catalyst, an organization performing research on women and the workplace, told CNN Money. “Moreover, when women do tend to negotiate, they are treated differently than men.” Beninger goes on to say that because women are not expected to negotiate as strongly as men, when they do so they are perceived as aggressive and oftentimes that yields a negative result. According to recent research, although there are several factors that contribute to the pay disparity between genders, discrimination against women continues to be a problem. With the increased emphasis on equity and fair play in workplace, one hopes to see a shift towards more equitable distribution of compensation between male and female executives in the near future, or at the very least an increased effort to spread the message of gender pay equality.

2018 Proxy Season Review

Sullivan & Cromwell LLP, [excerpt, p.43–47, 53]

July 2018

III. SAY-ON-PAY VOTES

A. COMPANIES MAINTAIN STRONG SAY-ON-PAY PERFORMANCE

The following table summarizes the 2017 and 2018 say-on-pay voting results for meetings at U.S. S&P 500 and Russell 3000 companies through June 30, 2018:

	Russell 3000		S&P 500	
	2018	*2017*	*2018*	*2017*
Percentage passed (majority support)	***97%***	99%	***98%***	99.5%
Percentage with >70% support	***92%***	94%	***93%***	94%
Percentage with ISS "Against" recommendations	***13%***	12%	***10%***	9%
Average support with ISS "For" recommendations	***95%***	95%	***94%***	94%
Average support with ISS "Against" recommendations	***66%***	70%	***62%***	69%

U.S. companies, broadly speaking, had similar results on say-on-pay votes in 2018 as compared to 2017 and other recent years, with the vast majority of companies achieving high levels of support. In addition, say-on-pay results between the U.S. S&P 500 companies and the U.S. Russell 3000 companies have largely converged.

Although there has been a slight increase in the percentage of failed votes (*i.e.*, votes with less-than-majority support) in 2018 to date, very few say-on-pay votes overall came close to failing, consistent with prior years. The generally low rate of negative results is a result of the efforts that companies have made to engage with shareholders and address concerns through changes in compensation practices and clearer compensation disclosure. Companies, shareholders and shareholder advisory firms all have become more adept at effective off-season communications where the company can obtain feedback on the most recent voting results, as well as set expectations and hear concerns for the coming year.

There continues to be significant year-over-year turnover in failed votes. However, this year, the number of companies that failed their say-on-pay vote after failing in the previous year was meaningfully higher than in the past. Of the 22 companies that failed their say-on-pay votes in 2017 and have had their 2018 vote, only 13 achieved majority support in 2018, and only nine had support levels over 70%. Although companies with failed votes generally have been able to be successful in engaging in, and disclosing, shareholder outreach efforts and, as appropriate, implementing program changes in a way that brings high support levels in future years, this year's results may suggest that low say-on-pay votes have become stickier.

Of the 50 companies in the Russell 3000 that failed say-on-pay votes in 2018 so far, only 10 had failed their 2017 vote, and 24 had support levels over 70% in 2017. The seven S&P 500 companies that failed say-on-pay in 2018 so far had support levels ranging from 66% to 99.7% in 2017. These reversals of results highlight the importance of continuous attention to compensation reporting and related

shareholder concerns. Companies should be aware that the metrics that impact levels of say-on-pay support are endpoint sensitive and can change significantly year-to-year.

Increasingly, off-season shareholder outreach has become a regular feature of corporate governance and shareholder relations for many large companies, facilitating an open dialogue between issuers and investors on compensation and other key topics. Shareholder outreach takes various forms at different companies, including face-to-face meetings, one-on-one phone calls, group conference calls and web meetings, and, in some cases, includes board members. Companies conducting such outreach must be mindful that company representatives may not disclose material non-public information in these discussions due to selective disclosure concerns under Regulation FD.

Companies should ensure that the appropriate personnel at institutional clients are involved in the discussions and the decision process—often institutional investors have both governance experts and investment professionals, each of whom will have critical input into the voting process, but may have differing views. Companies should also ensure that the appropriate company representatives are part of discussions with institutional investors. Board representation in discussions with large investors, especially on topics such as succession planning or executive compensation, may be appropriate but should be evaluated on a case-by-case basis, taking into account the purpose of the meeting and the preferences of the investor with whom the company is engaging.

Companies have increasingly engaged with proxy advisory firms in the off-season as well. ISS[39] and Glass Lewis[40] post their engagement policies on their websites. The policies of both firms restrict their ability to engage with companies during the solicitation period for the annual meeting, which means broader discussions with these firms must occur in the off-season.

As discussed above, recommendations from proxy advisory firms continued to influence voting results this year, and the role of proxy advisory firms and their impact on shareholder voting continue to attract debate and legislative reform efforts. The Corporate Governance Reform and Transparency Act, which was approved by the U.S. House of Representatives in December 2017 but has not yet been approved by the Senate, would require proxy advisory firms to register with the SEC and provide issuers with greater opportunity to preview, and more time to respond to, the firms' reports. While it is unclear to what extent any such reforms would affect the role and impact of these firms, companies should closely monitor the progress of these efforts.

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[39] ISS's engagement policies are available at http://www.issgovernance.com/policy/EngagingWithISS.

[40] Glass Lewis's engagement policies are available at http://www.glasslewis.com/for-issuers/glass-lewis-corporate-engagement-policy/.

For a more detailed discussion on trends in shareholder engagement, institutional investor influence and shareholder activism, see our publication, dated March 26, 2018, entitled "Review and Analysis of 2017 U.S. Shareholder Activism."

B. OVERALL ISS APPROACH ON SAY-ON-PAY EVALUATION

ISS has a multipronged approach to assessing executive compensation for the purposes of recommending a vote for or against the management say-on-pay proposal.[41] However, an analysis of ISS's 2018 negative recommendations for S&P 500 companies suggests that the most important criterion continues to be the pay-for-performance assessment, and that the most important factor under this pay-for-performance assessment is the alignment of CEO pay with Total Shareholder Return (or TSR) in relation to the ISS-determined peer group.[42]

ISS's policies provide that it will recommend a vote against a company's say-on-pay proposals if any of the following is true:

- there is a significant misalignment between CEO pay and company performance (pay-for-performance);
- the company maintains significant problematic pay practices (for example, excessive change-in-control or severance packages, benchmarking compensation above peer medians, repricing or backdating of options, or excessive perquisites or tax gross-ups); or
- the board exhibits a significant level of poor communication and responsiveness to shareholders.

ISS applies these standards by assigning companies a "high," "medium" or "low" level of concern for each of the five evaluation criteria listed in the following table, which shows the number of "high concerns" under each criterion for U.S. S&P 500 companies that received a negative say-on-pay recommendation from ISS in 2018:[43]

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[41] Glass Lewis's executive compensation assessment policy appears to be less formulaic than ISS's, though Glass Lewis publicly discloses less detailed information about its policy than ISS does. Based on Glass Lewis's published information, it evaluates compensation based on five factors: overall compensation structure, implementation and effectiveness of compensation programs, disclosure of executive compensation policies and procedures, amounts paid to executives and the link between pay and performance. In evaluating pay for performance, Glass Lewis looks at the compensation of the top five executive officers, not just the CEO. In addition, Glass Lewis looks at performance measures other than total shareholder return—it measures performance based on a variety of financial measures and industry-specific performance indicators. See http://www.glasslewis.com/wp-content/uploads/2018/01/2018_Guidelines_United_States.pdf for more information.

[42] Of the 41 S&P 500 companies that received negative ISS recommendations in 2018, nearly all warranted "high concern" on their pay-for-performance assessment, indicating a misalignment between CEO pay and company performance.

[43] The numbers for the categories add up to more than the total because some companies received "high concerns" in more than one category.

	U.S. S&P 500 Companies with Negative ISS Recommendations
Total with negative recommendations	41
Number that had "high concern" on:	
• Pay-for-Performance	39
• Compensation Committee Communication and Responsiveness	2
• Severance/Change-in-Control Arrangements	3
• Peer Group Benchmarking	1
• Non-Performance-Based Pay Elements	4

These results indicate that, although pay-for-performance is just one factor in the overall compensation assessment, it is the dominant determinant of ISS's outcome on the say-on-pay vote. A more detailed discussion of ISS's pay-for-performance policies and how they were applied in 2018 follows.

C. ISS PAY-FOR-PERFORMANCE ANALYSIS

Since the 2012 proxy season, ISS's methodology for evaluating the pay-for-performance prong of its assessment of executive compensation in the context of say-on-pay proposals begins with a quantitative analysis of both relative and absolute alignment of pay-for-performance.[44] If the quantitative assessment reflects an apparent pay-for-performance disconnect (*i.e.*, a "high" or "medium" concern), ISS applies a qualitative analysis, including an in-depth review of the company's Compensation Discussion & Analysis, to "identify the probable causes of the misalignment and/or mitigating factors."

1. Components of Quantitative Analysis

Beginning for 2018, there are four components of ISS's quantitative assessment:

- ***Relative Degree of Alignment, or RDA (relative alignment of CEO pay and total shareholder return over three years).*** The metric that is given the greatest weight in the quantitative assessment is the alignment of CEO pay and TSR,[45] relative to those of a peer group. The relative alignment metric looks at the difference between (a) the percentile rank within the ISS-selected peer group of a company's TSR and (b) the percentile rank within that peer group of a company's CEO pay.[46] The company's score is based on this difference calculated on a three-year basis. The threshold for receiving "high concern" is a difference of 50 percentile points or more. *As discussed below, this metric continues to be the strongest predictor of ISS recommendations and of overall voting results.*
- ***Multiple of Median, or MOM (relative CEO pay to peer group median over one year).*** The second relative component of the pay-for-performance assessment is prior-year CEO pay as a multiple of the peer group median. This metric considers pay independent of

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44 Technical information and guidance on ISS's say-on-pay methodology is available on the ISS website.

45 TSR measures how much an investment in the stock would have changed over the relevant period, assuming the reinvestment of dividends.

46 See Section III.C.3.a for a discussion of how "CEO pay" is calculated and some potential comparative problems this may cause.

company performance. ISS's scoring system may trigger a "high concern" if this multiple is 3.33x or higher.

- ***Pay-TSR Alignment, or PTA (absolute alignment of CEO pay and TSR over five years).*** The third component measures alignment between the long-term trend in the CEO's pay and the company's shareholder returns over a five-year period. This does not depend on year-by-year sensitivity of CEO pay to changes in TSR, but instead compares the straight-line slopes of five-year trend lines (based on a linear regression) for each of CEO pay and TSR. A "high concern" may be triggered if the CEO pay trend slope exceeds the TSR trend slope by 35 percentage points or more.
- ***Financial Performance Assessment, or FPA (relative alignment of CEO pay and financial performance over three years).*** This new relative measure compares the percentile ranks of a company's CEO pay and financial performance across three or four financial metrics, relative to the ISS-selected peer group, over the prior three-year period. FPA was first introduced as part of the pay-for-performance qualitative evaluation in 2017. As of 2018, the FPA measure has been added to the quantitative assessment and is applied as a secondary measure after the traditional three components (RDA, MOM and PTA) have been calculated. The FPA uses three or four of the following financial measures, depending on the company's industry: return on invested capital, return on assets, return on equity, EBITDA growth and cash flow. Performance is measured using the 12 most recent trailing quarters. The weighted average performance rank is compared to the company's CEO pay rank, similarly to the RDA.

The "medium concern" and "high concern" thresholds for non-S&P 500 companies are summarized as follows:

Primary Quantitative Measure	***Medium Concern Threshold***	***High Concern Threshold***
Relative Degree of Alignment	-40	-50
Multiple of Median	2.33x	3.33x
Pay-TSR Alignment	-20%	-35%

For S&P 500 companies, ISS updated its policy for meetings held on or after February 1, 2018, lowering the MOM medium concern threshold from 2.33x (which continues to be applicable for other Russell 3000 companies) to 2.00x. The lower threshold corresponds to the intensified investor scrutiny on the escalating CEO compensation among large-cap companies.

Primary Quantitative Measure	***Medium Concern Threshold***	***High Concern Threshold***
Relative Degree of Alignment	-40	-50
Multiple of Median	***2.00x***	3.33x
Pay-TSR Alignment	-20%	-35%

Based on the preceding, ISS will assign an initial quantitative score (ISS may deem multiple "medium concern" levels as the equivalent of an overall "high" quantitative concern). ISS then applies the FPA score as a potential modifier. The FPA will modify the initial score only if a company has either (a) a medium concern or (b) a low concern that borders on a medium concern threshold under one of the three primary measures.

IV. EQUITY COMPENSATION PLAN APPROVALS

	ADOPTION OR AMENDMENT OF OMNIBUS STOCK PLANS			
	Russell 3000		*S&P 500*	
	2018	*2017*	*2018*	*2017*
Number of proposals voted on	***478***	785	***68***	129
Percentage with ISS "against" recommendations	***21%***	20%	***9%***	5%
Average level of support with ISS "for" recommendations	***91%***	93%	***93%***	93%
Average level of support with ISS "against" recommendations	***77%***	77%	***73%***	76%
Number of failed proposals (<50% support)	***2***	3	***0***	0

U.S. listed companies are required under stock exchange rules to obtain shareholder approval for the plans under which they award executive compensation to employees and directors.[52] Because shareholders generally support the use of equity compensation by public companies as a means to align the interests of employees with those of investors, in most cases these proposals are uncontroversial and pass by a wide margin. As indicated in the chart above, the average support levels for these proposals are typically around or above 90%, and only two proposals failed to achieve majority support this year.

Beginning in 2015, ISS introduced an "equity scorecard" approach to assessing equity plans. The scorecard method, in which the passing score was raised from 53 to 55 in the 2018 policy updates, considers factors under three main categories:[53]

- ***Plan cost.*** Cost is calculated as the Shareholder Value Transfer relative to industry/market-cap peers; this measures the dilutive effect of the new shares requested as well as shares remaining for issuance under existing plans (often called "dilution" or "overhang"), and is calculated both with and without outstanding unvested awards.
- ***Equity plan features.*** Specifically, penalizing lack of minimum vesting periods, broad discretionary vesting authority, liberal share recycling and single-trigger change-in-control provisions.
- ***Historical grant practices.*** Specifically, three-year "burn rate" relative to market and industry peers, among other factors.

ISS recommended against around 21% of equity plan proposals, but recommended against only 9% in the case of S&P 500 companies; this difference is likely due to the impact of the larger public float on the plan cost and the movement away from problematic plan features. ISS recommendations have a fairly significant impact on voting results—in 2018, the average support level was 91% when ISS recommended "for" approval and 77% when ISS recommended "against."

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[52] *See* Section 303A.08 of the NYSE Listed Company Manual; Nasdaq Stock Market Rule 5635.

[53] ISS's current equity plan scorecard approach is described in its U.S. Equity Compensation Plans: Frequently Asked Questions.

Tab III: Executive Compensation and Director Pay

Board Lessons: Succeeding with Investors in a Crisis

Posted by Krystal Berrini and Rob Zivnuska, CamberView Partners, on Tuesday, June 5, 2018

Editor's note: Krystal Gaboury Berrini and and Rob Zivnuska are partners at CamberView Partners. This post is based on a *Bloomberg Law* article by Ms. Berrini, Mr. Zivnuska, Eric Sumberg, and Kathryn Night.

Each year, a small number of companies confront crisis-level events that draw high-profile scrutiny from a range of stakeholders. A well-executed emergency response plan can help limit the immediate fallout from a negative incident. However, in recent years, the companies that have been the most successful in managing the longer-term effects of a crisis have paid an increasing amount of attention to the viewpoints and concerns of investors. Though each situation presents a unique fact pattern, companies that have invested in building relationships with shareholders over time have been able to leverage those relationships to achieve better outcomes when a crisis hits. Below we outline the importance of relationship-building, effective ways to address investor engagement during a crisis and the importance of transparency and board leadership in maintaining credibility with investors over the long-term.

Building investor relationships before a crisis hits

From an investor perspective, crisis preparation begins months and years before an event occurs. Companies that dedicate resources to building strong relationships with their investors through a robust engagement plan are taking the necessary steps to generate a reservoir of credibility and trust which can be drawn upon in the face of a difficult event. There are a few main reasons why building relationships over time is so important:

First, making contact with an investor outside of the context of a difficult situation allows companies to establish a working relationship and open dialogue. Discussions in the context of a voting issue may feel transactional for investors; seeking investor views when there is not an immediate vote at stake demonstrates the company's genuine interest in obtaining and integrating investor feedback on important topics.

Second, tracking investor perceptions of the company's board, compensation and governance practices can inform the board's discussion of potential changes and facilitate the adoption of practices that are viewed as responsive to investor concerns.

Third, understanding the nuance of how to most effectively communicate with specific individuals and teams within each organization can enable companies to more effectively interpret subtle shifts in tone or behavior during a crisis situation and ultimately spot and address investor issues in advance of a vote.

Having a plan when a crisis occurs

After a negative event becomes public, companies should anticipate that investor concerns will necessitate an action plan and messaging that speaks to the longer-term. Companies are likely to have engagement discussions with anywhere from 20 to 40 institutional investors, depending on the shareholder base. That will include large investors with a significant economic stake as well as smaller investors who engage in governance activism and see a crisis as an opportunity to press for change on issues that may only be marginally related to the problem facing the company. Crises often create turbulence in the shareholder register: while index investors are permanent holders, active managers may be moving in and out of a stock as events unfold.

Companies that have taken time to build relationships with their investors will know instinctively in a crisis how to prioritize which investors to speak with as well as the most effective way to approach engagement discussions. For instance, previous meetings may make clear that a certain group of investors have been skeptical of management's direction or the board's oversight while others may have been trying to deliver a message by not engaging at all in the past. Some investors may have the ability to quickly marshal other shareholders to run a noisy campaign against directors or executive compensation. A company's ability to track and operationalize this knowledge with respect to the specific investor base is invaluable in shaping market sentiment and investor opinion in the days and weeks after a crisis event and is often key to a company's success in getting to a good outcome in the near term.

Putting the plan in action

In engagement, investors will be looking for issuers to take decisive action to address substantive issues while also being responsive to a broader set of concerns. Many questions will be asked about accountability around oversight mechanisms, whether the issues at hand are isolated or systemic and the board's role in the lead-up to the crisis. Investors will also expect new and enhanced disclosure around engagement, feedback received, and actions taken. It is common for those who make proxy voting decisions to measure the overall responsiveness of a company to a crisis situation by taking into account not only the changes that the investor explicitly requested but also additional actions that are initiated by the company, such as developing new firm-wide training or enhancing governance policies. Those companies with strong investor relationships are better positioned to get to the heart of what is required to quickly regain investor confidence and support.

The role of directors

In evaluating a company's response to a challenging situation, shareholders will be focused on the role of independent directors both before and after a crisis. Because investors lack visibility into what transpires in the boardroom, they depend on fulsome disclosure of processes that are indicative of independence and effective oversight. That may include enhanced disclosure of existing reporting structures as well as new policies implemented following the event.

A crisis will often thrust the board into a significantly more public posture. Companies should ensure that a director, and preferably one in a leadership role or with oversight of the subject matter, is prepared to engage with investors and the public more broadly, including the media.

Directors should also determine whether it is necessary to form an independent special committee, with independent counsel and advisors. The board may be expected to produce a report or provide other robust disclosure and share those findings with investors. Ensuring that the results of that exercise include all relevant facts and details will demonstrate to investors that the board has embraced its own responsibility for situations where oversight mechanisms proved inadequate.

Focusing on the investor perspective

As the first annual meeting after a crisis approaches, all of the proposals on the company's ballot, from directors to compensation and any shareholder resolutions, will be subject to greater scrutiny. Having individuals at investors and proxy advisors who can attest to the good faith and responsiveness of the company is among the most powerful tools companies can deploy to achieve success at the ballot box and in coming years. That valuable resource is most readily available to those boards and management teams that have built meaningful relationships with their key investor constituencies over time.

Harvard Law School Forum on
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Caremark and Reputational Risk Through #MeToo Glasses

Posted by Arthur H. Kohn, Elizabeth Bieber, and Vanessa C. Richardson, Cleary Gottlieb Steen & Hamilton LLP, on Saturday, June 2, 2018

Editor's note: Arthur H. Kohn is partner and Elizabeth Bieber and Vanessa C. Richardson are associates at Cleary Gottlieb Steen & Hamilton LLP. This post is based on their Cleary Gottlieb publication and is part of the Delaware law series; links to other posts in the series are available here.

Public and private businesses today face many decisions that do not arise from, and have consequences far beyond, solely financial performance. Rather, these decisions are primarily driven by, and implicate, important social, cultural and political concerns. They include harassment, pay equity and other issues raised by the #MeToo movement; immigration and labor markets; trade policy; sustainability and climate change; the manufacture, distribution and financing of guns and opioids; corporate money in politics; privacy regulation in social media; cybersecurity; advertising, boycotts and free speech; race relations issues raised by the pledge of allegiance controversy; the financing of healthcare; the tension between religious freedom and discrimination laws; and the impact of executive pay on income inequality, among others. If the nature of the issues is not unprecedented, the number, diversity and polarization seem to be.

Delaware courts and shareholders currently assess decisions made by boards of directors primarily under the business judgement rule and the 1996 *Caremark* standard. Many other states have similar schemes for evaluating director decisions or follow Delaware precedent. Generally, *Caremark* addresses the legal standard of culpability when directors are alleged to have failed to address a risk, while the business judgment rule provides a framework for assessing affirmative board decisions unless a more substantive review is warranted.

Companies and boards have traditionally viewed the risk of liability under *Caremark* as being primarily a compliance issue; a well-designed and administered compliance function should bubble up to directors the issues and information that require their attention, satisfying the *Caremark* duty of attention. A long series of Delaware decisions describe a *Caremark*-based derivative challenge as "possibly the most difficult theory in corporation law on which a plaintiff might hope to win a judgment."

This post explores the potential for change in the *Caremark* standard in light of the current intersection of business and social, political and cultural issues.

The *Caremark* Standard

The *Caremark* decision arose from a failure of Caremark International Inc. to comply with laws concerning inducements to prescribe drugs. The plaintiffs alleged that Caremark's directors breached their duty of care. Chancellor William Allen stated that "evaluation of the central claim made entails consideration of the legal standard governing a board of directors' obligation to supervise or monitor corporate performance". He determined that "where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention". Decisions subsequent to *Caremark* have drawn a distinction between, on the one hand, inadequate or flawed efforts by directors and, on the other hand, a conscious disregard for fulfilling fiduciary obligations. "The decision to act and the conscious decision not to act are thus equally subject to review under traditional fiduciary duty principles."[1]

Reasons for Revisiting the *Caremark* Standard in the Current Environment

As stated above, some of the most challenging issues facing business today have substantial components that are not traditional business issues. In a way, Chancellor Allen anticipates today's business challenge for directors by expressly premising his holding on moral considerations: "one wonders ***on what moral basis*** might shareholders attack a good faith business decision of a director as 'unreasonable' or 'irrational'" (emphasis added). That is not to say that the *Caremark* opinion suggests that moral failures should be a basis for director liability. Rather, the *Caremark* opinion suggests that the standard for director liability should in some way reflect the moral issues at stake: asking whether there is a moral basis for the courts to hold directors liable for not ferreting out an obscure compliance failure that results in a modest financial penalty is also by implication asking whether there is a moral basis for the courts to ***not*** hold directors liable for turning a blind eye to issues of great political, social or cultural consequence.

Chancellor Allen's "duty of attention" is an important focus for today's issues because directors may be inclined to think that addressing the fraught political, social and cultural aspects of today's issues is beyond their purview, because they are not primarily business issues. However, precisely for that reason, the moral basis for judging directors based on how they deal with today's issues may have evolved.

The *Caremark* Context

In his *Caremark* opinion, Chancellor Allen tightens the standard that was adopted in *Graham v. Allis-Chalmers Mfg. Co.* about thirty years earlier. The *Allis-Chalmers* court held, in a claim against directors arising in the context of anti-trust violations, that there was no basis to find the directors liable for breaching a duty to be informed of the corporation's operations, famously stating that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."

[1] *Louisiana Municipal Police Employees' Retirement System v. Pyott*, 46 A.3d 313 (Del. Ch. 2012).

Chancellor Allen found at least a broad reading of the *Allis-Chalmers* standard to be insufficient, stating that “modernly this question has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations.”

He held, to the contrary, that a board must assure itself “that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.” Chancellor Allen focused on the obligation of directors to collect the facts necessary to reach informed judgment and concluded that turning a blind eye was not an appropriate alternative.

In the same year that he wrote his *Caremark* opinion, Chancellor Allen also wrote the opinion in *Gagliardi v. TriFoods*, which he cited in *Caremark*. *Gagliardi* provides examples of the kinds of decisions that Chancellor Allen likely had in mind when he decided Caremark: (1) TriFoods’ former president causing the corporation to pay $125,000 to a consultant for the design of a new logo and packaging; (2) directors acquiescing in a “reckless” commission structure in order to build sales volume; (3) directors tolerating duplicate product research facilities; (4) directors overpaying in a corporate acquisition; and (5) directors failing to pre-empt harm to customer relations arising from delivery of poor product, and to supplier relations from poor payment practices.

Compare that list to the kinds of potential claims that could arise from the difficult issues of today:

1. failure to prevent a corporation from employing large numbers of undocumented illegal aliens, one of whom gets into a fatal car accident on the way home from work;
2. failure to oversee compliance with environmental standards, resulting in unacceptable levels of toxins in the drinking water of a poor urban neighborhood;
3. failure to terminate the employment of the CEO, a sexual predator;
4. failure to adopt best practices for background checks in connection with the sale of assault rifles, one of which is used in a school shooting;
5. failure to appropriately monitor or react to corporate compliance with political contribution rules, or to protect customer data, likely affecting the results of elections; or
6. failure to ensure an appropriate response to consumer boycott threats arising from advertising support on controversial media outlets.

This is a nightmare list of potential claims, to be sure (albeit only a partial one), but is it clear that the standard applied to director conduct in these situations would, taking into account Chancellor Allen’s moral basis test, be consistent with our current understanding of the relatively forgiving *Caremark* standard?

Whose Responsibility?

One line of thought suggests that responsibility for these new and difficult issues lies primarily with management, and not with directors. A few considerations seem particularly relevant to this question.

First, management, and not directors, are usually the driving force for company action. While the board oversees the company and sets strategy, management implements that strategy and generally has broad discretion afforded to it through board delegation under state law. As we have noted, directors may be sued directly for their or company actions, or inactions, but the system provides a relatively broad shield that insulates their decisions from being second-guessed by the judiciary. Management, tasked with the responsibility of running the day-to-day operations, is subject to more uncertain standards.

In 2009 in *Gantler v. Stephens,* Delaware made it clear that corporate officers owe the same fiduciary duties as directors. However, *Gantler* stopped short of reviewing officer conduct under any standard (and therefore did not apply the business judgment rule) and there have been limited overtures regarding the applicable standard of review for officers' conduct in cases since then.[2] In addition, the court in *Gantler* asserted that the consequences of a breach of fiduciary duties would not necessarily be the same as a director's breach. It remains unclear how an officer's fiduciary duties are to be measured; despite the assertion in *Gantler* that officers owe fiduciary duties, there is no mechanism to enforce or assess the fulfillment of those duties.[3]

Second, senior management is accountable directly to the board, as the board has the power to select and fire those individuals. Directors are accountable to shareholders who have the ability to vote them out as directors. In the past few years, there has been a rapid and significant evolution in investor expectations and attitudes towards the companies in which they invest in regard to stewardship. In addition, demand for socially responsible investing has grown, and traditional institutional investors, as well in some cases as activists, have focused their stewardship advocacy directly on boards (and in the creation of investment vehicles that invest only in companies that meet certain social or environmental criteria). As investor expectations in this regard continue to evolve, investors are increasingly focused on the power of their votes. We have already begun to see a shift in voting behavior evidencing votes serving both a financial and social and political functions. Thus far, however, institutional investors have been vocal about linking their views on social and political issues to the manner in which such decisions affect financial performance, or as a proxy for a board's understanding and management of risk that in turn affects financial performance. Whether significant numbers of investors will place a stronger emphasis in voting decisions on social and political views, such that elections are affected by issues that are not primarily financial issues, is an interesting and open question.

Third, there are typically minimal tangible repercussions under current law for a director who is found to have breached his or her fiduciary duties. Broad indemnification laws and agreements mean that few directors have been personally liable for any portion of a monetary judgment.[4] The specter of reputational harm is real, but does it justify the relatively director-friendly *Caremark* standard? How should additional demands on, or expectations for, directors, if they seem to be appropriate, be balanced with the risk that the most-qualified individuals may refuse to serve because of the corresponding additional risks? A year ago, few directors would have thought that the board's attitude towards ferreting out sexual harassment would be material to their jobs as directors; today many more see that concern. So, in a sense the change in

[2] The U.S. District Court for the District of Delaware in the bankruptcy case *Palmer v. Reali* in September 1996 noted that the of whether the business judgement rule applies to officers deserves further analysis, but restrained itself from opinion as the defendants cited no cases in which a Delaware court held that the business judgment rule applied to corporate officers.

[3] Interestingly, in late 2017, Nevada enshrined the business judgment rule for directors and officers in state law.

[4] The court in *Gantler* also noted that no parallel exculpation for officers exists under Delaware law.

expectations has already occurred without a change in law, but will a change in law follow? Should it?

How Could Change Come About?

While it may not be obvious what set of facts could give rise to a claim arising from today's issues, it is not a stretch to imagine that one would. Director fiduciary claims have already been brought based on allegedly pervasive sexual harassment issues. Are we at the beginning, middle or end of a period of unusual tension concerning today's divisive issues?

Perspectives on the *Caremark* Standard

As stated above, the *Caremark* standard requires boards to stay informed about matters that could affect "judgments concerning both the corporation's compliance with law and its business performance." What about corporate conduct that implicates today's pressing political, cultural and social issues. For example, should boards be expected to stay informed of issues relating sexual harassment at their companies, or business practices that could implicate important religious freedom issues, even if they do not seem to implicate material financial or legal compliance concerns?

As also stated above, the *Caremark* standard applies to board inaction, whereas the actions of directors are subject to substantive review if not protected by the business judgment rule. The business judgment rule protection requires independence, due care and good faith. In the context of today's highly visible and contentious issues, what justifies the different standards applicable to judicial review of board inaction, on the one hand, and board action, on the other? Should corporate losses arising from these issues be presumed to be the result of a "conscious decision not to act"?

Take-Aways

For as long as *Caremark* continues to be the law, directors should ensure that they at least meet the *Caremark* standard in connection with the #MeToo movement and other issues relevant to their businesses, but they should not be too concerned about new liability risks, even in the current environment. Meeting the *Caremark* standard includes periodically assuring that there is a system for information and problems to come to the board's attention. The application of the *Caremark* standard to today's issues does not require novel efforts.

However, reputational risks for *companies* and *directors*, distinct from liability risks, deserve to be highlighted in the current environment. The enterprise risk approach that many companies and boards take should be re-examined to ensure that they are designed so that reputational risk concerns will bubble up to the board. In our experience this adjustment has already happened at many companies.

Finally, a move away from the *Caremark* standard in judging board conduct seems conceivable, but certainly not inevitable. Any such change would likely be motivated by a different moral calculation than prevailed in the past, one that arises from the social, cultural and political nature and scope of the issues facing business today. It might reflect political calculations related to

today’s populist trends and a backlash against the corporate class. The change could be ushered in by Delaware courts examining a controversy arising under the current legal framework, or by changes in law, for which there is precedent in Sarbanes-Oxley (arising from the Enron and WorldCom scandals) and Dodd-Frank (following the financial crisis).

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:

Observations on Culture at Financial Institutions and the SEC

Posted by Jay Clayton, U.S. Securities & Exchange Commission, on Monday, June 18, 2018

Editor's note: Jay Clayton is Chairman of the U.S. Securities and Exchange Commission. This post is based on Chairman Clayton's recent remarks, available here. The views expressed in this post are those of Mr. Clayton and do not necessarily reflect those of the Securities and Exchange Commission or its staff.

Thank you Bill [Dudley] for that kind introduction and for inviting me to speak today [June 18,2018].[1] I'm planning to speak for fifteen or so minutes and to open the floor to questions.

I want to extend my congratulations to Bill Dudley on a very successful term. You are now a member of the long line of former leaders and perpetual culture carriers at the New York Fed. The respect for the New York Fed, among national and international regulators and, importantly, market participants of all stripes, is remarkable, but clearly well deserved. Congratulations are also in order for John Williams, who begins his term today. John, my colleagues and I at the SEC are looking forward to working with you in your new role.

I recognize that there are many constituencies—regulators, market participants, etc.—in the audience today and it is a great privilege to have the opportunity to speak to you all about a subject of individual and collective importance.

I will return to that theme—individual and collective—more than once today.

Let's turn to the topic for discussion: The importance of developing, improving and reinforcing positive culture in our financial institutions. I will offer some observations about culture at financial institutions and the SEC.

Culture is not an Option

The Financial Conduct Authority in the UK recently issued an illuminating discussion paper on the topic of culture in the financial services industry, with the fundamental observation: "Culture is not optional."[2]

[1] My views are my own, and do not necessarily reflect the views of the Commission, my fellow Commissioners, or the staff.

[2] Financial Conduct Authority, *Transforming Culture in Financial Services*, (Mar. 2018).

Every organization has a culture, and in some cases, the firm's culture is in fact a collection of many sub-cultures.

While the leaders of our financial institutions often are tasked with driving positive changes in culture, they must recognize they are not writing on a blank slate or, for that matter, a single slate.

Know Your Culture

In order to effectively manage, preserve and enhance your organization's culture, you need to know your culture.

Returning to the "not a blank slate" comment, the slate may have a lot of chalk marks. The most recent cultural initiative may be written in large, bold letters. But, below the chalk, there may be etchings, sometimes deep etchings in the slate. For the positive etchings, be thankful, very thankful. They take time and effort to develop and can carry an organization through challenges of many types. For the negative etchings, know there is work, perhaps painful work, to be done. If you ignore them, they are likely to get deeper and, at some point, will undermine the most well intentioned efforts.

Returning to knowing your culture, I'll make two related observations. First, to effectively manage the business of your organization on a day-to-day basis and over the long term, management needs to know what the culture of the organization is today, including the key drivers of that culture. For example, a new strategic initiative is much more likely to be successful if it is designed and implemented in a manner that is consistent with, and, hopefully, leverages the firm's culture.

Second, over time, whatever the cultural goals for your organization may be, the chances of achieving them go up dramatically if you understand where your culture stands relative to those goals. In driving organizational culture, it is difficult, if not impossible, to get from A to B unless you have a clear sense of what A is.

There is a regulatory relations observation I will make that flows from the need to know what your culture is today if you want to preserve and improve culture for tomorrow. This observation is informed by my work as an adviser and now as a regulator. Assume a significant conduct problem occurs at a financial institution and the firm's culture comes under regulatory scrutiny.

Let's take as given that both the firm's management and the regulator want the firm to have "good" culture, one, for example, that is consistent with long term shareholder, employee, customer and societal interests as well as law and regulation. In other words, we're all trying to row the same boat in the same direction. However, if there is a disconnect between what management thinks the firm's culture is today and what the regulator thinks the firm's culture is today, agreeing on measures to enhance the culture will be difficult—very difficult. Said starkly, if the regulator is convinced a firm has a cultural problem and the firm continues to fight that conclusion, tension is likely to be high and progress—which involves fostering mutual regulator-firm respect and trust—will be slow and costly all around.

Culture is a Collection of Countless Internal and External Actions

There is another theme that runs through the FCA study I referenced and is central to much of the discussion of today: In my words, culture is collective.[3] What do I mean? While there is great importance in setting a positive "tone at the top," an organization's culture is, in large part, defined by the countless daily actions of its people. Culture is not just what is said by management to the work force, but what is done, i.e., what actions are taken, day in and day out throughout the organization, with colleagues, customers, suppliers and regulators.

To put this point in context, let's look at the SEC. Yes, we have a Chairman and we have 4 Commissioners and a dozen or so other senior leaders, including the heads of our Enforcement, Trading & Markets, Investment Management, Corporation Finance, Compliance and Inspections, Economics and Risk Analysis, Office of Chief Accountant and our General Counsel. We each have a responsibility to set and act in accordance with the SEC's cultural objectives, both internally and externally. But, while our actions may be relatively the most prominent, they are a small fraction of the internal and external interactions of the SEC.

Every day, our market participants—individual investors, issuers, asset managers, brokerage firms, rating agencies and other regulators (including many represented here today)—interact with the women and men of the SEC. In many cases, those interactions are very important to those participants, as well as many others. As I like to say, we have thousands of "at bats" a day where our culture is on display and being shaped. How we handle ourselves in these countless situations defines who we are. Are we zealously pursuing our mission? Are we consistent and clear? Are we fair? Do we listen? Do we learn? And, most important, are we striving to deliver for America's long term Main Street investors?

Preserving and Enhancing Culture Through a Clear and Constant Mission

That last question—"Are we striving to deliver for America's long term Main Street investors?"—provides a basis for discussing my next observation. If culture is defined by the collection of countless daily actions taken across the organization, how do you ensure those actions are consistent with the organization's cultural objectives?

There are many familiar methods for communicating, monitoring and reinforcing cultural objectives—compliance programs, policies and procedures, training, personnel decisions (including evaluations and compensation), etc. I believe all of these methods are important and, in large financial organizations, essential. I also believe these methods are enhanced by, and in fact, to be effective over the long term, require, a clear, candid, easily understandable articulation of the organization's core mission.

My view of this message for the SEC is furthering the interests of our long term retail investors.

That short statement does not stand alone. As you would expect, we have many goals and obligations. For example, ensuring that trading—a largely institutional exercise—is fair and efficient is a critical part of our mission. Although it is a largely institutional market—and certain aspects of it are almost exclusively institutional (e.g., high yield bonds)—I believe the right question to ask is: are we seeking fairness and efficiency in this largely institutional market in a way that best serves the interests of our long term retail investors. Is there a disconnect here?

[3] Financial Conduct Authority, *Transforming Culture in Financial Services*, (Mar. 2018).

Why should we have retail on our minds when we are regulating an institutional market? There is no disconnect. Those institutions are holding and trading, in large part, the funds of retail investors. That perspective, or lens as we sometimes call it, should substantially inform how we regulate trading.

This perspective, this unifying perspective, this driver of culture, is similarly relevant when we look at investment products, corporate disclosure, and governance rules as well as when we set inspection and enforcement priorities. To be clear, and to give deserved credit to the SEC staff and those who came before me, this cultural dedication to our long term Main Street investors has been deeply etched in the SEC's slate for many years.

Culture Beyond the Law and Regulation

I will turn away from the SEC and back to organizations more generally. There are many reasons why having a clear mission is beneficial to culture and improving culture. I'll cite one in particular. It fills in the gaps. Organizations with the most comprehensive compliance programs and policies and procedures will inevitably encounter circumstances not contemplated by their policies and procedures. In those situations, what drives how people will act? The law and regulations? What if those also do not contemplate the situation? Or, more significantly, what if the law permits a range of actions with some that, while legal, can cause significant harm. In these circumstances, those on the front lines, those making decisions, need a touchstone.

To illustrate the point of how important the "gap filling" function of culture can be, allow me to put on my law professor hat for a moment. I will also reiterate the disclaimer that I am not commenting on behalf of the Commission or discussing any specific case that is or has been before the Commission. I will present my own hypothetical fact pattern.

Counterparty A, a sophisticated asset manager with years of experience in the fixed income market, including with illiquid and distressed securities, calls Broker B. Broker B is known as a market maker in the debt securities of an issuer, Issuer C. The fixed income securities of Issuer C, from time to time, have had limited liquidity. These securities are widely disbursed and have experienced price volatility in the past.

Counterparty A expresses interest in buying $10 million in face amount of Issuer C's bonds and asks Broker B for a price. Broker B says I can "fill" that at 90 (i.e., at .9 of par or approximately $9 million). Counterparty A then asks Broker B, if the Issuer C bonds are held in inventory and, if so, at what price Broker B acquired the bonds.

Assume, Broker B acquired $20 million of the bonds a few days ago at 80 and has held them in inventory.

Let's put aside the question of whether, it may be legal and appropriate for Broker B to charge Counterparty A 90 for these bonds. In fact, let's assume for the sake of this hypothetical that a price of 90 would be consistent with FINRA rules, internal policies and procedures and all applicable securities laws regarding pricing.

Unfortunately, Broker B, or a few people at Broker B, lie. They tell Counterparty A the bonds were purchased at 81 when they know they were purchased at 80.

Let's assume further that, after Counterparty A is told the bonds were purchased at 81 (when they were in fact purchased at 80), the legal department at Broker B reviews the matter and concludes this lie does not run afoul of the federal securities laws. Setting aside whether that advice is sound or accurate, does anybody really think it is a good idea to take that advice a step further and say a lie is acceptable?

Here is where culture comes in. The law may not prohibit all forms of lying, but your culture should reject it. Said another way, if any financial institution thinks behavior of this type is acceptable or does not require prompt, clear and significant action, that financial institution has a cultural problem. To me, there is no debate on that score. Faced with this or a similar scenario, the financial institution should not be asking "Do we have a problem?" It should be asking "What do we do to address this problem in a way that is clear, consistent with, and reinforces, our cultural goals?"

We do not Expect Perfection; We do Expect Commitment and Action

A final regulatory observation before I conclude: human beings make mistakes and some break from cultural expectations and legal requirements. We all, including those of us at the SEC, recognize this fact.

When this behavior occurs, key questions a firm should ask include whether the conduct represented a clear breach of the firm's controls *and* culture as well as whether the firm's remediation efforts, in addition to any controls enhancements, sent an appropriate and lasting cultural message. Turning back to my hypothetical, do the controls now make it clear that lying is unacceptable and that communications around mark-ups will be monitored. And, were the offending parties dismissed or otherwise meaningfully sanctioned. The actions we chose in these types of scenarios say a great deal about who we are—and what our culture is.

Conclusion

I will conclude by addressing the importance of the work that you all do in this particular profession. Professionals in the financial industry must recognize the pervasive reach of our markets and the importance of finance at an individual level. Every organization's culture should reflect 3 realities and these 3 realities need to be recognized by professionals at every level of an organization. First, it is a privilege to work as a professional in the financial sector. Second, firms have systemic responsibilities with widespread significance. Finally, firms and their professionals have important, individual responsibilities to real people that make up the investing public. We are counting on you, and, importantly, more importantly, the public is counting on you to develop cultures that recognize and responsibly address these realities.

This is a continuous exercise. Markets will change. Organizations will change. Culture and the effective implementation of positive culture must keep up. We at the SEC will give you feedback on your culture and we, including me, want feedback from all market participants on our culture.

Thank you.

Federal Reserve Takes Severe and Unprecedented Action Against Wells Fargo: Implications for Directors of All Public Companies

Posted by Edward D. Herlihy, Richard K. Kim, and Sabastian V. Niles, Wachtell, Lipton, Rosen & Katz, on Monday, February 5, 2018

Editor's note: Edward D. Herlihy, Richard K. Kim, and Sabastian V. Niles are partners at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell publication by Mr. Herlihy, Mr. Kim, and Mr. Niles.

In a stinging rebuke, the Federal Reserve on February 2nd issued an enforcement action barring Wells Fargo from increasing its total assets and mandating substantial corporate governance and risk management actions. The Federal Reserve noted in its press release that Wells will replace three current board members by April and a fourth board member by the end of the year. In addition, the Federal Reserve released three supervisory letters publicly censuring Wells' board of directors, former Chairman and CEO John Stumpf and a past lead independent director. These actions are a sharp departure from precedent, both in their severity and their public nature. They come on the heels of significant actions already taken by Wells, including appointing a former Federal Reserve governor as independent Chair and replacing a number of independent directors as well as its General Counsel.

As a matter of regulatory policy, we believe that these actions are more piercing political statement than a change in direction from the deregulatory posture of the Trump Administration or the recent Federal Reserve pronouncements about reducing the regulatory demands on bank boards of directors. It is telling that the Federal Reserve took action on Chair Janet Yellen's last day in office and that its press release features a quote from her—she rarely commented on enforcement actions during her tenure. That being said, there are important aspects of these actions that will reverberate within and beyond the financial sector, underscoring the ever-evolving challenges facing corporate boards:

- the characterization of compliance breakdowns as failures of governance and board oversight;
- the required replacement of board members;
- the censuring of directors after they had left the board for "lack of inquiry and lack of demand for additional information";
- the expressed view that a board's composition, governance structure and practices should support the company's business strategy and be aligned with risk tolerances;
- the expectation that business growth strategies be supported by a system for managing all key risks, including those arising from performance pressure and compensation

incentive systems and the potential that business goals could motivate compliance violations and improper practices;
- the view that "management assurances" of enhanced monitoring and handling of known misconduct be backed up by "detailed and concrete plans" reported to the board; and
- the citation to the company's published corporate governance guidelines detailing duties and responsibilities that were not fulfilled.

In its enforcement action, the Federal Reserve required that Wells submit written plans to enhance its board's effectiveness in carrying out its oversight and governance functions and to improve its firm-wide compliance and risk management program. Once the Federal Reserve has approved these plans and Wells has implemented them, Wells must arrange for an independent review of the improvements that have been made, which must be completed by September 30th. Wells must then arrange for a second independent review to assess the efficacy and sustainability of the improvements. Until the initial independent review is completed to the Federal Reserve's satisfaction, Wells is barred from increasing its total consolidated assets from the level reported to the Federal Reserve as of December 31, 2017.

While the bank regulators have in the past issued enforcement actions limiting banks from increasing their total assets, these actions have been reserved for deeply troubled institutions with severe capital and credit issues and not for financially strong institutions such as Wells. The Federal Reserve likely took this unusual step because Wells was already barred from making acquisitions as a result of other legal and regulatory restrictions. Nevertheless, Wells Fargo acquired a large portion of the assets of GE Capital in 2016 structured in a manner to avoid its regulatory bar on acquisitions, and this may have been a further impetus for the Federal Reserve's action.

Perhaps more surprising was the Federal Reserve's public release of supervisory letters to each of Wells Fargo's board members, former Chairman and CEO and past lead independent director criticizing their performance. Normally, supervisory letters are kept confidential by the regulators. In the letters, the Federal Reserve pointed to an overall lack of effective oversight and control of compliance and operational risks. These letters express the view that directors need "to have sufficient information from firm management to understand and assess problems at the firm" and that this requires "robust inquiry and demand for further information." Especially with respect to board leaders, once problems become known, failure to "initiate any serious investigation or inquiry" or to "lead the independent directors in pressing firm management for more information and action" will expose directors to criticism and potential reputational damage.

Last August, the Federal Reserve issued a proposed corporate governance proposal narrowing its focus on supervisory expectations for bank boards of directors, noting in its release that "boards often devote a significant amount of time satisfying supervisory expectations that do not directly relate to the board's core responsibilities." Proposed Guidance on Supervisory Expectations
for Board of Directors, 82 Federal Register, 37219 (August 9, 2017). In our view, these letters do not contradict that guidance—rather they lay out more specific supervisory expectations for boards when they become aware of specific instances of misconduct. The public release of these letters to Wells Fargo's current and former board members should be viewed as putting other companies on notice regarding the expectations laid out within them.

We note that there remains the possibility of further enforcement actions by the Federal Reserve involving Wells. In the current enforcement action, Wells agreed to fully cooperate and "to use its best efforts, as determined by the Board of Governors," to facilitate investigations by the Federal Reserve "of whether separate enforcement actions should be taken against individuals" who are or were affiliated with Wells. Given the highly public nature of the Federal Reserve's actions, the Congressional hearings that will likely follow, and the continuing outcries for holding individuals accountable in cases of corporate misconduct, it may be politically difficult for the Federal Reserve to refrain from taking further action against individuals previously or currently associated with Wells.

While financial institutions operate within their own unique regulatory framework, all companies should reflect on the increased expectations on board leaders and the board as a whole with respect to assuring that appropriate risk management and escalation systems are in place. This includes setting high expectations for General Counsels and compliance departments and following up assertively with robust and prompt inquiry and tracking when evidence emerges of serious compliance breakdowns. Because high-quality, timely and credible information provides the foundation for effective responses and decision-making by the board, the ability of a board and board committees to perform their oversight roles is dependent upon the relationship and flow of information among the directors, senior management, legal and compliance departments and the risk managers in the company. If directors do not believe they are receiving sufficient information, they should be proactive in asking for more, and directors should work with senior management to ensure that their information needs are being met, including agreeing on the type, format and frequency of risk, business and other information required by the board.

Tab IV: 2018 Season E&S Activism

2018 Proxy Season Review

Sullivan & Cromwell LLP, [excerpt, p.7–10]

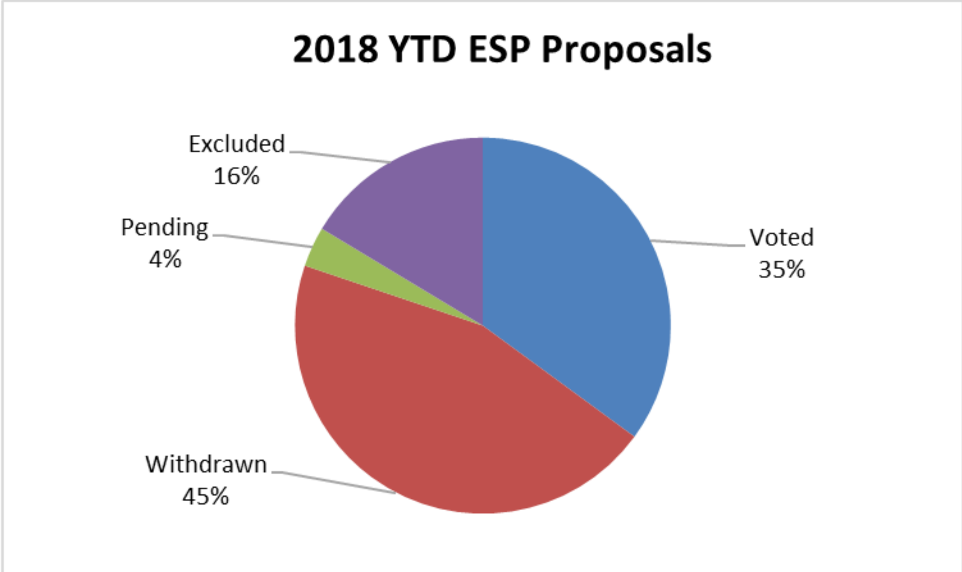
July 2018

In comparison, proxy access and special meeting rights are less common among the S&P Composite 1500 at this time. Over 500 U.S. companies have adopted proxy access provisions at this point, which is concentrated at large-cap companies. (About two thirds of S&P 500 companies have adopted proxy access, versus 21% of the S&P 400 and only 7% of the S&P 600.) In contrast, there is a similar level of adoption of special meeting rights among large-cap and smaller-cap companies (nearly two thirds of the S&P 500, versus around 50% among each of the S&P 400 and S&P 600). This trend is partially attributable to the fact that many of the smaller companies are incorporated in states that have adopted the Model Business Corporation Act, which mandates the shareholder right to call special meetings (about 30% of S&P 400 companies and 25% of S&P 600 companies are incorporated in states that mandate the right, as compared to about 15% of S&P 500 companies).

D. SHAREHOLDER PROPOSALS ON ENVIRONMENTAL/SOCIAL/POLITICAL MATTERS

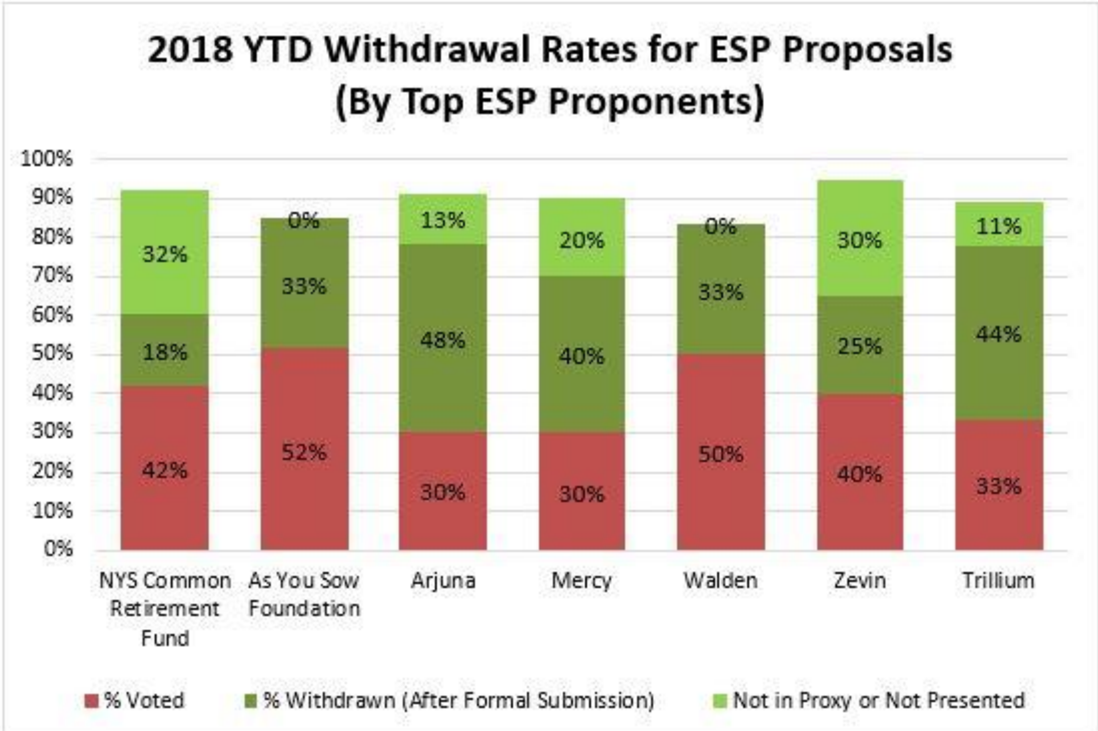
	ESP PROPOSALS							
	Shareholder Proposals Submitted		***Shareholder Proposals Voted On***		***Average % of Votes Cast in Favor***		***Shareholder Proposals Passed***	
	2018 YTD	***2017***	***2018 YTD***	***2017***	***2018 YTD***	***2017***	***2018 YTD***	***2017***
Environmental issues	***107***	121	***31***	61	***31%***	29%	***5***	3
Political issues	***87***	89	***49***	64	***29%***	26%	***0***	0
Anti-discrimination	***58***	65	***11***	32	***29%***	16%	***0***	0
Human rights issues	***34***	43	***10***	24	***9%***	7%	***0***	0
Sustainability report	***18***	23	***7***	10	***34%***	29%	***1***	1
Health and safety	***8***	20	***3***	9	***17%***	17%	***0***	0
Animal rights	***7***	7	***1***	4	***3%***	10%	***0***	0
Other social policy issues	***50***	53	***16***	5	***17%***	4%	***2***	0

Although the level of ESP proposals submitted remained relatively consistent year-over-year (both as a percentage of all shareholder proposals submitted and across the different ESP categories), there was a significant decrease in the percentage that reached a vote. This year, there were more withdrawn ESP proposals than those going to a vote, as shown in the following chart, which underscores the robust engagement between issuers and shareholders on ESP topics. However, the withdrawal data in this publication generally excludes shareholder engagement prior to the receipt of a formal proposal, which may obscure actual trends in shareholder engagement with respect to at least some categories of ESP proposals.



The major shareholder proponents referenced in Section I.B submitted close to 60% of all ESP proposals received by U.S. S&P Composite 1500 companies. Among these proponents, the New York State Common Retirement Fund submitted the greatest number of ESP proposals (38), most of which related to environmental issues and political contributions and lobbying. Collectively, social investment entities, such as As You Sow Foundation (33 ESP proposals submitted), Arjuna Capital (23), Mercy Investment Services (20), Zevin Asset Management (20), Walden Asset Management (18) and Trillium Asset Management (18), submitted the bulk of the proposals and tended to focus on environmental issues and gender pay equity. As the following chart shows, almost all the top ESP proponents withdrew 50% or more of their proposals this year (either before or after a proposal was included in a company's proxy statement), likely following engagement with the company.[4]

[4] The chart does not show the percentage of excluded or pending ESP proposals submitted by each proponent.



The significantly lower number of ESP proposals that went to a vote this year reflects issuers' recognition of the growing importance of ESP issues to institutional investors. Proposals relating to discrimination (predominantly gender pay equity) had the highest withdrawal rate of any category this year (most likely following an issuer's commitment to make improvements in this area), with less than a fifth of all submitted proposals reaching a vote. The withdrawal rate is unsurprising given the impact of the #MeToo movement and the public attention on workplace culture this year. The most common subjects among ESP proposals that reached a vote continued to be environmental issues (including climate change) and political contributions and lobbying, correlating with the comparatively lower withdrawal rate among the major shareholder proponents that focused on these issues (*e.g.*, As You Sow Foundation).

The ESP proposals that went to a vote received higher shareholder support on average than in 2017 (more than 25% for the first time). In particular, average support for proposals relating to discrimination almost doubled this year (29% in 2018 compared to 16% in 2017). The number of ESP proposals that passed this year doubled, notwithstanding the decline in the total number of ESP proposals voted on. Whereas no political proposals passed in 2018, as was the case in 2017, the number of environmental proposals that passed increased to five in 2018 (all related to either climate change or emissions) from three in 2017.

This year, ISS supported an even higher percentage of ESP proposals voted on (74% in 2018 compared to 64% in 2017), including 94% of the political proposals and 87% of the environmental proposals. ISS supported 73% of anti-discrimination proposals this year, more than doubling the percentages from 2015

to 2017. Overall, shareholder support averaged 32% for ESP proposals where ISS recommended in favor, compared to 8% for proposals where ISS recommended against.

New types of ESP proposals submitted by shareholders this year included those relating to recent "hot button" political issues, such as gun safety (at Dicks Sporting Goods and Sturm, Ruger & Co) and social media "fake news" (at Alphabet, Facebook, Twitter, Comcast, Disney and Time Warner). The gun safety proposals were all submitted by religious organizations, and the only one that has been voted on passed with 69% of the votes cast. Facebook, Disney, Comcast and Time Warner obtained no-action relief from the SEC to exclude proposals seeking the adoption of anti-"fake news" policies. The other "fake news" proposals requested reports on major global content management controversies. All these proposals were submitted jointly by the New York State Common Retirement Fund and Arjuna Capital, and received very low support (8.5% on average).

E. SHAREHOLDER PROPOSALS ON GOVERNANCE MATTERS

After a consistent and significant downward trajectory from 2015 to 2017, the number of proposals on governance matters (board-related and anti-takeover concerns) that came to a vote in 2018 remained at levels comparable to 2017. There was a dramatic spike in the number of proposals to lower the ownership percentage required for calling a special meeting and to adopt written consent rights, offsetting the steep drop in adopt proxy access proposals as more companies adopt a market-standard provision. There are very few proposals coming to a vote at this point on the traditional governance topics of destaggering the board, adopting majority voting in uncontested director elections, and eliminating supermajority provisions. Few large companies have not already adopted these practices, and many of the smaller companies that receive these proposals decide to adopt the practices rather than letting the proposal come to a vote.

Average support for governance proposals in 2018 was 37% overall (slightly lower than the 2017 average of 39%), continuing the downward trend since 2013.

Harvard Law School Forum on
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Political, Social, and Environmental Shareholder Resolutions: Do they Create or Destroy Shareholder Value?

Posted by Joseph P. Kalt (Harvard University & Compass Lexecon) and L. Adel Turki (Compass Lexecon), on Sunday, June 18, 2018

Editor's note: Joseph P. Kalt is the Ford Foundation Professor (Emeritus) of International Political Economy at the John F. Kennedy School of Government, Harvard University and a Senior Economist at Compass Lexecon. L. Adel Turki is a Senior Managing Director of Compass Lexecon. Kenneth W. Grant and Todd D. Kendall are Executive Vice Presidents, and David Molin is Vice President, at Compass Lexecon. The views expressed here are solely those of the authors and do not necessarily reflect the views of their employers or the National Association of Manufacturers and/or its members.

The increased use of politically-charged shareholder resolutions has garnered considerable attention in recent years, as shareholder meetings have become venues for discussion and debate regarding corporate positions and actions on issues of the day. Recent proxy seasons have seen corporate management being asked to address issues as diverse as deforestation, corporate clean energy goals, climate change, the uses of antibiotics and pesticides, political contributions, human rights risks through the supply chain, indigenous rights and human trafficking, cybersecurity, the development and reporting of sustainability metrics, and tax fairness. As we show, this change has both expanded the number of resolutions to which a given company may be required to respond and broadened the range of issues that boards and senior managers are being asked to address.

This study explores the impact of social and environmental shareholder proposals on shareholder returns. Specifically, using the case of climate-change-related proposals to test the economics, we examine statistically the reaction of companies' stock prices to both increased disclosure of climate-change-related information and shareholder proposals calling for such disclosure. We focus on climate change resolutions both because of the growing activism on the part of certain large institutional investors around climate change disclosure and because of the argument upon which that activism is predicated, i.e., that such additional disclosure provides meaningful information to the marketplace and therefore serves to benefit shareholders. Our analysis fails to find support for such assertions. Rather, we find that the evidence demonstrates that the adoption of such shareholder resolutions has no statistically significant impact on company returns one way or the other.

Notwithstanding the stridency of arguments surrounding politically charged shareholder proposals, our finding that such proposals do not enhance shareholder value is not surprising. The fundamental drivers of risk and the impact of an issue like climate change on the ability of

management's decisions to enhance or detract from shareholder value are political. Specifically, whether a company should be doing more or different in responding to an issue like climate change turns overwhelmingly on political actors and factors: Will nation A adopt certain kinds of policies to deal with climate change? If so, when? Will adopted policies "stick", or will new political forces come along and change the direction of policy? How will other nations respond? And so forth…

In the face of such fundamentally political determinants of a company's fate, shareholder resolutions that would purport to enhance shareholder value by compelling management to undertake certain adaptive measures or analyses implicitly entail the proposition that corporate managers are better able to make predictions about the direction of national and world politics than the myriad other sources—from think tanks to governments—to which investors might turn for such forecasting. There is no basis for such a proposition.

That is, there is no general expectation that corporate managers have special abilities in predicting tastes, preferences, voting behavior, and/or institutional capabilities across a wide and varied number of independent political actors operating within independently acting nations across the globe. Under such conditions, resolutions that, for example, compel disclosure of outcomes under particular political scenarios (e.g., the political paths that might put the world on a trajectory to achieve a goal such as the "not more than 2 degrees temperature rise" goal that came out of the Paris climate accords in 2015) do not add materially to the information already available to investors from other sources. As such, they cannot be expected to add to shareholder value.

Our results should not be taken to mean, however, that such resolutions are harmless. First, such proposals can often cost millions of dollars. Second, and perhaps of greater importance, such activism may open the door to the diversion of resources towards goals besides shareholder returns, with consequent harm to good corporate governance. It raises the question, for example, of which issues are to be considered "significant" by whom and, thus, warrant the use of management resources and consumption of corporate assets.

Creating incentives for managers to act in ways that focus more on social objectives rather than shareholder wealth may license boards and corporate executives to seek what we could agree are less worthy outcomes, such as maximizing personal wealth or popularity. While there is a substantial literature on the role of "corporate social responsibility" in corporate governance, and not every instance of firm social engagement necessarily leads to a reduction in the quality of governance, the academic literature also finds that the long-run impact of social-issue shareholder proposal activism is negative.

None of this is to say that we should not be extremely concerned about such issues as global climate change, human trafficking, cybersecurity, and the like. Effectively dealing with such problems, however, will require that wise public policy measures be taken across a wide swath of the world's nations. While frustration with slow progress on this front is understandably accompanied by the desire to "do something", doing something effective in such arenas is the task of our political institutions. Shareholder resolutions targeted at prominent corporations is an ineffectual substitute for sound policy making via the political institutions of democracy.

The complete publication is available here.

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.

Materiality Matters: Targeting the ESG Issues that Impact Performance

Posted by Emily Steinbarth and Scott Bennett, Russell Investments, on Thursday, May 10, 2018

Editor's note: Emily Steinbarth is a Quantitative Analyst and Scott Bennett is Director of Equity Strategy and Research at Russell Investments. This post is based on a Russell Investments publication by Ms. Steinbarth and Mr. Bennett Related research from the Program on Corporate Governance includes Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

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 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

[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 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.

in this field. That is, when measuring sustainability performance, the separation of material issues from immaterial issues matters.

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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Ratings that Don't Rate: The Subjective World of ESG Ratings Agencies

Posted by Tim Doyle, American Counsel for Capital Formation, on Tuesday, August 6, 2018

Editor's note: Timothy M. Doyle is Vice President of Policy and General Counsel at the American Council for Capital Formation. This post is based on an ACCF memorandum by Mr. Doyle.

As the trend of Environmental, Social, and Governance ("ESG") investing has risen, so too has the influence and relative importance of ESG rating agencies. With an increasing focus on social corporate responsibility, the ability to project a positive image around ESG-related topics is critical. As such, more companies have begun making select and unaudited disclosures in an effort to attract ESG-investing capital. The arbiters for obtaining this capital are the major ESG rating agencies.

However, individual agencies' ESG ratings can vary dramatically. An individual company can carry vastly divergent ratings from different agencies simultaneously, due to differences in methodology, subjective interpretation, or an individual agency's agenda. There are also inherent biases: from market cap size, to location, to industry or sector—all rooted in a lack of uniform disclosure.

Tellingly, many of the issues highlighted in the complete publication (available here) mirror failings we found in the proxy advisory industry (explored in a previous ACCF report, "The Conflicted Role of Proxy Advisors"). There, a history of conflicts of interest, inadequate voting guidance, and opaque business practices, raise serious questions about the ability of the industry to provide impartial and accurate recommendations.

Taken in conjunction with the issues identified here, the two papers collectively suggest that there are substantial challenges with the quality of information that investors are using to both deploy ESG focused capital and vote stock options.

The complete publication (available here) seeks to evaluate ESG ratings agencies to support investors in understanding the current state of play in the ESG ratings industry. Ultimately, we found significant disparities in the accuracy, value, and importance of individual ratings, for reasons including:

- **Disclosure Limitations and Lack of Standardization**: There are no standardized rules for Environmental and Social disclosures, nor is there a disclosure auditing process to verify reported data; instead, agencies must apply assumptions, only adding to the subjective nature of ESG ratings. The lack of transparency and reliance on unaudited

data is not dissimilar to the findings presented in a previous ACCF report on the conflicted nature of proxy advisors.

- **Company Size Bias**: Companies with higher market capitalization tend to be awarded ratings in the ESG space that are meaningfully better than lower market-cap peers, such as mid-sized and small businesses.
- **Geographic Bias**: Regulatory reporting requirements vary widely by region and jurisdiction—with two companies active in the same industry, doing the same general thing, often assigned different scores based on where they are headquartered. Companies domiciled in Europe, in particular, often receive much higher ESG ratings than peers based in the United States and elsewhere.
- **Industry Sector Bias**: Company-specific risks and differences in business models are not accurately captured in composite ratings. Because of significant differences in business models and risk exposure, companies in the same industry are unfairly evaluated under the same model.
- **Inconsistencies** Between Rating Agencies: Individual company ratings are not comparable across agencies, due to a lack of uniformity of rating scales, criteria, and objectives.
- **Failure to Identify Risk**: One of the purposes of ESG ratings is to evaluate risk and identify misconduct. ESG ratings do not properly function as warning signs for investors in companies that experience serious mismanagement issues.

The complete publication is available here.

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The Impact of DOL Guidance on ESG-Focused Plans

Posted by Ning Chiu, Betty M. Huber, and Charles Shi, Davis Polk & Wardwell LLP, on Tuesday, May 8, 2018

Editor's note: Ning Chiu, Betty M. Huber, and Charles Shi are counsel at Davis Polk & Wardwell LLP. This post is based on a Davis Polk publication by Ms. Chiu, Ms. Huber, and Mr. Shi. Related research from the Program on Corporate Governance includes The Agency Problems of Institutional Investors by Lucian Bebchuk, Alma Cohen, and Scott Hirst.

Last week the U.S. Department of Labor (DOL) issued a bulletin (the Bulletin) on its prior interpretations related to considerations of ESG factors by ERISA plan fiduciaries. Since then there has been some speculation that perhaps the positions outlined in the Bulletin would act as a speed bump to the increasing focus by investors on ESG matters at public companies.

As background, ERISA requires plan fiduciaries to act solely in the interest of plan participants and beneficiaries for the exclusive purpose of providing benefits to such persons and to discharge their fiduciary duties with the care, skill, prudence and diligence a prudent person would use under similar circumstances. Companies should be aware that the Bulletin is applicable only to fiduciaries of ERISA plans, which include private sector company-sponsored retirement plans (such as a company's own defined benefit pension plans and 401(k) plans) and union pension plans. Managers of private investment funds are bound by the Bulletin only if their funds are subject to ERISA (many private investment funds are not). Managers of mutual funds and governmental pension funds are not bound by the Bulletin as these funds are not subject to ERISA and therefore not subject to DOL oversight.

Effect on Investment Decisions. The Bulletin makes clear that plan fiduciaries in managing and investing plan assets cannot assume greater investment risks, or sacrifice investment returns, to fulfill social policy goals. The Bulletin states that this is a longstanding DOL position. The economic interests of the plan in providing retirement benefits must always be at the forefront of investment decisions. But social policy issues, which might otherwise be considered "collateral issues," could be treated by plan fiduciaries like any other economic consideration when those issues present material business risk or opportunities that officers and directors need to manage as part of their companies' business plans.

In other words, plan fiduciaries cannot focus on ESG factors solely to benefit the greater societal good, or assume that ESG factors that promote positive market trends are by their nature economically relevant. However, ESG factors or tools, metrics or analyses can be evaluated if fiduciaries believe they would impact an investment's risk or return.

Effect on Proxy Voting and Shareholder Engagements. Fiduciaries can participate in proxy voting and other shareholder engagement activities if there is a reasonable expectation that such

activities are likely to enhance the economic value of the investment after taking into account the costs involved. The Bulletin indicates that when the plan is just one of many investors, it may not be appropriate to “incur significant expense to engage in direct negotiations with the board or management,” or for plan fiduciaries to incur such expenses to “fund advocacy, press, or mailing campaigns on shareholder resolutions, call special shareholder meetings, or initiate or actively sponsor proxy fights on environmental or social issues.”

But the Bulletin, which uses variations of “significant” seven times in its brief four and a half pages, also states that there may be times when it would be a “prudent approach” to spend reasonable expenditures to actively engage with company management, if it involved, for example, “significantly indexed portfolios” and important ESG issues that present “significant operational risks and costs” to businesses that are “clearly connected” to long-term value creation. In essence, the cost of the activity must be justified relative to the expected economic benefit.

Increase in ESG Fund Activity. As the WSJ reported, assets invested in ESG funds are up nearly 60% from the prior year, as private equity and hedge funds have also started participating in these offerings. ESG funds are being marketed by Wall Street as a “bankable trend.” However, few 401(k) plans, or just 2.4%, offer ESG funds as an investment option and the Bulletin’s primary impact may be in limiting those offerings when retirement assets are involved.

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.

Impact of SEC Guidance on Shareholder Proposals in the 2018 Proxy Season

Posted by Marc Gerber, Hagen Ganem and Ryan Adams, Skadden, Arps, Slate, Meagher & Flom LLP, on Wednesday, July 4, 2018

Editor's note: Marc Gerber is partner, Hagen Ganem is counsel and Ryan Adams is an associate at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden publication by Mr. Gerber, Mr. Ganem, and Mr. Adams.

In the period leading up to the 2018 proxy season, the staff of the Division of Corporation Finance (Staff) of the Securities and Exchange Commission (SEC) published Staff Legal Bulletin No. 14I (SLB 14I), which provided new guidance concerning companies' ability to exclude shareholder proposals from their proxy statements under the "ordinary business" or "relevance" grounds of Rule 14a-8. Although some viewed the guidance as a significant shift that would increase the likelihood of excluding shareholder proposals from proxy statements, to date that has not been the case.

This lack of early company success, coupled with the need to use limited board or board committee resources to utilize the guidance, may create the impression that SLB 14I represents a dead-end street to be avoided. Lessons learned from this first year, however, suggest the Staff's guidance may yet represent a viable and worthwhile avenue to exclude certain shareholder proposals.

Background

The Ordinary Business Exclusion. Rule 14a-8(i)(7) allows companies to exclude shareholder proposals that deal with matters relating to a company's "ordinary business operations." The SEC has stated that the policy underlying this rule rests on two central considerations: the proposal's subject matter and the degree to which the proposal "micromanages" the company. Under the first consideration, the Staff recognizes that certain matters are "so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight." These proposals generally may be excluded from proxy statements unless they raise certain policy issues that the Staff determines are sufficiently significant and related to the company's business that they transcend otherwise ordinary business matters. SLB 14I acknowledged that such determinations raise difficult judgments and that a company's board generally is in a better position than the Staff to analyze these issues. Accordingly, SLB 14I invited companies to assist the Staff's review by including in no-action requests a discussion of the board's analysis of the policy issue raised and its significance to the company. SLB 14I did not address the micromanagement consideration of Rule 14a-8(i)(7).

The Economic Relevance Exclusion. Rule 14a-8(i)(5) allows companies to exclude shareholder proposals that relate to operations accounting for less than 5 percent of the company's total assets, net earnings and gross sales, and that are not "otherwise significantly related" to the company's business. This basis for exclusion has been of limited utility in recent years, as the Staff took a broad view that social or ethical concerns were nearly always significantly related to a company's business. Like with Rule 14a-8(i)(7), SLB 14I acknowledged that a company's board of directors generally is in a better position than the Staff to determine whether a proposal topic is "otherwise significantly related" to the company's business and invited company no-action requests to provide a discussion of the board's analysis regarding a proposal's lack of significance to the company's business.

SLB 14I in the 2018 Proxy Season: Speed Bumps, Wrong Turns and Cautionary Signs

Although a number of companies attempted to utilize the guidance in SLB 14I by including some discussion of the board's analysis in their no-action requests, to date there has been only one instance where a no-action request containing a board analysis received relief under Rule 14a-8(i)(5) and no instance where a board analysis resulted in a grant of no-action relief under Rule 14a-8(i)(7).

One Narrow Instance of Success. The one successful use of SLB 14I this season appeared in a no-action letter granted to Dunkin' Brands Group, Inc. Upon close inspection, however, the board analysis, while potentially helpful, may not have been critical to the outcome. As a result, the Dunkin' Brands letter may prove to be of limited help for companies seeking to exclude other proposals.

In the Dunkin' Brands letter, the company successfully argued that a proposal requesting a report on the environmental impact of using certain branded packaging, including an assessment of reputational, financial and operational risks associated with that packaging, was not relevant to the company's business under Rule 14a-8(i)(5). Specifically, the company argued that the proposal was not significantly related to its business because the company did not make the products at issue but instead licensed its brand to a third party who manufactured the products. The no-action request explained that the proposal was reviewed by the company's nominating and corporate governance committee, whose recommendations were submitted to the board, and took into consideration that the proposal's topic did not address the company's primary business operations but focused instead on packaging used in products manufactured by a third-party licensee. In addition, the board committee noted that a substantially identical proposal was submitted for inclusion in the company's 2017 proxy materials and received less than 14 percent of votes cast, and it was not a topic raised by shareholders in the course of the company's robust shareholder engagement program. The company also asserted that the proponent provided no support demonstrating the significance of the proposal to the company's business.

Although the Staff's response letter indicated that it took the board's analysis into account, the letter also stated that the proposal's significance to the company's business was "not apparent on its face" and that the proponent had "not demonstrated that it [was] otherwise significantly related to the Company's business." Thus, while SLB 14I affirmed that the "mere possibility of reputational or economic harm" will not preclude no-action relief, the Staff's decision appears to have rested on the proponent's failure to carry its burden rather than on the description of the

board analysis. The proponent's failure, together with the unique fact pattern relating to a third-party licensee's packaging, may limit the precedential value of the Dunkin' Brands letter.

Not All Ordinary Business Arguments Need a Board Analysis. The Staff's traditional framework for evaluating no-action requests to exclude proposals on ordinary business grounds has not changed as a result of SLB 14I. Accordingly, the Staff continued to permit exclusion of proposals that focused on ordinary business matters and did not raise significant policy issues. The board analysis described in SLB 14I, intended to assist the Staff in evaluating whether a policy issue contained in a proposal has a sufficient connection to a particular company's business, is not implicated when no policy issue is presented.

Consistent with this approach, where proposals during the 2018 proxy season raised topics that, based on precedent, were clearly ordinary business matters and did not implicate significant policy issues, the Staff granted relief even if there was no description of a board analysis in the no-action request. For example, the Staff granted relief under Rule 14a-8(i)(7) for a proposal requesting that a company adopt a policy to "tell the truth" in its news operations where the company argued that the proposal related to an ordinary business matter without providing a discussion of any board analysis. Similarly, the Staff granted relief under Rule 14a-8(i)(7) for a proposal relating to a company's process for selecting aircraft production sites where the company argued that the proposal related to ordinary business matters and that there was no significant policy issue for the board to analyze.

A Board Analysis Should Contain Sufficient Detail About the Significance of the Proposal to the Company's Operations. As described in SLB 14I, the Staff is looking for a description of the board's analysis of whether the particular policy issue raised in a proposal is significant to the company's business operations. Informally, the Staff has indicated that it is looking for more analysis than companies have provided thus far and that a description of the board's substantive analysis is more helpful than a detailed description of the procedural steps taken to arrive at the board's determination. In some instances this season, the Staff denied relief and noted that the information presented in the no-action request did not include "quantitative or other analysis that may be helpful in determining whether this particular proposal is significant to the Company's business operations." In other cases, the Staff denied relief and stated that "[a]lthough your discussion of the board's analysis sets forth several factors the board considered in evaluating the Proposal, it does not provide a sufficient level of detail to reach a determination that exclusion of the Proposal is appropriate." In addition, where proposals implicated previously recognized significant policy issues and the letter omitted any description of a board analysis, the Staff noted this omission in its response letter. These responses indicate that the Staff is looking for letters that provide a sufficient level of detail regarding the board's quantitative and qualitative analyses to allow the Staff to comfortably conclude that a significant policy issue raised by a proposal is not significant to the company in question.

A Board Analysis Should Discuss Prior Shareholder Support for the Proposal. To date, the Staff has not shown any inclination to rely on a board analysis where the proposal topic previously has been submitted to a shareholder vote (except in the Dunkin' Brands letter, discussed above). Specifically, the Staff denied relief in several instances where proponents highlighted past shareholder support, evidenced by prior votes ranging from 25 percent to more than 40 percent of votes cast, even where the company's description of the board analysis

otherwise appeared fulsome. In most of these cases, the Staff said the companies failed to meet their burden of adequately arguing for relief.

While the Staff confirmed through informal guidance that it remains receptive to a board's analysis as to why a proposal with similar levels of prior shareholder support is not significant to a company's business, it remains to be seen what type of argument would be sufficient to overcome what appears to be a presumption against no-action relief in such cases.

Micromanagement Arguments Have New Vitality. As noted above, SLB 14I did not address the "micromanagement" prong of the ordinary business exclusion analytical framework. Nevertheless, in a noteworthy turn of events, in 2018 the Staff granted an increased number of no-action requests based on micromanagement than in previous years: at least 11 no-action requests granted on this basis, compared to only four during the 2017 season and none during the 2016 or 2015 seasons.

The standard for relief under micromanagement derives from SEC releases and remains unchanged—whether a proposal "involves intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies." The increase in successful arguments this season appears to represent a fresh look at this basis by the Staff. For example, the Staff permitted a company to exclude a shareholder proposal requesting a report on the feasibility of achieving "net zero" greenhouse gas emissions by 2030 on the basis of micromanagement, even though the Staff rejected a micromanagement argument by the same company to exclude a nearly identical proposal in 2017.

Looking Forward

Whether inclusion of a board analysis invited by SLB 14I ultimately will result in exclusion of a shareholder proposal remains to be seen. The hoped-for deference to company boards did not materialize, and the path forward is not entirely clear. Nevertheless, lessons from 2018 can inform a more targeted and perhaps productive use of the guidance going forward. Additional obstacles can be expected, but the road to success under SLB 14I may yet be paved.

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Letter from JANA Partners & CalSTRS to Apple, Inc.

Posted by Barry Rosenstein, JANA Partners LLC, and Anne Sheehan, California State Teachers' Retirement System, on Friday, January 19, 2018

Editor's note: Barry Rosenstein is Founder and Managing Partner at JANA Partners LLC; Anne Sheehan is Director of Corporate Governance at The California State Teachers' Retirement System (CalSTRS). This post is based on the recent joint shareholder letter from JANA Partners and CalSTRS to the Board of Apple, Inc.

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."[1]

- 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.[2]
- 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.[3]
- 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.[4]
- 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.[5]
- 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.[6]

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[7] and spends over 4.5 hours a day on it (excluding texting and talking).[8] 78% of teens check their phones at least hourly and 50% report feeling "addicted" to their phones.[9] 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.[10] According to the APA survey cited

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[1] *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)

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

[3] *Id.*

[4] *Id.*

[5] 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

[6] 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]

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

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

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

[10] 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.")

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.[11] 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.[12]

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.

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

[12] 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

- *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,[13] 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,[14] 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,

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[13] 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.*

[14] 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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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

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:

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."

Tab V: Investment Stewardship

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:

Update on The New Paradigm: The Evolution of Stewardship Principles

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Wednesday, June 20, 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 and Karessa L. Cain.

Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here); and The Agency Problems of Institutional Investors by Lucian Bebchuk, Alma Cohen, and Scott Hirst (discussed on the Forum here).

When *The New Paradigm* (which we prepared for the World Economic Forum) and similar corporate governance frameworks were published in 2016-17, there was a broad consensus among business leaders and investors on the critical need to restore a long-term perspective. Pervasive and acute pressures for near-term financial results have been discouraging R&D, capex, employee training and other types of expenditures that may weigh on short-term earnings but are essential for sustainable economic growth. *The New Paradigm* posited that both corporations and investors have important contributions to make to create an environment that facilitates long-term value creation. For their part, corporations need to demonstrate that they are well governed and have an engaged, thoughtful board and a management team diligently pursuing a credible, long-term business strategy. In return, investors should embrace stewardship principles and provide the support and patience that such companies require to pursue long-term strategies. Working together, these stakeholders can recalibrate systemic norms and expectations in order to better balance short-term and long-term horizons.

In many respects, the cautious optimism underlying *The New Paradigm* was not unfounded. While almost all of the governance principles it espoused for boards were already well-established norms, the investor stewardship principles it outlined were more nascent. Over the last few years, there have been a number of initiatives to develop, expand and solidify these principles. Among other things, *The New Paradigm* contemplated that investors should:

- Promote long-term-oriented investment.
- Devote sufficient time and resources for effective, practical engagement.
- Act in a manner consistent with the best interests of long-term beneficiaries, including voting on an informed basis without abdicating decision-making to third parties.
- Be active listeners and, where appropriate, be proactive in engaging in dialogue with a company as part of building a long-term relationship.

- If there are concerns about a company, seek to work privately and collaboratively with the company to address them through constructive engagement.
- Provide steadfast support for the pursuit of reasonable strategies for long-term growth, and speak out against conflicting short-term demands.
- In a contested vote, promptly inform the company of its position and reasons for taking such position.
- Consider relevant sustainability, ESG and CSR factors when developing investment strategies and decisions.
- Proactively disclose their policies and preferences, including long-term investment policies, proxy voting and engagement guidelines, positions on sustainability, ESG and CSR matters, and guidelines for relations with activists.
- Establish their own culture of long-term thinking and patient capital that discourages a short-termist mindset and over-reliance on short-term performance metrics.

These principles have been recurring themes in the ongoing evolution of stewardship. Earlier this year, the Investor Stewardship Group's Framework for U.S. Stewardship and Governance became effective and includes six principles for investor stewardship to promote long-term value creation. In addition, the three largest index fund managers—BlackRock, State Street and Vanguard—have all issued policy statements as to what they expect in terms of governance and engagement. In his January 2018 letter to CEOs, for example, Larry Fink (BlackRock's CEO) noted that the responsibilities of asset managers have grown, and their "responsibility goes beyond casting proxy votes at annual meetings—it means investing the time and resources necessary to foster long-term value." In advocating for more meaningful and productive engagement between shareholders and the companies in which BlackRock invests, he indicated that "BlackRock recognizes and embraces our responsibility to help drive this change."

Furthermore, support for themes from *The New Paradigm* has not been limited to "passive" investors. In its recent description of its investment philosophy on shareholder activism(discussed on the Forum here), T. Rowe Price (TRP) emphasized its long-term perspective and the importance of being able to "cultivate constructive, private, two-way communications" with company management teams. It also noted that management teams have better information about their businesses than outside parties and accordingly their assessment of the company's opportunity set should be afforded a certain amount of deference. TRP made it clear that it does not permit activists to speak for or represent the views of TRP, it will not encourage activists to initiate campaigns to pressure corporations, and it will arrive at voting decisions in contested elections independently. It also indicated that, in the case of proxy contests, it will share its voting decision in advance of the vote at the parties' request.

While the impact of *The New Paradigm* continues to be a work in progress, it is clear that institutional investors have been reassessing their roles and responsibilities in the corporate governance ecosystem and thinking critically about the ways in which they inevitably impact the balance between long- and short-term pressures on companies.

Harvard Law School Forum on
Corporate Governance and Financial Regulation
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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.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:

How To Avoid Bungling Off-Cycle Engagements with Stockholders

Posted by Ethan A. Klingsberg and Elizabeth K. Bieber, Cleary Gottlieb Steen & Hamilton LLP, on Friday, June 1, 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.

Many clients are now turning from their annual meeting to plans for off-cycle engagements with their institutional investors, including the passive strategy behemoths (Blackrock, State Street and Vanguard which tend to own, in the aggregate, around 20% of many of our mid- and large-cap clients), traditional actively managed funds, pension funds, and hedge funds.[1] The rationale for these meetings is that postponement of outreach until a threat of a contested situation (such as a short-slate proxy contest or aggressive shareholder proposal) may be "too little, too late" and that these one-on-one meetings on "sunny days" (and even "partly cloudy days") are critical, if not for locking up support, at least for establishing a foundation for obtaining support if and when the storm clouds arrive.

Notwithstanding the chorus of shareholder-engagement advisors singing the praises of holding these off-cycle meetings (ourselves included), as well as public statements by the investors themselves in favor of such meetings, the truth is that the upside of these meetings is somewhat limited and the downside risks are significant. When pressed, any investor will tell you that, if there were an actual proxy contest, even a company with a record of excellent off-cycle engagement is far from immune from a decision—often reached at the 11th hour of the proxy contest—by the investor to vote in favor of a short-slate proposed by an activist. More importantly, a poor off-cycle meeting can be more detrimental than no meeting. Indeed, investors report that they regularly leave these meetings with a worse impression of companies. Moreover, since many of a company's institutional stockholders will each hold portfolios consisting of hundreds or even thousands of issuers, many of these stockholders will not take a meeting each year due to limited bandwidth, which thereby amplifies the adverse consequences of a poor meeting.

In view of the meaningful risks of these off-cycle meetings, we have compiled these guidelines and tips based on direct feedback from a spectrum of investors over the past six months, as well as experience prepping clients for these engagements following recent proxy seasons.

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[1] For a more detailed analysis of the current investor landscape and its impact on corporate strategy, see our previous post.

- *When?* Late summer through fall is the relative downtime for most institutional investors and therefore the best time to request a meeting in the absence of a time-sensitive issue.
- *What information to include in the meeting request?* Propose a list of topics to be covered and company representatives to attend. This advance information allows investors to evaluate the need for a meeting and, if the agenda and attendee list reflect the guidance below, will increase the chances of getting on the calendar for a constructive meeting. Expect comments on the proposed topics and attendees in advance of the meeting.
    - Be sure to highlight any specific recent development—e.g., a recent Schedule 13D or analyst report that asserts some misguided ideas for strategic alternatives—that the company would like to address at the meeting. Many investors, due to the breadth of their portfolios, may not be aware of these developments which merit a meeting and in the absence of this specificity, may turn down a meeting they would have otherwise accepted.
- *Which stockholders?* In addition to the top 20 holders in the company's profile, some smaller institutional holders may be worthwhile meeting as they can turn out to be among the most vocal holders. This is especially the case for pension funds, which often fail to show up on radars since they do not necessarily file 13Fs—but they do make shareholder proposals, partner and regularly communicate with and invest in activist hedge funds, and publish open letters criticizing issuers on a range of operational and ESG matters.
- *Telephonic or in-person?* It is advisable to be flexible on the format of the meeting. Preferences and availability of investors vary.
- *Who should attend from the company?* While only about a third of off-cycle engagements involve the participation of a non-management director, investors generally want to hear in the initial meeting request that they have the option of having such a director join the meeting. If potential misunderstandings relating to compensation, board composition/refreshment, internal controls over financial reporting, capital allocation, or strategic alternatives are on the agenda, the presence of a director who can speak to these issues (e.g., the chair or member of a relevant committee) will be of greater importance and the participation of that director is more likely to be of interest to the investor. Keep in mind that the stakes increase significantly when a non-management director is present and therefore prep sessions with the director are advisable. The head of IR should attend all meetings with shareholders (although director-only meetings may occur rarely (and require even greater preparation)) and other participants may include the general counsel or corporate secretary when governance items are on the agenda, the CFO and, if there are controversies in the market relating to the strategic direction of the company, the CEO. In addition, when a specific business line will be an agenda item and there have been doubts from analysts or investors about the direction or status of this business line, some investors appreciate the opportunity to hear directly from the head of this business line.
- *What topics should the company cover?* In addition to covering topics about which there are misunderstandings or controversies in the market (either raised publicly by analysts, media or activists or conveyed to the IR team offline), the agenda and presentation from the company will vary to some extent with each investor.
    - Generally, investors will want to hear about the vision for the long-term, including an analysis of the factors that will help and hinder growth. Plan to spend a quarter to one-third of an hour-long meeting reviewing company business and strategy. Drawing from investor day and analyst conference presentations is

okay, but focus on using only those slides that review the long-term plan and minimize jargon and acronyms—the target audience here is comprised not of sector analysts building quarterly models, but of folks focused on a holistic, longer-term vision. For instance, divisions that the company views as generators of growth in the more distant future but that are not currently drivers of results can be fruitful subject matter at these meetings even though they may be of little interest on quarterly earnings calls. In addition, keep in mind that some of the participants from the investor, especially those focused on stewardship and governance, may not have a deep background in the company's business plan.

  - Governance, board composition, and board processes should be covered as well. A review of the investor's published guidelines, policies and statements, as well as their voting history and involvement in campaigns for shareholder proposals, governance initiatives or activism, will provide helpful insights on how to craft your presentation about governance and how to refine these materials for each investor. In addition, even though many investors no longer strictly adhere to ISS or Glass Lewis recommendations, many still use data generated by those services and it is advisable to correct any material misunderstandings in the latest reports and address any significant criticisms from the proxy advisory firms.
  - Benchmarking governance and other practices against similarly situated issuers is encouraged by and helpful to investors, but companies need to be thoughtful when benchmarking. Take into account in advance the other issuers that are in the portfolio of the investor, whether the investor looks to ISS' definition of peers, and which other companies the investor has mentioned during past communications.
  - Address environmental and social responsibility as they relate to the sustainability of, and are components of, the growth plan of the company. Investors are not interested in hearing about recycling bins, headquarter LEED certifications, or pro bono community initiatives. They are interested in the extent to which the company is taking steps to assure that the company's ability to create value will not be impeded by adverse impacts that may arise from neglect of environmental and social matters.
  - Prepare an internal Q&A in advance. Investors often ask hard questions about challenges faced by the company and its business plan that differ from the questions on analyst calls which tend to be focused on a shorter term.
- *What signals to watch out for and to seek out and what to do with them?* Management regularly reports internally that their shareholders love them, only to be left in the awkward situation, when an activist surfaces, of having their board learn that the support is not unconditional and was overstated. These off-cycle meetings provide excellent opportunities to engage in dialogues and learn what the investors do not fully understand and what they view as areas of concern. It is appropriate for representatives of the company to probe the investor representatives about these topics. Issuers should aim to come away from these meetings with ideas on what reforms to consider internally and what disclosure to improve. In addition, it is advisable to deliver a summary report-out to the full board about the positive and less-than-positive feedback and what management's action plan is in response to the latter (which may well be making no strategic, procedural or structural changes, but simply improving the way the company's story is told).
- *Any disclosure requirements?* Generally the filing of the presentations for off-cycle meetings will not be necessary to comply with Regulation FD, but it is worthwhile to revisit this question with each presentation, especially if selected financial targets of long-

term plans are disclosed. If and to the extent any information in these presentations is not material but not yet publicly disclosed, the company should consider the benefits of and right occasions for disclosing some or all of this information more broadly. In addition, a company will earn points with proxy advisory firms and some institutional investors by including disclosure in the next annual meeting proxy statement about the extent and nature of your off-cycle engagement program.