Harvard Corporate Governance Roundtable

March 20–21, 2019

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Tab I: Keynote Session with Chief Justice Leo E. Strine, Jr.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

Who Bleeds When the Wolves Bite?

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

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

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

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

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

The full essay is available for download here.

Corporate Power is Corporate Purpose I: Evidence from My Hometown

Posted by Kobi Kastiel, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Thursday, February 2, 2017

Editor's note: Leo E. Strine, Jr. is Chief Justice of the Delaware Supreme Court, the Austin Wakeman Scott Lecturer on Law and a Senior Fellow of the Harvard Law School Program on Corporate Governance. This post is based on Chief Justice Strine's recent essay, Corporate Power is Corporate Purpose I: Evidence from My Hometown, issued as a Discussion Paper of the Program on Corporate Governance and forthcoming in the *Oxford Review of Economic Policy.* Related research from the Program on Corporate Governance includes Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law(discussed on the Forum here), and Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance, both by Chief Justice Strine.

Leo E. Strine, Jr., Chief Justice of the Delaware Supreme Court, the Austin Wakeman Scott Lecturer on Law and a Senior Fellow of the Harvard Law School Program on Corporate Governance, recently issued an article that is forthcoming in the *Oxford Review of Economic Policy.* The article, titled Corporate Power is Corporate Purpose I: Evidence from My Hometown, is available here. The abstract of Chief Justice Strine's essay summarizes it as follows:

> This article is the first in a series considering a rather tired argument in corporate governance circles, that corporate laws that give only rights to stockholders somehow implicitly empower directors to regard other constituencies as equal ends in governance. By continuing to suggest that corporate boards themselves are empowered to treat the best interests of other corporate constituencies as ends in themselves, no less important than stockholders, scholars and commentators obscure the need for legal protections for other constituencies and for other legal reforms that give these constituencies the means to more effectively protect themselves.
>
> Using recent events in the corporate history of E. I. du Pont de Nemours and Company—more commonly referred to today as DuPont—as a case study, this article makes the point that the board of directors is elected by only one constituency—stockholders—and that core power structure translates into corporate purpose. DuPont is an American icon, creator of household names like Nylon and Mylar, which prided itself on its core values, which included commitments to the safety and health of the communities in which DuPont operated and to treat its employees with dignity and respect. But when an activist investor came, DuPont reacted by preemptively downsizing—cutting jobs, and spinning

> off assets. After winning the proxy fight, DuPont failed to meet the aggressive earnings it used in its campaign. More job cuts came, the CEO was replaced with a member of her proxy fight slate, and DuPont soon embraced a merger consistent with the activists' goals. At the same time, DuPont demanded tax and other incentives from the affected community it had asked to rally around it in the proxy fight. It did all this even though at no time was there a threat of a lawsuit or judicial intervention from unhappy shareholders. The DuPont saga illustrates how power dictates purpose in our corporate governance system. DuPont's board knew that only one corporate constituency—the stockholders—called the shots and that they were expected to make their end investors' best interests, even if that meant hurting other constituencies. The DuPont saga isn't a story about bad people, but a reminder to those with genuine concern for non-shareholder constituencies to face the truth and support changes in the power dynamics affecting corporate governance that make due regard for non-shareholder constituencies a required obligation for the conduct of business.

The complete article is available for download here.

Tab II: Toward the 2019 Proxy Season

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

2018 Proxy Season Review

Posted by Marc Treviño and June Hu, Sullivan & Cromwell LLP, on Thursday, July 26, 2018

Editor's note: Marc Treviño and June Hu is an associate at Sullivan & Cromwell LLP. This post is based on a Sullivan & Cromwell memorandum by Mr. Treviño and Ms. Hu.

The complete publication (available here) summarizes significant developments relating to the 2018 U.S. annual meeting proxy season, including:

Rule 14a-8 Shareholder Proposals

- ***Environmental/social/political proposals gain traction.*** Although shareholders submitted a consistent level of environmental/social/political ("ESP") proposals as a percentage of all shareholder proposals submitted, there was a significant increase in the percentage withdrawn (for the first time surpassing the percentage going to a vote). This development appears primarily to reflect growing engagement by companies on a number of these issues, particularly anti-discrimination policies. Moreover, those going to a vote recorded a higher average percentage of votes cast in favor (more than 25% for the first time) and, notwithstanding the decline in the number of ESP proposals voted on, there was a marked increase in the number that passed (although still a low number). As in prior years, the vast majority of ESP proposals failed.

- ***Fewer gender pay equity, equal employment opportunity and board diversity proposals reach shareholder vote stage.*** The increase in ESP withdrawals related primarily to proposals addressing these proposals that ultimately went to a vote fell to less than half the number in 2017 (but those that went to a vote received meaningfully higher average support than they did last year). Similarly, although the total estimated number of board diversity proposals submitted this year was only slightly lower than the number in 2017, the number voted on fell below half the number in 2017. No proposal relating to anti-discrimination policies or board diversity passed in 2018.
- ***Overall pass rate for governance proposals declines significantly.*** After a consistent and significant downward trajectory from 2015 to 2017, the number of governance proposals that came to a vote in 2018 remained at levels comparable to 2017. However, a significantly lower number of governance proposals passed this year than in 2017, due in large part to a reduction in the relative number of proposals relating to proxy access, majority voting, board declassification and removal of supermajority vote proposals, each of which received average support of about 50% or more in both 2017 and 2018.
- ***Increased focus on proposals to reduce special meeting thresholds.*** There was a significant increase in proposals to lower the ownership percentage required for calling a special meeting, typically from 25% to 10%. These proposals almost always went to a vote and generally received substantial support from shareholders (average support of

40%). Although these proposals remained largely unsuccessful, the number that passed increased compared to 2017. The overall level of support is particularly notable in light of the lack of support from two or more of the largest institutional investors.

- ***Increased focus on proposals to adopt written consent.*** There was also a significant increase in proposals to adopt the right to act by written consent, which also almost always went to a vote and received average support of 42%, consistent with 2017. More of these proposals passed than last year, although representing a smaller proportion of the total number submitted.
- ***Substantial reduction in proxy access proposals, with few going to a vote.*** Proposals to adopt proxy access that came to a vote in 2018 declined to a negligible amount. Continuing a trend that began in 2017, most companies receiving such proposals opted to adopt a market-standard proxy access bylaw before a vote. Half of the proposals that did come to a vote did not pass (due to idiosyncratic reasons).
- ***Attempts to amend proxy access terms continue to be unsuccessful.*** All proposals that were voted on in 2018 to amend previously adopted proxy access bylaws, most often to remove or loosen restrictions on group size, failed.
- ***Continued focus on independent chair.*** Proposals for the board to have an independent chair remained common and, as in the past, generally received significant support from shareholders (25% to 40%). However, once again, none of these proposals passed, confirming that a consistent majority of shareholders generally are satisfied that a sufficiently empowered lead independent director is an appropriate alternative to mandatorily separating the CEO and chair roles.
- ***Despite recent scrutiny of dual class companies, number of proposals to eliminate dual class voting remains consistent with prior years.*** Between 2017 and 2018, major stock index compilers, such as the S&P Dow Jones Indices and FTSE Russell, have made policy changes that impact the eligibility of dual class companies for inclusion on their indices, and policy-makers also have issued several high-profile statements on the potential harms of dual class companies and the possibility of further regulatory scrutiny. However, the number of proposals in 2018 to eliminate supervoting shares (either by adopting a recapitalization plan for all equity securities to have one vote per share or by converting the supervoting shares into lower-vote shares) remained at a similar level and received a similar level of shareholder support (average support of 34%) as in 2017. As in prior years, none of these proposals passed.
- ***Compensation-related proposals remain limited.*** Once again, there were very few executive compensation-related shareholder proposals, continuing a trend that began once mandatory say-on- pay became the main focus of executive compensation concerns. However, this year shareholders submitted more than twice the number of proposals seeking to link compensation to social issues, with 2017 (less than 20%), and none of these proposals passed.

Analysis of ISS Negative Recommendations Against Directors

- ***"Lack of responsiveness" continues to be most impactful recommendation.*** Our analysis of negative recommendations by Institutional Shareholder Services ("ISS") in uncontested director elections indicates that directors who were seen as insufficiently responsive to a prior shareholder vote were those that were the most likely to receive less-than-majority support (with average shareholder support of only 64%). The total number of directors who received a negative recommendation on this basis in 2018 increased substantially (by almost four times), although responsiveness did not rank among the top reasons for a negative recommendation. Lack of responsiveness to a low say-on-pay vote was the second-most impactful recommendation (with average shareholder support of 70%). In addition, poor attendance (particularly at S&P 500 companies) continued to have a significant impact.

- ***Independence issues remain most common basis but had limited impact.*** The most common basis for a negative ISS recommendation in 2018 related to independence issues. This rationale continued to have a limited impact, however, with directors in this category receiving average shareholder support of 88%.
- ***Directors at newly public companies with adverse governance provisions continue to be subject to negative recommendations.*** The second most common basis for a negative ISS recommendation in 2018 related to adverse governance provisions at "newly public" companies not subject to a sunset. The average support level for directors in this category was 86%, suggesting that directors at these companies do not face significant risk of less-than-majority support.
- ***New poison pill policy increases negative recommendations.*** New ISS policies regarding poison pill issues yielded many negative recommendations (the number of directors receiving a negative recommendation on this basis quadrupled from 2017). Directors in this category received average shareholder support of 77%, but only four received less-than-majority support (less than 4%).

Compensation-Related Matters

- ***Continued strength on say-on-pay.*** Public companies continued to perform strongly on say-on-pay, with support levels averaging over 90% and less than 3% of companies receiving less-than-majority support. Our analysis of ISS negative recommendations on say-on-pay suggests the continued importance of a pay-for-performance model, 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. The most important qualitative factor was performance standards that are not deemed sufficiently rigorous by ISS or clearly explained.
- ***Broad shareholder support for equity compensation plans.*** No Russell 3000 company failed to obtain shareholder approval for an equity compensation plan, and overall support levels continued to average over 90%.

* * *

The Rule 14a-8 shareholder proposals discussed in Section I of the complete publication are those submitted to and/or voted on at annual meetings of the U.S. members of the S&P Composite 1500, which covers over 90% of U.S. market capitalization. The data discussed in Sections II, III and IV on negative ISS recommendations against directors in uncontested elections, say-on-pay votes and equity compensation approvals, respectively, are results from annual meetings of the U.S. members of the Russell 3000, which covers over 98% of U.S. market capitalization. For a discussion of U.S. proxy contests and other shareholder activist campaigns, see our post entitled Review and Analysis of 2017 U.S. Shareholder Activism.

The complete publication is available here.

2018 Annual Corporate Governance Review

Posted by Brigid Cremin Rosati, Edward Greene, and John Carroll, Georgeson LLC, on Tuesday, December 11, 2018

Editor's note: Brigid Cremin Rosati is Director of Business Development; Edward Greene is Managing Director; and John Carroll is Institutional Services Associate at Georgeson LLC. This post is based on a Georgeson/Proxy Insight publication.

We are pleased to present the 2018 Annual Corporate Governance Review. For the second year in a row, Georgeson partnered with Proxy Insight on the coordination of voting data and analytics. Proxy Insight was instrumental in sourcing the annual meeting and proxy voting data contained in this report.

New This Year

The 2018 report provides a comprehensive review of relevant corporate governance issues covering five sections: shareholder proposals on governance issues, shareholder proposals on environmental and social and issues, director elections, say-on-pay proposals and CEO pay ratio disclosure.

Based on reader feedback and trends in the current market, we have expanded our review of environmental, social and governance shareholder proposals that were the subject of a vote during the period July 1, 2017 through June 30, 2018. Consequently, this year we are providing additional information detailing voting decisions by institutional investors related to employment diversity shareholder proposals.

We have also added in a new section on institutional investor support for the election of directors year-over-year since 2015. Please see Part 3 for institutional investor voter support for elections of directors from major U.S. and international investment firms.

Finally, we have included a new section related to 2018 CEO pay ratio disclosure. With effect from this year, U.S. public companies are required to disclose their CEO pay ratio in their proxy statements. We have captured ratio trends across sectors for the Russell 3000 in Part 5 of the complete publication.

Summary of Report Sections

Throughout the complete publication we have included analysis of each section to give readers a substantive overview of the voting outcomes contained in that particular report part.

Shareholder Proposals, Report Parts 1 and 2

These sections include shareholder proposal information related to companies that 1) are members of the S&P 1500 Index (as of May 1, 2018) and 2) held annual meetings July 1, 2017 through June 30, 2018. We obtained the number of votes cast for, against, withheld, abstained and broker non-vote from our research partner, Proxy Insight, citing publicly available sources.

We then calculated for each proposal:

- The votes cast “For” and “Against” as a percentage of shares voted in the quorum.
- The votes cast “For” and “Against” as a percentage of the company’s total outstanding shares as of meeting record date.

In Part 1, information on shareholder proposals withdrawn or omitted was gathered with the assistance of ISS Corporate Solutions.

In Part 2, Figure 21, we have summarized 2018 definitive vote detail results for the largest U.S. and foreign institutional investors (measured by assets under management) voting decisions on a shareholder proposal related to employment diversity reporting.

Director Elections, Report Part 3

The director election data is a year-by-year review based on US companies in the Russell 3000 from 2015-2018. The “For” (%) is based on the percentage of times an investor voted “For” a director election proposal. This data is gathered from publicly disclosed investor voting decisions, including N-PX public filings.

Say-on-pay, Report Part 4

This section details vote outcomes for companies that 1) are members of the S&P 500 Index (as of May 1, 2018) and 2) held annual meetings July 1, 2017 through June 30, 2018. We obtained the number of votes cast for, against, withheld, abstained and broker non-vote from our research partner, Proxy Insight, citing publicly available sources.

We then calculated for each proposal:

- The votes cast “For” and “Against” as a percentage of shares voted in the quorum.
- The votes cast “For” and “Against” as a percentage of the company’s total outstanding shares as of meeting record date.

In Figure 24, the year-by-year review is based on the percentage of times an investor voted “For” a say-on-pay proposal for companies in the S&P 500 index. We gathered the data from publicly disclosed investor voting decisions, including Form N-PX public filings.

CEO Pay Ratio, Report Part 5

The CEO pay ratio data provided is based on companies which are members of the Russell 3000 (as of June 27, 2018). The table provides the highest and lowest values in each sector, as well as the average and median values.

Other Notes

Proxy Insight and Georgeson's data collection and calculation methodologies ensure the accuracy and comparability of our statistics from company to company and from year to year. We thereby avoid the anomalies that result from companies' and sponsors' inconsistent treatment of abstentions and broker non-votes.

Calculations of percentage of votes cast may not equal 100 percent due to rounding.

Georgeson has collected and published statistics on corporate governance proposals since 1987, the year institutional investors first sponsored shareholder proposals.

Shareholder Proposal Voting Results—Governance

This section details:

- Historical support for governance proposal types (Figures 1 – 7)
- The universe of proponents for governance shareholder proposals (Figure 8) and;
- Voting results on governance shareholder proposals (Figures 9.1—9.3).

Overview

There was a significant increase in the number of governance-related shareholder proposals that were the subject of a shareholder vote in 2018,[1] up 45 to 266 in total (see Figure 2). This growth was driven principally by increases in two proposals (see Figure 3).

1. Shareholder right to act by written consent—total of 36 voted on, up from 14 in 2017
2. Shareholder right to call a special meeting—total of 57 voted on, up from 24 in 2017

Support for these two proposal types has remained consistently high over the last five years. Additionally, issuers have often changed their governing documents to address such matters in the aftermath of receiving majority votes in favor.

The success of these two proposals is also connected to its sponsors, many of whom are well-versed in the U.S. Securities Exchange Act's shareholder proposal process.

The sponsors are:

- John Chevedden:
    - Written consent proposal: Mr. Chevedden was sponsor or co-sponsor of 26 of 36 the proposals

[1] When referencing '2018' or 'this year', we are referring to the reporting period July 1, 2017 through June 30, 2018.

    - Special meeting proposal: Mr. Chevedden was sponsor or co-sponsor of 39 of the 57 proposals
- Steiner Family:
    - Written consent proposal: The Steiner family was sponsor or co-sponsor of 7 of the 36 proposals
    - Special meeting proposal: The Steiner family was sponsor or co-sponsor of 12 of the 57 proposals

Of the 266 governance shareholder proposals that were the subject of a shareholder vote this proxy season, board-related proposals were the most popular measure, accounting for approximately 26% of all governance proposals. This category attracted an average level of support of approximately 33%. Below is a summary of key trends:

- Separate role of CEO/Chairman. This topic continues to be one of the most popular governance proposals. In the 2018, 46 such proposals were the subject of a shareholder vote. However, support has hovered around 30% for the past five years, as successful and/ or founder-CEOs have been effective in defending their dual roles.
- Require majority vote to elect directors: As this proposal continues to attract a majority vote at company meetings, the number of submissions has continued to fall year-over-year, indicating proactive adoption of majority voting procedures.

Proxy Access (see Figure 7)

In 2018, the total number of proxy access proposals, inclusive of both enact and fix-it types, that were the subject of a shareholder vote decreased by 12 from 2017. Moreover, this year was first time that fix-it proposals outnumbered enactment measures. However, all 30 fix-it proposals failed to attract a majority of votes in favor.

Notwithstanding the reduction in the number of enactment proxy access proposals, these measures attracted a higher level of support than fix-it proxy access proposals. This trend suggests that shareholders may be coalescing around best practices. The New York City (NYC) Comptroller's Office has been the most successful and prolific proponent of enactment proposals. Based upon our review of annual meeting results, the specific provisions of the NYC enactment proposals attract significant shareholder support. These provisions include:

i) The opportunity for shareholders to nominate candidates for two (2) board seats or 25% of the total number of board seats, whichever is greater; and

ii) The nominator (or group of shareholders comprising the nominator) be a shareholder for at least the previous 3 years while holding at least 3% of the issuer's stock over the entirety of that period.

Figures 9.1, 9.2 and 9.3 detail the entire universe of governance shareholder proposals that were the subject of a shareholder vote, organized by company, proposal type and sponsor.

Figure 1

Corporate Governance Proposals Submitted - 2014 to 2018

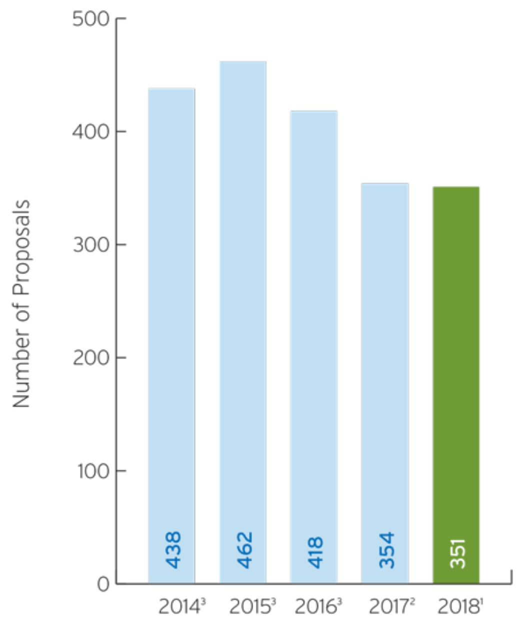
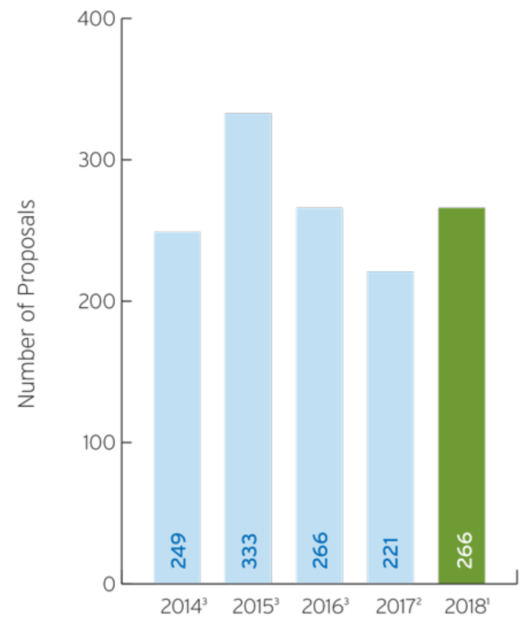


Figure 2

Corporate Governance Proposals Voted On - 2014 to 2018



[1] 2018 data is from S&P 1500 company annual meetings from 7/1/17 - 6/30/18
[2] 2017 data is from S&P 1500 company annual meetings from 7/1/16 - 6/30/17
[3] 2014-2016 data is from S&P 1500 company annual meetings from Jan 1 - June 30 of that particular year

Figure 3

Corporate Governance Proposals Voted On - 2014 to 2018

Proposal Type	2014[1]	%[2]	2015[1]	%[2]	2016[1]	%[2]	2017[1]	%[2]	%[3]	2018[1]	%[2]	%[3]
Board-Related (Excluding Proxy Access)	96	38.6%	83	24.9%	61	22.9%	53	24.0%	33.2%	68	25.6%	32.9%
Executive Compensation-Related	61	24.5%	71	21.3%	54	20.3%	32	14.5%	21.0%	34	12.8%	25.3%
Shareholder Right to Act By Written Consent	27	10.8%	35	10.5%	17	6.4%	14	6.3%	44.9%	36	13.5%	42.0%
Special Meetings	10	4.0%	19	5.7%	16	6.0%	24	10.9%	41.5%	57	21.4%	39.8%
Supermajority Provision	9	3.6%	11	3.3%	13	4.9%	9	4.1%	74.7%	6	2.3%	73.9%
Proxy Access	13	5.2%	72	21.6%	63	23.7%	49	22.2%	45.4%	37	13.9%	33.0%
Vote Counting Standard to Exclude Abstentions	0	0.0%	7	2.1%	6	2.3%	11	5.0%	8.8%	1	0.4%	7.8%
Eliminate Dual Class Stock	5	2.0%	8	2.4%	9	3.4%	8	3.6%	31.2%	8	3.0%	32.9%
Other	28	11.2%	27	8.1%	27	10.2%	21	9.5%	33.0%	19	7.1%	38.1%
Total	**249**	**100.0%**	**333**	**100.0%**	**266**	**100.0%**	**221**	**100.0%**		**266**	**100.0%**	

[1] Number of governance proposals at S&P 1500 companies
[2] Denotes percentages of that type of proposal for the total of governance proposals for that year
[3] Denotes average shareholder support for these proposals for that year

- 2014, 2015 and 2016 data is from S&P 1500 company annual meetings from Jan 1 - June 30 of that particular year
- 2017 data is from S&P 1500 company annual meetings from 7/1/16 - 6/30/17
- 2018 data is from S&P 1500 company annual meetings from 7/1/17 - 6/30/18

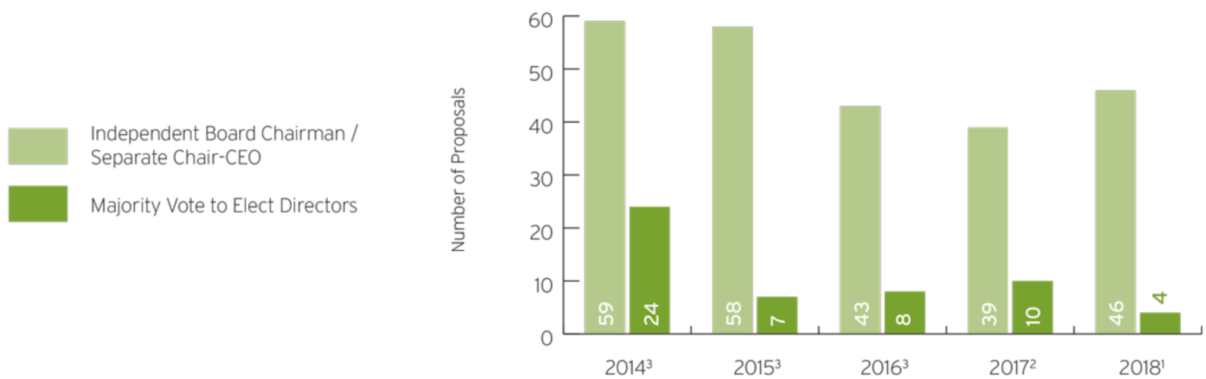
Figure 4

Corporate Governance Proposals – Summary Average Voting Results for Selected Proposals, 2018 Annual Meeting Season

Proposal Type	Results Available	As Percentage of Votes Cast			As Percentage of Shares Outstanding			
		For	Against	Abstain	For	Against	Abstain	Non-Vote
Board-Related *(does not include Proxy Access proposals – see bottom of table – or dissident board nominations)*	**68**	**32.9%**	**66.0%**	**1.1%**	**25.2%**	**50.1%**	**0.8%**	**11.7%**
› Independent Board Chairman/Separate Chair-CEO	46	31.9%	67.0%	1.1%	24.3%	51.7%	0.8%	11.4%
› Declassify Board	5	83.0%	15.4%	1.6%	64.1%	11.5%	1.1%	9.1%
› Majority Vote to Elect Directors	4	62.1%	37.5%	0.4%	50.1%	32.3%	0.3%	9.9%
› *Have Implemented a Form of Majority Voting*	2	64.1%	35.4%	0.5%	51.9%	30.4%	0.4%	10.8%
› *Have Not Implemented a Form of Majority Voting*	2	60.1%	39.7%	0.2%	48.4%	34.3%	0.2%	9.0%
Executive Compensation	**34**	**25.3%**	**73.7%**	**1.0%**	**19.8%**	**57.3%**	**0.8%**	**9.6%**
› Pro-rata Vesting of Equity Awards	8	30.7%	68.8%	0.5%	24.2%	56.0%	0.4%	9.9%
› Clawback of Incentive Payments	7	39.4%	59.2%	1.4%	30.6%	45.9%	1.0%	11.6%
› Report on Integrating Risks Related to Drug Pricing into Senior Executive Compensation	5	22.8%	75.3%	1.9%	17.2%	54.8%	1.4%	13.0%
› Assess Feasibility of Including Sustainability as a Performance Measure for Exec Comp	4	11.8%	86.7%	1.5%	9.3%	67.8%	1.1%	7.8%
› Submit Severance Agreement (Change-in-Control) to Shareholder Vote	3	29.3%	70.5%	0.2%	25.7%	61.3%	0.2%	12.2%
Shareholder Right To Call Special Meeting	**57**	**39.8%**	**59.5%**	**0.7%**	**30.4%**	**45.8%**	**0.5%**	**11.3%**
Shareholder Right To Act By Written Consent	**36**	**42.0%**	**57.3%**	**0.7%**	**31.9%**	**43.3%**	**0.5%**	**11.4%**
Eliminate or Reduce Supermajority Provision / Adopt Simple Majority	**12**	**65.7%**	**33.4%**	**1.0%**	**52.0%**	**27.4%**	**0.8%**	**9.4%**
Eliminate Dual Class Stock	**8**	**32.9%**	**66.5%**	**0.6%**	**27.5%**	**55.1%**	**0.4%**	**5.6%**
Proxy Access – Adopt (Enact)	**7**	**56.4%**	**43.0%**	**0.6%**	**45.4%**	**35.0%**	**0.5%**	**9.0%**
Proxy Access – Amend (Fix-it)	**30**	**27.5%**	**71.5%**	**1.0%**	**21.0%**	**54.4%**	**0.8%**	**12.3%**

Figure 5

Proposals Relating to Board Issues - 2014 to 2018

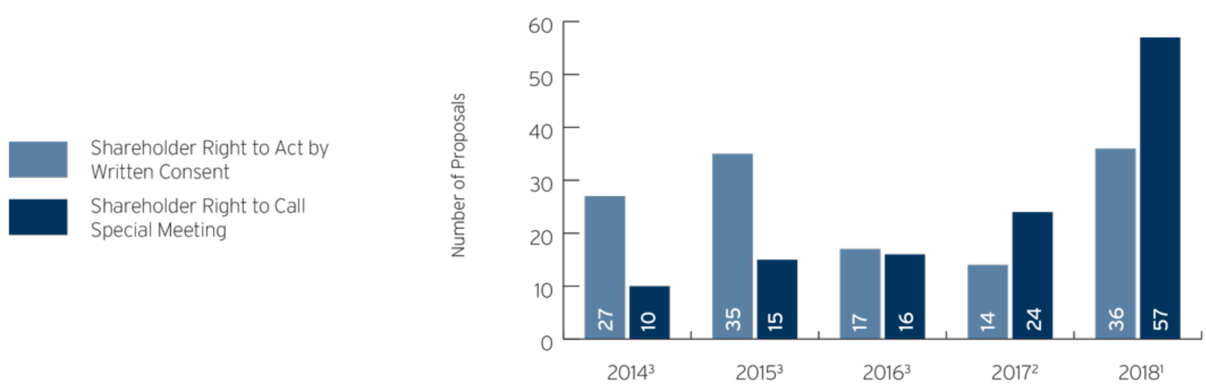


Average % of Shareholder Support – Based on Votes Cast

	2014[3]	2015[3]	2016[3]	2017[2]	2018[1]
Independent Board Chairman / Separate Chair-CEO	31%	30%	29%	30%	32%
Majority Vote to Elect Directors	57%	66%	51%	54%	62%

Figure 6

Proposals Relating to Shareholder Rights - 2014 to 2018

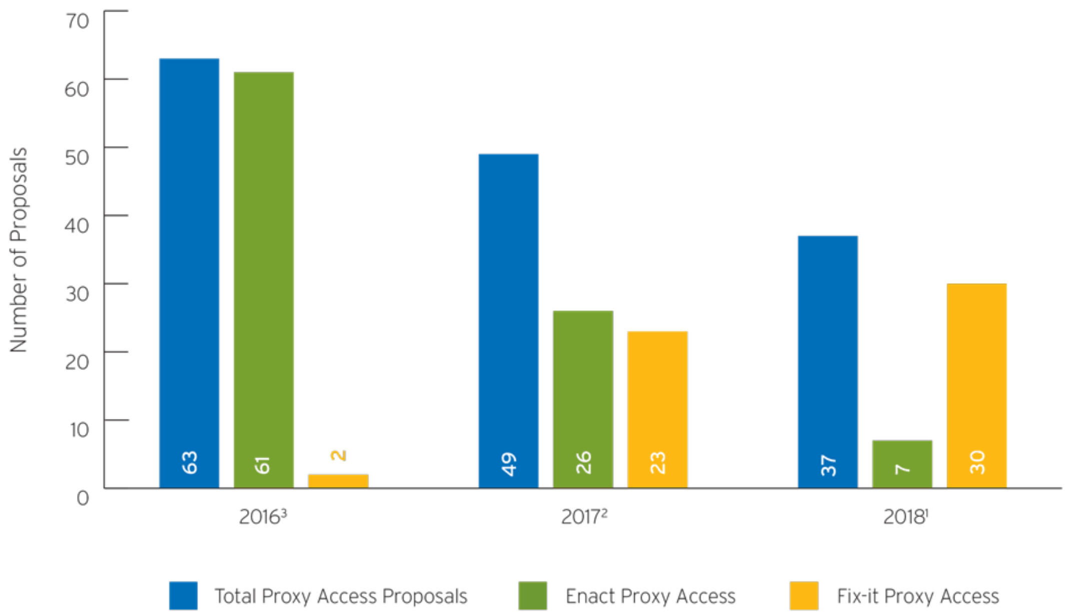


Average % of Shareholder Support – Based on Votes Cast

	2014[3]	2015[3]	2016[3]	2017[2]	2018[1]
Shareholder Right to Act by Written Consent	38%	39%	41%	45%	42%
Shareholder Right to Call Special Meeting	42%	43%	43%	42%	40%

Figure 7

Proposals Relating to Proxy Access - 2016 to 2018



	2016[3]			2017[2]			2018[1]		
	Passed	Failed	Average Support	Passed	Failed	Average Support	Passed	Failed	Average Support
Total Proposals	31	32	50.0%	19	30	45.4%	4	33	33.0%
- Enact Proposals	31	30	50.3%	19	7	60.4%	4	3	56.4%
- Fix-it Proposals	0	2	41.9%	0	23	28.5%	0	30	27.5%

[1] *2018 data is from S&P 1500 company annual meetings from 7/1/17 - 6/30/18*
[2] *2017 data is from S&P 1500 company annual meetings from 7/1/16 - 6/30/17*
[3] *2014-2016 data is from S&P 1500 company annual meetings from Jan 1 - June 30 of that particular year*

Figure 8

› Sponsorship of Governance Proposals – 2017 and 2018

	2017	2018
Labor Unions (10.5%*)	**25**	**28**
Amalgamated Bank (LongView Fund)	1	0
American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)	2	7
Association of BellTel Retirees Inc.	1	1
CTW Investment Group	1	0
Indiana Laborers' Pension Fund	0	1
International Brotherhood of Electrical Workers (IBEW)	3	1
International Brotherhood of Teamsters (TEAMSTERS)	7	11
Laborers District Council & Contractors Pension Fund of OH	0	1
Reserve Fund of the American Federation of Labor and Congress of Industrial Organizations	1	0
Service Employees International Union (SEIU Master Trust)	1	2
Sheet Metal Workers' National Pension Fund	1	0
Southwest Regional Council of Carpenters Pension Fund	1	1
Trowel Trades (Large Cap Equity Index Fund)	1	2
UNITE HERE	1	1
United Auto Workers (UAW)	3	0
United Media Guild	1	0
Public Pensions (5.3%*)	**27**	**14**
California Public Employees' Retirement System (CalPERS)	1	1
California State Teachers' Retirement System (CalSTRS)	7	2
City of Philadelphia Public Employees Retirement System (PhiPERS)	0	1
Connecticut Retirement Plans & Trust Funds	0	2
New York City Pension Funds	17	5
New York State Common Retirement Fund	2	2
Vermont Office of the State Treasurer	0	1
Religious Organizations (3.0%*)	**7**	**8**
Congregation of Sisters of St. Agnes	1	0
Episcopal Church (The Domestic and Foreign Missionary Society of the Protestant Episcopal Church)	0	1
Interfaith Center on Corporate Responsibility	0	3
Mercy Investment Services	0	2
Nathan Cummings Foundation	1	1
Seattle Mennonite Church	1	0
Sisters of St. Francis of Philadelphia	3	1
Unitarian Universalist Association	1	0

	2017	2018
Other Shareholder Groups (8.6%*)	**22**	**23**
As You Sow Foundation	0	1
AVGO	0	1
Clean Yield Asset Management	1	1
Comerica Bank & Trust	0	1
Dana Investment Advisors	0	1
Equality Network Foundation	4	0
GAMCO Asset Management Inc.	0	3
Greenlight Capital Inc.	2	0
Heartland Initiative Inc.	1	0
Humane Society of the United States	3	1
INVESTOR VOICE	1	0
KBS Realty Advisors	0	1
Kestrel Foundation	0	1
Land & Buildings Capital Growth Fund, LP	0	1
Marcato Capital Management LP	0	1
Marco Consulting Group Trust	2	0
Mercy For Animals	1	0
Needmor Fund	1	0
Northstar Asset Management Funded Pension Plan	1	1
Organization United for Respect	1	0
Pershing Square Holdings, Ltd.	0	1
Sonen Capital	1	0
Sum of Us	1	0
The Stephen M. Silberstein Revocable Trust	2	0
Trian Partners	0	1
Trillium Asset Management	0	1
Trinity Health	0	1
Voce Capital Management	0	1
Zevin Asset Management	0	4
Individual Shareholders (68.8%*)	**126**	**183**
Not Disclosed (3.8%*)	**14**	**10**
Total	**221**	**266**

** Percentages denote the total share of governance-related proposals sponsored by this type of investor.*

The complete publication, including footnotes, is available here.

2019 Proxy Season Preview

Posted by Steve W. Klemash, Jamie C. Smith, and Kellie C. Huennekens, EY Center for Board Matters, on Tuesday, February 26, 2019

Editor's note: Steve W. Klemash is America's Leader, Jamie C. Smith is Associate Director, and Kellie C. Huennekens is Associate Director, all at EY Center for Board Matters. This post is based on their EY memorandum.

Institutional investors tell us they want boards to help set the tone at the top for diversity and culture and better articulate how the company is investing in talent and transformation. They want to understand how companies are integrating business-relevant environmental and social considerations into a sustainable strategy that creates long-term value for a wide range of stakeholders. And they want to know how the board is overseeing emerging threats and opportunities amid continued market volatility and evolving risks.

Many investors are also further integrating environmental, social and governance (ESG) considerations into their stewardship programs and broader approach. For example, some asset managers are doing more to embed such factors into their investment processes and offering new ESG products and solutions; and asset owners are asking more questions around how their current and potential external managers are approaching ESG matters.

These are some of the themes emerging from our conversations with more than 60 institutional investors representing over US$32 trillion in assets under management, including asset managers (42% of participants), public funds (22%), labor funds (13%), socially responsible (13%) and faith-based investors (8%), as well as investor associations and advisors (3%).

This is the eighth year the EY Center for Board Matters has engaged with governance specialists from the investor community to learn about their priorities for the coming year. This post brings together investor input and draws on our tracking of governance trends across more than 3,000 US listed companies, and focuses on:

- The top three areas investors want boards to focus on in 2019
- Opportunities for enhancing communications around long-term strategy
- Key factors investors use to assess board oversight of risk
- Tips for more effective engagement
- Shareholder proposal trends

Top three areas where investors want boards to focus in 2019

1. Board diversity—investors push for diverse directors as focus on board composition continues

Just over half (53%) of the investors we spoke with emphasized that board diversity, primarily inclusive of gender, race and ethnicity, should be a top board focus in 2019, up from one-third three years ago. An additional 19% cited diversity as part of a broader set of board composition considerations, including skill set, refreshment and assessment approaches.

Many investors said they want to see boards recognize and truly embrace the value of diversity to decision-making and performance, including by fostering an inclusive board culture as well as embedding diversity considerations into recruitment and assessment policies. They further shared that the dynamics of engagement conversations on diversity can reveal whether boards are “checking the box” or genuinely upholding diversity as a value.

Many investors also noted the value of board diversity in setting a tone at the top that reflects a dynamic and inclusive view of talent. Relatedly, more investors are also expanding their focus to senior executives. Fourteen percent of investors explicitly raised both board and executive diversity as an important focus for boards, up from 4% three years ago. Some characterized a lack of diversity among directors and executive leadership as a human capital risk, particularly given today’s war on talent and the spotlight on corporate culture.

The push for diversity is occurring against a backdrop of slow-moving change in the boardroom. From 2017 to 2018, the percentage of women-held S&P 1500 directorships inched up two percentage points from 19% to 21%. That is double the annual one-percentage-point rate of increase we have observed since 2013.

Assessing racial and ethnic board diversity continues to be challenging for investors given the lack of disclosure. Thirty percent of investors who want boards to focus on diversity told us they are asking companies for better disclosure of director demographics. However, some directors may not want to self-identify for personal reasons.

Key board takeaway

Consider whether the board’s diversity and related communications (e.g., proxy disclosures regarding board composition and the role of diversity in board recruitment and assessment) set the appropriate tone at the top for the value the company places on diversity.

2. Company-relevant environmental and social issues, particularly climate risk

Around half (49%) of investors said a top board focus should be business-relevant environmental and social factors. That is, those that are most likely to impact the company’s strategy, risk profile and brand, such as water management for food and beverage companies; access and affordability for health care companies; and plastic pollution for consumer goods companies. Generally, these investors want to understand how boards and management are connecting these kinds of environmental and social issues to their long-term success and embedding related considerations into their risk management and strategy setting. And they want to see this integration consistently communicated in company disclosures on strategy and risk.

Most of these investors—more than a third (38%) of investors overall—are specifically focused on climate change, which is up from 15% three years ago. Notably, the types of investors citing climate risk were evenly divided among mainstream asset managers, public funds, and faith-based and socially responsible investors, reinforcing the increasingly broad spectrum of investors focused on this issue.

The direct relevance of climate risk is different for each company, and most investors focused on climate are engaging heavy greenhouse gas (GHG) emitters, such as those in the industrial or energy sectors. Regarding these companies, investors raised the need for concrete and significant GHG reduction goals and climate scenario planning that tests the resilience of company strategy against a 2 degree Celsius or lower scenario—both core elements of the Financial Stability Board's Task Force on Climate-related Financial Disclosures' (TCFD) recommendations. Thirty-eight percent of investors citing climate change raised that they are actively asking companies to take these steps.[1]

Another key theme arising from the conversation on climate risk was the need for enhanced reporting. Close to half (46%) of the investors citing climate risk raised the TCFD as a reporting framework they support.[2] These investors noted the importance of such reporting for companies' strategic planning and risk management, and many noted that they are part of the Climate Action 100+, an investor-led initiative that promotes voluntary disclosure in line with the TCFD's recommendations.[3]

As for expectations around board governance of environmental and social factors, including climate risk, investor expectations may vary based on company-specific circumstances. Nonetheless, most investors told us they recognize effective oversight can come in different forms, such as charging a dedicated board committee or one of the key committees with related oversight, recruiting directors with business-relevant sustainability expertise, talking to external independent experts, or setting a clear and ongoing agenda for the board to discuss sustainability impacts.

Key board takeaway

Challenge whether the company's risk management processes, capital allocation decisions and strategic planning integrate business-relevant environmental and social considerations, and whether the company's reporting process consistently demonstrates this integration. Consider the extent to which key stakeholders support external frameworks, such as the TCFD and the Sustainability Accounting Standards Board (SASB), and how company disclosures align with these frameworks.

[1] The Climate Action 100+ is a five-year investor-led initiative to engage key global companies on achieving the goals of the Paris Agreement.

[2] The TCFD provides a framework for companies to report climate-related risks and opportunities through existing financial reporting processes and has developed recommendations structured around governance, strategy, risk management, metrics and targets.

[3] The Climate Action 100+ is a five-year investor-led initiative to engage key global companies on achieving the goals of the Paris Agreement.

3. Human capital management—investors seek to understand how boards are governing talent and culture

More than a third (39%) of investors told us human capital management and corporate culture should be a top board focus, up from just 6% three years ago. While some are focused on particular issues (e.g., workforce diversity, pay equity), most are taking a broad view of the topic.

Several investors shared that recent business, technology and societal trends have played a role in them paying closer attention to human capital and culture, including a more discerning and empowered consumer base, radical shifts in the workforce and the growing importance of talent to an organization's intangible value in today's digital economy.

At a high level these investors want to understand the role of human capital management in the company's long-term strategy and how the company is evolving, investing in and developing its talent to further innovate and meet future needs, particularly in industries or geographies where talent scarcities are on the horizon, such as technology and financial services. They also want to understand how companies are addressing, including how boards are assessing, potential cultural and workforce issues to support long-term strategy and enhance and protect the company's reputation, brand value and ability to attract the best talent.

Twenty percent of the investors citing human capital management seek increased disclosure around related topics, and some view the pay ratio as an opportunity for companies to provide deeper context around their investments in human capital.[4] Most told us that, at least for now, they are prioritizing dialogue over disclosure. Some even indicated that this kind of information need not be for public consumption, and that they are seeking assurance that boards are actively engaged in reviewing related metrics. Overall, there was consensus that investors would like to better understand how boards are engaged and exercising oversight in this space.

Key board takeaway

Assess how the board is governing around talent and culture, including how well the board understands the current culture, and whether the human capital metrics the board is reviewing and the quality and frequency of management reporting to the board are sufficient for robust oversight.

Opportunities for enhancing communications around long-term strategy

We asked investors if they think most companies are doing a good job of balancing their investments for the short- and long-term. Nearly all qualified their responses, stressing that it is highly dependent on the company and acknowledging the market pressures that encourage short-termism. A quarter declined to answer, with most explaining that this is an evaluation they leave to their investment professionals and a few stating that this is a debate they avoid. But most

[4] The Human Capital Management Coalition is a cooperative effort among more than 26 asset owners with more than US$3 trillion in assets under management. The group petitioned the SEC in July 2017 to adopt rules requiring issuers to disclose information about their human capital management policies, practices and performance.

revealing to us was this: nearly 20% said it is hard to answer the question because of the current lack of disclosure around long-term strategy.

Some of these investors applauded particular companies for doing a great job in communicating their long-term approach but noted that many companies maintain a heavy emphasis on the short-term, including businesses with what appeared to them to be unacknowledged and unmitigated long-term risks. Notably, some said that when there is external pressure, such as an activist waging a proxy contest, companies are very articulate about their long-term strategy, but there is opportunity to better tell this story as part of their regular communications.

Investors generally want to understand how companies are anticipating and responding to external market developments and industry trends. They would like to see that a company's identification of key risks and strategic opportunities includes environmental and social factors that impact the company's business sustainability, and they want to see consistent messaging across various communications (e.g., the 10-K, the sustainability report and investor presentations). They also want a clear picture of how short-term goals and executive pay tie into and support long-term strategy.

In order to assess whether companies are effectively balancing the short- and long-term, investors told us they are looking at:

- **The company's story.** Is the company consistently communicating a strategy around long-term growth? Is there a strong articulation of the company's purpose and how the company is managing its business to create long-term value?
- **Executive compensation.** Does the pay program promote longer-term focus or does it primarily emphasize a one-year time frame? Are companies rewarding innovation, investment in the company, and progress tied to environmental or social goals?
- **Capital allocation/stock buybacks.** How is the company investing in services, products, retraining or innovation that could build long-term value? And how do recent stock buybacks reflect the best use of cash?
- **Environmental and social metrics.** Is the company investing energy, focus and disclosures around long-term sustainability goals? Does company strategy address business-specific opportunities and risks on environmental and social matters?
- **Risk disclosures.** Does there appear to be an underappreciation of significant risks, such as environmental risks, cybersecurity or broader technology challenges?
- **Sell-side research.** Is the company articulating business planning for the long-term?

Key board takeaway

Assess opportunities for enhancing communication of long-term strategy, and how near-term goals and pay incentives support that strategy.

Five factors investors use to assess board oversight of risk

We asked investors if they are raising particular risk issues (e.g., cybersecurity, talent/human capital management, climate, geopolitical) in company engagements and how they are assessing board oversight of those risks. Most said they don't want to be prescriptive regarding board oversight; they want to see evidence that the board is engaged and to understand related oversight structures and procedures. Some of the key factors they raised included:

1. **Management reporting to the board.** Investors are interested in how management is reporting to the board on key risk issues at a high level and may raise related questions in engagement discussions, e.g., who from management is reporting, how often and what kind of information is discussed.
2. **Committee oversight.** Investors generally want to see that a board committee has responsibility over and is engaged on key risks, or that there are procedures in place to ensure sufficient attention to the issue by the full board.
3. **Director qualifications and use of outside experts.** Investors generally want the board to include relevant expertise tied to key risks the company is facing. They also want assurances that the board is accessing outside experts as needed to stay current on external developments and challenge internal bias, as appropriate.
4. **Directors' ability to speak to risks disclosed in the 10-K.** Several investors said they expect board members to be able to speak fluently on how they are overseeing key risks identified in the annual report and may raise related questions in engagement conversations.
5. **Explanation of differences between company's disclosed risks and external frameworks/research.** Several investors said they often compare a company's disclosed risks to other benchmarks (e.g., industry research, ESG ratings reports, the SASB framework) and may raise questions about perceived gaps or areas of misalignment.

Tips for more effective engagement

We asked investors what they wish were different about their engagements with companies. Close to a third (30%) said that overall engagement has improved significantly, with most citing increased director involvement and a more respectful approach as important developments. Still, 91% cited opportunities for continuing to improve the process. Here are some tips based on what we heard:

- **Avoid engaging for engaging's sake—engage as needed outside of proxy season and avoid discussing proxy advisory firm views.** Investors said companies come across as tone deaf when they reach out in the spring (when investors are voting thousands of company ballots) or with no clear agenda, and when they focus on the views of proxy advisory firms that investors do not rely on for voting guidance.
- **Have a mutually agreed-upon agenda and the right people on the call.** Having an agenda that benefits both parties provides for a richer conversation and allows both sides to prepare accordingly. Having the relevant decision-makers and subject-matter experts involved—including directors as appropriate—can make conversation more productive and efficient. Some investors noted that when boards rely solely on sustainability officers to discuss environmental and social issues, that may reinforce concerns that these issues are isolated from board discussions on strategy and risk. Similarly, when a compensation committee defers to management or the compensation consultant, this may raise questions about the extent to which the committee owns the pay philosophy and decision-making. Overall, many expressed frustration at IR playing a lead role in engagement, given the perceived lack of familiarity on company-specific governance and sustainability topics and focus on "canned" messaging.

- **Make the discussion more investor-specific.** The more the company understands the investor's approach and position on governance issues, the more focused the engagement. While many investors post their proxy voting guidelines and stewardship reports on their websites (and some send letters to portfolio companies identifying engagement priorities), many said they do not expect companies to do in-depth research before a meeting, but at least expect the company to understand whether they are talking to an active or passive manager, or an asset manager or owner. Further, several investors said they wish companies would review notes from previous conversations with them to help move the dialogue forward. Finally, recognize that some investors view the shareholder proposal process as an important part of investor-company engagement.
- **Be forthcoming about challenges and controversies, as well as changes made in response to feedback.** Several investors noted frustration around companies not directly raising challenges or controversies. They said that, when coupled with "all is well" type messaging, the communication raises concern that companies are obfuscating, which makes investors skeptical about what the company does share, and results in a missed opportunity for relationship-building. Conversely, companies that directly raise the challenges they face and discuss plans to address them build trust. Further, companies that reach out to share recent or potential changes made in response to feedback reinforce the value of engagement and relationship-building efforts.

One shortcut to understanding widely held investor expectations is the Investor Stewardship Group's (ISG) framework of corporate governance principles, which reflects the common corporate governance standards of ISG members, which include some of the largest US-based institutional investors and global asset managers.

Shareholder proposal trends

Shareholder proposal submissions in 2018 were down 20% from five years ago based on our tracking of proposals submitted at Russell 3000 companies. Over the same time period, the portion of proposals that were withdrawn (in most cases because the proponents and the companies reached agreement) held steady at around one-third of all submissions. Notably, average support for proposals that went to a vote on environmental sustainability topics (e.g., asking companies to report on sustainability, climate risk, energy efficiency, greenhouse gas emissions) grew from 22% to 31%.

More changes to the shareholder proposal landscape may be ahead. Following a November 2018 U.S. Securities and Exchange Commission roundtable, Chairman Jay Clayton identified improving the proxy process as a key 2019 initiative for the Commission, specifically including examination of the share ownership and voting thresholds that determine whether shareholder proposals can be submitted and resubmitted.

To set the context for proxy season 2019, here are the top shareholder proposal topics by average vote support in 2018, a year in which a total of 281 companies had shareholder proposals voted.

Top 20 shareholder proposal topics in 2018, based on average support received*

	Average support	Maximum support
Eliminate classified board	87%	96%
Adopt majority vote to elect directors	78%	98%
Eliminate supermajority vote	64%	87%
Allow shareholders to act by written consent	43%	86%
Report on sustainability	41%	80%
Allow shareholders to call special meeting	40%	94%
Address corporate EEO/diversity	39%	48%
Review/report on health care/medicine	32%	62%
Address political spending	32%	47%
Enhance pay-for-performance alignment	32%	48%
Address greenhouse gas emissions	32%	57%
Appoint independent board chair	32%	58%
Adopt/amend proxy access	32%	85%
Eliminate dual-class common stock	30%	41%
Limit post-employment executive pay	30%	43%
Address food/consumer products	28%	43%
Address lobbying activities	26%	41%
Address alternative, renewable energy	23%	46%
Address internet/data security risks	20%	36%
Address board diversity	18%	33%

*Where at least five proposals were voted. Accordingly, certain topics that received strong, and even majority support, in 2018 are not included (e.g., proposals to address climate risk averaged 42% support last year, but only four came to vote while 17 were withdrawn).

Conclusion

The ES of ESG is growing in prominence, and many investors want to understand how companies are embedding relevant considerations in their long-term strategy. Many investors also want boards to set the tone at the top for diversity and do a better job of articulating oversight of long-term strategy, including how the company is investing in and developing talent, living its values and navigating external risks.

While these high-level insights come from a broad range of investors, boards must remember that institutional investor views can vary significantly. Understanding the widely supported leading practices set forward in the ISG framework as a baseline and engaging key shareholders and reviewing their policies and voting records are paramount to understanding and meeting investor expectations.

Questions for the board to consider

- Does the board's makeup and culture reflect the company's broader commitment to diversity and inclusion? And how is the board challenging itself to find diverse director candidates and communicating those efforts to investors?
- Do the company's various reporting channels (e.g., proxy statement, annual report, sustainability report, quarterly reports and earnings calls) tell a consistent story about long-term strategy and related risks, including business-relevant environmental and social factors? Is it clear how the executive pay program and short-term performance goals support that strategy?
- How is the company investing in and developing its talent as the business evolves? What is the company doing to provide for its talent needs in 3—5 years?
- Does the board understand how the company's culture aligns with the company's purpose, values and strategy, along with any particular cultural strengths or opportunities for improvement?
- Is the board able to articulate how it oversees the key risk factors disclosed by the company in its annual report? And has the company considered how its disclosed risks align to those of peers and external frameworks such as SASB or the TCFD?
- Are there opportunities to make the company's shareholder engagement program more targeted and outcome-driven?

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Preparing for the 2019 Proxy Season: Practical Guidance for Directors and Board Committees

Posted by Melissa Sawyer and Kathy Wang, Sullivan & Cromwell LLP, on Wednesday, December 12, 2018

Editor's note: Melissa Sawyer is partner and Kathy Wang is an associate at Sullivan & Cromwell LLP. This post is based on a Sullivan & Cromwell memorandum by Ms. Sawyer, Ms. Wang, Catherine Clarkin, Heather Coleman, James Shea, Jr., and Marc Treviño.

Corporate governance circles are abuzz with discussions about board refreshment, sustainability proposals and the repercussions of the #MeToo movement, among other hot topics. For most companies, however, these topics do not warrant immediate reactions. This post summarizes our recommendations and observations of emerging trends for the 2019 proxy season in response to the recent focus on these and other hot topics.

Nominating and Corporate Governance Committee Topics

- ***Board Refreshment Disclosures.*** Many companies have responded to the increased investor focus in recent years on board composition by including enhanced disclosure in their proxy statements about their board refreshment plans. Consistent with current practice, we expect these disclosures will continue to discuss the Nominating and Governance Committee's philosophy of board refreshment and general objectives, such as enhancing diversity. Companies that anticipate being subject to California's SB-826, which will require female representation on the boards of directors of publicly traded companies that identify as being headquartered in California by the end of calendar year 2019, should specifically consider how they comply or intend to become compliant with those requirements. Otherwise, unless the company is facing a shareholder activist or other specific investor criticism of the company's board composition, it likely is not necessary for the disclosure to provide details on the specific number of directors to be replaced in a specific timeframe.
- ***Board Self-Evaluations.*** Many boards now conduct an annual self-evaluation process. Some institutional investors have indicated that they expect boards will use an external consultant to conduct the evaluations at least once every few years. Although the manner in which the process is conducted may vary from company to company and year to year, it is important that any such process provides directors with an avenue to surface recommendations and concerns about the board's effectiveness. Increasingly, companies are disclosing information about their self-evaluation processes in their proxy statements and in discussions with investors.
- ***Mandatory Retirement Ages and Term Limits.*** Mandatory retirement ages and term limits have been raised as possible solutions to a lack of board diversity or excessive tenure, but in some cases strict quantitative requirements may actually be detrimental to

the company. While some governance watchdogs argue that long-serving directors are *per se* not independent because of their long ties with management, this argument would only hold if the company's directors and managers have similarly long tenures. Moreover, directors with long tenures can be an asset to the company. ISS stated in 2017 that "term and age limits, as they have been typically applied, may not be the solutions, because they force the arbitrary retirement of valuable directors." For some companies, in lieu of imposing strict age- or tenure-based requirements, consistent attention to board refreshment and a thoughtful board self-evaluation process are sufficient to address tenure concerns.

- ***Director Compensation.*** In recent years, many companies have included a limit on non-employee director awards (typically structured as an annual cap) in stock incentive plans submitted for stockholder approval. This was in response to a line of Delaware Court of Chancery cases suggesting that if a company's shareholders approved a plan with "meaningful limits" on director awards, subsequent challenges to awards within those limits would be entitled to the more deferential business judgment rule rather than the entire fairness standard (which often survives a motion to dismiss). A December 2017 Delaware Supreme Court decision called into question whether these limits are adequate for business judgment protection. In the *Investors Bancorp* case, shareholders brought breach of fiduciary duty claims against the company's board in connection with the grant of equity awards to the ten non-employee directors with a purported grant date fair value of nearly $22 million under a stockholder-approved equity compensation plan with an aggregate limit on non-employee director grants equal to 30 percent of all option or restricted shares available for issuance under the plan. The non-employee director awards averaged $2,159,400, compared to prior year non-employee director compensation that ranged from $97,200 to $207,005 and an alleged peer average of $175,817. The Court of Chancery dismissed the case, but the Delaware Supreme Court reversed and remanded for an entire fairness review, holding that the stockholder ratification defense is unavailable where the plan "gives the directors *discretion to grant themselves awards within general parameters* and a stockholder properly alleges that the directors inequitably exercised that discretion" (emphasis added). The Court noted that the director compensation in *Investors Bancorp* was many times greater than historical annual compensation and compensation levels at the company's competitors. In response to this ruling, we expect to see an increasing trend of companies adopting plans with caps close to their current director compensation levels or plans with fixed compensation formulas, as *Investors Bancorp* reiterated that director awards made in accordance with shareholder-approved specific amounts or formulas will be protected. Whenever incentive plans are submitted for a shareholder vote, the proxy disclosure should contain sufficient detail to establish that the shareholder vote was obtained on a fully informed basis.
- ***Director Participation in Shareholder Engagement.*** It is becoming increasingly common for directors to participate in shareholder engagement meetings. In fact, some large institutional investors now report that directors attend as many as 40 percent of their engagement meetings. Shareholders are more likely to request that directors participate if they expect the meeting to cover governance or management compensation issues. Given this backdrop, companies should be proactive and identify which independent directors will act as spokespeople for the board if investors reasonably request director participation. For instance, where governance considerations are a concern for investors, companies could consider identifying the chairperson of the Corporate Governance and Nominating Committee to participate, while issues relating to

executive compensation may be heard by directors on the Compensation Committee. Those directors could then participate in mock Q&A sessions with the CEO, CFO, and investor relations team to make sure they can accurately respond to a range of potential shareholder questions within the bounds of Regulation FD and in a manner that, to the extent appropriate, is consistent with the company's overall disclosure posture. Director participation should be seen as a supplement to—and not a substitute for—CEO and CFO participation.

- ***ESP Mandates.*** Some boards are amending their nominating and corporate governance committee charters to give that committee an expanded scope of responsibility over environmental, social, and political ("ESP") issues, such as sustainability. This appears to be a response to requests from investors for greater clarity concerning which committees have oversight of these issues, as well as some calls by institutional investors for companies to articulate their desired societal impact. In a January 2018 letter to CEOs, BlackRock's CEO said, "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society." Expanding the responsibilities of a committee in this manner is not strictly necessary; it is perfectly appropriate at many companies for these issues to be in the purview of the full board. Any decision to make this change should take into consideration the existing workloads of the committee members and current committee meeting schedules and agendas, as well as perspectives on which directors may have relevant expertise in ESP-related issues.

Compensation Committee Topics

- ***Human Capital Management.*** Talent management and human capital management continue to be top areas of focus for investors and governance watchdogs. In a March 2018 statement, BlackRock stated that companies could suffer meaningful financial impacts by mismanaging human capital and identified human capital management as a priority in its engagement with companies for 2018, emphasizing that it "is both a board and a management issue." The statement also set forth certain topics on which Blackrock intends to engage with boards to encourage board accountability in overseeing the company's strategy "to create a healthy culture and prevent unwanted behaviors." These issues are not limited to compensation structure, but also touch on all matters that impact the talent pipeline and workplace culture, such as diversity and inclusion initiatives and the manner in which the company addresses workplace misconduct claims. Some companies have amended their compensation committee charters to provide that the compensation committee will have the authority to oversee these issues in the first instance. However, given their importance, these issues also merit periodic discussion by the full board (and, indeed, some companies' corporate governance guidelines require the full board to oversee these matters). In order to provide this oversight, many companies' boards now receive quarterly reports concerning reports made to their employee and compliance hotlines and require management to consult with the board prior to agreeing to any workplace misconduct settlement in excess of a specified dollar amount or involving senior executives. More specifically, the recent focus on the #MeToo movement has raised questions about the role of directors in providing oversight of management as it relates to workplace sexual misconduct allegations. Although it is generally not appropriate for the board to engage in day-to-day management of operational matters, including the management of employees, it is appropriate for directors to become more involved in situations where a senior executive is alleged to have committed misconduct or there appears to be a significant pattern of misconduct across a division or the whole company. As evidenced by recent corporate #MeToo incidents, allegations of sexual misconduct at public companies may not only have a material negative effect on share prices, but can also cause long-standing reputational harm for the companies and, potentially, their boards. Moreover, repeated allegations of sexual harassment at a company may expose the board to liability for allowing the misconduct to continue or for failing to respond to such allegations. We recommend that members of the board, or a designated committee, work with management to review periodically the company's code of conduct, particularly sections on sexual harassment policies and training procedures, as well as to ensure that the necessary reporting and enforcement mechanisms are in place. Although some companies have added explicit language on sexual harassment to employment agreements and equity plans, most employment agreements and equity plans already require compliance with the company's code of conduct, which generally prohibits such misconduct.

- ***Executive Compensation.*** We anticipate that companies will receive more shareholder proposals seeking reports or studies concerning the pros and cons of tying compensation metrics to qualitative factors. With the Tax Cuts and Jobs Act of 2017 amending Section 162(m) to remove a long-standing exemption under which certain performance-based compensation was not subject to the deduction limit, there is no longer a tax-related reason for compensation committees to tie compensation to objective criteria. However, because most compensation committees already retain discretion to consider qualitative factors in making compensation decisions (for example, through the exercise of negative discretion), it may not be necessary to establish explicit qualitative criteria. Moreover, ISS and Glass Lewis still favor metrics that are calculated using quantitative pay-for-performance methods. In any event, care should be taken to ensure that the compensation section of the company's proxy statement accurately describes both the quantitative metrics as well as any qualitative factors considered in determining employee compensation.

Trends in Proxy Statement and Website Disclosures

- ***ESP Information.*** In recent years, corporate governance advocates have increasingly sought expanded disclosure of companies' ESP information. The resulting lobbying and shareholder proposals cover a wide range of topics, including sustainability, climate change, water management, political and lobbying expenditures, the opioid crisis, and gun control. ESP proposals are expected to increase in frequency in the 2019 proxy season as ESP data become more relevant to investors in their evaluation of company strategies, risks, and opportunities. Passive fund managers and other investors include ESP data in their overall assessment of potential investments. Accordingly, companies should consider whether to update any of their website or SEC disclosures to address ESP information more directly. Among other things, additional disclosures may help companies secure better scores on their ISS E&S scorecards.
- ***CEO Pay Ratio and Gender Pay Ratios.*** Mandatory CEO pay ratio disclosure debuted during the 2018 proxy season under SEC rules, and companies are already planning for its inclusion in the 2019 proxy season. Although SEC rules permit companies to supplement the required disclosure with additional ratios, most companies have opted to provide only the mandated pay ratio in their 2018 proxy statements, and we expect this

trend will continue into 2019. In addition, the U.K. gender pay gap reporting regulations (part of the Equality Act 2010) came into effect in April 2018, requiring companies in Great Britain with over 250 employees to comply with reporting obligations and publish data on the gender pay gap in their workforce on the companies' websites and on a government website. Many companies now disclose gender pay ratios comparing the wages paid to male and female employees outside of their proxy statements, and in some cases, these disclosures are drafted by non-lawyers without sufficient attention to potential legal issues, such as whether such information could be considered "additional soliciting material" that must be filed under SEC rules. Companies should ensure that any such disclosures receive appropriate review from legal counsel. Also, if a company's CEO or gender pay ratio (or the underlying trend in that ratio) is not in line with that of its peers, the disclosures may elicit a negative reaction as more investors start to digitize and calculate multi-year trend data. As such, the board should be briefed periodically on the data and methodology underlying these disclosures and, where necessary, information about the company's methodology should be included in the website disclosure.

- ***Sustainability Reports.*** Many companies are now publishing sustainability reports on their websites. These reports detail the ESP impacts of the company's activities and how the company's values and governance model facilitate the company's overall long-term strategy. In some instances, SEC rules require that a company include disclosures on issues related to sustainability in its proxy statements or periodic filings if the company considers those issues to be material to its financial condition or results of operations. However, unless such disclosures are actually required under SEC rules, it is not advisable to incorporate all or parts of a company's ESP-related disclosures into its SEC filings. The inclusion of these disclosures in a SEC filing (rather than a "furnished" 8-K) may have unintended legal implications: namely, the incorporation by reference into a registration statement under the Securities Act of 1933, which could subject the company and its underwriters to Section 11 liability for these statements and, therefore, result in additional offering-related due diligence by the underwriters and external counsel.
- ***Costs and Benefits of Disclosures.*** More generally, companies should carefully consider whether they should expand disclosure to address any of the governance "hot topics" described above (such as board refreshment goals), add more disclosure concerning their long-term strategy, or refresh or modernize any part of their proxy statements. Because some changes may require a substantial expenditure of time and money, companies should conduct a cost benefit analysis to determine whether any changes are actually necessary before rushing to judgment. Among the largest companies, the ones with the most modernized proxy statements tend to be the ones that have faced issues with shareholder activists or disclosure-related shareholder proposals. At the same time, some changes (such as adding a summary section at the front of the proxy statement) are relatively easy to implement and allow companies to communicate more effectively with their shareholders. It is critical, however, that any additional proxy statement disclosure be subject to the rigorous disclosure controls and procedures that public companies are required to have, and all information contained in these additional disclosures must be adequately supported by the company's verification process.

Shareholder Proposals

- ***Recent SEC Guidance.*** Staff Legal Bulletin 14I (SLB 14I), issued by the SEC Staff in November 2017, provided companies with guidance on the Staff's views on the ability to exclude a shareholder proposal from the company's proxy statement when the proposal does not have "economic relevance to the company's business" pursuant to Rule 14a-8(i)(5). The SEC stated that, under this framework, shareholder proposals that raise issues of social or ethical significance may be excluded, notwithstanding their general or abstract importance, based on the application of quantitative analytics of the proposal's economic relevance to the company's business. Further, SLB 14I noted that issues around economic relevance raise difficult judgment calls that the board is generally best situated to analyze. To assist the Staff in its review of these types of no-action requests, SLB 14I invited companies to include in their no-action requests a discussion reflecting the board's analysis of the particular policy issue raised by the proposal and its significance in relation to the company. In its recent Staff Legal Bulletin 14J (SLB 14J) issued in October 2018, the Staff gave additional guidance around what factors it considered most helpful in describing a board's rationale for excluding a shareholder proposal on the basis of the "economic relevance" prong. Companies who wish to exclude a shareholder proposal on the basis of the fact that it is not economically relevant should consider these factors when preparing a "no action" request.
- ***ESP Proposals.*** Unlike governance-related shareholder proposals, a significant portion of ESP-related shareholder proposals are withdrawn, as proponents often choose to settle and the company voluntarily makes additional disclosures in response to such proposals. The timeframe for settlement (*i.e.*, between the deadline for the receipt of shareholder proposals and the deadline for mailing the proxy statement) is relatively compressed for most companies, so advance planning may be warranted to guide management on how to best handle certain recurring types of proposals. Because most ESP proposals are industry-specific, companies should look at how peer companies have dealt with similar proposals. A company should evaluate, even in the absence of such proposals, whether there are any ESP factors that could be reflected in its disclosures and whether the company should start to engage in any ESP activities that are a regular subject of shareholder proposals in its industry.

As investors become more concerned with sustainability and long-term strategy, public companies increasingly have had to engage with shareholders on sensitive topics, including board composition, gender diversity, human capital management, and ESP activities, often resulting in increased disclosure regarding the company's policies and initiatives. Boards should take note of this trend and understand that directors may be held accountable for the execution and development of the company's long-term value creation plan. Every company will encounter unique and specific issues as it navigates the upcoming proxy season. Thinking through engagement with shareholders on an ongoing basis, and preparing for the proxy season, should start now to best position the company and the board to meet shareholders' needs proactively.

ISS and Glass Lewis Policy Updates for the 2019 Proxy Season

Posted by Holly J. Gregory, John P. Kelsh and Rebecca Grapsas, Sidley Austin LLP, on Tuesday, December 18, 2018

Editor's note: Holly J. Gregory and John P. Kelsh are partners and Rebecca Grapsas is counsel at Sidley Austin LLP. This post is based on a Sidley memorandum by Ms. Gregory, Mr. Kelsh, Ms. Grapsas, Claire H. Holland, Corey Perry, Kai H.E. Liekefett and Thomas J. Kim.

Institutional Shareholder Services (ISS) and Glass Lewis & Co. (Glass Lewis) have updated their proxy voting policies for shareholder meetings held on or after February 1, 2019 (ISS) or January 1, 2019 (Glass Lewis).[1] This post (i) summarizes the changes in proxy voting policies that apply to U.S. companies, (ii) discusses the practical implications of the changes and (iii) provides guidance about preparing for the 2019 proxy season in light of these developments and related deadlines.

The Appendix to the complete publication (available here) identifies the various circumstances in which ISS and Glass Lewis may recommend voting against one or more directors in an uncontested election.

The key changes to ISS' proxy voting policies for 2019 relate to:

- **Board Gender Diversity—**Beginning in 2020, ISS will generally recommend voting against nominating committee chairs (and potentially other directors) at companies with no female directors unless certain mitigating factors apply.
- **Economic Value Added Data for Pay-For-Performance Evaluation—**In 2019, solely for informational purposes, ISS will include on a phased-in basis Economic Value Added (EVA) data in its proxy research reports as a supplement to GAAP/accounting performance measures to provide additional insight into company performance when evaluating pay-for-performance alignment. ISS will continue to explore the potential future use of EVA data as part of its pay-for-performance evaluation.
- **Management Ratification Proposals**
    - Under a new policy, ISS will generally recommend voting against management proposals to ratify provisions of the company's existing charter or bylaws, unless such provisions align with best practice.

[1] ISS, *2019 Americas Proxy Voting Guidelines Updates* (Nov. 19, 2018), available here; ISS; *Executive Summary of 2019 Global Proxy Voting Guidelines Updates and Process* (Nov. 19, 2018), available here; ISS, *U.S. Compensation Policies for 2019 – Preliminary Frequently Asked Questions* (Nov. 21, 2018), available here; Glass Lewis, *2019 Proxy Paper Guidelines: United States* (Oct. 24, 2018), available here; and Glass Lewis, *2019 Proxy Paper Guidelines: Shareholder Initiatives* (Oct. 24, 2018), available here.

- ISS will also recommend voting against or withholding from individual directors, members of the governance committee or the full board, where boards ask shareholders to ratify existing charter or bylaw provisions considering specified factors.
- Under a revised policy, if a management proposal to ratify existing charter or bylaw provisions fails to receive majority support, ISS will conduct a board responsiveness analysis for the next annual meeting.

- **Chronic Poor Attendance by Directors—**In cases of "chronic poor attendance" by a director (defined as three or more consecutive years of poor attendance without reasonable explanation), in addition to recommending votes against the director(s) with chronic poor attendance, ISS will generally recommend voting against or withholding from appropriate members of the nominating/governance committee or the full board.
- **Director Performance Evaluation—**Under a revised policy, when evaluating director performance, ISS will assess a company's 5-year total shareholder returns (TSR) as part of the initial screen for underperformance rather than during the second step of its evaluation.
- **Reverse Stock Splits—**Under a revised policy, ISS will evaluate on a case-by-case basis certain management proposals to implement reverse stock splits, taking into consideration (i) disclosure of substantial doubt about the company's ability to continue as a going concern without additional financing, (ii) the company's rationale or (iii) other factors as applicable.
- **Shareholder Proposals on Environmental and Social (E&S) Issues—**Under a revised policy, ISS expanded the factors it will consider when analyzing E&S shareholder proposals to include whether there are significant controversies, fines, penalties or litigation associated with the company's E&S practices.
- **Excessive Non-Employee Director Compensation—**ISS will delay until at least 2020 its previously-announced new policy of potentially issuing negative vote recommendations against members of the board committee responsible for setting or approving excessive non-employee director compensation in two or more consecutive years without a compelling rationale or other mitigating factors.

The key updates to Glass Lewis' proxy voting policies for 2019 relate to:

- **Board Gender Diversity—**Beginning in 2019, Glass Lewis will generally recommend voting against nominating committee chairs (and potentially other nominating committee members) at companies with no female directors unless the company is outside of the Russell 3000 index or the board has provided a sufficient rationale for not having any female directors. This rationale may include a timetable for addressing the lack of diversity on the board and any notable restrictions affecting board composition (e.g., director nomination agreements with significant investors).
- **Management Ratification Proposals—**Under a new policy, where a company has excluded a special meeting shareholder proposal in favor of a management proposal ratifying an existing special meeting right that is materially different from the shareholder proposal, Glass Lewis will typically recommend voting against the management proposal <u>and</u> against the governance committee chair. In very limited circumstances, Glass Lewis may recommend voting against governance committee members if a company excludes *any* conflicting shareholder proposal (not limited to special meeting proposals) based on

SEC no-action relief if Glass Lewis believes the exclusion was detrimental to shareholders.

- **Conflicting Special Meeting Proposals—**Glass Lewis has codified its policy with respect to vote recommendations on special meeting proposals.
    - Where both management and shareholder proposals requesting different thresholds for the right to call a special meeting are on the ballot, Glass Lewis will generally recommend voting for the lower threshold (typically the shareholder proposal) and against the higher threshold.
    - Where conflicting management and shareholder proposals are on the ballot and the company does not currently maintain a special meeting right, Glass Lewis may consider recommending that shareholders vote for the shareholder proposal and abstain from voting on the management proposal.
- **Director Performance Evaluation—**When making voting recommendations on directors based on company performance, in addition to the company's stock price performance, Glass Lewis will consider the company's overall corporate governance, pay-for-performance alignment and responsiveness to shareholders.
- **E&S Risk Oversight—**Where mismanagement of environmental or social risks has threatened or decreased shareholder value, Glass Lewis may consider recommending that shareholders vote against directors responsible for oversight of E&S risks (or, if not specified, audit committee members), after reviewing the situation, its effect on shareholder value and any corrective action taken by the company.
- **Shareholder Proposals on E&S Issues—**When evaluating E&S shareholder proposals, Glass Lewis will focus on the financial implications of a company adopting, or not adopting, the proposal, taking into account the standards developed by the Sustainability Accounting Standards Board (SASB) with respect to financial materiality.
- **Written Consent Shareholder Proposals—**Under a revised policy, where companies have adopted a special meeting right of 15% or lower and reasonable proxy access provisions, Glass Lewis will generally recommend voting against shareholder proposals requesting that companies adopt a shareholder right to action by written consent.
- **Diversity Reporting Shareholder Proposals—**Glass Lewis will generally recommend in favor of shareholder proposals requesting that companies provide enhanced disclosure on the diversity of their workforce and actions taken to promote diversity within their workforce.
- **Auditor Ratification—**Glass Lewis expanded the factors it will consider when evaluating auditor ratification proposals to include (i) the auditor's tenure, (ii) a pattern of inaccurate audits, and (iii) any ongoing litigation or significant controversies, which may call into question an auditor's effectiveness. In limited cases, these factors may cause Glass Lewis to recommend voting against the proposal.
- **Virtual-Only Shareholder Meetings—**Beginning in 2019, Glass Lewis will generally recommend voting against governance committee members where the board plans to hold a virtual-only shareholder meeting and the company does not provide disclosure assuring shareholders that they will have the same participation rights as at an in-person meeting.
- **Director and Officer Indemnification—**Glass Lewis clarified that it believes it is appropriate for a company to provide indemnification and/or maintain liability insurance to cover its directors and officers so long as the terms of such agreements are reasonable.
- **Net Operating Loss (NOL) Protective Amendments—**Where a company proposes adoption of a NOL poison pill and concurrently proposes adoption of protective bylaw

amendments specifically restricting certain share transfers, if Glass Lewis supports the terms of a particular NOL poison pill, it will generally support the protective bylaw amendments in the absence of significant concerns with the specific terms of that proposal.

- **Quorum Requirements—**Although Glass Lewis prefers a quorum requirement of a majority of outstanding shares entitled to vote, it will generally support management proposals seeking shareholder approval of a lower quorum requirement if the reduced quorum is at least one-third of shares entitled to vote, either in person or by proxy, considering specified factors.
- **Excise Tax Gross-Ups—**Under a new policy, Glass Lewis will consider recommending against the say-on-pay proposal and compensation committee members when new excise tax gross-up provisions are adopted in executive employment agreements, particularly if the company had committed not to provide any such entitlements in the future.
- **Contractual Payments and Arrangements—**Glass Lewis specified certain contractual terms relating to executive compensation that may contribute to a negative voting recommendation on a say-on-pay proposal, including, among others, excessive sign-on awards and multiyear guaranteed bonuses.
- **Materially Decreased Executive Compensation Disclosure for Smaller Reporting Companies—**Glass Lewis may consider recommending against compensation committee members where materially decreased CD&A disclosure substantially impacts shareholders' ability to make an informed assessment of the company's executive pay practices.
- **Grants of Front-Loaded Awards—**In a new discussion on the grants of front-loaded awards, Glass Lewis noted that it will evaluate such grants with particular scrutiny, taking into account the quantum and design of the awards and the company's rationale for granting such awards.
- **Clawback Provisions—**Where a company maintains a clawback policy that merely meets minimum legal requirements, Glass Lewis clarified that the lack of more robust recoupment tools may inform its overall view of the company's compensation program. Further, if a board has adopted a comprehensive clawback policy that provides sufficient protections against financial and reputational harm, Glass Lewis will generally not support a shareholder proposal seeking amendment of that policy.

A more comprehensive discussion of the policy updates follows.

Governance-Related Policy Updates[2]

Board Gender Diversity

ISS: In 2019, boards with no female directors will receive a notation in their proxy research reports, but ISS will not issue negative vote recommendations against directors on the basis of a lack of gender diversity on the board. **Beginning in 2020, where a board has no female directors, ISS will generally recommend voting against the nominating committee chair**

[2] Glass Lewis also added new policies for 2019 applicable to OTC-listed companies and business development companies that are beyond the scope of this post.

and potentially other directors responsible for director nominations (e.g., at companies with no formal nominating committee), on a case-by-case basis.

The new policy will apply to companies in either the Russell 3000 or S&P 1500 indices. ISS will also consider on a case-by-case basis any exceptional circumstances that may temporarily explain or excuse the lack of board gender diversity. Mitigating factors include:

- A firm commitment in the proxy statement to appoint at least one female to the board in the near term ("near term" is not defined);
- The presence of a female on the board at the preceding annual meeting; or
- Other relevant factors as applicable.

In ISS' 2018 Governance Principles Survey, only 3% of investor respondents replied that they do not consider the lack of female directors on a public company board to be problematic (down from 8% in 2017).[3] ISS noted that board gender diversity is linked to better financial performance and that the presence of at least one female director has become "the market norm."

During the one-year grace period, boards should reevaluate their composition and consider adding qualified female directors. At a minimum, companies with no female directors should consider how best to disclose either a plan to increase gender diversity on the board or their rationale for not having any female directors.

Glass Lewis: As announced in November 2017, **beginning in 2019, where a board has no female directors, Glass Lewis will generally recommend voting against the nominating committee chair. Depending on factors such as the company's size, industry and governance profile, Glass Lewis may also recommend voting against other nominating committee members.**

Glass Lewis will assess a company's disclosure of diversity considerations and may refrain from issuing negative vote recommendations (i) if a company is outside of the Russell 3000 Index or (ii) when a board has provided a sufficient rationale for not having any female directors. This rationale may include, but is not limited to, a disclosed timetable for addressing the lack of diversity on the board and any notable restrictions affecting the board's composition (e.g., director nomination agreements with significant investors).

In light of a new California law enacted in September 2018 requiring all corporations headquartered in California to have at least one female director by the end of 2019, **in 2019, if a company headquartered in California does not have at least one female director, Glass Lewis will generally recommend voting against the nominating committee chair unless the company has disclosed a clear plan for addressing the issue by the end of 2019.**

Management Proposals to Ratify Existing Charter or Bylaw Provisions

ISS: **Under a new policy, ISS will generally recommend voting against management proposals to ratify provisions of the company's existing charter or bylaws, unless such provisions align with best practice. Further, ISS will recommend voting against or**

[3] ISS, *2018 Governance Principles Survey, Summary of Results* (Sep. 18, 2018), available here.

withholding from individual directors, members of the governance committee or the full board, where boards ask shareholders to ratify existing charter or bylaw provisions considering the following factors:

- The presence of a shareholder proposal addressing the same issue on the same ballot;
- The board's rationale for seeking ratification;
- Disclosure of actions to be taken by the board should the ratification proposal fail;
- Disclosure of shareholder engagement regarding the board's ratification request;
- The level of impairment to shareholders' rights caused by the existing provision;
- The history of management and shareholder proposals on the provision at the company's past meetings;
- Whether the current provision was adopted in response to the shareholder proposal;
- The company's ownership structure; and
- Previous use of ratification proposals to exclude shareholder proposals.

These policy updates signify steps ISS is taking to discourage the practice of management seeking to ratify certain existing shareholder rights in order to block a shareholder proposal that seeks more favorable shareholder rights. ISS noted that in 2018 the SEC Staff permitted seven companies to exclude special meeting shareholder proposals where management put forth a "conflicting" proposal seeking ratification of the existing special meeting right provision.

Finally, under a revised policy, if a management proposal to ratify existing charter or bylaw provisions fails to receive majority support, ISS will conduct a board responsiveness analysis at the next annual meeting, considering specified factors.

Currently, the board responsiveness analysis is only triggered if the board fails to act on a shareholder proposal that received the support of a majority of the shares cast in the previous year.

<u>Glass Lewis</u>: **Under a new policy, where a company has excluded a special meeting shareholder proposal in favor of a management proposal ratifying an existing special meeting right that is materially different from the shareholder proposal, Glass Lewis will typically recommend voting against the management ratification proposal <u>and</u> against the governance committee chair**.

Further, where the SEC has allowed a company to exclude a shareholder proposal and Glass Lewis believes that the exclusion was detrimental to shareholders, Glass Lewis may, in very limited circumstances, issue negative vote recommendations against governance committee members.

In the discussion of this new policy, Glass Lewis acknowledged that "certain shareholder proposals can unduly burden companies" but explained the need for the policy by referencing the "dynamic nature of the considerations given by the SEC when determining whether companies may exclude certain shareholder proposals."

Conflicting Special Meeting Proposals

<u>ISS</u>: No change.

Glass Lewis: Glass Lewis will generally recommend voting for management or shareholders proposals seeking a special meeting right that falls within the 10-15% range. **Where there are both management and shareholder proposals requesting different thresholds for the right to call a special meeting, Glass Lewis will generally recommend voting for the lower threshold (typically the shareholder proposal) and recommend voting against the higher threshold.**

Where there are conflicting management and shareholder special meeting proposals and the company does not currently maintain a special meeting right, Glass Lewis may consider recommending that shareholders vote for the shareholder proposal and abstain from voting on management's proposal.

Chronic Poor Attendance

ISS: **In cases of "chronic poor attendance" by a director (defined as three or more consecutive years of poor attendance without reasonable explanation), in addition to recommending votes against the director(s) with chronic poor attendance, ISS will generally vote against or withhold from appropriate members of the nominating/governance committee or the full board.**

Under current policy, ISS will generally issue negative vote recommendations against directors (except new nominees) who attend less than 75% of the aggregate of their board and committee meetings for the period in which they served unless an acceptable reason is disclosed. The new policy codifies the approach ISS has taken when reviewing instances of chronic poor attendance by directors on a case-by-case basis. ISS may also apply this approach where there is a long-term pattern of absenteeism, such as poor attendance the previous year and three out of the past four years.

Under the updated policy, if a director has chronic poor attendance without reasonable justification:

- **After three years, ISS will issue a negative vote recommendation against the nominating/governance committee chair;**
- **After four years, ISS will issue negative vote recommendations against the full nominating/governance committee; and**
- **After five years, ISS will issue negative vote recommendations against all nominees.**

Glass Lewis: No change.

Director Performance Evaluation

SS: ISS' policy on evaluating director performance is triggered when a board lacks mechanisms to promote accountability and oversight, coupled with sustained poor performance relative to peers. Under the current policy, sustained poor performance is measured by 1 and 3 year total shareholder returns (TSR) in the bottom half of a Russell 3000 company's 4-digit GICS industry group. If ISS detects sustained poor performance, it then considers the company's 5-year TSR and operational metrics. **Under a revised policy, when evaluating director performance, ISS**

will assess a company's 5-year TSR as part of the initial screen for underperformance (along with the existing 1 and 3 year screens) rather than during the second step of the evaluation.

Glass Lewis: When making voting recommendations on directors based on company performance, **Glass Lewis clarified that, in addition to the company's stock price performance, it will consider the company's overall corporate governance, pay-for-performance alignment and responsiveness to shareholders**. Previously Glass Lewis' recommendation was based solely on stock price performance in the bottom quartile of the company's sector for the last three years.

Reverse Stock Splits

ISS: Currently, ISS will recommend in favor of management proposals to implement a reverse stock split when the number of authorized shares will be proportionately reduced. **Under a revised policy, ISS clarified that it will also support such proposals if the effective increase in authorized shares is equal to or less than the allowable increase calculated in accordance with ISS' Common Stock Authorization policy. Also under the revised policy, ISS will evaluate on a case-by-case basis certain management proposals to implement reverse stock splits (e.g., by companies that are not listed on a major stock exchange), taking into consideration (i) disclosure of substantial doubt about the company's ability to continue as a going concern without additional financing, (ii) the company's rationale or (iii) other factors as applicable**.

Glass Lewis: No change.

E&S Risk Oversight

ISS: No change.

Glass Lewis: Glass Lewis believes that companies should have an appropriate board structure in place to monitor and manage material risks related to E&S issues. For large cap companies and where Glass Lewis identifies material oversight issues, Glass Lewis will review a company's overall governance practices and identify which directors or board-level committees have been charged with oversight of environmental and/or social issues. Glass Lewis will also note instances where companies have not clearly defined such oversight in their governance documents. In 2018, Glass Lewis began identifying in its proxy research reports the directors assigned with specific oversight of E&S issues at the committee level.

Where it is clear that companies have not properly managed or mitigated environmental or social risks to the detriment of shareholder value, or when such mismanagement has threatened shareholder value, Glass Lewis may consider issuing negative vote recommendations against directors responsible for oversight of environmental and social risks. If the company's governance documents do not specify which directors are responsible for overseeing environmental and social risk, Glass Lewis may issue negative vote recommendations against audit committee members. In making these determinations, Glass Lewis will carefully review the situation, its effect on shareholder value, as well as any corrective action or other response made by the company.

Shareholder Proposals on E&S Issues

ISS: **Under a revised policy, ISS expanded the factors it will consider when analyzing environmental and social (E&S) shareholder proposals to include whether there are significant controversies, fines, penalties or litigation associated with the company's environmental or social practices**. This update codifies factors ISS already takes into consideration.

Glass Lewis: **When evaluating E&S shareholder proposals, Glass Lewis will place significant emphasis on the financial implications of a company adopting, or not adopting, the proposal.** Glass Lewis will consider the standards developed by the Sustainability Accounting Standards Board (SASB) when determining financial materiality.

Written Consent Shareholder Proposals

ISS: No change.

Glass Lewis: Glass Lewis has revised its policy concerning shareholder proposals requesting that companies allow shareholders the right to action by written consent. **If a company has adopted a special meeting right of 15% or below and has adopted reasonable proxy access provisions (but does not specify what qualifies as "reasonable"), Glass Lewis will generally recommend voting against shareholder proposals asking companies to provide shareholders with the right to action by written consent**. Glass Lewis believes that special meetings are preferable to action by written consent because they provide more protection for minority shareholders and better ensure that management is able to respond to shareholder concerns.

Shareholder Proposals on Diversity Reporting **ISS**: No change.

Glass Lewis: Glass Lewis believes that companies should provide shareholders with adequate information to be able to assess the management and mitigation of any risks relating to human capital. **Accordingly, Glass Lewis will generally recommend in favor of shareholder proposals requesting that companies provide enhanced disclosure on the diversity of their workforce or details about actions taken to promote diversity within their workforce**. When making these recommendations, Glass Lewis will consider:

- The industry in which the company operates and the nature of its operations;
- The company's current level of disclosure on issues related to workforce diversity;
- The level of such disclosure at the company's peers; and
- Any lawsuits or accusations of discrimination within the company.

Auditor Ratification Proposals

ISS: No change.

Glass Lewis: **Glass Lewis expanded the factors it will consider when evaluating auditor ratification proposals to include (i) the auditor's tenure, (ii) a pattern of inaccurate audits, and (iii) any ongoing litigation or significant controversies, which may call into question**

an auditor's effectiveness. In limited cases, these factors may cause Glass Lewis to recommend voting against the proposal.

Glass Lewis also supplemented the discussion of auditor ratification in its guidelines to reflect updated disclosure standards relating to expanded auditor reports and communication of critical audit matters.

Virtual-Only Shareholder Meetings

ISS: No change.

Glass Lewis: As announced in November 2017, **beginning in 2019, Glass Lewis will generally recommend voting against governance committee members where the board plans to hold a virtual-only shareholder meeting and the company does not provide disclosure that assures shareholders that they will be afforded the same rights and opportunities to participate as they would at an in-person meeting**.

Glass Lewis provided the following examples of "effective disclosure" about shareholder participation rights at a virtual-only shareholder meeting:

- Addressing the ability of shareholders to ask questions during the meeting, including time guidelines for shareholder questions, rules around what types of questions are allowed, and rules for how questions and comments will be recognized and disclosed to meeting participants;
- Procedures, if any, for posting appropriate questions received during the meeting, and the company's answers, on the investor page of the company's website as soon as practical after the meeting;
- Addressing technical and logistical issues related to accessing the virtual meeting platform; and
- Procedures for accessing technical support to assist in the event of any difficulties accessing the virtual meeting.

This policy is another data point for companies to consider when evaluating the pros and cons of moving to or continuing to hold virtual-only shareholder meetings. Companies that have determined to hold virtual-only shareholder meetings should review their meeting processes and consider including detailed disclosure about how shareholders will be able to participate in the meeting to try to avoid negative vote recommendations from Glass Lewis.

Director and Officer Indemnification

ISS: No change.

Glass Lewis: In a new discussion about director and officer indemnification, **Glass Lewis explicitly stated its belief that it is appropriate for a company to provide indemnification and/or maintain liability insurance to cover its directors and officers so long as the terms of such agreements are reasonable.**

NOL Protective Amendments

ISS: No change.

Glass Lewis: When proposing the adoption of a NOL poison pill (i.e., a rights plan adopted for the purpose of preserving NOLs), a company will often concurrently propose the adoption of bylaw amendments specifically restricting certain share transfers in order to protect the company's deferred tax assets. Previously Glass Lewis would support adoption of the NOL poison pill and oppose the protective bylaw amendments. **Glass Lewis revised its policy on NOL poison pills to clarify that, in such cases, if it supports the terms of a particular NOL poison pill, it will generally support the protective bylaw amendments in the absence of significant concerns with the specific terms of the proposal.**

Quorum Requirements

ISS: No change.

Glass Lewis: In a new discussion about quorum requirements, Glass Lewis expressed its general belief that a majority of outstanding shares entitled to vote is an appropriate quorum requirement for the transaction of business at shareholder meetings. **Glass Lewis added that it will generally support management proposals seeking shareholder approval of a lower quorum requirement if the reduced quorum is at least one-third of shares entitled to vote, either in person or by proxy**. When evaluating such proposals, Glass Lewis will also consider the company's specific facts and circumstances, such as size and shareholder base.

Compensation-Related Policy Updates

In addition to the updates summarized below, ISS (i) clarified its pay-for-performance model and how peer groups contribute to recommendations, (ii) described its expectations for enhanced disclosure when the board uses discretion in determining bonuses and (iii) explained in greater detail the rating scale it uses when assessing the structure and disclosure of compensation programs.

ISS issued preliminary FAQs on U.S. compensation policies for 2019 on November 21, 2018 and will provide additional details about compensation-related policy updates in FAQs to be published in December 2018. In the preliminary FAQs, ISS announced changes to its Equity Plan Scorecard methodology for 2019. First, ISS is introducing a new "overriding" factor that will be triggered if a company's equity compensation program is estimated to dilute shareholders' holdings by more than 20% (S&P 500 companies) or 25% (Russell 3000 companies). Second, ISS is updating the change in control (CIC) vesting factor to provide points based on the quality of disclosure of CIC vesting provisions rather than the actual vesting treatment. Full points will be earned if the equity plan specifically discloses the CIC vesting treatment for both performance- and time-based awards. No points will be earned if the plan is silent—or provides for merely discretionary vesting—for either type of award.

Use of EVA Data in Financial Performance Assessment Screen

ISS: **In 2019, ISS will include on a phased-in basis EVA data in its proxy research reports as a supplement to GAAP/accounting performance measures to provide additional insight into company performance for purposes of ISS' pay-for-performance evaluation. There will**

be no methodology change for 2019; the EVA data will be featured solely for information purposes.

ISS will continue to explore the potential future use of EVA data as part of the financial performance assessment screen of its quantitative pay-for-performance evaluation.

Glass Lewis: No change.

Excise Tax Gross-Ups

ISS: No change.

Glass Lewis: Glass Lewis is strongly opposed to excise tax gross-ups and believes that the inclusion of excise tax gross-up provisions in new or amended agreements is unacceptable. **Under a new policy, Glass Lewis will consider recommending against the say-on-pay proposal and compensation committee members when new excise tax gross-up provisions are adopted in executive employment agreements, particularly if the company had committed not to provide any such entitlements in the future**.

Contractual Payments and Arrangements

ISS: No change.

Glass Lewis: **Glass Lewis specified certain contractual terms relating to executive compensation that may contribute to a negative voting recommendation on a say-on-pay proposal, including:**

- **Excessive sign-on awards;**
- **Multiyear guaranteed bonuses; and**
- **Executive employment terms such as key man clauses, board continuity conditions, excessively broad change in control triggers and poor wording of employment agreements.**

When evaluating severance and sign-on arrangements, Glass Lewis will consider general U.S. market practices and the size and design of entitlements. Glass Lewis noted the following:

- It believes companies should abide by predetermined severance payouts in most circumstances;
- It believes the basis and total value of severance should be reasonable and not exceed the upper limit of general market practice (most commonly Glass Lewis sees multiples of salary and/or bonus of three or less);
- It considers the inclusion of long-term incentives in the cash severance calculations to be inappropriate; and
- It will consider severance sums actually paid to departing executives and, in special cases, their appropriateness under the circumstances.

Materially Decreased Executive Compensation Disclosure for Smaller Reporting Companies

ISS: No change.

Glass Lewis: When analyzing the performance of compensation committee members, **Glass Lewis will consider the impact of materially decreased proxy statement disclosure regarding executive compensation policies and procedures and may consider recommending against compensation committee members where a reduction in disclosure substantially impacts shareholders' ability to make an informed assessment of the company's executive pay practices**.

The impetus for the new policy is that the SEC amended the definition of "smaller reporting company" (SRC) effective in September 2018. The new definition enables a company to qualify as an SRC if (i) it has less than $250 million of public float (increased from $75 million), or (ii) it has (a) no public float or a public float that is less than $700 million and (b) less than $100 million in annual revenues.

The amended definition significantly expands the number of companies that are eligible to qualify as an SRC and take advantage of the related scaled disclosure requirements. For SRCs, the summary compensation table is only required to disclose two (rather than three) years of information covering the principal executive officer and two additional executive officers (rather than the principal executive officer, principal financial officer and three additional executive officers). Further, SRCs are not required to provide a CD&A or tables detailing grants of plan-based awards, vesting or exercise of equity awards or a quantification of termination payments.

Grants of Front-Loaded Awards

ISS: No change.

Glass Lewis: In a new discussion about grants of front-loaded awards (i.e., large grants that are intended to serve as compensation for multiple years), **Glass Lewis noted that it will evaluate grants of front-loaded awards with particular scrutiny, taking into account the quantum and design of the awards and the company's rationale for granting such awards**.

Glass Lewis believes that provisions around change of control or separations of service must ensure that executives do not receive excessive payouts that do not reflect shareholder experience or company performance.

Glass Lewis expects any front-loaded awards to include a firm commitment not to grant additional awards for a defined period. If a company violates its commitment not to grant further awards, Glass Lewis may recommend voting against the pay program unless the company provides a compelling rationale.

In analyzing the grant of front-loaded awards to executives, Glass Lewis will consider the quantum of the award on an annualized basis (as opposed to the lump sum) and as compared to past practice and peer data, among other benchmarks.

Clawback Provisions

ISS: No change.

Glass Lewis: Glass Lewis broadened its policy on clawback provisions now that its focus has shifted from (i) whether a company maintains a clawback policy that satisfies minimum legal requirements to (ii) the specific terms of clawback policies.

Even though the SEC has not finalized the Dodd-Frank clawback rules which are more stringent than the Sarbanes-Oxley clawback rules, Glass Lewis revised its policy to make clear that it expects boards to adopt detailed bonus recoupment policies that go beyond the Sarbanes-Oxley requirements to prevent executives from retaining performance-based awards that were not truly earned. Glass Lewis believes that clawbacks should be triggered, at a minimum, in the event of a reinstatement of financial results or similar revision of performance indicators upon which bonuses were based. **Where a company maintains only a bare-minimum clawback policy, Glass Lewis clarified that the lack of more robust recoupment tools may inform its overall view of the company's compensation program**.

Further, **Glass Lewis made clear that if a board has adopted a comprehensive clawback policy, it will generally not support a shareholder proposal seeking amendment of that policy**. However, Glass Lewis may consider supporting a shareholder proposal seeking to expand a company's clawback policy if Glass Lewis believes the company has not adopted a clawback policy that provides sufficient protections against financial and reputational harm for the company.

Excessive Non-Employee Director Compensation

ISS: In 2019, ISS will not issue negative vote recommendations against members of the board committee responsible for setting or approving excessive non-employee director compensation in two or more consecutive years without a compelling rationale or other mitigating factors. ISS will delay implementation of this policy until at least 2020 because it is still developing its methodology for identifying non-employee director pay outliers for purposes of the policy. ISS will provide details on the revised methodology in the compensation-related FAQs to be published in December 2018.

Glass Lewis: No change.

Guidance in Preparing for the 2019 Proxy Season

Key Dates	
Until December 7, 2018	Companies with annual meetings scheduled to be held between February 1 and September 15, 2019 may notify ISS of any changes to their self-selected peer companies for purposes of benchmarking 2018 CEO compensation
December 7, 2018	Publication of full set of ISS proxy voting guidelines for 2019

December 31, 2018[4]	Publication of: • ISS FAQs on U.S. proxy voting policies and procedures • ISS FAQs on U.S. executive compensation policies and equity compensation plans (including the setting of annual burn rate thresholds and pay-for-performance quantitative concern thresholds)
December 31, 2018	Companies in the Russell 3000 Index may submit updates to their peer groups on file with Equilar, which Glass Lewis uses to generate peer groups used in formulating its voting recommendations
January 1, 2019	Updated 2019 Glass Lewis policies take effect for meetings that occur on or after this date
January 2019	ISS will evaluate new shareholder proposals received by U.S. companies and make any necessary updates to its proxy voting guidelines for 2019
January 31, 2019	Deadline for S&P 500 companies holding meetings between March 1 and June 30, 2019 to elect to receive draft proxy voting reports by registering contact details with ISS
February 1, 2019	Updated 2019 ISS policies take effect for meetings that occur on or after this date

Companies may wish to review and become familiar with the various circumstances in which ISS and Glass Lewis may recommend a negative vote in uncontested director elections (set forth in the Appendix of the complete publication, available here) or on other proposals that may be included in their proxy statements. Companies may also wish to contact their analysts at ISS shortly after filing the proxy statement to discuss any issues that could potentially trigger a negative vote recommendation. Companies may engage with Glass Lewis outside of the proxy solicitation period and outside of proxy season.

In addition to the steps discussed above, we recommend that companies:

- Provide updates, if any, to self-selected compensation peer groups.
    - If the company (i) is in the Russell 3000 or Russell MicroCap Index, (ii) has an annual meeting scheduled to be held between February 1 and September 15, 2019 and (iii) made changes to its peer group used to set compensation for the fiscal year that will be disclosed in the next proxy statement (i.e., for 2018 compensation decisions), notify ISS of updates to its self-selected peer companies for purposes of CEO compensation benchmarking by **December 7, 2018.**

[4] In the *Executive Summary of 2019 Global Proxy Voting Guidelines Updates and Process*, ISS indicates that updated FAQs will be published on ISS' website on December 31, 2018 but in the *U.S. Compensation Policies for 2019 – Preliminary Frequently Asked Questions*, ISS indicates that the compensation-related FAQs will be published in mid-December 2018.

- A company's self-selected compensation peer companies are a key input to ISS' peer selection process. However, ISS makes clear in its Peer Group Selection Methodology FAQs [5] that there are instances in which a company's self-selected peer may not appear in the ISS peer group, such as when it does not meet the applicable size constraints or inclusion would lead to an overrepresentation of a particular industry within the ISS peer group.

- Companies should take advantage of the opportunity to indicate any changes to their self-selected compensation peer groups since the fiscal year covered by ISS' last report. Companies can submit peer company updates using the Governance Analytics platform, information about which is available here. If a company does not provide an updated peer group to ISS, the previously collected peer group will be used to determine ISS' peers for the company's 2019 report.
  - ISS will conduct a separate peer submission process in mid-2019 for companies with annual meetings scheduled to be held after September 15, 2019.
- For its pay-for-performance analysis, Glass Lewis uses the top 15 peers from a peer group generated by Equilar based on a company's self-disclosed peer group and the strength of connection between peer companies (i.e., one-way vs. reciprocal connections). Equilar updates its market-based peers twice yearly—in January and June. Companies in the Russell 3000 Index that plan on filing an updated peer group in their 2019 proxy statements may submit updates to their peer groups on file with Equilar by **December 31, 2018** using the form available here.
  - Verify data used by the proxy advisory firms in developing their reports.
- Glass Lewis allows companies to review an Issuer Data Report (IDR) comprising the key data points it uses in developing its report on the company's annual meeting. IDRs do not contain Glass Lewis' analysis or voting recommendations. IDRs are distributed by email to participating companies approximately 3-4 weeks prior to the annual meeting (although sometimes as close as 16 days prior), and companies generally have 48 hours (or 24 hours, in limited circumstances) to review the IDR and suggest corrections, with supporting public documentation; the review time may be over a weekend. Glass Lewis will only issue IDRs for companies that have released all proxy materials no less than 30 days before the annual meeting date. If a company was a participant in the 2018 IDR program, Glass Lewis will automatically notify it when the 2019 sign-up period begins. For more information, see the Glass Lewis Issuer Data Report website, which includes a link for companies to request an email notification that is typically sent 1-7 business days in advance of when an IDR is available for review.
  - Carefully review draft "preview" and/or final proxy voting reports relating to the company—with input from outside counsel and compensation consultants, as appropriate—and notify the relevant proxy advisory firm of any errors as soon as possible.

[5] ISS, *U.S. Peer Group Selection Methodology and Issuer Submission Process –Frequently Asked Questions* (Nov. 9, 2017), available here.

- S&P 500 companies that have registered with ISS to receive draft reports have a very narrow timeframe in which to correct any data errors or to otherwise engage with ISS on any issues; companies that are not in the S&P 500 generally do not receive access to draft reports.
    - S&P 500 companies may participate in the voting recommendation preview process by registering contact details with ISS using the Contact Information Form available here before ISS' deadline, which is **January 31, 2019** for meetings held between March 1 and June 30, 2019; for meetings outside of this timeframe contact information must be provided at least 35 days prior to the meeting. Companies that received and responded to a draft in the previous year need not register again, but may update their list of contacts if needed.
    - Draft reports (which do not include a company's QualityScores) are typically sent approximately 2-4 weeks prior to the annual meeting, and will likely be closer to 2 weeks during the height of proxy season.
    - All comments and corrections are due in writing by the deadline specified in the cover letter accompanying the draft report, generally within 1-2 business days.
- Companies may report a data discrepancy in a Glass Lewis report through the "Report an Error or Omission" page on Glass Lewis' website; because Glass Lewis bases its analysis entirely on publicly available information, a company must precisely identify where within the company's public disclosure Glass Lewis can find and verify the correct information with which to revise its report.
    - Review the composition of the board and the company's corporate governance and compensation practices for potential vulnerabilities under ISS and Glass Lewis policy updates (for example, in relation to board gender diversity or virtual-only shareholder meetings) and decide what action, if any, to take in light of this assessment.
    - Develop outreach tactics to engage with key institutional investors on governance-related matters, especially if the company had a majority-supported shareholder proposal at its last annual meeting that has not been implemented, and/or relatively low support for "say-on-pay" (less than 70% of votes cast for ISS and below 80% for Glass Lewis).
    - Review corporate governance and compensation disclosure included in last year's proxy statement, and make improvements where appropriate.

The complete publication, including Appendix, is available here.

Tab III: Social Responsibility

Purpose & Profit

Posted by Larry Fink, BlackRock, Inc., on Wednesday, January 23, 2019

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

Dear CEO,

Each year, I write to the companies in which BlackRock invests on behalf of our clients, the majority of whom have decades-long horizons and are planning for retirement. As a fiduciary to these clients, who are the owners of your company, we advocate for practices that we believe will drive sustainable, long-term growth and profitability. As we enter 2019, commitment to a long-term approach is more important than ever—the global landscape is increasingly fragile and, as a result, susceptible to short-term behavior by corporations and governments alike.

Market uncertainty is pervasive, and confidence is deteriorating. Many see increased risk of a cyclical downturn. Around the world, frustration with years of stagnant wages, the effect of technology on jobs, and uncertainty about the future have fueled popular anger, nationalism, and xenophobia. In response, some of the world's leading democracies have descended into wrenching political dysfunction, which has exacerbated, rather than quelled, this public frustration. Trust in multilateralism and official institutions is crumbling.

Unnerved by fundamental economic changes and the failure of government to provide lasting solutions, society is increasingly looking to companies, both public and private, to address pressing social and economic issues. These issues range from protecting the environment to retirement to gender and racial inequality, among others. Fueled in part by social media, public pressures on corporations build faster and reach further than ever before. In addition to these pressures, companies must navigate the complexities of a late-cycle financial environment—including increased volatility—which can create incentives to maximize short-term returns at the expense of long-term growth.

Purpose and Profit: An Inextricable Link

I wrote last year that every company needs a framework to navigate this difficult landscape, and that it must begin with a clear embodiment of your company's purpose in your business model and corporate strategy. Purpose is not a mere tagline or marketing campaign; it is a company's fundamental reason for being—what it does every day to create value for its stakeholders. **Purpose is not the sole pursuit of profits but the animating force for achieving them.**

Profits are in no way inconsistent with purpose—in fact, profits and purpose are inextricably linked. Profits are essential if a company is to effectively serve all of its stakeholders over time—not only shareholders, but also employees, customers, and communities. Similarly, when a company truly understands and expresses its purpose, it functions with the focus and strategic discipline that drive long-term profitability. Purpose unifies management, employees, and communities. It drives ethical behavior and creates an essential check on actions that go against the best interests of stakeholders. Purpose guides culture, provides a framework for consistent decision-making, and, ultimately, helps sustain long-term financial returns for the shareholders of your company.

The World Needs Your Leadership

As a CEO myself, I feel firsthand the pressures companies face in today's polarized environment and the challenges of navigating them. Stakeholders are pushing companies to wade into sensitive social and political issues—especially as they see governments failing to do so effectively. As CEOs, we don't always get it right. And what is appropriate for one company may not be for another.

One thing, however, is certain: the world needs your leadership. As divisions continue to deepen, companies must demonstrate their commitment to the countries, regions, and communities where they operate, particularly on issues central to the world's future prosperity. Companies cannot solve every issue of public importance, but there are many—from retirement to infrastructure to preparing workers for the jobs of the future—that cannot be solved without corporate leadership.

Retirement, in particular, is an area where companies must reestablish their traditional leadership role. For much of the 20th Century, it was an element of the social compact in many countries that employers had a responsibility to help workers navigate retirement. In some countries, particularly the United States, the shift to defined contribution plans changed the structure of that responsibility, leaving too many workers unprepared. And nearly all countries are confronting greater longevity and how to pay for it. This lack of preparedness for retirement is fueling enormous anxiety and fear, undermining productivity in the workplace and amplifying populism in the political sphere.

In response, companies must embrace a greater responsibility to help workers navigate retirement, lending their expertise and capacity for innovation to solve this immense global challenge. In doing so, companies will create not just a more stable and engaged workforce, but also a more economically secure population in the places where they operate.

A New Generation's Focus on Purpose

Companies that fulfill their purpose and responsibilities to stakeholders reap rewards over the long-term. Companies that ignore them stumble and fail. This dynamic is becoming increasingly apparent as the public holds companies to more exacting standards. And it will continue to accelerate as millennials—who today represent 35 percent of the workforce—express new expectations of the companies they work for, buy from, and invest in.

Attracting and retaining the best talent increasingly requires a clear expression of purpose. With unemployment improving across the globe, workers, not just shareholders, can and will have a greater say in defining a company's purpose, priorities, and even the specifics of its business. Over the past year, we have seen some of the world's most skilled employees stage walkouts and participate in contentious town halls, expressing their perspective on the importance of corporate purpose. This phenomenon will only grow as millennials and even younger generations occupy increasingly senior positions in business. In a recent survey by Deloitte, millennial workers were asked what the primary purpose of businesses should be—63 percent more of them said "improving society" than said "generating profit."

In the years to come, the sentiments of these generations will drive not only their decisions as employees but also as investors, with the world undergoing the largest transfer of wealth in history: $24 trillion from baby boomers to millennials. As wealth shifts and investing preferences change, environmental, social, and governance issues will be increasingly material to corporate valuations. This is one of the reasons why BlackRock devotes considerable resources to improving the data and analytics for measuring these factors, integrates them across our entire investment platform, and engages with the companies in which we invest on behalf of our clients to better understand your approach to them.

BlackRock's Engagement in 2019

BlackRock's Investment Stewardship engagement priorities for 2019 are: governance, including your company's approach to board diversity; corporate strategy and capital allocation; compensation that promotes long-termism; environmental risks and opportunities; and human capital management. These priorities reflect our commitment to engaging around issues that influence a company's prospects not over the next quarter, but over the long horizons that our clients are planning for.

In these engagements, we do not focus on your day-to-day operations, but instead seek to understand your strategy for achieving long-term growth. And as I said last year, for engagements to be productive, they cannot occur only during proxy season when the discussion is about an up-or-down vote on proxy proposals. The best outcomes come from a robust, year-round dialogue.

We recognize that companies must often make difficult decisions in the service of larger strategic objectives—for example, whether to pursue certain business lines or markets as stakeholder expectations evolve, or, at times, whether the shape of the company's workforce needs to change. BlackRock itself, after several years of growing our workforce by 7 percent annually, recently made reductions in order to enable reinvestment in talent and growth over the long term. Clarity of purpose helps companies more effectively make these strategic pivots in the service of long-run goals.

Over the past year, our Investment Stewardship team has begun to speak to companies about corporate purpose and how it aligns with culture and corporate strategy, and we have been encouraged by the commitment of companies to engaging with us on this issue. We have no intention of telling companies what their purpose should be—that is the role of your management team and your board of directors. Rather, we seek to understand how a company's purpose informs its strategy and culture to underpin sustainable financial performance. Details on our approach to engaging on these issues can be found at BlackRock.com/purpose.

I remain optimistic about the world's future and the prospects for investors and companies taking a long-term approach. Our clients depend on that patient approach in order to achieve their most important financial goals. And in turn, the world depends on you to embrace and advocate for a long-term approach in business. At a time of great political and economic disruption, your leadership is indispensable.

Sincerely,

Larry Fink

STATE STREET GLOBAL ADVISORS

January 15, 2019

Dear Board Member,

As one of the world's largest investment managers, we engage with companies in our investment portfolios as part of our fiduciary responsibility to maximize the probability of attractive long-term returns for our clients. Unlike our active investment strategies where we can sell a company's stock when we disagree with management, in our index-based strategies we own the company's stock for as long as it is included in the index. Therefore we engage as long-term investors through our asset stewardship practice on those issues that impact long-term value.

Our focus in recent years has been on good governance and other practices that affect a company's ability to generate positive returns for investors over the long run. Those issues span a variety of environmental, social and governance (ESG) topics material to sustainable performance. We approach these issues from the perspective of long-term investment **value**, not from a political or social agenda (aka 'values'). This distinction is especially important to understand in light of growing concerns about the influence of large index managers. It is the focus on long-term **value** that drives our engagement around effective, independent board leadership; board quality, including cognitive diversity enhanced by better gender diversity; and environmental sustainability.

We also believe in the importance of full transparency in terms of the issues we choose to highlight in our asset stewardship practice, why we consider them important for investors and how we suggest companies address them. We regularly publish our views on important stewardship issues, join forces with other institutional investors to document best practices, and summarize our engagements and voting actions in our annual stewardship report. We also take the opportunity each year ahead of proxy season to communicate our stewardship focus for the coming months, which is why I am writing to you today.

This year we will be focusing on **corporate culture** as one of the many, growing intangible value drivers that affect a company's ability to execute its long-term strategy. We acknowledge that corporate culture, like many other intangible assets, is difficult to measure and manage. However, we also recognize that at a time of unprecedented business disruptions, whether in the form of technology, climate or other exogenous shocks, a company's ability to promote the attitudes and behaviors needed to navigate a much more challenging business terrain will be increasingly important. We all know the old chestnut that culture eats strategy for breakfast, but studies show that intangibles such as corporate culture are driving a greater share of corporate value, precisely because the challenges of change and innovation are growing more acute.

The Importance of Corporate Culture

The global accounting firm EY recently found that "intangible assets" such as culture average 52% of an organization's market value (and in some sectors as much as 90%). Researchers have documented that in the US and UK now, more value is driven by intangible, rather than tangible, assets.[1] However, through engagement we have found that few directors can adequately articulate their company's culture or demonstrate how they assess, monitor and influence change when necessary.

Investors and regulators are paying attention as well, as flawed corporate culture has resulted in high-profile cases of excessive risk-taking or unethical behaviors that negatively impact long-term performance. The Embankment Project for Inclusive Capitalism, which we participated in, found that key issues aligned to corporate culture, such as human capital management; represent important areas for value creation going forward. However, it also found that the relationship between financials and human capital issues such as retention rates, employee satisfaction, and pay differences is "not yet widely understood" and "much harder to communicate to investors than quarterly earnings."

Indeed, we have found that boards sometimes fail to adequately ensure that the current corporate culture aligns with corporate strategy. This is especially important in times of crisis or strategic change, such as the transition of a CEO or during mergers and acquisitions or strategic turnarounds. These are critical inflection points during which a lack of focus on culture can delay, or even derail important strategic objectives and pose existential challenges for management.

Helping Boards Align Culture and Strategy

Since we recognize both the importance and difficulty of aligning culture and strategy, we have created the attached framework to help companies begin to address the issue by 1) conducting an analysis to determine whether culture and strategy are aligned; 2) implementing mechanisms to influence and assess progress; and 3) improving reporting that can help directors discuss their role in influencing and monitoring corporate culture.

To be clear, we do not believe it is the responsibility of the corporate board to *manage* a company's culture – that is the responsibility of senior management. Nor do we believe changing corporate culture is easy or that there is a one-size-fits-all answer for all companies. Clearly different companies, sectors and business strategies will require different approaches. Further, sometimes indicators such as high employee turnover can actually be a sign that a much-needed cultural change is afoot.

However, we do believe that this is a material issue that must be addressed by companies and investors. By engaging on this topic in a more rigorous and structured way and by elevating these issues to boards, we believe we can help improve the overall governance quality of listed companies over the long term. As such, you should expect to discuss this issue with our asset stewardship team during their engagements over the next year.

[1] Jonathan Haskel and Stian Westlake, *Capitalism Without Capital: The Risk of the Intangible Economy,* (Princeton University Press, 2017).

Focused on the Long Term

Ultimately, better understanding how businesses across the globe are aligning corporate culture with strategy will improve how we analyze our portfolio companies in the years ahead. We believe that at a time of historic disruption, increased focus on corporate culture and how it supports strategy is essential to sustainable, long-term value creation. That is good for investors, good for the quality of the indices on which so many investment portfolios are based, and good for our shared prosperity.

Sincerely,

Cyrus Taraporevala

President and CEO of State Street Global Advisors

Aligning Corporate Culture with Long-Term Strategy

Key Takeaways

- **Corporate culture is critical to the long-term success of a company. When aligned with long-term strategy, corporate culture can help enable organizations to achieve their goals and differentiate them from competitors; when misaligned with long-term strategy, corporate culture can hinder performance.[1,2]**
- **We believe that the board plays an important role in assessing and monitoring corporate culture, and that senior management plays an instrumental role in defining and shaping corporate culture.**
- **Despite the importance of corporate culture, we have found that few directors can adequately articulate a company's culture and demonstrate how they oversee and influence change when necessary; this is partly because corporate culture, as an intangible asset, is difficult to measure.[3]**
- **Based on insights gleaned from years of engagement, we have developed a framework to help guide directors and senior management through this complex process.**
- **We call on boards to proactively review and monitor corporate culture, evaluate its alignment with strategy, and incentivize management to take corrective action, if necessary.**
- **Finally, given growing investor interest in this area, directors and senior management should be prepared to discuss the management of human capital in the context of corporate culture as a driver of long-term value.**

Corporate culture plays a critical role in the long-term success of a company.[4,5] There are many examples in recent years where excessive risk-taking, aggressive sales practices and/or unethical behaviors, which negatively impacted long-term company performance, were attributed to flawed corporate culture.

Senior management plays an instrumental role in defining and shaping corporate culture within an organization. Through our engagement efforts over the past few years, we have explored how corporate culture enables a company's ability to achieve its business goals. We recognize that there is no one-size-fits-all culture. Companies have different business models, strategies and histories and therefore have different cultures. However, we have found that an effective corporate culture is one that is aligned with the company's long-term strategy, reflected in the executive incentive structure and motivational for employees. Consequently, we believe that culture requires due consideration and oversight by the board. Yet, during engagement, we have found that few directors can adequately articulate a company's culture and demonstrate how they assess, monitor and influence change when necessary.[6]

What is Corporate Culture?

Corporate culture encompasses a broad range of shared attitudes shaping the behaviors of individuals as a group across an organization. It allows employees to identify with their organization and differentiates companies from competitors. It is closely associated with human capital management.

Growing Regulatory and Investor Interest in Corporate Culture

In June 2018, the U.K. Financial Reporting Council affirmed the importance of culture by formalizing the board's role in aligning corporate culture with the company's purpose, values and strategy in the revised U.K. Corporate Governance Code.[7] Boards in the U.K. are now expected to assess and monitor culture and seek assurance that management has taken corrective action to fix any misalignment. In October 2017, the National Association of Corporate Directors in the U.S. issued a Blue Ribbon Commission Report on Culture as a Corporate Asset to help guide its members on this matter.[8]

Recognizing the importance of this issue, State Street Global Advisors will focus on corporate culture as a priority engagement topic in 2019. We call on boards to proactively review and monitor corporate culture, evaluate its alignment with strategy, and incentivize management to take corrective action, if necessary.
In this paper we:

- Explain the need for board involvement and oversight of corporate culture
- Provide a framework for companies to evaluate the alignment of corporate culture with its long-term strategy and for directors to guide senior management in its implementation
- Provide examples of some best practices related to culture that we have identified through engagement

The Board's Role in Assessing and Monitoring Corporate Culture

It is important when setting strategy and overseeing its implementation for the board to expand its oversight function to include assessing and monitoring culture. However, we observe that boards sometimes fail to adequately ensure that the current corporate culture matches expectations and is aligned with the company's strategy. This can be particularly true in times of crisis or strategic change, such as the transition of a CEO or during mergers and acquisitions (M&A) or strategic turnarounds. The lack of focus on culture can delay or even derail important strategic objectives and pose unanticipated challenges for management. For example, potential employee turnover and operational impacts associated with changing corporate culture can lead to challenges for management teams trying to implement strategic changes. Even in relatively stable times, culture can shift and fall out of line with strategy undetected if it is not actively monitored.

While senior management plays a more direct and influential role in defining and shaping corporate culture within an organization, board oversight is still needed. Oversight of corporate culture is inherently complicated in that, as an intangible, culture can be difficult to articulate or change. Further, changing corporate culture takes time and is often a multi-year exercise, the results of which are difficult to monitor. This is precisely why boards need to proactively consider culture in the context of strategy. For example, we came across a high-performing company with a strong and distinct culture that has built its brand and strategy to leverage the benefits it perceives from that culture. The board sees it as focusing on what they know the company (and its people) can do well. Given the close interplay between culture and strategy at this company, the board is acutely aware of and seeks to preserve the company's culture.

Engaging on Corporate Culture. When engaging with directors and management on corporate culture, we seek to understand the following:

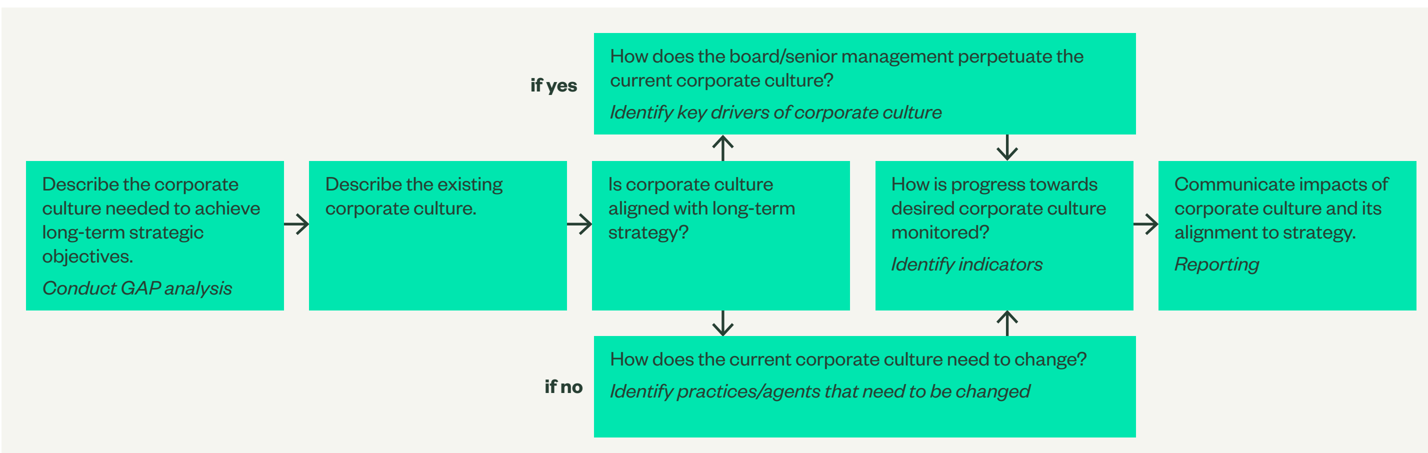
- Can the director(s) articulate the current corporate culture?
- What does the board value about the current culture? What does it see as strengths? How can the corporate culture improve?
- How is senior management influencing or effecting change in the corporate culture?
- How is the board monitoring the progress?

Our questions are aimed at gathering insights into the board's understanding of the behaviors that are inherent to the organization and their assessment of whether these behaviors support or challenge the company's strategy. If changing culture is identified as a key goal, we look to see how the board is monitoring and rewarding the change. We find that directors often understand the value of culture and prioritize changing culture, and in some cases even incorporate it, where appropriate, as a driver of executive compensation.

A Framework for Assessing and Monitoring Corporate Culture

Based on insights gleaned from years of engagement, we have developed a Framework for Assessing and Monitoring Corporate Culture (see Figure 1) that we hope will help guide directors and senior management on this important matter. Under this framework, we suggest that senior management with oversight from the board undertake three key exercises: Comparative Analysis, Implementation and Reporting. In addition, we have also provided examples of how some companies have addressed these issues. Neither this framework nor these examples are meant to be prescriptive; rather they are tools and illustrations to help boards develop their own approach to incorporating culture into long-term strategy.

Figure 1
Framework For Aligning Corporate Culture with Long-Term Strategy



Source: State Street Global Advisors.

Phase 1
Comparative Analysis

As a first step, a company should consider the alignment of the current company culture and long-term strategy by conducting a comparative assessment, such as through a gap analysis. If aligned, identify how to perpetuate the current corporate culture by identifying the key drivers. If misaligned, determine the desired culture and identify the practices or agents that must change. The analysis should contemplate corporate culture in the context of the company's long-term strategy, as meaningful changes may take many years to occur.

For example, the board of an underperforming company on the brink of bankruptcy, through its new CEO, successfully managed to change culture that resulted in the company gaining a leadership position in the industry. The CEO sought to change corporate culture and promote innovation as part of a strategic turnaround. However, the existing culture at the company focused on fault finding and finger pointing among executives, which was contrary to the desired vision of a cohesive and solutions-oriented workforce. Recognizing the gap between the existing and desired behaviors among executives, the CEO focused on making executive meetings a safe environment where information could be shared without blame. This facilitated more timely identification of problems and allowed for collaboration among the group.

We have also come across companies that as part of transformative M&A strategies conduct gap analyses between the cultures of their existing and new businesses. The gap analysis process helps identify behaviors that are desirable for the success of the new company and allows the board and management to encourage these behaviors among the employees.

Phase 2 **Implementation**

After analyzing the corporate culture and its overlap with long-term strategy, mechanisms to influence and monitor progress can be identified and implemented. Boards together with senior management should consider identifying indicators reflecting the desired culture. In the context of rewards systems, culture-related indicators could be aligned with incentives, where appropriate. Senior management is the most influential agent for cultivating corporate culture and should take the leadership in its implementation throughout the organization. The board and senior management should be aligned and implementation expectations should be clearly understood.

For example, some companies have identified characteristics of human capital management (HCM) that help gauge their corporate culture. They monitor factors such as employee turnover, retention rates, employee satisfaction survey results, diversity & inclusion dimensions, and pay differences among their employees across divisions and job functions.

Phase 3 **Reporting**

Finally, communication channels across the organization should be established to better influence corporate culture in an effective and consistent manner. The U.K. Financial Reporting Council stated that annual reports should "explain the board's activities and any action taken" pertaining to assessing and monitoring culture, as well as, "include an explanation of the company's approach to investing in and rewarding its workforce."[9]

We have found through our engagement and market observations that this is a challenging area for boards and management teams to report on. We have found few companies that can effectively communicate their board's involvement in influencing culture. However, given growing investor interest in this area, directors should also be prepared to discuss their role in influencing and monitoring culture at the company.

Conclusion

Boards have been grappling with the difficult task of overseeing corporate culture. As a starting point, we believe that the simple framework presented in this paper will help guide directors and senior management as they tackle this complex issue. We hope that prioritizing corporate culture in our stewardship program and providing transparency into our approach to engagement on this topic will lead to meaningful conversation about an intangible, yet critical component to the long-term success of a company.

Contact

We hope board members and senior management of our portfolio companies find this guidance useful. Any questions or comments may be directed to:

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Endnotes

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9 Financial Reporting Council. The UK Corporate Governance Code. London, U.K., July 2018.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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It's Time to Adopt the New Paradigm

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Monday, February 11, 2019

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. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Steven A. Rosenblum, Karessa L. Cain, Sabastian V. Niles, Amanda S. Blackett, and Kathleen C. Iannone.

Capitalism is at an inflection point. For the past 50 years, corporate law and policy has been misguided by Nobel Laureate Milton Friedman's ex-cathedra doctrinal announcement that the sole purpose of business is to maximize profits for shareholders. Corporations have also been faced with technological disruption, globalization and the rise of China, capital markets dominated by short-term trading and focused on quarterly profits, and unrelenting attacks and threats by activist hedge funds. In response to these pressures, corporations focused primarily on increasing shareholder wealth in the short-term, at the expense of employees, customers, suppliers, long-term value and the local and national communities in which they operate. The prioritization of the wealth of shareholders at the expense of employee wages and retirement benefits, with a concomitant loss of the Horatio Alger dream, gave rise to the deepening inequality and populism that today threaten capitalism from both the left and the right.

Action by corporations, asset managers, and investors is imperative. We have developed *The New Paradigm*—a roadmap for an implicit corporate governance and stewardship partnership—based on the idea that corporations and shareholders can forge a meaningful and successful private-sector solution to attacks by short-term financial activists and the short-termism that significantly impedes long-term economic prosperity. *The New Paradigm* is structured to obtain its benefits without the ill-fitting encumbrance of legislation and regulation. It is flexible and self-executing by corporations notifying their investors that they have adopted it and by investors notifying the corporations in which they have invested that they have adopted it. It is not a contract and can be unilaterally modified.

The Changing Landscape

After the 2008 fiscal crisis, the role of the corporation began to receive closer examination. This was fueled by, among other things, recognition of short-termism as a cause of the fiscal crisis, a growing concern about climate change, the failure of wages to keep pace with inflation, and a recognition in academia that Friedman's shareholder primacy, the related Chicago School theories of an efficient market (Eugene Fama), and agency cost (Michael Jensen and Fama) were fueling discontent and systemic imbalance. Within a few years after 2008, many corporations and investors, and most importantly the three major index fund managers, publicly recognized that action is vital.

This new mindset has been embraced by the major index fund managers who frequently own, in the aggregate, approximately 15% of the shares of listed companies. A prime example is the statement by Larry Fink (CEO of BlackRock) in his January 2018 letter to CEOs of major corporations (with similar views reiterated in his 2019 letter):

> Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate. Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.

Another major index fund manager, State Street, addressed similar themes in its 2019 letter to board members:

> Our focus in recent years has been on good governance and other practices that affect a company's ability to generate positive returns for investors over the long run. Those issues span a variety of environmental, social and governance (ESG) topics material to sustainable performance. We approach these issues from the perspective of long-term investment value, not from a political or social agenda (aka 'values'). This distinction is especially important to understand in light of growing concerns about the influence of large index managers. It is the focus on long-term value that drives our engagement around effective, independent board leadership; board quality, including cognitive diversity enhanced by better gender diversity; and environmental sustainability.

* * *

> This year we will be focusing on corporate culture as one of the many, growing intangible value drivers that affect a company's ability to execute its long-term strategy. We acknowledge that corporate culture, like many other intangible assets, is difficult to measure and manage. However, we also recognize that at a time of unprecedented business disruptions, whether in the form of technology, climate or other exogenous shocks, a company's ability to promote the attitudes and behaviors needed to navigate a much more challenging business terrain will be increasingly important. We all know the old chestnut that culture eats strategy for breakfast, but studies show that intangibles such as corporate culture are driving a greater share of corporate value, precisely because the challenges of change and innovation are growing more acute.

So too, Vanguard in its 2018 Annual Report:

> In our engagements over the past year, it has been clear that more companies have a greater understanding and appreciation of their longest-term investors. We saw that companies and other market participants are coalescing around this way of thinking. And we observed that many themes continue to mature in the industry, with a stronger focus on long-termism, sustainability, and risk oversight.
>
> Our funds can hold stocks for decades, and we were pleased to see long-termism come to the fore and be a key part of many industry discussions. For many years, we have advocated for companies to focus on delivering sustainable long-term value for shareholders. We were gratified this past year to see more and more companies make strides to incorporate sustainability into their strategy, risk planning, and disclosure, with this objective in mind.

* * *

> Central to our approach to these topics is our unwavering commitment to the long-term economic value of your funds' investments. While we recognize that our shareholders have a wide range of ideological perspectives, our decisions on these matters are grounded in long-term economic value. …

Similar views as to strategy, purpose, and culture have also been expressed by other major asset managers and by many institutional investors.

On the academic front, in a widely-acclaimed 2017 article in the *Harvard Business Review*, "The Error at the Heart of Corporate Leadership," Harvard Business School Professors Joseph Bower and Lynn Paine rejected shareholder primacy and made a compelling case for director-centric stakeholder governance:

> Don't misunderstand: We are capitalists to the core. We believe that widespread participation in the economy through the ownership of stock in publicly traded companies is important to the social fabric, and that strong protections for shareholders are essential. But the health of the economic system depends on getting the role of shareholders right. The agency model's extreme version of shareholder centricity is flawed in its assumptions, confused as a matter of law, and damaging in practice. A better model would recognize the critical role of shareholders but also take seriously the idea that corporations are independent entities serving multiple purposes and endowed by law with the potential to endure over time. And it would acknowledge accepted legal principles holding that directors and managers have duties to the corporation as well as to shareholders. In other words, a better model would be more company centered.

On the legislative front, the Accountable Capitalism Act, a bill that would make all corporations with $1 billion or more of annual revenue subject to a federal corporate governance regime (by requiring them to be chartered as a United States corporation), was introduced this past August by Senator Elizabeth Warren. Among other things, this regime would mandate that not less than 40% of the directors of a United States corporation be elected by employees, and that directors must consider the interests of all corporate stakeholders—including employees, customers, suppliers, investors, and the communities in which the corporation operates. In a recent *New York Times* op-ed, Senators Chuck Schumer and Bernie Sanders discussed federal legislation that would prohibit share buybacks (and perhaps dividends) if corporations do not meet specified employee wage and benefit levels. Although the passage of such bills in the United States currently seems highly unlikely, their introduction serves as a warning that legislative solutions could be imposed over time if the issues of sustainability and stakeholder interests are not adequately addressed by the private sector. It must be recognized that employee and public discontent lead to populism, and populism may well lead to state corporatism.

Finally, the British Academy has undertaken a study to create a framework for “The Future of the Corporation.” The project is led by Oxford Professor Colin Mayer, who presents a carefully considered reinterpretation of the nature of the corporation that focuses on corporate purpose, its alignment with social purpose, the trustworthiness of companies, and the role of corporate culture in promoting purpose and trust. This view of the corporation rejects shareholder primacy as the corporation’s sole goal:

> Corporate purpose is distinct from the consequential implications for the corporation’s profitability and shareholder returns. The purpose of corporations is not to produce profits. The purpose of corporations is to produce profitable solutions for the problems of people and planet. In the process, it produces profits, but profits are not per se the purpose of corporations.

Professor Mayer believes this view of the corporation of the future will make capitalism sustainable and should be implemented by establishing a regulatory system that would promote an alignment of corporate conduct with social purposes and ensure that companies’ ownership, governance, and measurement and incentive systems are appropriate for these purposes. His views are more fully reflected in *Prosperity: Better Business Makes the Greater Good* (Oxford University Press 2018). We are in full agreement with, and endorse, Professor Mayer’s basic views and proposals, which hold the promise of promoting prosperity and safeguarding a responsible capitalism. We are not in accord with resort to legislation to achieve them. There can be no doubt that meaningful change is critical, and inevitable, through either legislation or voluntary action by corporations, asset managers, and investors.

The Path Forward

A number of private-sector initiatives are underway to establish a modern corporate governance framework that is calibrated to the current environment. For our part, at the request of the World Economic Forum, we prepared a paper titled, *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*, which was issued in September 2016. As part of that project, we sought to create a foundation for broad-based consensus and, accordingly, in the drafting stage we tested *The New Paradigm* with a number of major corporations and incorporated the feedback we received. In addition, we took into account the published stewardship and engagement policies of the major index funds and institutional investors.

In essence, *The New Paradigm* conceives of corporate governance as a voluntary collaboration among corporations, shareholders, and other stakeholders to achieve sustainable long-term value and resist short-termism. It provides a roadmap for boards to demonstrate that they are providing thoughtful, engaged oversight and that management is diligently pursuing credible, long-term business strategies. In addition, *The New Paradigm* is attuned to the significant influence and role of asset managers and institutional investors, and urges them to embrace stewardship principles, reject activists, and provide the support and patience needed for companies to pursue long-term sustainable strategies. It posits that, while sometimes there may be differences of opinion and changes may be warranted, corporations and shareholders are almost always better served by working together on a collaborative basis than by doing battle or allowing an activist to interpose itself.

Since the time that we initially proposed *The New Paradigm*, a number of developments have prompted us to reassess and revise this framework, with a view to further tailoring it as a middle-of-the-road approach and enhancing its usefulness as a private-sector solution to combat short-termism, while hopefully warding off a new round of politically driven and potentially misdirected governmental intervention. The following is an updated version of *The New Paradigm* that we have prepared outside the auspices of the World Economic Forum. In addition, we are mindful of the ever-expanding assortment of corporate governance frameworks, codes, and principles for boards and investors to consider, and have accordingly sought to integrate these frameworks with a view to offering *The New Paradigm* as a comprehensive roadmap that could be adopted by all of the proponents of governance and stewardship guidelines.

Corporations, asset managers, and institutional investors that embrace *The New Paradigm* should endorse the efforts of the *Investor Stewardship Group*, *Focusing Capital on the Long Term Global*, the *Coalition for Inclusive Capitalism*, and similar organizations, to promote governance, stewardship and engagement principles consistent with *The New Paradigm*.

No legislation or regulation is necessary to implement *The New Paradigm*. Corporations, asset managers, and institutional investors can unilaterally announce their acceptance of and adherence to the principles of *The New Paradigm*. Consistent with observations made by Chief Justice Leo Strine of the Supreme Court of Delaware, in his 2017 *Yale Law Journal article*, “Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System,” from both a corporate law and a trust law standpoint the principles of *The New Paradigm* are intended to achieve long-term growth in value while eschewing actions and policies that threaten future growth and value, or the franchise itself. Adoption of and adherence to the principles of *The New Paradigm* is consistent with the fiduciary duties of boards of directors to their corporations and shareholders, and of asset managers to investors and the underlying beneficiaries for whom they are acting.

The New Paradigm does not solve all the problems that corporations will continue to face, including challenges stemming from technological disruption, globalization, social media, and political instability, but it does take a significant step toward enabling corporations to better realize their potential to be drivers of broad-based socioeconomic prosperity today and in the future. And by curbing destructive short-term activism, *The New Paradigm* will negate a drift towards state corporatism.

The New Paradigm

The New Paradigm is a roadmap for an implicit corporate governance and stewardship partnership between corporations and investors and asset managers to achieve sustainable long-term investment and growth rejects shareholder primacy and is instead premised on the idea that stakeholder governance and ESG are in the best interests of shareholders. While it recognizes a pivotal role for boards of directors in harmonizing the interests of shareholders and other stakeholders, it also assumes that shareholders and other stakeholders have more shared objectives than differences—namely, they have the same basic interest in facilitating sustainable, long-term value creation. In this framework, the board of directors can exercise business judgment to implement the company's objectives, and the company and its shareholders engage on a regular basis to achieve mutual understanding and agreement as to corporate purpose, societal purpose and performance. Ultimately, the shareholders' power to elect the directors determines how any conflicts are resolved, if they are not resolved by engagement. However, since the company and its shareholders have the same fundamental objectives, there should be little room for activism and short-termism.

The New Paradigm is premised on the idea that companies and shareholders can forge a meaningful and successful private-sector solution to attacks by short-term financial activists and the short-termism that significantly impedes long-term economic prosperity. It is not a contract and can be unilaterally modified. The framework of *The New Paradigm* is divided into three buckets:

First, *governance* is about the relationship between a company and its shareholders (asset managers and investors) and between company management and the board of directors. Companies will embrace core principles of good governance and, in cultivating genuine and candid relationships with shareholders, will be in a position to demonstrate that they have engaged, thoughtful boards overseeing reasonable, long-term business strategies.

Second, *engagement* is the exchange of information and requests between a company and its shareholders. Engagement is dialogue, not dictates from either side. Engagement connotes expectations around a two-way commitment between companies and shareholders to proactively engage with each other on issues and concerns that affect the company's long-term value, and provide each other with the access necessary to cultivate long-term relationships. Companies commit to being responsive to the issues and concerns of shareholders, while shareholders will proactively communicate their preferences and expectations.

Third, *stewardship* is the relationship between shareholders (asset managers and investors) and a company. Stewardship reflects a commitment on the part of asset managers and investors to be accountable to the beneficial owners whose money they invest, and to use their power as shareholders to foster sustainable, long-term value creation. In embracing stewardship principles, asset managers and investors will develop an understanding of a company's governance and long-term business strategy, and commit to constructive dialogue as the primary means for addressing subpar strategies or operations.

In this framework, if a company, its board of directors and its CEO and management team are diligently pursuing well-conceived strategies that were developed with the participation of independent, competent and engaged directors, and its operations are in the hands of competent executives, asset managers and investors will support the company and refuse to support short-term financial activists seeking to force short-term value enhancements without regard to long-term value implications.

2018 Proxy Season Review

Sullivan & Cromwell LLP, [excerpt, p.7–10]

Jul. 2018

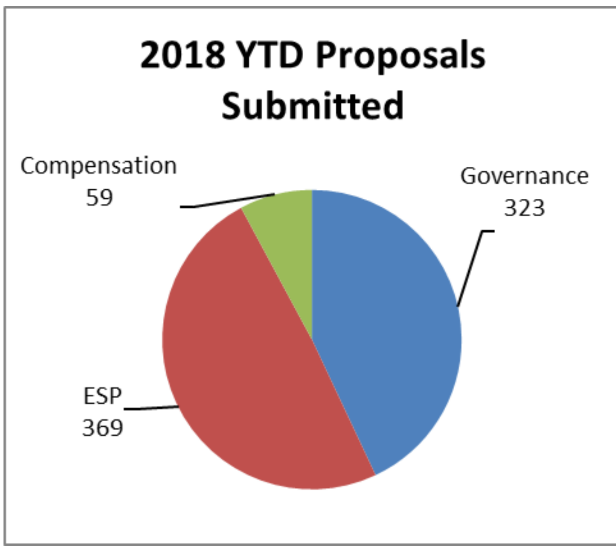
I. RULE 14A-8 SHAREHOLDER PROPOSALS

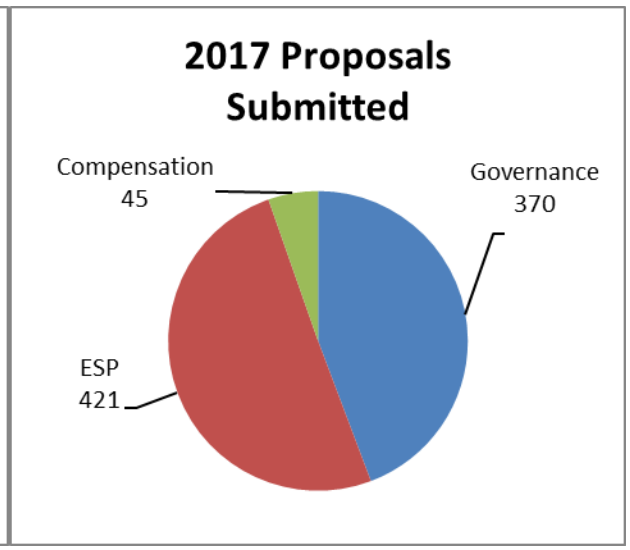
A. OVERVIEW OF SHAREHOLDER PROPOSALS

The following table and pie charts summarize, by general category, the Rule 14a-8 shareholder proposals submitted in 2017 (full year) and 2018 year-to-date, the number voted on and the rate at which they passed.*

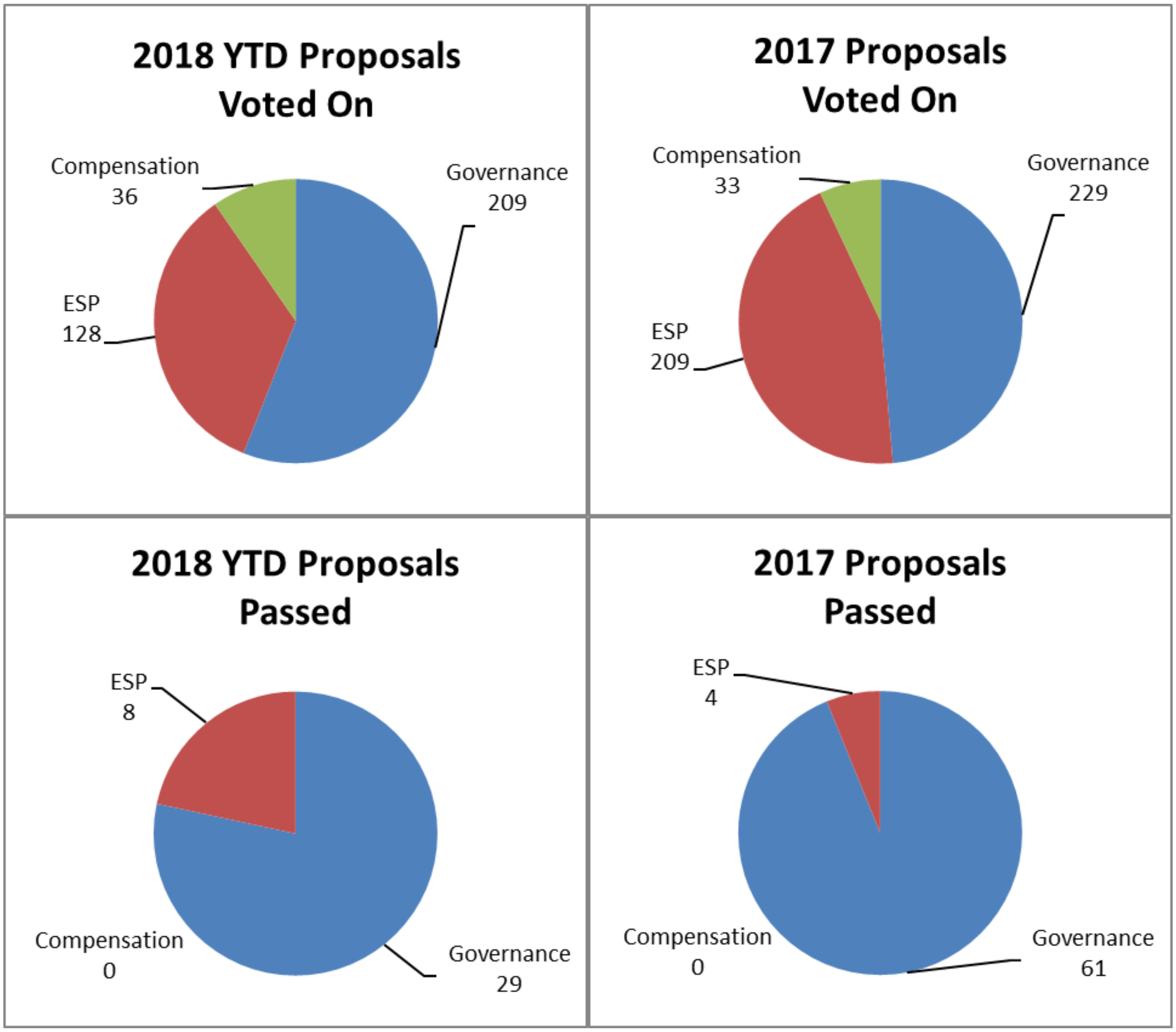
SUMMARY OF 2017-2018 SHAREHOLDER PROPOSALS

	Shareholder Proposals Submitted		***Shareholder Proposals Voted On***		***Average % of Votes Cast in Favor***		***Shareholder Proposals Passed***	
Type of Proposal	***2018 YTD***	***2017***	***2018 YTD***	***2017***	***2018 YTD***	***2017***	***2018 YTD***	***2017***
ESP-related	***369***	421	***128***	209	***26%***	22%	***8***	4
Governance-related	***323***	370	***209***	229	***37%***	39%	***29***	61
Compensation-related	***59***	45	***36***	33	***23%***	22%	***0***	0
Total	***751***	836	***373***	471				





* The data in this publication incorporates proposals made at meetings held on or before June 30, 2018, unless otherwise specified. We estimate that around 90% of U.S. public companies held their 2018 annual meetings by that date. In this publication, when we refer to a proposal as "passing," we mean that it received the support of a majority of votes cast, regardless of whether this is the threshold for shareholder action under state law or the company's bylaws.



In 2018, more environmental, social and political ("ESP") proposals were submitted than any other type of shareholder proposal. However, as discussed further in Section I.D below, these proposals were withdrawn at a substantially higher rate, and less than a third reached the shareholder vote stage. Very few of the ESP proposals that reached a vote actually passed, although average shareholder support and pass rate both increased meaningfully compared to 2017. The most common topics continued to be environmental issues, political contributions and lobbying, gender and other discrimination, and human rights.

The number of governance-related proposals submitted was below the number of ESP proposals submitted again this year (continuing a trend that began in 2017), but governance-related proposals remained the most likely to reach a vote. As discussed further in Section I.E below, these proposals continued to represent the majority of proposals that actually passed, although the pass rate declined sharply to 14% from 26% in 2017. This decline resulted from a marked reduction in proposals that have received high shareholder support historically, such as adopt proxy access, eliminate supermajority thresholds, majority voting in uncontested elections and declassify the board proposals (each of which received average support of about 50% or more in both 2017 and 2018), and from an increase in written consent proposals and proposals to reduce special meeting thresholds, which generally do not pass (but do receive high average levels of shareholder support).

The number of compensation-related proposals remained at a negligible level, which is a continuation of a trend that began in 2011 when mandatory say-on-pay votes came into effect. No compensation-related proposals have passed in 2018. *See* Section I.F below for a further discussion.

The data on submitted, withdrawn and voted on shareholder proposals discussed in this section derives from ISS's voting analytics with respect to about 800 known shareholder proposals submitted this year to U.S. members of the S&P Composite 1500, which covers about 90% of U.S. market capitalization. We have supplemented the ISS data with information published by certain proponents on their websites and other independent research. The number of proposals submitted includes proposals that were withdrawn before or after being included in a company's proxy statement (usually following engagement with the company) or excluded from a company's proxy statement through the SEC no-action process. The data on submitted proposals understates the number of proposals submitted, as it generally does not include proposals that were submitted and then withdrawn unless either the proponent or the company voluntarily reported the proposal to ISS or, in the case of the major shareholder proponents discussed in Section I.B below, on their websites.[1] For purposes of our presentation, unless stated otherwise, we refer to proposals withdrawn by the proponent either before or after the mailing of a company's proxy materials, as well as proposals which are not presented by the proponent at the shareholder meeting, as "withdrawn." We refer to proposals that have been excluded through the SEC no-action process as "excluded."

B. WHO MAKES SHAREHOLDER PROPOSALS

The focus of a relatively concentrated group of individuals and entities tends to drive the voting agenda at U.S. public companies. The top 10 proponents account for more than half of shareholder proposals submitted to U.S. S&P Composite 1500 companies. The following table shows a breakdown of the types of proposals submitted by the top shareholder proponents in 2018.

[1] As further described in Sections I.B and I.E.3, the discussion in this publication on proxy access proposals submitted by the Office of the New York City Comptroller takes into account information derived from independent research (in addition to data from ISS and the Comptroller's website), because the Comptroller has not yet published its annual list of proposals for 2018.

	Filers	ESP	Governance	Compensation	Total
1.	John Chevedden	4	109	0	113
2.	James McRitchie	2	42	2	46
3.	William Steiner	0	43	1	44
3.	NYS Common Retirement Fund	38	3	3	44
5.	NYC Comptroller	9	24	7	40
6.	As You Sow Foundation	33	0	4	37
7.	Trillium Asset Management	18	13	1	32
8.	Zevin Asset Management	20	0	9	29
9.	Walden Asset Management	18	6	0	24
10.	Arjuna Capital	23	0	0	23
11.	Mercy Investment Services	20	0	2	22
12.	AFL-CIO	5	5	6	16
13.	Calvert Investment Management	8	4	0	12
13.	The International Brotherhood of Teamsters General Fund	4	2	6	12
13.	Friends Fiduciary Corporation	12	0	0	12

- ***Individuals.*** The most prolific proponents, by far, were three individual investors who have been prominent for a number of years: John Chevedden, James McRitchie and William Steiner. Collectively, these individuals and their family members were responsible for the submission of over 200 proposals—representing over 40% of all proposals submitted, and the vast majority of governance-related proposals. In addition to governance-related proposals, these individuals also submitted a small number of proposals regarding political contributions and executive compensation.
- ***Public Pension Funds and Entities.*** Public sector pension funds and entities proposed more than 90 proposals to public companies for 2018 meetings. The most frequent proponents in this category were the New York State Comptroller, on behalf of the New York State Common Retirement Fund (with 44 proposals submitted, the vast majority of which were related to environmental issues (including climate change) and political contributions and lobbying), and the New York City Comptroller (with an estimate of 40 proposals submitted, almost half of which were proxy access proposals,[2] as described in Section I.E.3 below). Other topics commonly addressed by proposals from pension funds and other public sector entities include board diversity and gender pay equity.
- ***Labor Unions.*** Labor unions, such as the AFL-CIO, the Teamsters and the United Auto Workers and related entities, were the proponents of over 40 proposals, primarily relating to governance and compensation-related issues.
- ***Social Investment Entities.*** As further discussed in Section I.D below, the majority of proposals on ESP issues continued to come from asset management or advisory institutions that seek to make "socially responsible" investments and advance social causes. The entities that were most active in 2018 included As You Sow Foundation (37 proposals submitted), Trillium Asset Management (32), Zevin Asset Management (29), Walden Asset Management

2 As of the date of this publication, the Office of the New York City Comptroller has not yet published its annual list of proposals for 2018. We have provided a rough estimate of the number of proposals submitted by the Comptroller based on a combination of ISS data and independent research. Due to the limited information available to us at this time, our estimates may not accurately depict actual patterns in the Comptroller's priorities.

Climate Change and Proxy Voting in the U.S. and Europe

Posted by Maximilian Horster, ISS-ESG; and Kosmas Papadopoulos, ISS Analytics, on Monday, January 7, 2019

Editor's note: Maximilian Horster is Managing Director at ISS-ESG and Kosmas Papadopoulos is Managing Editor at ISS Analytics. This post is based on their ISS-ESG memorandum. Related research from the Program on Corporate Governance includes Socially Responsible Firms by Alan Ferrell, Hao Liang, and Luc Renneboog (discussed on the Forum here) and Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

Summary

- Investor awareness of environmental and social shareholder is growing on both sides on the Atlantic.
- European companies generally surpass U.S. firms on climate change disclosures.
- Climate change increasingly comes to a vote in the U.S. via the shareholder proposal process, and investors increasingly expressing support at the ballot.
- Shareholder resolution filings are relatively scarce in Europe, where high ownership requirements make it difficult to file proposals in most markets (especially for individual investors).
- Cultural differences may also explain the fewer proposals filed in Europe, as institutional investors often prefer engagement to instigate change

As the world came together in Katowice, Poland for the annual U.N. climate conference last week, institutional investors were also present, as they reiterated their climate commitments through at least three side conferences geared towards financial market participants. Host country Poland's own stance on climate change is similar to how torn the investment world is on the issue: Poland is one of Europe's most fossil fuel-dependent economies, with 80 percent of energy produced by burning coal. However, Poland is the first European country ever to issue a Green Bond—even before climate change poster child France, which has implemented reporting requirements and organized climate summits for investors endorsed by President Macron. Institutional investors are in the same situation: While many have launched ground-breaking new investment strategies and commitments to tackle climate change, these initiatives are often small in comparison to their core assets and are merely a modest first step vis-à-vis the challenges and risks that climate change poses.

The past four years (2014, 2015, 2016, and 2017) are the four hottest years on record since 1880, when tracking of global temperatures began. Nine of the ten hottest years on record took place in the past 15 years. 2018 will likely join the top ten list, as year-to-date records indicate temperatures for the January-to-October period to be the fourth highest on record for the first ten months of the past 139 years.

Top 10 warmest years (NOAA) (1880–2017)

Rank	Year	Anomaly °C
1	2016	0.94
2	2015	0.90
3	2017	0.84
4	2014	0.74
5	2010	0.70
6	2013	0.66
7	2005	0.65
8	2009	0.64
9	1998	0.63
10	2012	0.62

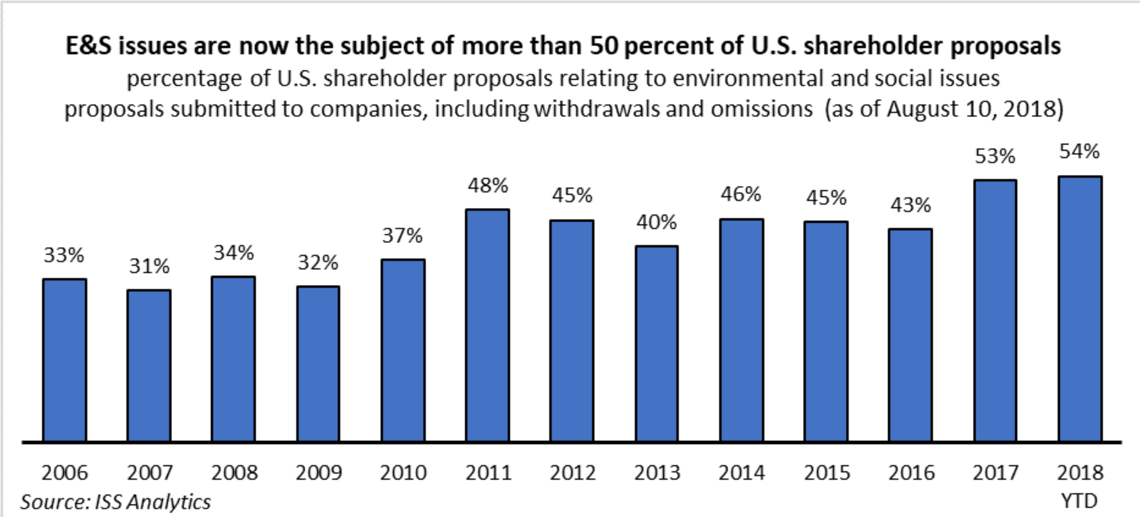
Source: U.S. National Oceanic and Atmospheric Administration, 2018

Investors are taking note of the effects of global warming and the associated risks.

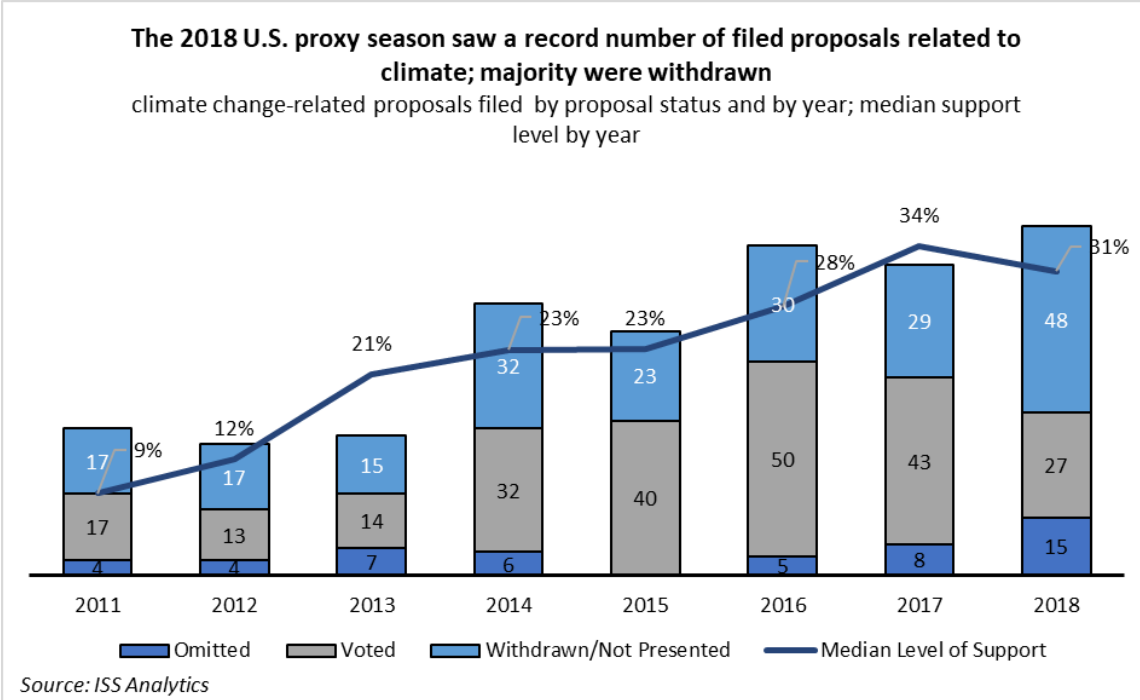
- **Short-Term Risks.** Signs of acute physical risks in 2018 included floods (southeast Asia and southern U.S.), droughts (California, central Europe), snow during summertime (Spain), and other extreme weather events. The world's largest reinsurer Munich Re calls the likelihood of the increase of such weather patterns the "the new normal."
- **Long-Term Risks.** Long-term physical risks include the effects on agriculture, rising sea levels, or other consequences that will likely impact communities, companies, supply chains, and investors.
- **Transitional Risks.** Transitional risks are the effects of climate regulation and societal change that international agreements (e.g. Paris Agreement) or national legislation (e.g. energy transition laws) can pose on companies and can impact investment returns.

Environmental and climate proposals continue their ascent in the U.S.

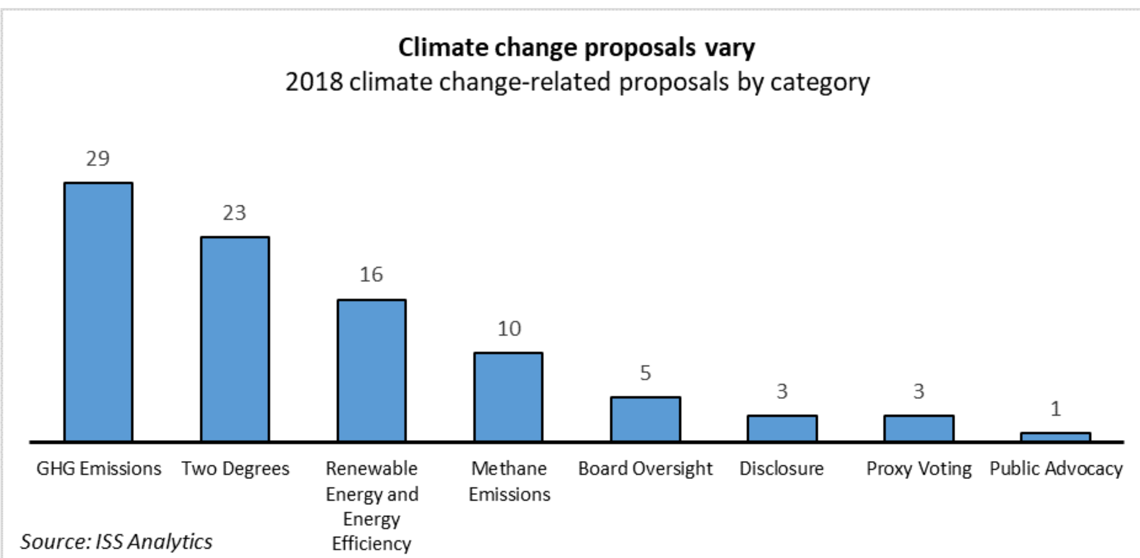
In the U.S., shareholder resolutions on climate-related issues often serve as an indicator of the level of financial market concern on the subject. In 2017 and 2018, shareholder resolutions focusing on environmental and social issues made up the majority of all filed shareholder proposals, showing a notable increase relative to resolutions focusing on governance topics compared to prior years. What is more, some members of the Chevedden Group, a group of individual shareholder proponents who have historically focused on filing dozens of proposals related to governance issues, recently indicated they will shift their focus towards environmental and social issues.



Proposals focusing on the environment, including climate change, ranked first among the various categories environmental and social proposals filed in 2018, with a total of 121 proposals dealing with the environment filed at U.S. companies. Climate change-related proposals reached a record-high of 90 filed proposals. In 2018, companies were more willing to address proponent requests prior to the general meeting, following exceptionally high support levels in 2017, including majority support levels at the high-profile meetings of **Exxon Mobil Corporation** and **Occidental Petroleum Corporation**. As a result, the majority of climate-related proposals were withdrawn from ballots by proponents, indicating a successful engagement with the company. Moreover, median support levels have increased significantly in the past eight years, from single digits in 2011 to more than 30 percent in 2017 and 2018.



Requests to adopt and report on emissions targets and goals made a significant portion of climate-related proposals in 2018. Proposals dealing with emissions targets mark an evolution compared to the types of proposals that were filed five years ago, which primarily focused on emissions disclosure. In more recent years, shareholder proponents have been pushing for reduction targets, including goals of net-zero emissions at some companies.



In 2017, only six environmental and social shareholder resolutions in the U.S. received support by more than 50 percent of votes cast. In 2018, this number doubled to 12 resolutions, with four majority-supported resolutions dealing with climate change issues, and three proposals focusing on sustainability reporting. Social issues dominate the rest of the highly-supported items, including two relatively new types of proposals dealing with the opioid crisis and gun violence.

Majority-Supported Environmental and Social Shareholder Proposals in 2018

Company	Shareholder Resolution	Support (F/(F+A))
Rite Aid Corp.	Report on Sustainability	80.0%
Sturm Ruger & Company, Inc.	Report on Gun Safety	68.8%
Depomed Inc.	Governance Measures Related to Opioids	62.3%
Rite Aid Corp.	Report on Governance Measures related to Opioids	61.4%
Kinder Morgan	Report on Sustainability	60.4%
Kinder Morgan	Climate Risk – Two Degree Scenario	59.7%
Middleby Corporation	Report on Sustainability	57.2%
Genesee & Wyoming	Adopt GHG Emissions Reduction Goals	57.2%
Ameren Corporation	Report on Coal Ash Risks	53.2%
Anadarko Petroleum	Climate Risk – Two Degree Scenario	53.0%
American Outdoor Brands Corp.	Report on Gun Violence	52.2%
Range Resources Corp.	Report on Methane Emissions Reduction	50.3%

Source: ISS Analytics

Shedding Light on Diversity-Based Shareholder Proposals

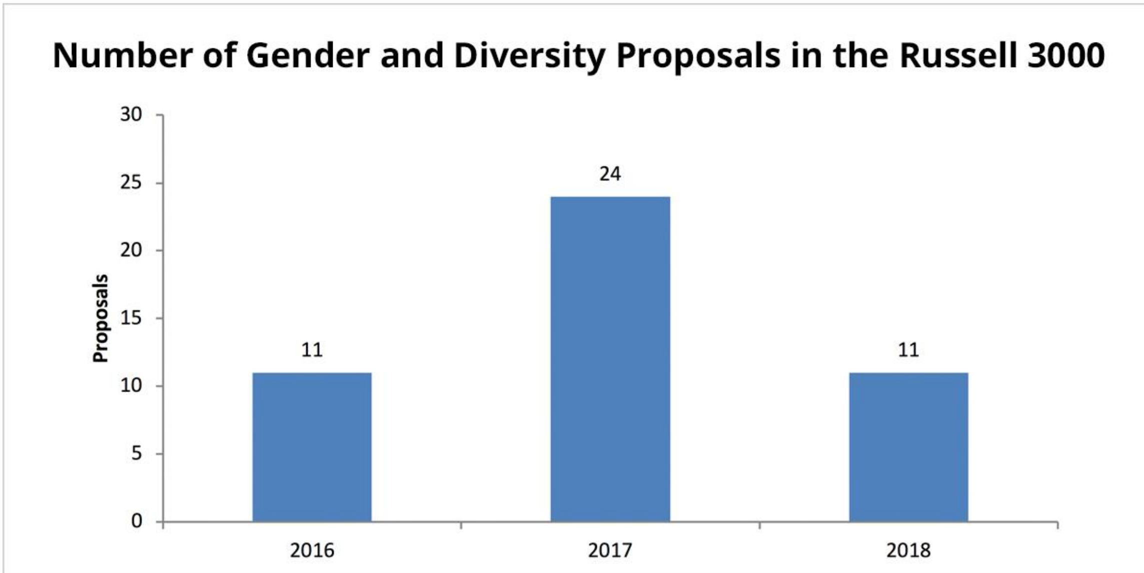
Posted by Angelo Martinez, Equilar, Inc., on Tuesday, October 16, 2018

Editor's note: Angelo Martinez is a Senior Research Analyst at Equilar, Inc. This post is based on an Equilar memorandum by Mr. Martinez. Related research from the Program on Corporate Governance includes Socially Responsible Firms by Alan Ferrell, Hao Liang, and Luc Renneboog (discussed on the Forum here) and Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

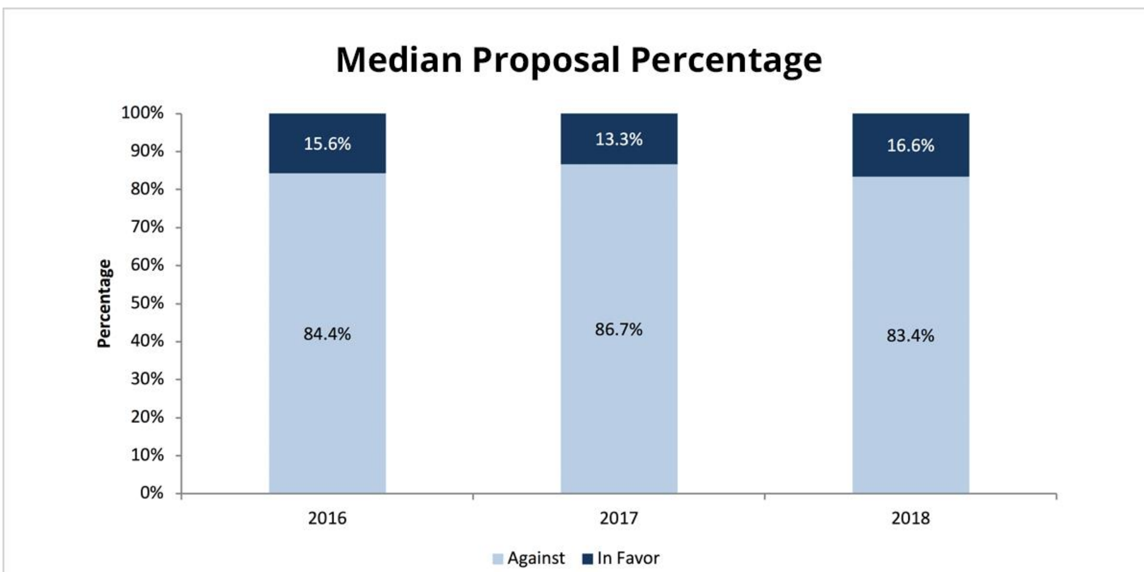
Environmental, social and governance (ESG) proposals voice shareholder concerns about topics including, but not limited to, climate change disclosure, lobbying and political campaign contributions, gender pay equity and employment diversity. According to a recent Equilar study, at least 200 ESG shareholder proposals were voted on each year from 2015 to 2017, combining for a total of 633 shareholder proposals.

One might imagine that if shareholders urged companies to provide more information addressing ESG issues, companies would be more apt to do so. However, the numbers tell a different story. In fact, over the past three years, ESG proposals have received a median approval rating of 20.8% with only 2.5% of all proposals receiving enough votes to pass. While these numbers do not look promising, a deeper dive into more recent data seems to suggest a rather positive outlook regarding two important ESG issues.

With board diversity at the forefront of governance issues, it is important for companies to demonstrate that they are making a concerted effort to foster the inclusion of women and underrepresented minorities on executive teams and in the boardroom. As Russell 3000 boards crawl towards gender parity, shareholder concerns regarding these two matters are continually increasing in prevalence and importance. Shareholder proposals dealing with gender and diversity are defined as proposals that request companies to disclose measures taken to create greater diversity on the board or in the workplace, prepare a report with a comprehensive breakdown of its workforce by race and gender, or provide information regarding the policies and goals of the company to reduce and address the gender pay gap. Figure 1 below demonstrates a trend upwards, as the number of these proposals voted on by investors topped out at 24 proposals in 2017, yet there has been at least ten proposed over the past three years. The prevalence of these proposals, despite only representing about 6% of all ESG proposals over the past three years, is hard to ignore.



During this same time period, the median support for such proposals increased by one percentage point overall, though median support increased by 24.8% from 2017 to 2018. While only two of these proposals have received a majority and passed, both dealt with diversity. These two proposals requested that the firm release a report regarding the steps it "is taking to foster greater diversity on the Board." The fact that such a small number of these proposals passed suggests that, by and large, companies believe that their current efforts and policies regarding diversity are more than enough and don't require the additional disclosure that shareholders are requesting.



Historically, the onus has been on companies to only mitigate and reduce exposure to financial risk; yet, recent years prove that it is also important to be able to successfully navigate non-financial risk and protect shareholder value. It will be interesting to see whether these trends and support for diversity proposals will continue. Continued growth in prevalence for such proposals will hopefully lead boards and executive teams across the Russell 3000 to simultaneously examine current practices and policies regarding diversity and gender pay equity and justify to shareholders that they are properly addressing these concerns. As long as activism continues to rise, shareholder engagement regarding ESG issues will become more important than ever for companies to address and understand. A continued, open dialogue with shareholders can only benefit both parties, as all sides continue to move towards an agreement regarding these issues.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

Remarks to the SEC Investor Advisory Committee

Posted by Jay Clayton, U.S. Securities and Exchange Commission, on Friday, December 14, 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 to the SEC Investor Advisory Committee, 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, Anne (Sheehan). Good morning everyone. I would like to thank the Committee members and the panelists for taking the time to engage on the topics on today's [December 13, 2018] agenda.

I understand that the planned discussion regarding disclosures on human capital will be postponed to a later date. I believe that the strength of many of our public companies is due, often in large part, to their human capital, and I therefore appreciate that the Committee is focusing on these disclosures. I look forward to a discussion on this topic in the future.

In lieu of this discussion, the Committee has asked that we use this time to discuss the Commission's rulemaking and regulatory efforts in 2018 and my agenda for 2019. I am pleased to lead this discussion and answer questions that Committee members may have.

Before we move into that discussion, I would like to say a few words about the other scheduled topics that will be discussed today—(1)disclosures on sustainability and environmental, social, and governance (ESG) topics, and (2)unpaid arbitration awards. These are issues that I have been thinking about as I focus on ensuring that the Commission carries out its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Before going into my remarks, I note that my thoughts are my own and do not necessarily reflect the views of my fellow Commissioners or the SEC staff.

Disclosures on Sustainability and Environmental, Social, and Governance (ESG) Topics

Disclosure is at the heart of our country's and the SEC's approach to both capital formation and secondary liquidity. As stewards of this powerful, far reaching, dynamic and ever evolving system, a key responsibility of the SEC is to ensure that the mix of information companies provide to investors facilitates well-informed decision making. The concepts of materiality, comparability, flexibility, efficiency and responsibility (i.e., liability) are the linchpins of our approach. This group knows these concepts well, knows that they are interrelated, and knows that, when we consider changes to our approach to disclosure, these concepts should be front of mind.

Turning to “ESG”, a broad term, we are increasingly seeing disclosure of ESG information by issuers in the marketplace and requests for ESG information by investors. I am also aware of efforts by third parties to develop disclosure frameworks relating to ESG topics as well as calls by some market participants for issuers to follow third-party disclosure frameworks relating to ESG topics.

Although third-party standards relating to ESG topics may allow for comparability across companies, that does not mean that issuers should be required to follow these frameworks in order to comply with SEC rules. Each company, and each sector, has its own circumstances, which may or may not fit within a standard framework. That does not mean the standards do not have value. They do, in some cases, in much the same way that appropriately presented non-GAAP financial measures and key performance indicators (KPIs) add value to the mix of information.

As third-party standards have evolved and been discussed by market participants, I have seen investor-company dialogue around certain issues and in certain sectors improve. That said, I think it is important to remember two principles: first, in complying with our disclosure rules, companies should focus on providing material disclosure that a reasonable investor needs to make informed investment and voting decisions based on each company’s particular facts and circumstances; and, second, investors—and here I’m thinking about asset managers who are required to vote in the best interest of their clients—should also focus on each company’s particular facts and circumstances. Here, I would like to underscore that investment advisers have a fiduciary duty to act in the best interest of their clients. Advisers cannot put their own interests ahead of the interests of their clients—whether those interests relate to the adviser’s compensation, corporate matters (including, as examples, board composition, purchase, merger and sale decisions, or ESG matters) or otherwise.

Staying with the issues presented by the asset manager client relationship for a moment, I am also aware of various efforts to encourage asset managers to integrate ESG factors into their investment strategies. It is important to note that, although we do regulate disclosure and oversee registered investment advisers, we do not regulate the merits of any particular investment strategy. The success of a particular investment strategy depends upon a multitude of factors, which may or may not include the extent to which the asset manager incorporates ESG factors. From my perspective, what is important is that investors have full and fair disclosure of the material facts about the investment strategy their fiduciary is following so that they are in a position to make informed investment choices.

Clayton Q&A and ESG at the SEC's Investor Advisory Committee Meeting

Posted by Cydney Posner, Cooley LLP, on Thursday, December 20, 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 Socially Responsible Firms by Alan Ferrell, Hao Liang, and Luc Renneboog (discussed on the Forum here) and Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

At last week's meeting of the SEC's Investor Advisory Committee, the Committee members held a Q&A session with SEC Chair Jay Clayton, followed by a discussion of environmental, social and governance disclosure, where the main question appeared to be whether to recommend that ESG disclosure be required through regulation, continued as voluntary disclosure but under a particular framework advocated by the SEC or continued only to the extent of private ordering as is currently the case.

Among the points addressed in the Q&A was a potential government shutdown. Clayton said that the SEC was planning for a possible shutdown, and that, as in previous shutdowns, he expected the SEC would be able to continue its operations for a number of days post-shutdown.

In his opening statement, Clayton observed that demands for ESG information have increased and, in response, many companies have voluntarily increased the amount of ESG information they disclose. In providing this information, Clayton advised, companies "should focus on providing material disclosure that a reasonable investor needs to make informed investment and voting decisions based on each company's particular facts and circumstances." Likewise investors—principally asset managers—should also focus on each company's particular facts and circumstances. Importantly, he stressed that these advisers should not put their own interests in ESG or other matters before those of their clients. If investors integrate ESG into their strategies, they should make sure that the material facts about the strategy are disclosed. Although some market participants have called for companies to follow designated frameworks to increase comparability, "that does not mean that issuers should be required to follow these frameworks in order to comply with SEC rules." The standard frameworks may not fit the circumstances of each company or industry, but that doesn't mean that they don't add value to the mix of information. Rather, Clayton suggests, their value is analogous to that provided by "appropriately presented non-GAAP financial measures and key performance indicators (KPIs)."

In her last committee meeting as an SEC Commissioner, Kara Stein (besides tearing up, which was very sweet), also addressed ESG in her opening statement. She noted that, although traditionally, ESG factors were not considered to be components of financial analyses, now many investors do consider the long-term investment risks and benefits of ESG issues. And these concerns were not limited to institutional investors: "43% of shareholder proposals submitted during the last proxy season focused on these matters. Why? Because these investors believe that there are verifiable links between ESG matters and a company's operational strength, efficiency, and management. These investors believe it is important to have an understanding of these issues in order to better assess the company's performance. On the other hand, other investors maintain that focusing on ESG matters should not come at the expense of investment returns." Hopefully, she suggested, the meeting discussion would provide some insight on the right balance of these ideas.

For her part, Commissioner Hester Peirce conveyed her attitude pretty clearly when she indicated that "ESG" stands for "enabling shareholder graft." Hmmm, seems to be in sync with former Senator Phil Gramm. (See this PubCo post.) While that may sound "unfriendly" to ESG, at its essence, it does reflect the view of a significant segment, which is that ESG should not be wielded as a tool to impose one's "values" on companies where the impact may be detrimental to shareholders; rather it should be a driving force only to the extent that it is expected to have a positive effect on shareholder value.

[Based on my notes, so standard caveats apply.]

Clayton Q&A

Sustainability as part of disclosure framework. The Q&A started with a kind of meta-analysis of our disclosure framework; that is, wouldn't the incorporation of "sustainability" (apparently the preferred term for ESG among many) into disclosure requirements really just reflect a necessary modernization of the disclosure framework? The example given was that, initially, assets reflected on balance sheets were primarily fixed assets such as property, plant and equipment. Now companies' most valuable assets are human capital, intellectual property and other intangible assets. Doesn't the whole framework need to be modernized? In response, Clayton contended that the current materiality disclosure framework ("materiality, comparability, flexibility, efficiency and responsibility (*i.e.*, liability) are the lynchpins") is the right one, but that what goes into it needs to reassessed. That is, we need to recognize when things have changed, and, Clayton maintained, what is important now is forward-looking information. For example, Clayton observed that, because the market reflects anticipated future performance, stocks tend to move at the time of the earnings release and analyst call—when guidance tends to be issued—not at the time of filing of the 10-Q. (Is that a harbinger of his view on the need for quarterly filings, now that it's back on the agenda? See this PubCo post.) Although KPIs are valued because they can presage future performance, they're not part of the regulatory framework because there is little comparability across companies or industries. As a result, adding KPIs and NGFMs to GAAP is really difficult. What Clayton would like to see with regard to KPIs and NGFMs is a clear tie-back to GAAP and period-to-period consistency for each company. In addition, he indicated, these types of measures should track how management *looks at* its business, not just how management wants *to present* its business.

Decline in research for smaller companies. Clayton attributed the decline to the impact of MiFID II, the revision in the EU to the Markets in Financial Instruments Directive, which required the disclosure of the amount of commission payment used for research (and was predicted to reduce the levels of research for smaller companies in an effort to show lower research expenses). He suggested that it was not proving to be successful and had reduced the supply of research.

Roundtable takeaways. When asked to identify his takeaways from the SEC's recent proxy process roundtable, Clayton mentioned needed process changes, the need to improve the shareholder proposal process without adversely affecting shareholder engagement and, with regard to proxy advisor reform, the need to clarify the dynamic between advisor and client and to reaffirm that the investment advisor still retains responsibility. While he recognized that proxy advisors add value and efficiencies, the process required improvements such as an opportunity for companies to respond.

Investor town halls. When asked about the town halls that the SEC is conducting, Clayton seemed to view them as very successful. He said that the most important question for investors to ask is "how much of my money is going to work for me?" How is the investment advisor paid and what are the revenue incentives for the advisor?

Accredited investors. Clayton noted that he was not in love with the current accredited investor system because it was entirely binary: if the individual qualifies, they can stand to lose all and if they don't qualify, they can't be at risk at all. However, the current system offers the advantage of being easy to administer, so a new system would need a strong verification system. The SEC plans to conduct a comprehensive review of the entire patchwork system of registration exemptions.

Discussion of ESG disclosure

Former SEC General Counsel and former PCAOB member Dan Goelzer described the historic development (or rather the lack of development) of ESG regulation. Currently, there are few specific regulations governing ESG disclosure and the nature and level of disclosure is determined primarily on the basis of materiality and material omissions. Following litigation in the 1970s to compel the SEC to adopt environmental and social disclosure requirements, in 1975, the SEC issued a release indicating that the SEC would not consider social and environmental goals on their own; rather any regulation must be designed to protect the economic interests of investors. At that time, only a small number of investors were motivated by social concerns. Subsequently, rules were adopted addressing the impact of environmental expenses on earnings and, pursuant to Dodd-Frank, rules regarding conflict minerals. With the SEC's climate change release, disclosure of the material impact of climate change could be required under several existing requirements, such as risk factors and MD&A. Now, however, there is a much greater interest in the economic significance of sustainability, and many institutional investors take sustainability into account in making investment decisions.

> **SideBar**
>
> The growing interest of investors in ESG issues is reflected in their increasing support for shareholder proposals addressing environmental and social topics. *BNA* reports that large asset managers, such as BlackRock, Vanguard and State Street, are "now twice as likely as individual investors to back shareholder advocacy on environmental and social issues," according to data from Broadridge and PwC. Overall, in 2018, votes in favor of social and environmental proposals increased to 27% from 18% in 2014, reflecting perhaps the risk that some institutions have identified in issues like climate change. You may recall that a number of climate disclosure proposals even received majority votes in favor in the last couple of years, supported by several large institutions. (See this PubCo

> post and this PubCo post.) In 2018, almost 29% of shares held by institutional investors were voted in favor of environmental and social shareholder proposals, up from 19% in 2014. (See this PubCo post.)As a result, many companies now provide voluntary sustainability reports and some even include the information in their SEC filings. Goelzer reported that 73% address ¾ of the topics identified by the Sustainability Accounting Standards Board and 42% address all the topics. However, he contended that much of the voluntary disclosure was not really well suited to provide information because much of it was boilerplate and not comparable across companies or even year to year. As a result, many investors are dissatisfied with the disclosure and calling for regulation. (See this PubCo post regarding a rulemaking petition advocating that the SEC mandate ESG disclosure under a standardized comprehensive framework.) However, it may be hard to justify applying regulations across the board and, in Goelzer's view, the application of non-governmental standards under a framework may be the best bridge. In his view, SASB standards are most closely aligned with SEC standards, and the SEC could encourage the use of the framework, without even needing to resort to formal rulemaking, by signaling from its bully pulpit about the importance of the information and the need to ensure that it is investor-grade, as well as through the staff comment process on statements made.

At the meeting, the SASB representative indicated that SASB looks at topics most likely to affect financial performance and includes performance metrics to aid in comparability and consistency over time. With regard to sustainability disclosure, what has been missing are accepted standards, and the SASB representative joined in advocating that the SEC take steps to recognize SASB as an acceptable framework for disclosure, in the same way as it has for the COSO framework for internal control over financial reporting and the OECD framework for conflict minerals.

> **Sidebar**
>
> As discussed in this PubCo post, independent standard-setting organization SASB has announced that it has published a series of sustainability accounting standards specifically tailored for 77 industries. According to the SASB Chair, the publication of these standards represents an "important milestone" because they provide "codified, market-based standards for measuring, managing, and reporting on sustainability factors that drive value and affect financial performance." The SASB standards—according to SASB, "the world's first set of industry-specific sustainability accounting standards covering financially material issues"— were published after six years of study and market consultation (see this News Brief from 2013 describing the release of the SASB standards for the health care sector). By focusing on development of standards and associated metrics specific to particular industries, SASB seeks to identify a "subset of sustainability factors most likely to have financially material impacts on the typical company in an industry." The objective is to provide investors and companies "decision-useful" information, information that can help them make more informed decisions. What is "sustainability accounting"? According to SASB, "[s]ustainability accounting reflects the management of a corporation's environmental and social impacts arising from production of goods and services, as well as its management of the environmental and social capitals necessary to create long-term value. It also includes the impacts that sustainability challenges have on innovation, business models, and corporate

> governance and vice versa." It is also noteworthy in this context that proxy advisor Glass Lewis has announced that SASB guidance on material ESG will be integrated into GL's research reports and vote management application.

A Bloomberg representative contended that the problem is with the voluntary nature of current standards, which allows companies to engage in cherry-picking and "greenwashing," that is, filtering to portray an environmentally responsible public image. Nearly all companies, he maintained, were at economic risk from climate change, be it physical risk or transition risk. Investors want to know their processes for addressing these risks and how climate change affects their strategies, metrics and targets. With regard to climate change scenario analyses, he suggested that they could indicate the company's resilience as well as the quality of management. He also advocated that the SEC acknowledge that, if companies are voluntarily reporting, the SASB framework provides a good approach.

The representative from State Street suggested that ESG concerns are mainstream now, as many studies have shown that higher ESG scores are aligned with lower cost of capital, better operating performance and stock price improvements. However, because the data can be subjective, the framework was important. ESG data has proliferated and research has emerged from many sources, resulting in a lot of noise. The SSGA representative advocated broad adoption of a framework like SASB; the baseline question, she said, was whether the company has performed an analysis, but the use of different frameworks impairs comparability and consistency. Interestingly, she observed that there is some misunderstanding of the quality of the information reported—the underlying information is more primitive than financial information that is then analyzed to come up with ratings. Similarly, one committee member noted that some metrics are not really reducible to numbers.

A representative from Travelers noted that, in the past year, the company had 55 ESG-related survey requests, which required the expenditure of substantial time and money. She contended that there was some confusion about what ESG comprehended: it should be about "value," she argued, not "values." However, she thought private ordering of ESG disclosure worked well and did not favor the imposition of SEC requirements. In contrast, the representative from CalPERS contended that private ordering was inefficient and the resulting data risked becoming just "noise." The time was ripe to move to the regulatory arena. For example, how should investors address the fact that most companies do not voluntarily report? With all the companies CalPERS has to monitor, the current process was too *ad hoc*.

Another committee member commented that companies should keep in mind that even voluntary sustainability reports are subject to Rule 10b-5 liability and, according, should be subject to disclosure controls and other processes in place for SEC filings. In addition, he noted that some companies objected to scenario analyses on the basis that they could reveal competitive information.

So the question became whether the SEC disclosure regime "under-mandated" disclosure regarding ESG issues. From Goelzer's perspective, rulemaking such as that requested by the ESG petition could be difficult because, unlike MD&A, which is based on financial statements prepared under GAAP, there was no comparable starting point for ESG disclosure. Whether any rulemaking would be too burdensome would depend on the difficulty of the requirements. And rulemaking might actually ease the burden to the extent that it streamlined the process and eliminated the need to respond to the proliferation of surveys. In addition the absence of an SEC reporting requirement means that a lot of power resided in the ESG rating agencies.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Making Sense of the Current ESG Landscape

Posted by Peter Atkins, Marc Gerber and Richard Grossman, Skadden, Arps, Slate, Meagher & Flom LLP, on Thursday, October 18, 2018

Editor's note: Peter Atkins, Marc Gerber and Richard Grossman are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden memorandum by Mr. Atkins, Mr. Gerber, and Mr. Grossman. Related research from the Program on Corporate Governance includes Socially Responsible Firms by Alan Ferrell, Hao Liang, and Luc Renneboog (discussed on the Forum here) and Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

The question whether a public for-profit company can "do good" and make money at the same time has never been more relevant. Public companies are being bombarded with messages, requests and demands around "ESG"—environmental, social and governance—matters. These come from shareholders, asset managers, special interest groups, activist investors, private equity funds, ESG rating firms, trade groups, politicians, regulators, academics and others. They take a variety of forms, including shareholder proposals, surveys and questionnaires, letter writing campaigns, proxy voting policies, investor stewardship reports, speeches, white papers, academic studies, and legislation. Topics covered (putting aside the "G"—the governance issues with which boards are likely to be familiar) are numerous and varied, including sustainability, climate change, water management, human capital management, gender pay equity, board and workforce diversity, supply chain management, political and lobbying expenditures, the opioid crisis, and gun control. Boards of directors and management of public companies need to understand the increasing importance of this ESG landscape in which the company and investors are operating, including the growing prominence of ESG investing, the company's environmental and social (E&S) profile and vulnerabilities, and the path forward for the company as it deals with particular E&S issues.

This post briefly summarizes some of the key trends of the rapidly evolving E&S landscape of which directors and company management should be aware. In addition, it highlights a corporate law framework that has particular relevance for directors of companies incorporated in states such as Delaware that follow a shareholder primacy model—that shareholder welfare is the sole goal of directors, and that other interests may be taken into account only to further that goal.

ESG Investment. Recent reports place the level of ESG-focused investment at approximately $20 trillion of assets under management. New ESG funds and ETFs are being launched on a regular basis and with increasing frequency, and studies show that millennials have a greater interest in socially responsible investing. Within this umbrella, ESG investing can take various forms, for example making investments in companies viewed as positively addressing environmental or social issues, choosing to exclude companies in certain industry sectors viewed as problematic from an ESG perspective, or integrating ESG data into an assessment of risk-adjusted returns in order to make investment decisions.

The demand for ESG investment approaches has spurred a number of traditional investors, activist funds and private equity funds to enter this space. For example, in January 2018, ValueAct Capital launched its Spring Fund to invest in companies addressing environmental and societal problems and capture the excess returns it believes will be generated thereby. Another activist investor, Jana Partners, is reported to have hired staff for a new socially responsible fund to be named Jana Impact Capital. Also, recent reports indicate that private equity firm TPG is raising $3 billion for its second social impact fund, after previously raising a $2 billion fund focused on investments with positive social and environmental impacts.

ESG Ratings. An inevitable corollary of the increase in ESG-focused investment is the demand by those investors for ESG data and the corresponding and exponential growth in the number of entrants into the business of collecting, aggregating, synthesizing and ranking that data. The challenge is that each ESG ratings provider has its own methodology, and a company may receive widely divergent ratings from different organizations. Moreover, the ESG rating agencies may use different combinations of data sources other than company disclosures, including press reports, litigation filings, internet postings and other third-party sources, even though the company may not agree with the veracity or accuracy of those data sources.

It is possible that, over time, some ratings methodologies may prevail over others and the field will narrow to two or three dominant raters, as is the case in the governance space with ISS and Glass Lewis. And ISS and Glass Lewis are attempting to protect their turf by also including E&S ratings in their reports. In February 2018, ISS announced the launch of its E&S QualityScore, which seeks to analyze company disclosure across more than 380 factors organized into four environmental pillars and four social pillars. ISS includes those scores in its annual meeting voting recommendations report, and in May 2018 expanded its E&S coverage to 4,700 companies. Recently, Glass Lewis announced that guidance on material ESG topics from the Sustainability Accounting Standards Board would be integrated into its proxy research reports and vote management application.

ESG Activism. On January 6, 2018, activist Jana Partners and the California State Teachers' Retirement System (CalSTRS) published an open letter to Apple Inc. The letter expressed their view that Apple needed to offer parents more tools to protect children and to ensure that young customers use Apple products in an appropriate manner. Citing various studies regarding potential negative consequences of children's use of smart phones, the letter linked the issue to Apple's long-term value and called on Apple to take various steps to address the issue. Days later, Apple announced that it would introduce new features and tools to assist parents in combating children's overuse of smart phones. It remains to be seen whether other traditional activist investors, seeking to attract ESG-focused capital, launch similar ESG-themed campaigns.

ESG activism can also take the form of industry-wide or issue-specific campaigns. For example, a coalition of 30 treasurers, asset managers, and faith-based, public and labor funds formed Investors for Opioid Accountability and filed shareholder proposals on board oversight of business risks related to opioids at 10 companies involved in the manufacturing or distribution of opioids. Recently, another group of investors launched a resource to evaluate and act on water risks in investment portfolios, including tips on engaging with companies and on water-related shareholder proposals.

ESG Shareholder Proposals. According to ISS data, for 2017 and year-to-date 2018, proposals relating to E&S now make up a majority of all shareholder proposals submitted to US companies, at 53.4 percent and 54.4 percent, respectively. ISS reports that the median vote results year-to-date are at a record high of 23.4 percent, but it is noteworthy that median results for some topics are significantly higher—41.4 percent for sustainability reporting and 36.4 percent for workforce diversity. In a turning point, in 2017, climate change proposals relating to two degree Celsius scenarios received majority support for the first time, at three different companies. Other 2017 majority-supported E&S proposals related to sustainability reporting and board diversity. This year appears to have set a new record, with 10 E&S proposals receiving majority support year-to-date: two on climate change, two on sustainability reporting, three on other environmental topics, one on governance measures related to managing the opioid crisis risk and two calling on gun manufacturers to produce reports on gun safety measures.

Perhaps in recognition of these increasing levels of support, 2018 has been noteworthy for the increased withdrawal rate, with almost half of all E&S proposals submitted being withdrawn. Based on various reports and anecdotal evidence, it is likely that a large portion of the withdrawals were the result of company engagement with proponents and reaching satisfactory agreement for the company to take some action or make some additional disclosure.

Company Actions. In the financial activist space, the advice that has crystallized over the past few years is to look at your company the way an activist and/or a long-term shareholder would; anticipate and analyze the potential criticisms and be ready to respond; engage with institutional investors to learn their views and establish the board's and management's credibility with them; and communicate the company's business strategy, and the board's role in overseeing the development and execution of that strategy, clearly and coherently, to build support before an activist shows up.

It turns out that there are many parallels in the ESG space and, as described above, the lines between financial activists and ESG activists may continue to blur. As a result, a company's ESG vulnerability and profile may need to be given appropriate attention alongside traditional valuation and operational metrics.

Shareholder Primacy as a Guidepost. ESG should not be perceived as divorced from traditional economic metrics. At least for companies incorporated in states such as Delaware, that are subject to a fiduciary model of shareholder primacy—where the ultimate priority is the preservation and enhancement of shareholder welfare—boards should consider whether there is a nexus (and, if so, how strong) between specific ESG issues and the pursuit of shareholder welfare. The starting point involves consideration of ESG in light of the company's business strategy, which is the driver of shareholder value, the dominant component of shareholder welfare. Questions may include: Will addressing ESG topics allow the company to satisfy growing consumer trends and increase sales? Will addressing other ESG factors position the company to have a better workforce and decrease worker attrition and the related costs?

Even in those cases where a particular ESG matter does not fit directly within a company's business strategy, a company may need to consider whether inaction or a failure to be responsive to an issue presents risks to a company. These might include negative perceptions by consumers, regulators, employees or the public that could lead to a boycott of the company's products, regulatory intervention, active employee protest or morale decline, negative publicity, or other forms of harm to the company's ability to compete and produce shareholder value.

The rise in ESG investing presents new risks and perhaps opportunities. ESG investors' dissatisfaction with a company's ESG policies (or lack thereof) or responsiveness may have significant adverse effects. In particular, this could include loss of interest in the company as an investment or, perhaps, initiation of a public campaign, submission of shareholder proposals, or an election contest or a "vote no" campaign focused on changing the company's ESG position. On the positive side, understanding and anticipating ESG issues that may be promoted by investors might attract positive interest in the company and support from such investors.

These and many other potential questions are strategic decisions—like any other business strategy decisions—and as such are subject to board oversight. And once the board and management determine how, if at all, ESG factors align with that business strategy or are otherwise appropriate topics for action to preserve or enhance shareholder welfare, the board needs to determine the level of corporate investment appropriate in light of the expected returns (or losses avoided), how to measure success and how to incentivize management accordingly. Shareholder engagement then presents a forum to understand the concerns of investors and how they view the company, as well as to explain ESG in the context of that business strategy and the board's oversight role. It then becomes critical for the company to communicate, whether in annual reports, proxy statements, sustainability or corporate social responsibility reports, or other public statements, its approach to ESG matters as part of its overall business strategy.

Over the years there has been a debate, which continues loudly today, about whether directors can or should consider the interests of non-shareholder constituencies. The Chief Justice of the Delaware Supreme Court, Leo E. Strine, Jr., has made clear where Delaware law stands on the subject:

> "[A] clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare."[1]

ESG issues can be presented as having, and often do have, an "other, non-shareholder constituency" character. However, the context today is quite different than during the 1980s, which witnessed the rise of corporate constituency statutes that have been adopted by more than 30 states. That difference is manifested by the concentration of U.S. public company ownership in a relatively few institutional asset managers, the active and growing support from those entities (and from other equity owners) for environmental and social responsibility by public for-profit companies, and the heightened level of consciousness in the media, academia and general population regarding the demand for ESG responsibility by public for-profit companies.

To borrow a phrase from then-Justice Andrew Moore of the Delaware Supreme Court, in his 1985 *Revlon* decision, directors would appear to have wide latitude—and responsibility—for dealing with ESG issues to the extent they represent matters "rationally related [to] benefits

[1] Leo E. Strine, Jr., "The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law," 50 *Wake Forest Law Review* 761,771 (2015).

accruing to the stockholders." That said, it is incumbent on directors to do their homework and apply appropriate processes to establish informed decision-making regarding that key determination—which also will enable them to defend challenges to spending shareholder money on "causes" that not all shareholders may support and to demonstrate to the "new" shareholder constituency, ESG investors, the attention paid to the subject at the board level.

Beyond that, of course, are a myriad of other important and potentially difficult decisions that may be required. These may include: Whether, when, to whom and how to engage in outreach regarding ESG issues. Choosing among ESG matters. Deciding how, how much and when to spend company resources to support selected ESG matters. How and when to communicate choices made and actions taken.

In the end, although more consequential than ever, these are board decisions just like others, requiring the exercise of business judgment in the best interests of the company and its shareholders.

The SEC's New Shareholder Proposal Guidance

Posted by Brian Breheny, Marc Gerber, and Richard Grossman, Skadden, Arps, Slate, Meagher & Flom LLP , on Monday, November 12, 2018

Editor's note: Brian Breheny, Marc Gerber, and Richard Grossman are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden memorandum by Mr. Breheny, Mr. Gerber, Mr. Grossman, and Hagen J. Ganem.

On October 23, 2018, the Division of Corporation Finance (Staff) of the U.S. Securities and Exchange Commission (SEC) published Staff Legal Bulletin No. 14J (SLB 14J), which provides important guidance concerning shareholder proposals. Specifically, SLB 14J addresses:

- board analyses that may be provided in the context of certain "ordinary business" or "relevance" no-action requests;
- the "micromanagement" prong of the "ordinary business" exclusion; and
- application of the "ordinary business" exclusion to certain proposals addressing senior executive or director compensation.

Board Analyses

At this time last year, the Staff published Staff Legal Bulletin No. 14I (SLB 14I), which invited companies to assist the Staff by including in no-action requests a discussion of the board's analysis of whether a proposal is "otherwise significantly related" to a company's business, in the case of a "relevance" no-action request under Rule 14a-8(i)(5), or focuses on sufficiently significant policy issues with a nexus to the company's business operations, in the case of an "ordinary business" no-action request under Rule 14a-8(i)(7). As described in our July 2018 post, although a number of companies attempted to utilize this guidance by including some discussion of the board's analysis in their no-action requests, virtually all of these attempts were unsuccessful. In the course of the post-proxy season engagement between the Staff and various shareholder proposal constituencies, many questioned whether the potential benefits of including a board analysis in a no-action request were illusory.

In an apparent attempt to address the frustration felt in some corners, the Staff, in SLB 14J, reiterated that a well-developed discussion of the board's analysis can assist the Staff in evaluating certain no-action requests. In particular, the Staff stated that a well-developed discussion "will describe in sufficient detail the specific substantive factors the board considered in arriving at its conclusion that an issue is not otherwise significantly related to its business … or is not sufficiently significant in relation to the company." The Staff then suggested a non-exclusive list of potential factors a board may consider:

- the extent to which the proposal relates to the company's core business activities;

- quantitative data, including financial statement impact, related to the matter that illustrates its lack of significance;
- whether the company already has addressed the issue in some manner, such that the difference between the proposal's specific request and the actions already taken does not present a significant policy issue for the company;
- the extent of shareholder engagement on the matter and level of shareholder interest expressed in that engagement;
- whether anyone other than the proponent has requested the type of action or information sought by the proposal; and
- whether the company's shareholders previously have voted on the matter and the board's views of the voting results, including whether any subsequent actions taken by the company or intervening events since the vote impact the significance of the issue to the company.

The Staff confirmed that the inclusion of a board analysis is not required in a no-action request and that the inclusion or absence of a board analysis does not create any presumption for or against exclusion of a proposal.

Micromanagement

The ordinary business basis for excluding a shareholder proposal has two distinct prongs. One prong looks to the substance of the proposal; the second prong relates to the degree to which a proposal "micromanages" the company "by probing too deeply into matters of a complex nature," which may occur if the proposal "involves intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies." The Staff explains in SLB 14J that a proposal can relate to subject matter that is appropriate for shareholder consideration but can be excludable because it does so in a manner that micromanages the company.

As we observed in our July 2018 post, micromanagement arguments found new life during the 2018 proxy season. Although SLB 14J does not change the overall substance of the micromanagement prong of the ordinary business exclusion, the discussion of micromanagement suggests that its newfound vitality is likely to continue into the upcoming shareholder proposal season.

Proposals Addressing Senior Executive or Director Compensation

For some time, proposals concerning the workforce generally have been excludable as relating to ordinary business matters, and proposals focusing on senior executive or director compensation have not been excludable as ordinary business. SLB 14J addresses three aspects of this framework.

First, SLB 14J articulates the existing framework for analyzing proposals that address both senior executive or director compensation and ordinary business matters. It explains that the Staff analyzes the focus of the proposal to ascertain whether the underlying concern of the proposal is an ordinary business matter or is a senior executive and/or director compensation matter. Accordingly, SLB 14J says that proponents cannot avoid exclusion by including an aspect of senior executive or director compensation in a proposal that otherwise focuses on an ordinary business matter.

Second, SLB 14J articulates a new approach regarding proposals that address aspects of senior executive or director compensation that also are available or applicable to a company's general workforce. Where a proposal focuses on aspects of compensation available only to senior executives or directors, generally the proposal may not be excluded as relating to an ordinary business matter. On the other hand, if a proposal focuses on aspects of compensation that are broadly available to a company's general workforce, in addition to its senior executives and/or directors, and the company demonstrates that the executives' or directors' eligibility to receive the compensation does not implicate significant compensation matters, the proposal may be excluded on ordinary business grounds. It remains to be seen whether this distinction will prove to be of practical use to companies in arguing for the exclusion of proposals.

Third, and perhaps most significantly, SLB 14J expresses a reversal of the Staff's prior position that proposals addressing senior executive or director compensation could not be excluded on the basis of micromanagement under the ordinary business exclusion. Consistent with the micromanagement discussion above, SLB 14J states that going forward the Staff may agree that proposals addressing senior executive or director compensation that seek intricate detail or seek to impose specific timeframes or methods for implementing complex policies can be excluded on the basis of micromanagement. Where, precisely, the Staff draws the line on micromanagement and senior executive or director compensation only will become clear over time as the Staff considers the arguments in the context of specific proposals.

For additional information, a copy of SLB 14J is available here.

The Economic Relevance and Ordinary Business Exclusion for Shareholder Proposals

Posted by Cydney Posner, Cooley LLP, on Thursday, November 15, 2018

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

Corp Fin has just released a new staff legal bulletin on shareholder proposals—we're up to 14J—that once again examines the exclusions under Rules 14a-8(i)(5), the "economic relevance" exception, and 14a-8(i)(7), the "ordinary business" exception. Notably, these rules were also the subject of SLB 14I. More specifically, the new SLB provides guidance with regard to the following:

- the nature of the board analysis the staff would find most "helpful" in evaluating a no-action request to exclude a shareholder proposal,
- "micromanagement" as a basis for exclusion under Rule 14a-8(i)(7) and
- the application of Rule 14a-8(i)(7) to exclude proposals related to senior executive and/or director compensation matters.

Background

Rule 14a-8(i)(7). Under Rule 14a-8(i)(7), a company is permitted to exclude a proposal that "deals with a matter relating to the company's ordinary business operations." Why? Because the resolution of these types of matters is considered to be more properly the province of management and the board of directors than of the shareholders. In SLB 14I, the staff explained that the ordinary business exception is based on "two central considerations": the extent to which the proposal "micromanages" the company as well as the "subject matter" of the proposal. Generally, proposals may be excluded under Rule 14a-8(i)(7) if they "raise matters that 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,'" unless, that is, the "significant policy exception" applies. That exception would preclude exclusion of the proposal if the proposal focuses on policy issues that are so significant that "they transcend ordinary business and would be appropriate for a shareholder vote. Whether the significant policy exception applies depends, in part, on the connection between the significant policy issue and the company's business operations." SLB 14I advised that whether a policy issue is sufficiently significant to fall under the exception

"often raise[s] 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."

As a result, the SLB introduced a new element into the no-action request: in light of the difficult judgment calls involved, the staff "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."

***Rule 14a-8(i)(5)*.** Rule 14a-8(i)(5) permits a company 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 guidance in SLB 14I addressed the second prong of the rule, the proposal's significance to the company's business, indicating that the staff's analysis would be focused on a proposal's significance to the company's business when it otherwise related to operations that accounted for less than 5% of total assets, net earnings and gross sales. The SLB noted that the *burden was on the proponent* to show that a proposal was "otherwise significantly related to the company's business." That is, if the "proposal's significance to a company's business is not apparent on its face," it "may be excludable unless the proponent demonstrates that it is 'otherwise significantly related to the company's business.'" As with the "ordinary business" exception in Rule 14a-8(i)(7), Corp Fin advised that it would expect a company's Rule 14a-8(i)(5) no-action request to include a discussion that reflects the board's analysis of the proposal's significance to the company, again detailing "the specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned." (See this PubCo post.)

Board Analysis

In this past proxy season, a number of companies submitted no-action requests that, consistent with SLB 14I, included a discussion of the board's analysis, but, for the most part, without successfully persuading the staff to agree with a request for exclusion of the proposal. Accordingly, new SLB 14J offers guidance on ways to provide board analyses that might be more "helpful" to the staff. In the new guidance, the staff advises that board discussions were not as "helpful" where they did not describe the specific factors considered by the board, but were instead just conclusory or simply described the processes followed by the board—apparently notwithstanding SLB 14I's advocacy of analyses that "detailed the specific processes employed by the board." In contrast, the discussions that the staff "found most helpful focused on the board's analysis and the *specific substantive factors* the board considered in arriving at its conclusion [emphasis added]." In addition, the staff indicated that, although the "absence of a board analysis will not create a presumption against exclusion… without having the benefit of the board's views on the matters raised, the staff may find it difficult in some instances to agree that a proposal may be excluded. This is especially the case where the significance of a particular issue to a particular company and its shareholders may depend on factors that are not self-evident and that the board may be well-positioned to consider and evaluate. Likewise, the presence of a board analysis will not create a presumption of exclusion."

SideBar

On a 2017 webcast regarding SLB 14I, "Shareholder Proposals: Corp Fin Speaks," presented by TheCorporateCounsel.net, Matt McNair, Senior Special Counsel in Corp Fin's Office of Chief Counsel, confirmed that a board analysis was not mandatory. For example, where, based on a long trail of prior no-action letters, the proposal falls clearly within the exclusion, a board analysis may not be necessary. Note that this position was consistent with the positions previously articulated by Corp Fin director William Hinman and Corp Fin Associate Director Michele Anderson at the PLI Securities Regulation Institute. (See this PubCo post.) In addition, McNair's view was that the board discussion should focus on the board's insight with regard to the sufficiency of the connection or nexus to the company's business. (See this PubCo post.)

The new SLB then outlines the types of "specific substantive factors" that the staff expects to see discussed "in sufficient detail" in a "well-developed discussion," adding that the factors identified below are "not exclusive or exhaustive, nor is it necessary for a board analysis to address each one of the… factors":

- "The extent to which the proposal relates to the company's core business activities.
- Quantitative data, including financial statement impact, related to the matter that illustrate whether or not a matter is significant to the company.
- Whether the company has already addressed the issue in some manner, including the differences—or the delta—between the proposal's specific request and the actions the company has already taken, and an analysis of whether the delta presents a significant policy issue for the company. [Note, however, that the staff distinguished this analysis from the analysis required for "substantial implementation under Rule 14a-8(i)(10).]
- The extent of shareholder engagement on the issue and the level of shareholder interest expressed through that engagement.
- Whether anyone other than the proponent has requested the type of action or information sought by the proposal.
- Whether the company's shareholders have previously voted on the matter and the board's views as to the related voting results."

If a previous vote was significantly in favor or against, the staff will consider whether the company has taken any subsequent actions or whether other intervening events have occurred since the vote that may have mitigated or increased the issue's significance to the company. In addition, the more recent a vote, the more likely it is to be "indicative of the topic's significance to a company and its shareholders." Staff determinations will be made on a case-by-case basis, although the staff will generally not concur in exclusion of proposals that focus on substantive governance matters.

Micromanagement under Rule 14a-8(i)(7)

As noted above, one of the central considerations of the "ordinary business" exception is the extent to which the proposal seeks to "micromanage" the company "by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment." Under this prong of the exclusion, the staff does not look at the subject matter, but rather "only to the degree to which a proposal seeks to micromanage."

Excessive micromanagement could arise "where the proposal involves intricate detail, or seeks to impose specific timeframes or methods for implementing complex policies." In applying that framework, the staff has agreed to the exclusion of a proposal to "generate a plan to reach net-zero greenhouse gas emissions by the year 2030, which sought to impose specific timeframes or methods for implementing complex policies." Similarly, the staff has also granted no-action relief for the exclusion of a proposal seeking an intricately detailed study or report, including where the "substance of the report relates to the imposition or assumption of specific timeframes or methods for implementing complex policies." The new SLB emphasizes, however, that "the staff's concurrence with a company's micromanagement argument does not necessarily mean that the subject matter raised by the proposal is improper for shareholder consideration. Rather, in that case, it is the manner in which a proposal seeks to address an issue that results in exclusion on micromanagement grounds."

Application of Rule 14a-8(i)(7) to proposals that address senior executive and/or director compensation

Consistent with prior SEC guidance, proposals that relate to general employee compensation and benefits are excludable under Rule 14a-8(i)(7), while proposals that focus on significant aspects of senior executive and/or director compensation generally are not excludable under that rule. In analyzing the availability of the exclusion in this context, the SLB indicates that the staff takes into account both the actual resolution and the supporting statement. The SLB addresses the issues of proposals that relate to both executive comp and ordinary business, proposals that relate to both executive comp and workforce comp and proposals that may be viewed to micromanage executive comp.

Proposals that address senior executive and/or director compensation and ordinary business matters

In some cases, the availability of the exclusion depends on whether, at the end of the day, the focus of the proposal is executive comp or ordinary business. For example, the staff has agreed to exclusion of proposals that were styled as executive comp proposals but were considered by the staff to be primarily concerned with ordinary business, such as "a proposal requesting that the board prohibit payment of incentive compensation to executive officers unless the company first adopted a process to fund the retirement accounts of certain retired employees." In that case, the staff viewed the proposal to be focused not on executive comp but rather on "the ordinary business matter of employee benefits." By looking at the underlying focus of the proposals, the staff seeks to avoid elevating form over substance: the new SLB confirms that "including an aspect of senior executive or director compensation in a proposal that otherwise focuses on an ordinary business matter will not insulate a proposal from exclusion under Rule 14a-8(i)(7)."

Proposals that address aspects of senior executive and/or director compensation that are also available or applicable to the general workforce

Proposals related to executive comp are typically not excludable under Rule 14a-8(i)(7), but may be excludable "if a primary aspect of the targeted compensation is broadly available or applicable to a company's general workforce and the company demonstrates that the executives' or directors' eligibility to receive the compensation does not implicate significant compensation matters. For example, a proposal that seeks to limit when senior executive officers will receive golden parachutes may be excludable under Rule 14a-8(i)(7) if the company's golden parachute provision broadly applies to a significant portion of its general workforce." The rationale for this position is that, even where the proposal is framed in terms of executive comp, if the form of comp is broadly available or applicable to a company's general workforce, the proposal would "not generally raise significant compensation issues that transcend ordinary business matters." In the new SLB, the staff advises that it will take the following approach:

- Companies will generally not be permitted to rely on Rule 14a-8(i)(7) to exclude proposals that focus on aspects of compensation that are available or apply only to senior executive officers and/or directors.
- Companies will generally be permitted to rely on Rule 14a-8(i)(7) to exclude proposals that focus on aspects of compensation that are available or apply to senior executive officers, directors and the general workforce.

Proposals that micromanage senior executive and/or director compensation practices

Although, historically, the staff has not concurred in exclusion of proposals addressing executive comp on the basis of micromanagement, the staff has now changed its position and does "not believe there is a basis for treating executive compensation proposals differently than other types of proposals." Accordingly, the staff may now agree to exclusion, on the basis of micromanagement, of executive comp proposals "that seek intricate detail, or seek to impose specific timeframes or methods for implementing complex policies." As an example of a potentially excludable proposal, the SLB describes a proposal "detailing the eligible expenses covered under a company's relocation expense policy such as the type and duration of temporary living assistance, as well as the scope of eligible participants and amounts covered."

Tab IV: Current Legal Developments and Proposals

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

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

(1) In general.—An entity that is organized as a corporation, body corporate, body politic, joint stock company, or limited liability company in a State shall obtain a charter from the Office as follows:

(A) If the entity is a large entity with respect to the most recently completed taxable year of the entity before the date of enactment of this Act, the entity shall obtain the charter not later than 2 years after the date of enactment of this Act.

(B) If the entity is a large entity with respect to any taxable year of the entity that begins after the date of enactment of this Act, the entity shall obtain the charter not later than 1 year after the last day of that taxable year.

(2) Failure to obtain charter.—An entity to which paragraph (1) applies and that fails to obtain a charter from the Office as required under that paragraph shall not be treated as a corporation, body corporate, body politic, joint-stock company, or limited liability company, as applicable, for the purposes of Federal law during the period beginning on the date on which the entity is required to obtain a

charter under that paragraph and ending on the date on which the entity obtains the charter.

(b) RESCISSIONS.—

(1) IN GENERAL.—An entity that has obtained a charter as a United States corporation and, with respect to a subsequent taxable year of the entity, is not a large entity may file a petition with the Office to rescind the charter of the United States corporation.

(2) DETERMINATION.—Not later than 180 days after the date on which the Office receives a petition that an entity files under paragraph (1), the Office shall grant the petition if the Office determines that the entity, with respect to the most recently completed taxable year of the entity preceding the date on which the petition was filed, was not a large entity.

SEC. 5. RESPONSIBILITIES OF UNITED STATES CORPORATIONS.

(a) DEFINITIONS.—In this section:

(1) GENERAL PUBLIC BENEFIT.—The term "general public benefit" means a material positive impact on society resulting from the business and operations of a United States corporation, when taken as a whole.

(2) SUBSIDIARY.—The term "subsidiary" means, with respect to a person, an entity in which the person owns beneficially or of record not less than 50 percent of the outstanding equity interests of the entity, calculated as if all outstanding rights to acquire equity interests in the entity had been exercised.

(b) CHARTER REQUIREMENTS.—

(1) IN GENERAL.—The charter of a large entity that is filed with the Office shall state that the entity is a United States corporation.

(2) CORPORATE PURPOSES.—A United States corporation shall have the purpose of creating a general public benefit, which shall be—

(A) identified in the charter of the United States corporation; and

(B) in addition to the purpose of the United States corporation under the articles of incorporation in the State in which the United States corporation is incorporated, if applicable.

(c) STANDARD OF CONDUCT FOR DIRECTORS AND OFFICERS.—

(1) CONSIDERATION OF INTERESTS.—In discharging the duties of their respective positions, and in considering the best interests of a United States

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.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Keeping Investors out of Court—The Looming Threat of Mandatory Arbitration

Posted by Salvatore Graziano and Robert Trisotto, Bernstein Litowitz Berger & Grossmann LLP, on Monday, February 87, 2019

Editor's note: Salvatore Graziano is a managing partner and Robert Trisotto is a former associate with Bernstein Litowitz Berger & Grossmann LLP. This post is based on their BLB&G memorandum.

Over eighty years ago, federal securities laws were enacted to safeguard investments on national securities markets. These securities laws—premised on the notion that investors should receive accurate and thorough information regarding the public companies that they own—have transformed United States stock exchanges into the most prominent and trusted exchanges in the world.

Despite this impressive history, the management of some publicly-traded companies have increasingly sought to evade federal securities laws by altering their charters or bylaws in ways that the drafters of securities laws likely never imagined. For instance, companies have attempted to deter shareholders from filing lawsuits against corporate management by adopting fee-shifting provisions in their charters or bylaws. Such provisions would place a losing shareholder on the hook for the company's attorney's fees and expenses in disputes over management's actions on behalf of investors.

Companies have also tried to restrict shareholders' access to certain forums to enforce the securities laws. For example, after the US Supreme Court held that state courts are open to investors to file class actions alleging claims under the Securities Act of 1933 in Cyan, Inc. v. Beaver County Employees' Retirement Fund, companies such as Blue Apron Holdings, Inc., Stitch Fix, Inc., and Roku, Inc. adopted clauses in their charters aimed at requiring shareholders to file Securities Act claims in what management viewed to be a more favorable forum: federal court.

Perhaps most troubling, companies have tried, albeit unsuccessfully, to adopt mandatory arbitration provisions in their charters or bylaws to completely shut off the courtroom to investors. Companies' past efforts to force arbitration on investors were rejected by the SEC. But, recent commentary from the SEC suggests it may revisit its policy against mandatory arbitration provisions. This has sparked a vigorous discussion about the practical effects that mandatory arbitration provisions would have on investors' ability to adequately vindicate their rights under the securities laws. As detailed further below, forced arbitration raises serious concerns about depriving investors of important federal rights to litigate securities fraud violations in court. Although arbitration may offer benefits to companies and their management, many scholars and advocates have concluded that the potential harm to investors of being forced to arbitrate securities violations significantly outweighs such benefits.

The SEC has historically protkeeping-investors-out-of-court-the-looming-threat-of-mandatory-arbitrationected investors from forced arbitration

The SEC has long protected investors from companies' efforts to force them into mandatory arbitration instead of litigation in federal courts. For instance, in 1988, Franklin First Financial Corporation declared its intention to include a mandatory arbitration provision in its charter and bylaws in advance of its planned IPO. Similarly, in 2012, The Carlyle Group LP filed a draft registration statement with the SEC that would have required investors to arbitrate disputes. In both cases, the SEC refused to accelerate the effective date of the companies' registration statements, thereby effectively blocking the companies' ability to proceed with their planned IPOs. The result: Both companies abandoned their plan to prohibit shareholders from filing class-action lawsuits.

The SEC has also prevented public companies from modifying their existing bylaws to provide for mandatory shareholder arbitration. For example, when a proposal was made to amend the bylaws of Gannett Co., Inc. to require investor disputes to be submitted to arbitration, the SEC encouraged Gannett to omit the proposal from its proxy materials (by stating that it would "not recommend enforcement action to the Commission" if it was indeed omitted) as there was support for the view that "implementation of the proposal would cause the company to violate the federal securities laws." The SEC has also supported other companies' (Alaska Air Group, Inc. and Pfizer Inc., for example) decisions to exclude similar pro-arbitration proposals.

SEC officials have signaled potential policy shift towards arbitration

Despite repeatedly rejecting companies' attempts to force arbitration on investors for the past three decades, the SEC has recently suggested that it may reconsider its position on mandatory arbitration provisions. In a July 2017 speech to the Heritage Foundation, former SEC Commissioner Michael Piwowar supported changing the SEC's policy to allow companies to force shareholders to resolve claims through arbitration rather than in court. Piwowar stated that "[f]or shareholder lawsuits, companies can come to us to ask for relief to put in mandatory arbitration into their charters…I would encourage companies to come and talk to us about that." Additionally, the US Department of the Treasury issued a report in October 2017 suggesting that mandatory arbitration be used as a tool to reduce the costs of shareholder litigation and recommended that "the SEC continue to 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." More recently, in August 2018, SEC Commissioner Hester Peirce stated in a public interview that she "absolutely" thinks that public companies should have the option to require investors to resolve shareholder disputes through arbitration.

This is not the view of all SEC officials. For example, in February 2018, SEC Commissioner Robert J. Jackson, Jr. expressed his "concern" about mandatory arbitration provisions because of the important role shareholder litigation plays in policing corporate misconduct and given the SEC's limited resources. Also in February 2018, SEC Investor Advocate Rick Fleming called mandatory arbitration "draconian" because it would "strip [] away the right of shareholders to bring a class action lawsuit," which is vital in "helping to protect investors and deter wrongdoing." But the fact remains that certain SEC officials appear to be inclined to open the door for mandatory arbitration.

Mandatory arbitration provisions may significantly erode investor rights

Mandatory arbitration provisions have the potential to undermine investors' ability to prosecute securities claims in court and hold companies accountable for their misconduct. Under the Federal Rules of Civil Procedure, investors can institute a class action to hold companies liable for their violations of securities laws in federal court. But, if limited to arbitration and subjected to class action waivers, individual investors may not be able to afford to pursue their claims unless they have very large losses.

In a class action, a plaintiff seeks relief for a company's securities violations on behalf of itself and the class, allowing it to share the cost of litigating with all investors. In contrast, in arbitration subject to class action waiver provisions, the claimant can only seek relief for its own claims and thus must bear the costs of the arbitration alone. Securities fraud cases are often complex cases, requiring multi-million-dollar capital expenditures before trial. If the case goes to trial, litigation expenses could be much more. By preventing investors from asserting their claims in a class action in the federal courts, mandatory arbitration provisions could force countless investors to forego meritorious claims.

Mandatory arbitration provisions could also eliminate shareholder litigation's ability to deter violations of securities laws. Arbitration generally takes place in a private setting and arbitration clauses typically prohibit the disclosure of any information about the proceedings. Absent public accountability, companies can keep their misconduct a secret, hiding it from the public in perpetuity.

Arbitration and class action waiver provisions could also stifle critical enforcement of the securities laws. Shareholder litigation serves as an essential tool to enforce securities violations, along with enforcement by the SEC and the Department of Justice. Each year, private litigants hold public companies accountable for billions of dollars of securities fraud violations. Their results compare well to governmental enforcement actions. SEC Commissioner Jackson noted earlier this year that, following securities fraud scandals at WorldCom, Enron, Tyco, Bank of America, and Global Crossing, the SEC recovered only about $1.75 billion while investors in private class action suits recovered more than ten times that amount, or about $19.4 billion. Without shareholder class actions to seek relief for securities violations, companies' misconduct could get a free pass, investors could be undercompensated, and there would be far fewer factors deterring fraud and other corporate misconduct. With a reduced probability of being caught, corporate managers could commit fraud without fear of serious consequence.

The way forward—institutional investors must proactively address managerial overreach and fraud

Institutional investors should remain vigilant in monitoring and combating efforts by corporate management to strip them of their valuable rights to litigate securities fraud claims in court. With companies, the business lobby, and other anti-shareholder special interests ready to reignite the fight over mandatory arbitration provisions, investors must voice their concerns about forced arbitration to legislators and the SEC, and be prepared to pursue available legal remedies to challenge the attempted use of mandatory arbitration provisions. Investors should stand together against these renewed attacks on fundamental shareholder rights.

The Division of Corporate Finance's Response to Mandatory Arbitration Proposal

Posted by Cydney Posner, Cooley LLP, on Saturday, February 23, 2019

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

The issue of mandatory arbitration bylaws is a hot potato—and a partisan one at that (with Rs tending to favor and Ds tending to oppose). And in this no-action letter issued yesterday to Johnson & Johnson—granting relief to the company if it relied on Rule 14a-8(i)(2) (violation of law) to exclude a shareholder proposal requesting adoption of mandatory arbitration bylaws—Corp Fin successfully passed the potato off to the State of New Jersey. Crisis averted. However, the issue was so fraught that SEC Chair Jay Clayton felt the need to issue a statement supporting the staff's hands-off position:

The issue of mandatory arbitration provisions in the bylaws of U.S. publicly-listed companies has garnered a great deal of attention. As I have previously stated, the ability of domestic, publicly-listed companies to require shareholders to arbitrate claims against them arising under the federal securities laws is a complex matter that requires careful consideration,

> consideration that would be more appropriate at the Commissioner level than at the staff level. However, as Clayton has previously indicated, mandatory arbitration is not an issue that he is anxious to have the SEC wade into at this time. To be sure, if the parties really want a binding answer on the merits, he suggested, they might be well advised to seek a judicial determination.

SideBar

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.

In what again seems to be an odd role reversal, a Harvard professor and shareholder of Johnson & Johnson submitted a proposal *requesting* that the board adopt a mandatory arbitration bylaw applicable to "disputes between a stockholder and the Corporation and/or its directors, officers or controlling persons relating to claims under federal securities laws in connection with the purchase or sale of any securities issued by the Corporation." The bylaw would also prohibit class actions and include a five-year sunset provision unless re-approved by the shareholders. And again, curiously, the company *fought to exclude* the proposal on the basis of Rule 14a-8(i)(2), that the bylaw would violate federal and state law.

More specifically, the bylaw, the company argued, would violate federal law because it would, among other things, "weaken the ability of investors in Johnson & Johnson's securities to pursue a private right of action under Exchange Act Section 10(b) and Rule 10b-5." In addition, the company maintained, the staff has "long taken the view that including arbitration clauses in the governing documents of U.S. public companies is contrary to public policy." In any event, echoing Chair Clayton, the company contended that a shareholder proposal was not the best place to address this issue. In response, the proponent argued that SCOTUS has frequently held that "mandatory individual arbitration, under the auspices of the Federal Arbitration Act, does not conflict with the ability of an aggrieved party to vindicate rights provided under *any* federal statute absent 'a clearly expressed congressional intention' to the contrary."

The company then expanded its argument, contending that the proposal, if implemented, would also violate state law, resulting in costly litigation, and submitting in support an opinion of NJ counsel. Although, interestingly, the NJ opinion staked out a position in favor of arbitration, it ultimately concluded, notwithstanding the absence of NJ case law on point, that implementation of the proposal would likely violate NJ state law on two bases. Looking to precedent from Delaware, the opinion contended, first, that NJ does not permit the company to mandate in its bylaws arbitration of federal securities law claims, and second, that the bylaw would not be binding on future shareholders who did not approve the provision. The proponent disagreed, arguing that other Delaware case law supports the concept that "an external claim can be addressed in a charter or bylaw provision *if* it arises out of a relationship between the corporation and its shareholders *qua* shareholders." Second, the proponent maintained that, under "basic principles of corporate law,… bylaws are a contract between a company and its shareholders, the terms of which shareholders accept when they become shareholders, and which are subject to amendment."

Into the midst of this debate the company then submitted a letter from the Attorney General of the State of New Jersey, the state's chief legal officer, which advised the SEC the proposal was excludable under Rule 14a-8(i)(2) because

> adoption of the proposed bylaw would cause Johnson & Johnson to violate applicable *state* law. Longstanding principles of New Jersey law limit the subject matter of corporate bylaws to matters of internal concern to the corporation. Under New Jersey law, as under Delaware law, forum-selection provisions relating to claims under the federal securities laws do not address matters of internal concern, and bylaw provisions purporting to dictate the forum for such claims—including but not limited to mandatory arbitration provisions—are void.

Moreover, the NJAG argued, recent amendments to the New Jersey code specifically addressed forum-selection bylaws, but did not authorize forum-selection bylaws relating to federal securities law claims, thus reinforcing the NJAG's position. Among other things, the proponent urged the SEC not to give the NJAG Letter "any special weight" because the AG was just interpreting *Delaware* law to reach a conclusion about New Jersey law.

But to no avail. The staff gave plenty of special weight to the NJAG—in fact, the staff's no-action relief rode entirely on the back of the NJAG:

> When parties in a rule 14a-8(i)(2) matter have differing views about the application of state law, we consider authoritative views expressed by state officials….We view this submission [by the NJAG] as a legally authoritative statement that we are not in a position to question.

In addition, the staff made the point, in granting the no-action request, that it was

> not expressing its own view on the correct interpretation of New Jersey law [or] whether the Proposal, if implemented, would cause the Company to violate federal law. Chairman Clayton has stated that questions regarding the federal legality or regulatory implications of mandatory arbitration provisions relating to claims arising under the federal securities laws should be addressed by the Commission in a measured and deliberative manner.

In light of the staff's position as a dispenser of only informal views regarding the propriety of Enforcement action, not as a body opining on the legality of the proposal, Corp Fin suggested that the "[p]arties could seek a more definitive determination from a court of competent jurisdiction."

In his contemporaneous statement, Clayton observed that this issue has previously arisen in the "hypothetical context" of whether Corp Fin would be willing to declare an IPO effective if the company had included mandatory arbitration provisions in its governing documents. At the time Clayton had "stated that, if the issue were to arise in an actual initial public offering of a domestic company, it would not be appropriate for resolution at the staff level but would rather be best addressed in a measured and deliberative manner by the Commission." Now the issue has come up again in a different context, and Clayton agreed that the approach taken by the staff was appropriate:

> Since 2012, when this issue was last presented to [Corp Fin] in the context of a shareholder proposal, federal case law regarding mandatory arbitration has continued to evolve. Further, I am not aware of any circumstances where the Commission has weighed in on the legality of mandatory shareholder arbitration in the context of federal securities law. In light of the unsettled and complex nature of this issue, as well as its importance, I agree with the approach taken by the staff to not address the legality of mandatory shareholder arbitration in the context of federal securities laws in this matter, and would expect our staff to take a similar approach if the issue were to arise again. I continue to believe that any SEC policy decision on this subject should be made by the Commission in a measured and deliberative manner.

More generally, Clayton emphasized that the non-binding, informal nature of staff views expressed as part of the no-action process "do not and cannot definitively adjudicate the merits of a company's position with respect to the legality of a shareholder proposal. A court is a more appropriate venue to seek a binding determination of whether a shareholder proposal can be excluded."

SideBar

You may recall that, back in July 2017, then 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 this PubCo post.) 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."

But in subsequent Senate testimony, Clayton put the kibosh on these signals. According to an article in Pensions & Investments, in testimony before the Senate Banking Committee in February 2018, Clayton indicated that barring shareholder securities fraud litigation was not in the offing. In questioning, Senator Elizabeth Warren, asked whether Clayton would support the "enormous change" of allowing companies to adopt mandatory arbitration provisions. 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.] (See this PubCo post.)

The following month, at a meeting of the SEC's Investor Advisory Committee, Clayton delivered an opening statement that explained why mandatory arbitration provisions were “not on my list of near-term priorities.” In Clayton’s view, the SEC has limited rulemaking capacity and resources, which should be reserved for matters that were more pressing for investors and markets, more central to the SEC’s core “mission” and were ripe for consideration and addressable with a reasonable time commitment. With regard to mandatory shareholder arbitration provisions, he was “not anxious for this issue to come before the agency. This is a complex issue that invokes divergent and deeply held perspectives and could inevitably exhaust a disproportionate share of the Commission’s resources.…This does not mean that the topic is not worthwhile to discuss, and I encourage those with strong views to support their position with robust analysis.” Nevertheless, Clayton clarified that he had “not formed a definitive view on whether or not mandatory arbitration for shareholder disputes is appropriate in any particular circumstance. I believe any decision would be facts and circumstances dependent.” (See this PubCo post.)

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Statement on Shareholder Proposals Seeking to Require Mandatory Arbitration Bylaw Provisions

Posted by Jay Clayton, U.S. Securities and Exchange Commission, on Tuesday, February 12, 2019

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.

The issue of mandatory arbitration provisions in the bylaws of U.S. publicly-listed companies has garnered a great deal of attention. As I have previously stated, the ability of domestic, publicly-listed companies to require shareholders to arbitrate claims against them arising under the federal securities laws is a complex matter that requires careful consideration.[1]

On various occasions, I have been asked about this issue in the hypothetical context of whether the staff of the Division of Corporation Finance would declare effective the registration statement of a domestic company seeking to include mandatory arbitration provisions in its governing documents at the time of its initial public offering. In response to these inquiries, I stated that, if the issue were to arise in an actual initial public offering of a domestic company, it would not be appropriate for resolution at the staff level but would rather be best addressed in a measured and deliberative manner by the Commission.

The issue has risen again, but it is being presented in a different context. A domestic, publicly-listed company has received a shareholder proposal that would require the company to take steps to adopt mandatory arbitration provisions. The company has asked the staff of the Division of Corporation Finance for informal guidance on whether the company may exclude the proposal from its proxy statement. Specifically, the request seeks the staff's view on whether, under Rule 14a-8(i)(2), the company may omit from its proxy statement a shareholder proposal relating to mandatory arbitration of shareholder claims arising under the federal securities laws. Rule 14a-8(i)(2) permits exclusion of a proposal that, if implemented, would cause the company to violate any state, federal or foreign law to which it is subject. The company has argued that the proposal, if implemented, would result in a violation of both federal and state law.

This is a complex matter under both federal and state law, and it has been interpreted differently by the company (arguing that such a clause would violate both state and federal law) and the proponent (arguing that such a clause would not violate state or federal law). The staff considered

[1] For background, see (1) letter to the Honorable Carolyn B. Maloney dated April 28, 2018, available at https://maloney.house.gov/sites/maloney.house.gov/files/MALONEY%20ET%20AL%20-%20FORCED%20ARBITRATION%20-%20ES156546%20Response.pdf; (2) S. Hrg. 115-176, Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, Feb. 6, 2018, available at https://www.govinfo.gov/content/pkg/CHRG-115shrg28854/pdf/CHRG-115shrg28854.pdf at 146-151; (3) Remarks before the SEC Investor Advisory Committee (March 8, 2018), available at https://www.sec.gov/news/public-statement/statement-clayton-2018-3-8.

in its analysis the arguments made by the company, the proponent and the Attorney General of New Jersey, the state's chief law enforcement officer and legal advisor. The staff issued a response stating that it would not recommend enforcement action should the company decide to exclude the proposal on the grounds that it would violate New Jersey state law. In the context of Rule 14a-8, the staff does not independently adjudicate the legality of any provision of state law, and it is not doing so in this matter. Here, the parties have each asserted different interpretations of state law, neither party has identified New Jersey case law precedent directly on point, and the Attorney General has provided an opinion that implementation of the proposal would violate state law. In light of the submissions, and in particular the letter of the Attorney General of New Jersey, I believe the approach taken by the staff—to not recommend enforcement action in this complex matter of state law—is appropriate.

The staff of the Division of Corporation Finance explicitly noted that it was not expressing a view as to whether the proposal, if implemented, would cause the company to violate federal law. Since 2012, when this issue was last presented to staff in the Division of Corporation Finance in the context of a shareholder proposal, federal case law regarding mandatory arbitration has continued to evolve. Further, I am not aware of any circumstances where the Commission has weighed in on the legality of mandatory shareholder arbitration in the context of federal securities law. In light of the unsettled and complex nature of this issue, as well as its importance, I agree with the approach taken by the staff to not address the legality of mandatory shareholder arbitration in the context of federal securities laws in this matter, and would expect our staff to take a similar approach if the issue were to arise again. I continue to believe that any SEC policy decision on this subject should be made by the Commission in a measured and deliberative manner.

More generally, it is important to note that the staff's Rule 14a-8 no-action responses reflect only informal views of the staff regarding whether it is appropriate for the Commission to take enforcement action.[2] The views expressed in these responses are not binding on the Commission or other parties, and do not and cannot definitively adjudicate the merits of a company's position with respect to the legality of a shareholder proposal. A court is a more appropriate venue to seek a binding determination of whether a shareholder proposal can be excluded.

[2] Chairman Jay Clayton, Statement Regarding SEC Staff Views (Sept. 13, 2018), available at https://www.sec.gov/news/public-statement/statement-clayton-091318. See also, Division of Corporation Finance, Informal Procedures Regarding Shareholder Proposals, available at https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8-informal-procedures.htm.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Delaware Law Status of Bylaws Regulating Litigation of Federal Securities Law Claims

Posted by Lawrence A. Hamermesh (Widener University), on Thursday, November 29, 2018

Editor's note: Lawrence A. Hamermesh is Professor Emeritus at Widener University Delaware Law School and Executive Director of the Institute for Law & Economics at the University of Pennsylvania law School. This post is based on a white paper issued by Professor Hamermesh and Professors Lucian Bebchuk, John Coates IV, John Coffee Jr., Wendy Gerwick Couture, James Cox, Michael Kaufman, Donald Langevoort, Ann Lipton, Joshua Mitts, Frank Partnoy, Brian JM Quinn, Joel Seligman, Dean Gordon Smith, James Spindler, Marc Steinberg, Randall Thomas, Robert Thompson, Urska Velikonja, David Webber, and Verity Winship.

As one commentator recently observed, "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."[1] Responding to that interest, SEC Chairman Jay Clayton correctly observed that the validity of such bylaws "involves our securities laws, matters of other federal and state law, an array of market participants and activities, as well as matters of U.S. jurisdiction."[2]

This submission focuses on only one of the elements identified by Chairman Clayton, namely the validity of such a bylaw under state law—and more specifically, Delaware corporate law.[3] The signatories to this submission hold a wide range of differing views regarding the utility of federal securities class actions. What they hold in common, however, is the view that Delaware corporate law does not permit a corporate bylaw (or charter provision, for that matter) to require that claims arising under the federal securities laws be resolved in arbitration or indeed in any specified venue. The reasoning supporting that view is set forth below.[4]

The efficacy of a charter or bylaw provision purporting to affect federal securities class actions must be determined under Delaware case law interpreting the scope of Sections 102(b)(1) and

[1] Andrew Rhys Davies, *The Legality of Mandatory Arbitration Bylaws*, Sep. 13, 2018, discussed on the Forum here.

[2] Letter to Hon. Carolyn Maloney from Chairman Jay Clayton, April 24, 2018, *available at* https://maloney.house.gov/sites/maloney.house.gov/files/MALONEY%20ET%20AL%20-%20FORCED%20ARBITRATION%20-%20ES156546%20Response.pdf.

[3] The substance of this submission is drawn largely from a post by Lawrence A. Hamermesh and Norman M. Monhait on June 29, 2015, available at http://blogs.law.widener.edu/delcorp/2015/06/29/fee-shifting-bylaws-a-study-in-federalism/#sthash.hh7my2nZ.sB2182Nx.dpbs. This submission does not address the separate question of whether a corporation's articles or bylaws may be viewed as a contract for the purposes of the Federal Arbitration Act (FAA), 9 U.S.C. §1, et seq., enacted February 12, 1925.

[4] A similar issue of Delaware corporate law was recently argued in the Delaware Court of Chancery, on motions for summary judgment regarding the validity of bylaws adopted by Roku Inc., Stitch Fix Inc., and Blue Apron. Those bylaws purport to require that claims under the Securities Act of 1933 be litigated in federal court, rather than in a state court.

109(b) of the Delaware General Corporation Law (DGCL). The leading authorities in this regard are the opinion of then Chancellor Leo E. Strine, Jr. in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*,[5] and the Delaware Supreme Court's subsequent opinion in *ATP Tour v. Deutscher Tennis Bund*.[6] Relying on the concept that the DGCL and a corporation's charter and bylaws constitute a "flexible contract" to which the stockholders are a party,[7] those opinions uphold bylaw provisions requiring that claims arising under the DGCL and Delaware corporate law be litigated in a specified forum, and that attorney's fees and expenses in such litigation must be borne by unsuccessful plaintiff stockholders.[8] Those opinions clarify, however, that Sections 102(b)(1) and 109(b) cannot be read, despite their breadth and the presumptive validity of provisions adopted pursuant to them, to authorize provisions regulating litigation under the federal securities laws.

In *Chevron*, what the court endorsed was a bylaw that specified a forum (Delaware) for litigating "the kind of claims most central to the relationship between those who manage the corporation and the corporation's stockholders"—namely, "suits brought by stockholders as stockholders in cases governed by the internal affairs doctrine."[9] In contrast, the court went out of its way to distinguish a bylaw regulating "external" matters, such as "a bylaw that purported to bind a plaintiff, even a stockholder plaintiff, who sought to bring a tort claim against the company based on a personal injury she suffered that occurred on the company's premises or a contract claim based on a commercial contract with the corporation."[10] A bylaw regulating selection of a forum to litigate such external claims "would be beyond the statutory language of 8 Del. C. 109(b)" for the "obvious" reason that it "would not deal with the rights and powers of the plaintiff-stockholder *as a stockholder*."[11]

By the same token, a bylaw purporting to regulate the litigation of claims under Rule 10b-5 "would not deal with the rights and powers of the plaintiff[] *as a stockholder*," and would therefore not be within even the broad scope of Section 109(b). As the Delaware Court of Chancery has observed, "[a] Rule 10b-5 claim under the federal securities laws is a personal claim akin to a tort claim for fraud. The right to bring a Rule 10b-5 claim is not a property right associated with shares, nor can it be invoked by those who simply hold shares of stock."[12] Accordingly, regulation of the venue for (or other aspects of) a claim under Rule 10b-5 is beyond the subject matter scope of the charters and bylaws of Delaware corporations.

Nothing in *ATP* altered this analysis. Addressing the principal certified question in that case, the Court was necessarily focused on "suits brought by stockholders as stockholders in cases *governed by the internal affairs doctrine*."[13] In the underlying litigation, the plaintiffs alleged "Delaware fiduciary duty claims," as well as antitrust claims. There is no indication in

[5] 73 A.3d 934 (Del. Ch. 2013).

[6] 91 A.3d 554 (Del. 2014).

[7] *Chevron*, 73 A.3d at 940 ("bylaws, together with the certificate of incorporation and the broader DGCL, form part of a flexible contract between corporations and stockholders, in the sense that the certificate of incorporation may authorize the board to amend the bylaws' terms and that stockholders who invest in such corporations assent to be bound by board-adopted bylaws when they buy stock in those corporations.").

[8] The latter proposition, set forth in *ATP*, was legislatively overruled in 2015. 80 Del. Laws, c. 40, §§ 2-3.

[9] 73 A.3d at 952.

[10] *Id.* In cases involving such external claims, the stockholders indirectly bear the costs of the litigation to the corporation, but *Chevron* makes clear that this circumstance does not convert the matter into one within the internal affairs of the corporation and therefore subject it to regulation by the charter or bylaws of the corporation.

[11] *Id.* (emphasis in original).

[12] *In re Activision Blizzard Inc. Stockholder Litigation*, C.A. No. 8885-VCL (Del. Ch. May 21, 2015), slip op. at 50.

[13] 91 A.3d at 556 (emphasis added).

the *ATP* opinion that the Supreme Court questioned former Chancellor Strine's view that the "flexible contract" formed by the statute, charter, and bylaws could not extend to any litigation other than "suits brought by stockholders as stockholders in cases governed by the internal affairs doctrine." Indeed, if the underlying litigation had involved only antitrust claims, the Court would have concluded (consistent with *Chevron*) that the bylaw could not have provided for fee-shifting in relation to the claims presented. And having been asked merely to opine about the overall facial validity of the bylaw, the Court had no occasion to parse the facts to determine whether the bylaw could require shifting fees that might have been solely attributable to the antitrust claims.

In sum, the "flexible contract" identified in *Chevron* and *ATP*, and established by the governing corporate statutes, the certificate of incorporation, and the bylaws, encompasses a great deal—the subject matter scope of Sections 102(b)(1) and 109(b) is broad. But it is not limitless, as *Chevron* expressly teaches. And in our view, it does not extend so far as to permit the charter or the bylaws to create a power to bind stockholders in regard to the venue for federal securities class actions. In summary, Delaware law does not permit bylaws to restrict the forum for federal securities actions, because the right to bring such actions is not a property right associated with shares of corporate stock, and it thus falls outside of the scope of what Delaware law permits the corporate charter and bylaws to regulate.

California Law Awaiting Governor's Signature Exceeds State's Jurisdiction

Posted by Theodore N. Mirvis and Kevin S. Schwartz, Wachtell, Lipton, Rosen & Katz, on Monday, September 24, 2018

Editor's note: Theodore N. Mirvis and Kevin S. Schwartz are partners at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton firm memorandum by Mr. Mirvis and Mr. Schwartz.

We previously reported that California made headlines this summer with legislative action that would institute gender quotas for boards of directors of public companies headquartered in the state. This first-of-its-kind measure has now been approved by both legislative chambers and may be signed by the Governor in the coming week. California's commitment to increasing diversity in the boardroom is laudable, but this proposed law would unconstitutionally sweep within its scope all publicly traded corporations with headquarters in California, even if those corporations are chartered outside of California. This constitutional infirmity warrants immediate reconsideration.

The California bill (SB 826) would require any public company with shares listed on a major U.S. stock exchange that has its principal executive offices in California to have at least one woman on its board by December 31, 2019. By year-end 2021, such companies with five directors would be required to have at least two women on the board, and companies with six or more directors would be required to have at least three women on the board. The law would be enforced with fines of $100,000 for a first-time violation and $300,000 for subsequent violations.

The statute's unconstitutional reach deserves immediate scrutiny. Given the long-recognized constraints on state control of companies incorporated in other jurisdictions, the bill could properly apply *only* to corporations incorporated in California, regardless of the situs of their operations or headquarters. Despite attempts by the bill's sponsor to argue that the statute's scope will survive constitutional scrutiny, there should be little doubt that the law cannot be applied to Delaware corporations with headquarters in California or to any other corporations chartered outside of California. In our view, it is unwise to risk certain constitutional challenge and the resultant confusion about the salutary goal of increased diversity. It would certainly be ill-advised to disregard the long- standing internal affairs doctrine, which guards against the chaos of multi-jurisdictional regulation of corporate affairs by confining regulatory power to the state of incorporation. If it is not reconsidered, the enforceable reach of the statute will be severely limited, as Professor Joseph Grundfest demonstrated in a significant article on the measure.

From the perspective of those concerned with effective corporate governance, increased diversity in the boardroom is a valuable and important goal. One can readily appreciate the concerns of those who believe that achieving that diversity has taken too long. A robust debate about various methodologies and strategies for advancing the cause of diversity will doubtless yield results in the near term. Boards and investors share a common interest in this subject. The key is to find the right path forward, while recognizing that the time for removing all barriers to increased diversity is overdue.

My Beef with Stakeholders: Remarks at the 17th Annual SEC Conference, Center for Corporate Reporting and Governance

Posted by Hester M. Peirce, U.S. Securities and Exchange Commission, on Wednesday, September 26, 2018

Editor's note: Hester M. Peirce is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on her recent remarks at the 17th Annual SEC Conference, Center for Corporate Reporting and Governance, available here. The views expressed in this post are those of Ms. Peirce and do not necessarily reflect those of the Securities and Exchange Commission or its staff.

Good morning and thank you, Fram, for the kind introduction. Before I begin my remarks, I have to give my standard disclaimer, which is that my remarks reflect only my own views and not those of the Commission or my fellow Commissioners.

I greatly appreciate the opportunity to be part of this conference. Last time I flew to California, the skies were so clear that I was able to keep an eye on the changing landscape below all the way across the country. The vastness and great variety was striking. Having grown up in Ohio, I can attest to the fact that the magnificence of the landscape is just one of the features that makes so-called flyover country remarkably beautiful. The wealth of talent and ingenuity in the people of the heartland is where the real beauty lies.

Indeed, one of the issues on which I am committed to working with Chairman Clayton and my fellow commissioners is ways to unlock the deep potential of the middle of the country by ensuring that our securities laws do not inadvertently prevent people from investing in their own communities. Accredited investor rules, for example, have a different effect in Ohio, where incomes pale in comparison to lofty coastal paychecks. We also can work with states to ensure that the SEC does not stand in the way of state efforts to create innovation-friendly regulatory regimes. As the Chairman said when he spoke in Nashville several weeks ago, "There are obviously a lot of miles, many good, talented people, and many promising companies between the coasts," and I agree with the Chairman that we should "make sure our regulation of capital formation enables capital to flow to the areas in between."[1]

All that said, there is nevertheless something special about California. It is a place that provides fertile ground for innovation, imagination, celebration, and—to be frank—legislation.

[1] Jay Clayton, Remarks on Capital Formation at the Nashville 36/86 Entrepreneurship Festival, Aug. 29, 2018, *available at* www.sec.gov/news/speech/speech-clayton-082918 (discussed on the Forum here).

As I was thinking about which topics to address today, one piece of legislation caught my eye. The California legislature has passed a bill that would set certain parameters for the gender composition of corporate boards. One of the fundamental aspects of corporate law in the US is the central role of states.[2] Corporations are state-chartered, which allows for experimentation of the nature California is contemplating with Senate Bill 826.[3] As I understand it, however, the bill would cover public companies incorporated in other states if their headquarters are in California.

Moreover, as they say, nothing that happens in California, stays in California. For that reason, I want to spend a few minutes today discussing concerns that I have about government attempts to remake corporations for the benefit of so-called stakeholders.

"Stakeholder" is certainly in the top ten list of words that get bandied about Washington. A bit behind "ecosystem" and a bit ahead of "sustainability." I am guilty of using all of these terms, but stakeholder is the one that weighs most heavily on my conscience.

"Stakeholder" is so popular precisely because it is so elastic. In the corporate context, however, that elasticity has some troubling implications. It is used to refocus corporate decision-makers on constituencies other than their shareholders. In the stakeholder-centric view of the world, a corporation and its directors owe a duty not just to shareholders, but to a broader group of "stakeholders."

The scope of that term varies with the user, which is perhaps one of the term's most alluring features. The term "stakeholder" typically includes the company's employees but almost always also extends to include a variety of individuals whose lives may be affected by the corporation in some way.[4] They may have a business relationship with the corporation as its suppliers, buyers, or creditors. They may interact with the company in their private lives, by, for example, living near premises owned or occupied by the corporation. In its most expansive definition, "stakeholder" can include those with far more attenuated connections to the corporation. For example, the entire city or society in which a company operates can be deemed a "stakeholder" in the company's operations. Lest we feel left out of the stakeholder "ecosystem," regulators are often included in the term too.

Clearly, a company's operations do affect many of these groups. There is no denying that employees, suppliers, and localities often feel the effects of the choices a company's board makes. The question of who might be affected by a decision is, however, a different question from whether the company must consider their interests—separate and apart from the company's own interests—as part of any decision-making. That question is, in turn, separate from the question of whether these individuals, by virtue of their status as "stakeholders," are entitled to a

[2] *See, e.g.,* Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 Yale J. on Reg. 209 (2006).

[3] S.B. 826, 2018 Leg., 2017-2018 Leg. Sess. (Cal. 2018).

[4] *See, e.g.*, Jensen, Michael C. "Value Maximization, Stakeholder Theory, and the Corporate Objective Function*"* Harvard Bus. Sch., Working Paper No. 01-01, pgs. 8–9, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=220671 ("Stakeholders include all individuals or groups who can substantially affect, or be affected by, the welfare of the firm—a category that includes not only the financial claimholders, but also employees, customers, communities, and government officials."); Green, Ronald M. "Shareholders as Stakeholders: Changing Metaphors of Corporate Governance," 50 Wash. & Lee L. Rev. 1409, 1411 (1993) (defining "stakeholder" to include employees and local communities); R. Edward Freeman & John McVea, "A Stakeholder Approach to Strategic Management," Darden Graduate Sch. of Bus. Admin., Working Paper No. 01-02, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=263511 (stating that stakeholders include "employees, customers, suppliers, lenders and society").

say in how the company conducts its business.[5] I posit that the proper answer to these last two questions is “no.”

That answer should not be shocking. In other areas of life, similar questions are similarly answered. As a resident of a condominium, I am a stakeholder of my neighbors. Decisions they make about what to cook, for example, have a direct effect on me, but I do not expect to be consulted in their menu planning. Yes, a neighbor wanting to maintain good neighborly relations will try to avoid burning toast every morning and may offer me a bowl of the fish stew he is making in order to keep me from complaining about the strong aroma. Cooking decisions are still his to make.

The competing interests of stakeholders in the corporate context are admittedly a bit weightier than neighborly culinary relations, but to mandate stakeholder engagement after the model of shareholder engagement is to ignore the ways in which non-shareholder groups of individuals already influence company policy.

Employees, creditors, suppliers, customers, communities, and regulators feature prominently in the thoughts of corporate boards and managers. All of these groups have avenues for making their voices heard by the companies with which they interact. Given the importance of many stakeholders to a company’s success, these avenues are unlikely to be dead ends. Any competent manager, for example, understands the role that employee satisfaction plays in productivity, retention, and development. Creditors and suppliers negotiate contracts with a keen interest in furthering their own interests.

Community relations are likewise of paramount importance to companies. They often voluntarily take steps to ensure that they are contributing to the community’s well-being. Regulation also can play a role in ensuring that, for example, a company takes into account the interests of its neighbors and others affected by the company’s actions but without a contractual relationship with the company. Regulation can help to internalize externalities.[6] Regulatory limits on noise, air, and water pollution fall into this category.

Directors of corporations, other than benefit corporations which are a unique and limited category, have a fiduciary duty to their shareholders to maximize the value of the corporation. There will inevitably be disputes about how to achieve this goal, but the objective is clear. In this context, it is important to remember that shareholders are not uniform and their interests are not always uniform.[7] They may have competing interests, but the directors work for the company, rather than any particular shareholder or group of shareholders. What is best for the long-term value of the company may not be best for each and every shareholder. Shareholders’ best interests turn on what the rest of their investment portfolio looks like and what their non-investment interests in the company are. For example, a shareholder might be a stakeholder not only on the basis of her share ownership, but because she is an employee or neighbor of the company. Hence, the focus on maximizing the corporation’s value, which in turn maximizes shareholder wealth—even if

[5] *See, e.g.*, Accountable Capitalism Act, *available at* www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act.pdf (proposing that a corporation’s employees select at least 40% of its directors).

[6] *See* Brito, Jerry and Dudley, Susan E., *Regulation: A Primer*, Mercatus Center at George Washington University, 2012.

[7] Hu, Henry T.C. and Black, Bernard “The New Vote Buying; Empty Voting and Hidden (Morphable) Ownership,” 79 S. Cal. L. Rev. 4, May 2006.

some shareholder may prefer the company to provide her with something other than financial value.

Directors and managers, for their part, sometimes may prefer to cater to stakeholders. Stakeholders may represent interests aligned with the personal interests of directors and managers. More generally, a mandate to serve imprecisely defined stakeholder groups affords managers and directors more latitude and makes their performance harder to measure. If the law allows directors and managers to elevate certain stakeholders over shareholders, the law is complicit in a breach of fiduciary duty.

Focusing on the company's long-term value also serves the public. The company's price, which reflects the market's view about the company's long-term value, serves a critical role in ensuring that the company is actually meeting the public's needs. One of the essential functions of securities markets is price discovery. As securities trade, information about the company's expected performance is incorporated into the price. A company increases its stock price by selling better products and services or producing them more efficiently and lowering its prices to attract customers. The better the company meets the needs and wants of its buyers, the more income it earns and the more value it returns to its shareholders. The stock price also helps to nudge companies to return resources to shareholders that the company cannot use productively. If a company cannot put resources to work, it returns them to shareholders, who can then put them to work in another enterprise that does have a good use for them. A company that serves the interests of its collective shareholders serves the interests of the public.

Requiring a company to instead cater to other interests therefore risks compromising not only its shareholders' interests, but the public interest as well. It complicates boardroom decision-making and muddles the effectiveness of price as a signal of the company's value. Valuing a company that is dancing to the tune of multiple fiddlers is no easy task, so an uncertainty discount would inevitably be built into the price of the company's shares.

When an investor buys a piece of a company, the price she pays reflects certain understandings about the board's duty to the company, and by extension, to its shareholders. Directing companies to give priority to stakeholders rather than shareholders would lower the value of existing shares and hence the price investors are willing to pay for an ownership interest in the company.

While there have been discussions about the rights of stakeholders for many years now, they seem to be finding a particularly attentive audience these days. The aforementioned California bill, which awaits the Governor's signature,[8] embraces a stakeholder approach. The bill is prefaced with a finding that getting more women on boards "will boost the California economy, improve opportunities for women in the workplace, and protect California taxpayers, shareholders and retirees …."[9] Shareholders are mentioned, but the list of beneficiaries features stakeholders prominently.

The bill cites evidence for the proposition that companies with women on their boards are better by a number of measures than other companies. My point is not to dispute the evidence, but to

[8] Cal. Legislative Info., leginfo.legislature.ca.gov/faces/billHistoryClient.xhtml?bill_id=201720180SB826 (last visited Sept. 20, 2018).

[9] S.B. 826, 2018 Leg., 2017-2018 Leg. Sess. (Cal. 2018).

suggest that companies looking out for their long-term value already have strong incentives to take that evidence under consideration along with all the other factors that may affect the company's long-term value.

If a company must consider interest groups beyond its shareholders—a discrete and relatively easily identifiable group—it becomes challenging to draw the lines exactly right to include one group of stakeholders and exclude another. Even those who support the notion of stakeholder interests do not go so far as to claim that every person who is affected by a company in some form or fashion, no matter how attenuated the effect, should be deemed a stakeholder.

The California legislation effectively forces corporations, including non-California corporations, to consider all women as stakeholders. That is a big group. Once we introduce the idea that a company must act in the interest of some subset of its stakeholders, and condition the grant of a charter on its proper treatment of those deemed "stakeholders," policymakers might be tempted to get this or that favored group included in the stakeholder definition. Opening such a wide door introduces uncertainty and political influence into corporate operations.

We have a deep and well-developed body of corporate law. It rests on the assumption that the board owes its principal duty to the shareholders collectively, not to an amorphous group of stakeholders. There is no compelling reason to overturn centuries of settled law, and there are many reasons not to.

The focus of the California bill—women on boards—is one piece of a broader set of ideas encapsulated by the snappy acronym ESG. ESG stands for "environmental, social, governance,"[10] but the "S" in ESG could just as well stand for "stakeholder." The corporation, the idea goes, should consider its impact on society as a whole. The ESG criteria establish standards of conduct for a corporation. Much like the word "organic," however, ESG may not be the same to you as it is to me. Companies are at the mercy of the standard setters, whose approaches to collecting and analyzing information differ.[11]

Many advocates of using ESG criteria cite data that support the claim that companies that implement ESG-friendly policies outperform those that do not. Testing this hypothesis is tough since, although discussed as one set of criteria, in fact, ESG factors typically evaluate an eye-popping array of corporate behavior. These criteria may cover everything from the number of women who sit on the board to whether a plant carries a green certification to the company's involvement in certain disfavored industries.[12] In considering what may contribute to a company's success, pointing to gender diversity, concern for the environment, and avoidance of "sin" products is so scattershot as to be useless. These factors simply have nothing to do with one another.

[10] Investopedia.com, "Environmental, Social and Governance (ESG) Criteria," *available at* www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp.

[11] Mackintosh, James, "Social, Environmental Investment Scores Diverge," *The Wall Street Journal*, p. B1, Sept. 18, 2018.

[12] CFA Institute, Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors 12 (2008), *available at* https://www.cfainstitute.org/en/advocacy/policy-positions/environmental-social-and-governance-factors-at-listed-companies.

The only uniting feature is the motto most-often associated with ESG investing—"do well by doing good."[13] One of the core tenants of ESG investing is that it is ethical and good, but ethics and goodness are subject to interpretation. In fact, while some ESG factors—such as some of those associated with the "G" part—track with conventional notions of good business, many seem to be included in the ESG rubric because they hew to a what a select group of stakeholders believe to be good or moral behavior.

It may be useful to pause here and clarify an important point. If an individual wants to invest in companies that align with her moral beliefs, that is fine. An individual investor is certainly free to make trade-offs to risk lower returns for whatever other interest she may have. Nor is there a problem with certain funds pursuing stated social interest goals. Many such funds exist. Assuming they have disclosed their objectives as a part of their investment strategies they not only may, but *must* pursue the ESG guidelines they have set for themselves. Such funds have proliferated in recent years, and investors seeking to apply ESG standards to financial interests will find many options available to them. I am not taking issue with these arrangements as long as ESG investors do not force the companies in which they invest to take steps that harm the company's long-term value.

The problems arise when those making the investment decisions are doing so on behalf of others who do *not* share their ESG objectives. This problem is most acute when the individual cannot easily exit the relationship. For example, pension beneficiaries often must remain invested with the pension to receive their benefits. When a pension fund manager is making the decision to pursue her moral goals at the risk of financial return, the manager is putting other people's retirements at risk.

The difficulty in understanding the legal implications of using ESG to evaluate investments arises in part from the fact that the same investment may raise legal concerns or may be entirely appropriate depending on the fiduciary's intent. For example, investing in a company that develops green technology is likely appropriate if the fund manager makes the investment because of a belief that green technology's popularity will make it a profitable investment. If, however, the manager makes the investment because of a belief that it is virtuous to support green technology regardless of its commercial prospects, it becomes less clear that the manager has fulfilled her fiduciary duty.

If you do any research in this area, you will find that a considerable number, approximately 70 percent of managers by some estimates, say that they use ESG factors in evaluating their investments.[14] You will also find a number of articles and papers reporting that companies that have implemented ESG-friendly policies outperform those companies that have not.[15] From these

[13] *See, e.g.*, Georgescu, Peter "Just 100 Do Well By Doing Good," Forbes online, Jan. 10, 2018, *available at* https://www.forbes.com/sites/petergeorgescu/2018/01/10/just-100-well-by-doing-good/#5baace3c6335; PriceWaterhouseCoopers "Sustainable Investing: Doing Well by Doing Good," Dec. 2017, *available at* https://www.pwc.co.uk/audit-assurance/assets/pdf/hot-topic-sustainable-investing-doing-well-by-doing-good.pdf; Patsky, John W. "ESG Investing: Doing Good While Doing Well," John Hancock Investments, *available at* https://www.jhinvestments.com/ESG-investing-doing-good-doing-well.

[14] Morgan Stanley, "Sustainable Signals: Asset Owners Embrace Sustainability" pgs. 1–2, 2018, *available at* http://www.morganstanley.com/assets/pdfs/sustainable-signals-asset-owners-2018-survey.pdf.

[15] *See, e.g.*, Holder, Michael "Evidence Links ESG Performance to Better Investments," GreenBiz, Jan. 10, 2018, *available at* www.greenbiz.com/article/evidence-links-esg-performance-better-investments*;* Skroupa, Christopher P. "High ESG Performance Translates Into High Financial Performance," Forbes online, Jun. 16, 2017, *available at*www.forbes.com/sites/christopherskroupa/2017/06/16/high-esg-performance-translates-into-high-financial-performance/#6f49d7a1d708; Friede, Busch, and Bassen, "ESG and Financial Performance: Aggregated Evidence from

findings, some have argued, that fiduciaries not only *may* use ESG factors, but that they *must* to fulfill their fiduciary duty.[16]

There are two problems with this conclusion. First, given the breadth of topics that the term "ESG" purports to address, it is difficult to say that, for any company, it is the ESG factors in particular that have resulted in higher returns. Second, because ESG can mean so many things, a company may implement a number of policies that wind up counted as "ESG" measures that are simply the same good practices that companies have embraced for centuries. The problem is that, because discrete, time-tested measures have good results, once they are dubbed "ESG," their success becomes an argument for implementing all kinds of unrelated, untested measures that conveniently share the ESG label.

Thus we arrive at the next problem with using ESG factors: there are no clear standards. Even if we were to accept—and I do not—that it is desirable to use funds held by large investors as a means of fueling social change, it is not clear that the factors managers now consider actually have the intended effects. In many instances, ESG reporting has been presented as though it were comparable to financial reporting, but it is not.[17] While financial reporting benefits from uniform standards developed over centuries, many ESG factors rely on research that is far from settled. Counting the number of female directors may tell you something about how well a company is run. Or it may simply tell you that the company has more female directors. There are studies going both ways.[18] In most cases, the companies themselves are ill-equipped to make these determinations. Does a company that brews beer really have the expertise to assess what energy source would be the best for the environment?

A bit closer to home for me, neither do regulators have the requisite expertise to assess how well companies adhere to ESG standards and properly disclose whether their practices conform to those standards. We have a tough enough time with non-GAAP metrics.

I should note that there are efforts underway to establish such standards.[19] The problem is that, unlike financial reporting, many of these factors are not susceptible to standards that would be

More Than 2000 Empirical Studies," Journal of Sustainable Finance & Investment, 5:4, 210-233, Dec. 2015, *available at* www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917.

[16] *E.g.*, UNEP Finance Initiative, A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment, p. 13, 2005, *available at* www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf , ("[I]ntegrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions").

[17] This often manifests as a call for "integrated reporting," which would present financial, environmental, social, and governance performance together. *See, e.g.*, Eccles, Robert G. and Serafeim, George, "Accelerating the Adoption of Integrated Reporting," CSR Index, Francesco de Leo, Mattias Vollbracht, eds., InnoVatio Publishing Ltd., 2011.

[18] *See*, *e.g.*, Adams, Renee B and Ferreira, Daniel, "Women in the Boardroom and Their Impact on Governance and Performance," Center for Economic Institutions Working Paper Series, Hitsubashi University, April 2008 (finding that gender diversity on boards resulted in more monitoring behavior, which could negatively impact market valuation and operative performance for well-functioning firms); *The Economist*, "Ten Years on From Norway's Quota for Women on Corporate Boards," Feb. 17, 2018 (noting that "[g]ender quotas at board level in Europe have done little to boost corporate performance or help women lower down"; Ali, Liu, and Su "Women on board: Does the Gender Diversity Reduce Default Risk?", 9th Conference on Financial Markets and Corporate Governance 2018, Jan. 25, 2018 (finding that the presence of female board members decreased firms' default risk). A recent article discussing meta-analyses of peer reviewed academic studies concluded that there is "no business case for—or against—appointing women to corporate boards" and that efforts to increase women's representation should be based on fairness and equality. Klein, Katherine "Does Gender Diversity on Boards Really Boost Company Performance?", Knowledge@Wharton, May 18, 2017.

[19] For example, the Sustainability Accounting Standards Board defines itself as "the independent standards-setting organization for sustainability accounting standards that meet the needs of investors of fostering high-quality disclosure of material sustainability information." Sustainability Accounting Standards Board, "About the SASB," *available at* www.sasb.org/about-the-sasb. There are also firms that provide ratings and research for assessing ESG criteria. *See,*

comparable across companies. If the research has had mixed findings, how can standards be set? In this case, poorly established standards may be worse than no standards at all. One of the core principles underlying modern accounting standards is the notion that financial statements should be comparable across companies. An investor should be able to place two companies' financials side-by-side and have an accurate sense of which company is performing better and in what ways. Imprecise or shifting standards create the risk that investors, and the market, will believe they can compare two companies on certain ESG factors when in reality the companies are quite different.

Second, there is a degree of subjectivity in the setting and application of standards. Some ESG standards seem to reflect personal moral beliefs that may not be universally held. Some funds cite to ESG standards as a reason for no longer investing in companies involved in the firearms industry.[20] Again, it is perfectly appropriate for any individual to choose not to invest in any industry she finds objectionable, and funds currently exist for individuals who want to screen out everything from guns to alcohol to gambling. But there is hardly uniform agreement among Americans on the subject of firearms, and many Americans see no harm in owning guns and gun stocks.[21] Our capital markets should accommodate both groups.

Once a standard is set, deciding whether a company meets it can also be difficult. Is a company that operates on solar power up to snuff enough to satisfy environmental standards, even if it uses fossil fuel to power its own plant?

Companies and their stakeholders have just begun to wrestle with these issues. Speaking for just one stakeholder—my regulatory self—I look forward to listening to the full range of views on these interesting and important issues. Thank you for your time this morning. I would be happy to take some questions, even those that include the S-word.

e.g., Morningstar "Investing in a Sustainable Future," *available at* www.morningstar.com/company/sustainability; Sustainalytics, "ESG Ratings & Research," *available at* www.sustainalytics.com/esg-ratings.

[20] Strasburg, Gottfried, and Fuhrmans, "Firms Reassess Involvement in Gun Industry in Wake of Florida Shooting," The Wall Street Journal, Feb. 25, 2018, *available at* www.wsj.com/articles/firms-reassess-involvement-in-gun-industry-in-wake-of-florida-shooting-1519606834.

[21] *See* Evans, Rachel "Gun-Free ETFs Are Everywhere but No One's Buying," Bloomberg, Mar. 1, 2018, *available at* www.bloomberg.com/news/articles/2018-03-01/gun-toting-index-funds-retain-mom-and-pop-investors-amid-outcry.

Mandating Women on Boards: Evidence from the United States

Posted by Sunwoo Hwang (University of North Carolina), Anil Shivdasani (University of North Carolina), and Elena Simintzi (University of North Carolina), on Thursday, November 8, 2018

Editor's note: Sunwoo Hwang is a PhD candidate at the University of North Carolina Kenan-Flagler Business School; Anil Shivdasani is the Wells Fargo Distinguished Professor of Finance at the University of North Carolina Kenan-Flagler Business School; and Elena Simintzi is Assistant Professor of Finance at the University of North Carolina Kenan-Flagler Business School. This post is based on their recent paper.

On September 30, 2018, California enacted Senate Bill 826 mandating that all publicly-traded companies headquartered in the state to have at least one female director by the end of 2019. The law further requires that by year-end 2021, all firms have at least one female director if the board has four members or fewer, two female directors if the board has five members, and three female directors if the board has six members or more. With the passage of this law, California has become the first state in the United States to mandate female directors on boards of publicly held firms. Not surprisingly, the law has generated substantial debate with proponents praising efforts towards balanced gender representation. Opponents have raised concerns over appointments of less qualified female board members and discrimination against male candidates.

A priori, the effects of board regulatory mandates are ambiguous. If discrimination or biases prevent women from being appointed to corporate boards, endogenously determined boards will not be optimal for shareholders since they will not reflect the benefits of gender-diversity. Studies suggest that diversity in decision making facilitates consideration of a more comprehensive range of strategies and can lead to higher quality decision-making. However, if the pool of qualified female director candidates is limited, firms will incur costs from the appointment of inexperienced or less qualified directors that can outweigh the benefits of increased gender diversity. By perturbing an equilibrium outcome in the director labor market, board mandates can also impose externalities on firms that rely on a shared director labor market.

In our paper, we present evidence suggesting that mandating board gender diversity through legislation is costly for shareholders. At the announcement of the signing of SB 826, companies headquartered in California experienced a statistically significant abnormal return of -1.58%. Using the pre-legislation variation in board composition and the differing thresholds on female representation mandated by the law as a source of exogenous variation, we show that the decline in shareholder wealth effects is related to the requirements for female director additions. Announcement returns are more negative for companies for which the legislation is more binding and firms with a greater shortfall of female directors experience sharper declines in shareholder wealth than firms closer to the legislative requirements.

We argue that the costs of mandated female board membership arise from supply-side constraints on the pool of female board candidates. In addition, the negative wealth effects associated with the law are concentrated among firms with weak corporate governance or low profitability while those with strong corporate governance or strong profits do not experience significant changes in shareholder wealth. This suggests that supply-side constraints on female directors result in weakly governed boards being unable to attract the most qualified women directors.

Our results contribute to the debate over the impact of legislative mandates on board composition. Our findings suggest that regulatory mandates, as a means to overcome biases against women in the professional workforce, may be insufficient to create shareholder value in firms. Our results do not speak to the value of gender diversity in endogenously chosen boards. Rather, our message is that considering the implications of supply-side factors is important in evaluating the economic effects of legislation on board composition. We are, however, silent on whether such mandates are warranted based on societal and welfare considerations.

The complete paper is available here.

Harvard Law School Forum on
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What Happened at the SEC's Proxy Process Roundtable?

Posted by Cydney Posner, Cooley LLP, on Wednesday, November 21, 2018

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

At last week's proxy process roundtable, three panels, each moderated by SEC staff, addressed three topics:

- proxy voting mechanics and technology—how can the accuracy, transparency and efficiency of the proxy voting and solicitation system be improved?
- shareholder proposals—exploring effective shareholder engagement, experience with the shareholder proposal process, and related rules and SEC guidance
- proxy advisory firms—can the role of proxy advisors and their relationship to companies and institutional investors be improved?

The first panel, on proxy plumbing, was characterized by the panelist who began the discussion as "the most boring, least partisan and, honestly, the most important" of the three topics. (But it was surprisingly not boring.) The last panel, on proxy advisory firms, was characterized by Commissioner Roisman as the "most anticipated," but the expected fireworks were notably absent—except, perhaps, for the novel take on the subject offered by former Senator Phil Gramm. Here are the Commissioners' opening statements: Chair Clayton, Stein and Roisman.

(Based solely on my notes, so standard caveats apply.)

Proxy voting mechanics and technology

To introduce this panel, a member of the SEC's Investor Advisory Committee, which had addressed the topic of "proxy plumbing" at length at its September meeting (see this PubCo post), observed that the current system of share ownership and intermediaries is a byzantine one that accreted over time and certainly would not be the system anyone would create if starting from scratch. There was broad agreement that the current system of proxy plumbing is inefficient, opaque and, all too often, inaccurate. So the question was: should the SEC start over from scratch with a complete overhaul or are there approaches that could repair the existing system? On that issue, there was no agreement. As framed by the first panelist, "do we have the willpower" to reinvent the system?

Accuracy in vote count. The SEC staff moderator opened this panel by observing that Securities Transfer Association found that, out of 183 meetings its members had tabulated in the past year, 130 had overvoting problems. Although most were ultimately reconciled, the question remained as to why the overvoting occurred. Many of the issues related to the inaccuracy of vote counts—overvoting, undervoting, empty voting, uncertainties regarding the accuracy of vote totals, and difficulties associated with vote counting, confirmation and reconciliation—arise out of the decision made decades ago to move to a system of share immobilization, under which most shares are held in street name and reflected in positions listed at a centralized depositary (DTC), where they are treated as a "fungible mass of shares not traceable to any individual." While the system makes share transfers easier, the arrangement is itself complex, compounded by many layers of intermediation—the transfer agent, the custodian and perhaps several subcustodians—that can complicate and obscure proxy voting and lead to mismatches that ultimately disqualify votes. As a basic matter, investors would like the ability to see through the chain of intermediaries to confirm that their shares have been voted as directed.

Anecdotally, panelists described instances of overvoting, delays in counting of registered shares, breaks in the chain of custody leading to separation of necessary documentation and resulting disqualification of votes, and shares not counted because of conflicts on the face of the omnibus proxy. In one example given, a DTC participant had overvoted and, in trying to correct the overvote in the system, was told not to worry about it because it's all a fungible mass and not everyone votes. (So much for accuracy.) In another example, a slight change in the name of the voting custodian—not of the beneficial owner—led to that large beneficial owner's shares not being voted—and the problem not being caught—for ten years. Where share lending is involved, questions arise regarding who has the right to vote the shares, with the result that not all shares are voted in accordance with the instructions of the beneficial owner. What's more, sometimes beneficial owners whose shares have been lent are still sometimes sent a VIF even when, as a technical matter, the shares are no longer on the broker's books, leading to overvoting potential. In some cases, the level of overvoting can be in the millions. To illustrate the importance of these problems, participants discussed various issues associated with obtaining an accurate vote count in connection with a recent proxy contest involving over 2.5 billion shares, where the difference in the vote total come down to ¼ of 1%. In that contest, the final results were not available for two months. Moreover, no reconciliation was done prior to announcement of the preliminary results. That narrow difference made the voting issues more significant, but the panelists confirmed that these issues were omnipresent, even if not determinative in other cases.

Entities with a different economic interest in the outcome didn't see it quite the same way. A representative from Broadridge, for example, saw most of these issues as fixed or readily fixable. Problem with overvoting? We have an overvoting service to fix that problem. Vote confirmation? We are all in violent agreement that we should have vote confirmation. Hey, we did a pilot program for end-to-end vote confirmation with transfer agents to address that issue and it was determined to be viable, but we can't get participation from the vote tabulators. The SEC needs to push this process forward, he suggested. However, another panelist that participated in the pilot did not think it was used effectively. A transfer agent suggested that there's no clear definition of what "confirmation" even means. A broker representative insisted that they do have well-functioning processes to track share ownership. One panelist suggested that the various participants in the system should think hard about whether they are more part of the problem than part of the solution.

Communication with beneficial owners. There were many complaints about issuers' difficulty in communicating with beneficial owners. First, questions were raised about the ongoing retention of the NOBO/OBO distinction, particularly the apparent default to OBO status for clients at many brokers. One panelist partially attributed the decline in retail participation in the proxy process to the OBO default and suggested that the SEC attempt to survey why investors choose to be OBOs—are they confusing anonymity as an investor with anonymity as a proxy voter? If so are there other ways to address that issue? Some panelists questioned whether shareholders really understand the difference—or care. To facilitate engagement, issuers wanted the ability to communicate directly with all holders by email, and some noted that, even for NOBOs, email addresses were not available. (With regard to the advisability of electronic communications, it was noted that, since the adoption of notice and access, retail voting participation had declined.) In addition, there were costs associated with obtaining the NOBO names. Nevertheless, revelation of the shareholders' names and contact information, whether to companies or to activists, can be viewed as privacy issue—a hot topic these days.

Universal proxy. A universal proxy is a proxy card that, when used in a contested election, includes a complete list of board candidates, thus allowing shareholders to vote for their preferred combination of dissident and management nominees using a single proxy card. In the absence of universal proxy, in contested director elections, shareholders can choose from both slates of nominees only if they attend the meeting in person. Otherwise, they are required to choose an entire slate from one side or the other. The historic view has been that dissidents—hedge fund activists and otherwise—tend to favor universal proxies, while companies have more often opposed them. However, it became apparent at the meeting of the SEC's Investor Advisory Committee (see this PubCo post), that a consensus has recently developed on the potential value of universal proxy cards in proxy contests, as some issuers have apparently recognized that universal proxy could, in some cases, help the management slate. For example, a proxy advisory firm might recommend in favor of two dissident candidates only; however, shareholders would have difficulty following that recommendation because, in the absence of universal proxy, they would be compelled to either vote for only the two recommended directors or to choose one full slate or the other—and that could end up being the dissident slate.

Nevertheless, the details will matter. For example, one issue that remained on the table was the percentage of shareholders that dissidents would need to solicit, with a hedge fund representative arguing for a low percentage, while others maintained that, to be fair, there should be parity with the solicitation requirements applicable to companies. A representative of the Society of Corporate Governance expressed concern about the possible permutations in the outcomes of the director vote—for example, what if there were no director who could be the audit committee chair? What would happen if the dissident violated the rules? What does the layout of the proxy card look like? Meetings involving proxy contests represented such a small sliver of the total number of meetings, she said, there was really no reason to distract attention from these larger proxy plumbing issues. However, another panelist observed that the SEC's 2016 universal proxy proposal was in pretty good shape and would not end up being a major distraction. In addition, a hedge fund representative contended that universal proxy would be very helpful in addressing the issue related to determining which proxy card was the last-voted card.

> **SideBar**
>
> In 2016, the SEC proposed amendments to the proxy rules that would have mandated the use of universal proxy cards in contested elections, but, at the time of the proposal, opinions about universal proxies, both pro and con, were deeply

> held, and nothing came of the controversial proposal—at least not yet. In a 2015 speech, Mary Jo White, who chaired the SEC when the proposal was issued in 2016, said that a hotly debated question was whether universal proxies "would increase or decrease shareholder activism or otherwise impact the outcome of election contests. Some believed that it would embolden activists to run more contests. Others posited that it could stimulate increased cooperation and settlements between issuers and activists, thereby decreasing contests. No one specifically called into question the fundamental concept that our proxy system should allow shareholders to do through the use of a proxy ballot what they can do in person at a shareholders' meeting." As reported in this post on thecorporatecounsel.net, in an apparent first use, one U.S. corporation elected to use a universal proxy card in connection with an election contest. The card named all the nominees of both the company and the dissident hedge-fund activist. Nevertheless, the dissident sent out its own card listing only its nominees, and the company then asked its shareholders to use its universal card to vote for all company nominees and two dissident nominees. (The company ended up settling with dissident and was then looking at its strategic options.) See this PubCo post.

Technology. Is technology the answer? Some panelists recommended that pilots be commenced using various technologies, particularly "private and permissioned blockchain" (with or without a gatekeeper), which could reduce complexity and improve traceability. According to the Nasdaq representative, blockchain has been tried successfully in Estonia and South Africa, confirming that, in his view, end-to-end vote monitoring was possible. One panelist suggested that principles needed to be determined first; while technology might be a shiny new object, it shouldn't drive the decision. Another panelist argued that blockchain should not be viewed as a silver bullet; its success would depend on the extent of implementation—would it be used in a complete reinvention of the system or just as a veneer?

Bottom line. Which raises again the issue: start again from scratch or low-hanging fruit? A number of panelists argued that, while some system participants had taken useful steps, overall the system was "patched together" and needed a fundamental rethinking. According to the CII representative, instead of intermediaries voting the "fungible mass of shares," voting of shares should belong directly to the beneficial owner; the use of blockchain or other distributed ledger technology would allow for traceable shares. In essence, there would be no need for all of these intermediaries, which just adds opacity to the system. In addition, he contended, participants in the system should be subject to market competition; to the extent there is a natural monopoly, it should be regulated like a utility. (To this point, Clayton noted that it was important to respect that the intermediary system was useful for trading and settlement in the context of trading.) That didn't mean, however, that near-term steps, such as routine and reliable vote confirmation, guidance on reconciliation and universal proxy, couldn't be undertaken now.

Shareholder Proposals

Perhaps it was just the contrast to the nearly uniform condemnation of the archaic proxy plumbing system, but most panelists for this topic seemed to view the shareholder proposal system as relatively smooth functioning and didn't offer that much criticism. The representative of CalSTRS even went so far as to suggest that, since shareholder proposals constitute only 2% to 3% of the proposals, why try to remedy a problem that really doesn't exist?

Submission thresholds. Most of the controversy centered around the propriety of the intial and resubmission threshold levels. Some panelists viewed the shareholder proposal as an essential tool that has, over time, resulted in important changes in corporate governance that are now well-accepted. For example, the CalSTRS representative noted that the process is especially useful if holders won't engage. James McRitchie observed that many of the proposals submitted decades ago by the Gilbert Brothers (see this article), such as the right to ratify the selection of auditors, are now standard fare at annual meetings. Similarly, a representative of the NYC pension fund described a long history of voting for proposals that, over time, gained substantial public acceptance, thus making the case for retaining low resubmission thresholds. In addition, with the prevalence of dual-class voting, one panelist suggested, even a low percentage of the total vote could actually represent a significant percentage of the outside vote. These participants advocated retention of the current thresholds. The AFL-CIO representative contended that thresholds were intentionally low to allow small investors the opportunity to participate; big institutional investors can pick up the phone and engage directly with the company on their issues and don't need the shareholder proposal process, he maintained.

On the other side, some panelists such as the Business Roundtable argued that shareholder proposals allow a few holders to attempt to impose on companies their personal policy priorities, but involve costs that are borne by all shareholders. Moreover, the low resubmission thresholds allow a small subset to override majority will. In addition, the representative of the Chamber of Commerce argued that the shareholder proposal process was one of the factors driving companies away from IPOs. (In response, the AFL-CIO representative noted that the average public company receives a shareholder proposal only once every 7.7 years, and so it was preposterous to suggest that shareholder proposals were a reason companies avoided going public.) These panelists advocated raising the initial and resubmission ownership thresholds, longer holding periods, disclosure of the proponents' holdings in the company, filing fees and strengthening of the "misleading statements" and "relevancy" exclusions.

SEC guidance. Other issues raised related to specific guidance from the SEC. For example, the Chamber advocated reversal of the SEC staff's position in Staff Legal Bulletin 14H, which narrowed the meaning of a "direct conflict" under the Rule 14a-8(i)(9) exclusion in favor of reinstitution of the position taken in the original *Whole Foods* no-action letter. (See this PubCo post and this PubCo post.) McRitchie advocated that the SEC "plug the hole" that had resulted from Corp Fin's grant of relief to *AES Corporation*. In that letter, AES had sought relief permitting exclusion under Rule 14a-8(i)(9) of a proposal to allow a special meeting to be called by 10% of the shares on the basis that it directly conflicted with a management proposal to be submitted at the same meeting to *ratify* the company's existing special meeting provisions, which included the 25% threshold. The staff agreed with the company's position. (See this PubCo post, discussed on the Forum here.) In McRitchie's view, the staff's position in that letter could effectively "wipe out all proposals."

Other issues. The NYC pension fund advocated allowing proponent access to vote tallies that are currently available only to the issuer. With regard to shareholder proposals related to social issues, one issuer representative contended that if the purpose is to allow a stakeholder without a real interest in the company to advocate for social change, that was not an appropriate use of the proposal process. Similarly, the Chamber representative argued that more than half of the proposals are social proposals and that they don't pass; if they are just political speech, he said, they should be viewed differently. Other panelists, such as the representative from the AFL-CIO argued that investors are increasingly concerned with ESG issues precisely because they affect long-term value creation. The representative of BlackRock, which is well known for its advocacy on certain social issues such as board diversity, said that it evaluates all of these proposals through the lens of maximizing long-term economic value. And here's a suggestion from one panelist that I suspect most of us could definitely get on board with: the basis for the staff's determination to grant or refuse no-action relief is sometimes a conundrum, and it would be very helpful if the SEC provided more clarity as to its reasoning in its responses to no-action letters.

Proxy Advisory Firms

The topic of reigning in the proxy advisory firms, which some view as having too much unaccountable power over proxy votes, has become something of a political hot potato.(See, *e.g.*, this PubCo post and this PubCo post.) But the panel's discussion regarding the power of proxy advisors was surprisingly tepid.

Robo-voting? Investment advisors on the panel made the case, with regard to the recommendations of proxy advisors, there was very little so-called "robo-voting." Asset manager State Street, for example, said that proxy advisors were used to execute State Street's own voting guidelines, as well as for research and operational ease. Others described a similar approach. ISS and Glass Lewis maintained that they do not drive voting decisions; rather, investors follow their own policies, and ISS and GL help execute votes in accordance with instructions. GL also noted that 80% of its voting is customized. An active fund manager indicated that it needed proxy advisors for their independent research function, workflow management and data aggregation. A smaller wealth manager advised that, from a practical perspective, it needed the help of proxy advisors to fulfill its duty of care and execute mechanics; without the assistance of proxy advisors, over time, its research department would spend more time on proxy research than on investment analysis. Its practice was first to perform due diligence on the benchmark standards and determine if they were consistent with the view of the firm.

Conflicts of interest. The proxy advisors discussed how they address the standard proxy advisor conflicts of interest through disclosure and ethical walls. However, the representative of the American Enterprise Institute, former Senator Phil Gramm, offered quite a unique take on the issue. Gramm harkened back to the Enlightenment, where the idea was to allow people to follow their own ideas and interests in using the fruits of their labor, and the corporation was allowed to develop in the interests of shareholders independent of the government, guilds and social conventions, and subject only to the constraints of the Parliament. In his view, the real conflict of interest lies in those organized special interest groups that, because they are unable to convince the legislature or the agencies to adopt laws or rules promoting their views, instead use "intimidation" to impose policies on corporate America that, in Gramm's view, are not in the interests of shareholders. In his view, the index funds, a growing category of investment fund, advocated in favor of certain high-profile social issues that have gained public favor strictly as a marketing tool to promote their funds. When investment advisors vote against social issues and are identified as part of the "flat-earth society," they will see an adverse effect on the marketability of their products. As index funds grow, he predicted, this problem would increase, with the result that we would "undo the Enlightenment" and return to the Middle Ages, where these "leeches" bled business and stopped growth. It's one thing, he said, for a holder to vote its own shares on social issues, but when voting the shares of others, they should vote only to increase shareholder value. The problem as he saw it was the SEC's position that allowed index and other investment funds to fulfill their fiduciary responsibilities by following the advice of proxy advisors. (See this PubCo post.) He advocated that no investment advisor should be exempt from fulfilling its fiduciary duties and that the SEC reverse its position on Staff Legal Bulletin No. 20, "Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms.

The State Street representative agreed that it does have a fiduciary responsibility, but that State Street believed that ESG does affect sustainable long-term economic value and shareholder returns and that its strategy involved taking these issues into account. State Street takes its time in evaluating issues—how does the risk, such as an environmental risk, manifest itself? It's not about "values," she said, but rather about long-term "value." (Of course, there are numerous studies supporting the case that good ESG practices can improve operational and stock price performance. See, *e.g*., this PubCo post and this PubCo post.) Another wealth manager argued that, given the small proportion of shareholder proposals relative to other voting issues, to curtail the manager's ability to rely on proxy advisors' advice for this reason would be an instance of the tail wagging the dog.

Correcting the record. Other issues discussed included the difficulty experienced by smaller companies in attempting to correct the record when errors are made in the proxy advisors' analyses. One suggestion was to consider requiring a more iterative process involving the company prior to publication of the recommendation or perhaps even an ombudsman to resolve disputes. ISS suggested that some "errors" are actually just differences of opinion, and noted that some of its clients, for whom the reports are prepared, do not want ISS to share the report with companies before they see it.

Proxy advisor registration. Surprisingly, there did not seem to be much call for registration of proxy advisors, possibly because of the fear of rising costs associated with registration and further regulation. However, last week, a bipartisan group of six Senators introduced the Corporate Governance Fairness Act, which would require the SEC to regulate proxy advisers under the Investment Advisers Act. The bill would subject the firms to periodic SEC examinations, including review of the firms' conflict-of-interest policies.

Clearing the Bar: Shareholder Proposals and Resubmission Thresholds

Posted by Brandon Whitehill, Council of Institutional Investors, on Tuesday, December 4, 2018

Editor's note: Brandon Whitehill is a Research Analyst at the Council of Institutional Investors. This post is based on a CII Research and Education Fund memorandum by Mr. Whitehill.

The shareholder proposal process—when a public investor submits a proposal, the board of directors considers the issue and the company's shareholders vote on the proposal—is a leading conduit for engagement and dialogue between investors and issuers in the U.S. public capital markets. Between 2011 and 2018, more than 3,600 shareholder proposals went to a vote at Russell 3000 companies, and many more were submitted but not voted.[1]

One-third of the proposals voted over this period went to a vote two or more times at the same company. But to be eligible for resubmission, a proposal must meet a minimum threshold of support in previous attempts. This analysis uses a dataset of the voted shareholder proposals between 2011 and 2018 at Russell 3000 companies to determine the impact of the current resubmission thresholds as well as the potential impact of proposals to raise them.[2]

The key findings of this analysis include:

- The vast majority of shareholder proposals satisfy the current resubmission thresholds of 3%, 6% and 10%. About 95% of proposals are eligible for resubmission after the first attempt, 90% after the second and third attempts and nearly all proposals that clear those thresholds and are submitted again remain eligible in subsequent submissions.
- About 20% of proposals win majority shareholder support on the first attempt.
- Less than 5% of proposals that fail to win majority support the first time go on to pass in a subsequent attempt. Even so, proponents can often successfully engage companies if their proposals win substantial, but less than majority, support.
- Looking at environmental, social and governance classifications (ESG), governance issues comprise the most common proposal subject matter and win the highest levels of support. About 97% of governance proposals, 92% of environmental proposals and 87% of social proposals satisfy the current resubmission thresholds during this period.

[1] All data for the 2011–2018 dataset used in this analysis come from ISS Link, SEC Filings and CII analysis. Download the dataset at https://www.ciiref.org/resubmission-thresholds.

[2] No analysis of shareholder proposals and resubmission thresholds is perfect, including this one. The dataset used here relies on the descriptions of shareholder proposals assigned by ISS Link, which does not always comport with what the SEC or courts might judge as a proposal on "substantially the same subject matter." For example, ISS classifies a proposal to reduce a supermajority voting threshold differently from one eliminating a supermajority threshold, when in reality the proposals could be the same or substantially similar. The dataset for this analysis does, however, take into account the five-year lookback on resubmission thresholds. For example, if a proposal was voted in 2011 and resubmitted in 2016, the 2016 attempt is coded to correspond with the first-year threshold.

- Raising the resubmission thresholds will necessarily exclude more proposals. A modest increase to 5%, 10% and 15% would roughly double the number of ineligible proposals. A more substantial increase to 6%, 15% and 30%, as included in the Financial CHOICE Act and advocated by certain management-oriented groups, would triple the number. Doubling the current thresholds to 6%, 12% and 20% would have an impact that falls between these two scenarios.
- The 6/15/30 scenario could render more than half of environmental and social proposal ineligible for resubmission, particularly after the third attempt. Under the 5/10/15 and 6/12/20 scenarios, about 90% of governance proposals and 70% of environmental and social proposals would remain eligible for resubmission.
- Of the proposals that were eligible under existing rules but would fail to satisfy the increased thresholds, only about one-third were actually resubmitted between 2011 and 2018, and those that were gained two to four percentage points in support on average. Raising the resubmission thresholds could, however, exclude anywhere from seven to 38 proposals that went on to win substantially higher support when resubmitted, depending on the scenario (see Box 1).

Box 1–Impact of Raised Resubmission Threshold Scenarios

This analysis considers three proposals to raise the resubmission thresholds: a modest 5/10/15, a doubling 6/12/20 and a substantial 6/15/30 increase scenario. The table below shows the impact of each scenario based on the dataset of 3,620 shareholder proposals voted at Russell 3000 companies between 2011 and 2018. For more detail, see Table 11 on page 19 of the complete publication, available here.

Excludable proposals shows the number of proposals eligible for resubmission under the current 3/6/10 thresholds that would be excludable in each scenario. Resubmitted is the number of proposals that were actually resubmitted. Higher support refers to the number of proposals that went on to win substantially higher support in a subsequent attempt that would be excludable in each scenario. And change in support is the average percentage point change in support in the next attempt for those proposals that were resubmitted.

Scenario	Excludable Proposals	Resubmitted	Higher Support	Change in Support
Modest (5/10/15)	240	73	7	+2.7%
Doubling (6/12/20)	348	122	15	+3.9%
1997/CHOICE (6/15/30)	457	180	38	+2.8%

The complete publication is available here.

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Universal Proxies: What Companies Need to Know

Posted by Tiffany Fobes Campion, Christopher R. Drewry and Joshua M. Dubofsky, Latham & Watkins LLP, on Wednesday, December 5, 2018

Editor's note: Tiffany Fobes Campion is a senior attorney, Christopher R. Drewry is partner and Joshua M. Dubofsky is partner at Latham & Watkins LLP. This post is based on a Latham memorandum by Ms. Campion, Mr. Drewry, and Mr. Dubofsky. Related research from the Program on Corporate Governance includes Universal Proxies by Scott Hirst (discussed on the Forum here).

Key Points

- In contested director elections, the binary nature of the current US proxy voting regime requires a choice between either a company's or an activist's slate without the ability to "mix and match" among nominees. This regime can impact voting, and thus outcomes, in proxy contests, creating risk that the company might lose its entire slate in a contested election.
- Universal proxies allow stockholders to vote for nominees of their choosing from both the company and activist slates, mitigating binary "win or lose" outcomes.[1]
- Universal proxies are generally thought to favor activists because of an increased likelihood that at least some activist nominees are elected, but in the context of activist nomination of majority- or full-board slates, there may be strategic advantages for a company to use a universal proxy.
- The SEC proposed rules to require universal proxy cards in all contested elections in October 2016.[2] While the SEC's plans for adoption are unclear, there is a renewed interest in universal proxy cards, particularly after the SEC's November 15 roundtable on the proxy process.
- Despite the absence of adopted SEC rules, in the 2018 proxy season some companies, like Mellanox Technologies and SandRidge Energy, Inc., took steps to use a universal proxy in proxy contests with Starboard Value and Carl Icahn, respectively.[3]
- A company's governing documents may determine its ability to use a universal proxy when an agreement with the dissident to use a universal proxy cannot be reached.

[1] *See* Scott Hirst, Harvard Law School, Program on Corporate Governance, Universal Proxies, 35(2) Yale J. on Reg. 71 (forthcoming, last updated Sept. 25, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2805136.

[2] *See* Universal Proxy, Release No. 34-79164 (October 16, 2016) [81 FR 79122 (November 10, 2016)], https://www.sec.gov/rules/proposed/2016/34-79164.pdf.

[3] Latham & Watkins advised Mellanox in connection with the consideration and implementation of its universal proxy proposal and Mellanox's proxy contest defense against Starboard Value.

What Is a Universal Proxy?

A universal proxy is an alternative to the proxy regime currently used in the US for contested director elections. A universal proxy allows public stockholders to vote for any combination of company and activist nominees, mimicking the voting choices that a stockholder attending a stockholder meeting would have on a ballot.

The Current US Proxy Voting Regime

Under the current US regime, stockholders voting by proxy in a contested election must make a binary choice between voting on either:

- The company proxy card, which includes only the company's director nominees, or
- The activist proxy card, which includes the activist's nominees and, if the activist is nominating a minority of the Board (referred to as a "short" slate of nominees), some of the company's nominees recommended by the activist to "round out" the slate.

Stockholders must select between the nominees proposed on the company proxy card or those proposed on the activist card, and are not permitted to mix-and-match nominees from the two proxy cards. Stockholders may only mix-and-match nominees if they vote in person at the stockholder meeting—an option that few stockholders actually pursue.

Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis, often determine to support some activist nominees, driving stockholders to the activist proxy card due to the binary nature of the voting system. Although support by proxy advisory firms for a particular party's card does not guarantee a win, it dramatically impacts the voting behavior of institutional investors, many of whom expressly follow or give significant weight to proxy advisor recommendations. In a few recent situations, ISS has sought to mitigate this "all or none" consequence by recommending "withholds" as to selected directors on the company cards, intending to clear a path for a limited number of activist nominees by reducing the size of the company slate.[4] To date, this approach has resulted in the company prevailing on all candidates.[5]

Under the current regime, there is the potential that the directors actually elected are different than those that a plurality of stockholders would have preferred. In a study of US proxy contests between 2001 to 2016, Harvard Law School Professor Scott Hirst found that as many as 15% of contested elections resulted in outcomes that differed from the preference of a plurality of stockholders.[6]

An Alternative: Universal Proxies

[4] *See* ISS' recommendations for the 2017 director elections at: (1) Automatic Data Processing, Inc. contested by Pershing Square Capital Management, (2) Deckers Outdoor Corporation contested by Marcato Capital Management, and (3) Cypress Semiconductor Corp. contested by founder and former CEO TJ Rodgers.

[5] In the two situations that went to a vote, Automated Data Processing's contest with Pershing Square and Deckers Outdoor Corporation's contest with Marcato Capital Management, stockholders elected the entire company slate without modification. Whether stockholders disagreed with, or simply did not follow the nuance of, ISS' recommendation is unknown.

[6] *See* Hirst.

Rather than selecting between the company or activist slate, a universal proxy card names all of the company and activist nominees for election as directors, and provides stockholders the ability to vote for any properly nominated director nominee. Stockholders voting by proxy will still need to choose between the company or activist proxy card, but will be permitted to mix-and-match nominees to vote for their preferred candidates. As a result, stockholders are able to vote for incumbent directors that they believe should be retained and for activist nominees (if any) they would like to add to the board. Stockholder interest and corporate governance groups view universal proxies as a way of enhancing stockholder governance at public companies, and therefore generally support the use of universal proxy cards in contested director elections.

Why Do US Public Companies Not Use a Universal Proxy?

Certain provisions in the existing US proxy rules present practical challenges to the use of universal proxy cards. In particular, the Securities Exchange Commission's (SEC's) "Bona Fide Nominee Rule," stipulates that a proxy card cannot confer authority to vote for any director nominee if that nominee has not consented to being named on that proxy card and in the related proxy statement, and to serve if elected. This means to use universal proxy cards in a contested election, a company and activist need to obtain the consent of the other party's nominees. In past proxy contests, this consent has rarely been provided, particularly at a point in the contest when one party may view the universal proxy card as favoring the other party.

In October 2016, the SEC proposed rules to modify the Bona Fide Nominee Rule and require the use of universal proxy cards in all contested elections. Many public companies and their representatives have voiced concern that the proposed rules would disproportionately favor activists and, perhaps as a result, the SEC did not appear to be advancing the rule making process. However, at the SEC's November 15 roundtable on the proxy process, academics, proxy solicitors, major institutional investors, and an organization representing corporate secretaries and business executives all voiced support for universal proxy cards if some minor modifications were made to the proposed rules.[7] During the roundtable, SEC Chairman Jay Clayton specifically cited universal proxy cards as a key item of interest and follow-up for the SEC staff.

To date, universal proxy cards have mostly been used for companies incorporated outside of the US. The first instance of a widely held, large-cap US company using a universal proxy card occurred in June 2018 at SandRidge, an oil and natural gas exploration and production company based in Oklahoma, in its full- board proxy contest with Carl Icahn.

Why Would a Company Want to Use a Universal Proxy?

Each proxy season, many public companies find themselves in a situation similar to SandRidge—facing a proxy contest for control of the board. Since 2014, there has been an average of 88 proxy contests for board seats each year, and activists sought board control in an average of 32% of those contests.[8] In proxy contests for control of the board, a company could consider using a universal proxy that allows stockholders to mix-and-match candidates as an alternative to the current binary choice between the company's slate or the activist's control slate. In the

[7] Primarily, interest groups have voiced a desire to increase the number of stockholders a dissident must solicit to use a universal proxy card.

[8] SharkRepellent.net data as of November 14, 2018 based on scheduled or anticipated meeting date.

context of majority- or full-board contests in particular, Hirst's study of proxy contests found that removing the binary proxy voting mechanism would likely result in stockholders electing more management nominees and fewer activist nominees.[9]

In addition, companies facing a proxy contest for control of the board should consider the influence and practices of proxy advisory firms. If the proxy advisory firms wish to see any degree of change at a company, they are typically willing to support some activist nominees. As activist nominees are typically not included on a company's proxy card under the binary regime, activists can transform an advisory firm's support for "some change" at a company into a real threat of a change of control of the board. With a universal proxy card, proxy advisory firms can recommend less than all of the nominees proposed by an activist's change in control slate, rather than being forced into the binary "all or none" recommendation. However, if the various proxy advisory firms recommended for different nominees it may ultimately facilitate the election of more activist nominees than any one proxy advisory firm recommends (see below: *A Cautionary Tale: What Happened When a US Company Used a Universal Proxy?*).

Again, universal proxies likely will facilitate at least some activist nominees being elected to the board and thus may favor activists on an absolute basis—but may work to the advantage of a company facing a change in control slate. Absent such circumstances, a company likely will continue to prefer the traditional binary proxy card structure.

How Can a Company Use a Universal Proxy?

Generally speaking, three possible paths exist to obtain the director nominee consents required by the SEC's Bona Fide Nominee Rule and thus enable a universal proxy.

Option 1: In the context of a contested election, negotiate to use a universal proxy card

- A company and an activist engaged in a proxy contest can agree to use universal proxy cards and require their respective director nominees to consent to be named on both proxy cards.
- In reality, due to the contentious nature of proxy contests and the complex strategy inherent to the binary voting regime, companies and activists rarely reach agreement on this issue.
    - For example, either the company or the activist denied the request to use a universal proxy card in recent contests at ADP, Destination Maternity, DuPont, GrafTech International, Shutterfly, Target Corp., and Tessera Technologies.

Option 2: Adopt bylaws requiring director nominees to consent to inclusion in a company's proxy

- More than 80 companies have adopted advance notice bylaws that require each director nominee to consent to be named as a nominee in the company's proxy statement and associated proxy card, and to serve if elected.[10] Modern bylaws also require each director nominee to complete a written questionnaire in a form provided by the company

[9] *See* Hirst.
[10] *See*, e.g., the bylaws of Automatic Data Processing, Square, Inc. and Tableau Software, Inc.

with respect to the nominee's background and qualifications, which can supply the necessary information for the company's proxy statement.

- This may allow a company to use a universal proxy card in a contested election—if it so desires and at the company's option—without the explicit agreement of the activist described in Option 1.
- These bylaws remain untested under Delaware law and the corporate laws of other states.
- In contrast, requiring director nominees to consent to be named as a nominee in the company's proxy statement and associated proxy card as part of a director nominee questionnaire *without* the supporting bylaw language has been subject to litigation in Delaware and may not be upheld by Delaware courts (*See Engaged Capital Flagship Master Fund, LP v. Rent-A-Center, Inc.*, C. A. No. 2017-0165-JRS (Del. Ch. Mar. 10, 2017)).[11]
- The SEC staff has suggested that activist nominees included in a company's universal proxy would become "participants" in the company's solicitation. This would necessitate expansive disclosures of information that the company would likely not have access to, absent comprehensive questionnaires mandated by the company's bylaws or disclosures with respect to activist nominees made in proxy statements filed by the activist.

Option 3: Adopt bylaws requiring all parties to use a universal proxy card in contested elections

- A company could adopt bylaws mirroring the SEC's proposed universal proxy rules, which require all parties to use a universal proxy card in contested director elections.
- In addition to the consent and information requirements of the bylaw discussed in Option 2 above, these bylaws would address logistical details for the proxy cards, such as the order of nominees and font style and size.
- Recently, Mellanox—an Israeli, NASDAQ-listed company based in California that serves as a leading supplier of computer networking products—proposed, and its stockholders ultimately adopted, such a provision in connection with its proxy contest with Starboard Value. The provision, added to Mellanox's governing documents, requires universal proxies in all contested director elections. Ultimately, Mellanox and Starboard reached agreement and did not proceed with filing contested proxy materials or using a universal proxy. However, universal proxies will be used for any future contested election at Mellanox.
- To date, no company incorporated in the US has adopted a universal proxy bylaw, and none have been tested under Delaware law or the corporate laws of other states.
- Be aware that requiring a universal proxy card in all contested elections may result in the election of activist nominees, even if an activist does not have a strong case or lacks the support of proxy advisory firms.

[11] In a 2017 proxy contest, Rent-A-Center, Inc. deemed the nomination materials submitted by Engaged Capital to be deficient due to the nominees' failure to consent to being named in Rent-A-Center's proxy statement, as required by Rent-A-Center's director questionnaire. Engaged filed a lawsuit against Rent-A-Center in the Delaware Court of Chancery seeking an order declaring Engaged's nomination materials to be valid without such consent and to prohibit Rent-A-Center from including Engaged's nominees in the company's proxy statement. The court granted Engaged's motion to expedite the action, noting that there was the potential that Rent-A-Center's actions restricted or inhibited the stockholder franchise, creating irreparable harm, and thus the matter was ripe for a decision. However, before the court made a decision on the merits, Rent-A-Center notified Engaged that it would not be including the dissident's nominees in its proxy materials, rendering the claim moot. It is unknown how the court would have held on the merits.

When Should a Company Consider These Options?

While Option 1 can only be used in the context of a proxy contest, most US companies could unilaterally implement, without stockholder approval, the bylaws described in Option 2 or Option 3 above. Universal proxy cards are generally considered stockholder-friendly, however unilateral adoption of new bylaws in the context of an ongoing proxy contest could be considered defensive or to have an impact on stockholders' ability to vote in an election of directors. Therefore, adoption in that context may be subject to additional scrutiny if challenged in court, or may be a rallying point for certain stockholder groups. In the view of the authors of this post, companies can materially enhance their ability to use a universal proxy pursuant to their bylaws by adopting bylaws facilitating the use of a universal proxy and enhancing their director nominee questionnaires before an activist campaign has been launched or a proxy contest has been initiated. Under current policies, proxy advisory firms and most stockholders would likely have a neutral or positive reaction to the adoption of such bylaws outside of an ongoing activist campaign.

Further, companies unilaterally adopting the bylaws described in Option 2 or Option 3 above should consider the potential for future SEC review of the underlying procedures and mechanics, and be cognizant that such review would likely occur during an active proxy contest. In this vein, the SEC staff's review of Mellanox's proposed universal proxy provision and other related proxy statements has been detailed and deliberative.

A Cautionary Tale: What Happened When a US Company Used a Universal Proxy?

SandRidge, in its full-board proxy contest with Carl Icahn, was the first widely held, large-cap US company to use a universal proxy card. While each proxy contest is unique and the outcome depends on a variety of factors, the SandRidge proxy contest can be considered an insightful example, and may be viewed as a cautionary tale of the potential outcomes that may follow implementation of a universal proxy card.

SandRidge was able to use a universal proxy card because Icahn's nominees, perhaps inadvertently, provided the consents required by the Bona Fide Nominee Rule as part of Icahn's nomination materials. However, Icahn did not have the reciprocal necessary consents from the company nominees, and thus was unable to use a universal proxy card.

To fill seven seats on the board, SandRidge asked that stockholders vote for five incumbent directors and any two of Icahn's four independent nominees. SandRidge noted that the company previously vetted and offered board seats to two of those nominees during settlement negotiations.

Ultimately, ISS and Glass Lewis each recommended that stockholders vote on the SandRidge universal proxy card, but, rather than the five plus two split SandRidge sought, ISS and Glass Lewis each recommended four incumbent directors and three of Icahn's nominees. Both ISS and Glass Lewis supported the two previously vetted independent Icahn nominees. However, the proxy advisory firms were split on which third Icahn nominee to recommend and incumbent director not to support. This split resulted in a confusing, and perhaps outcome determinative, matrix of recommendations, as summarized in the below table.

NAME	BACKGROUND	VOTE RECOMMENDATION				OUTCOME
		SandRidge	Icahn	ISS	GL	
COMPANY NOMINEES						
Barnes, Sylvia	Appointed in February 2018; only female nominee	FOR	N/A	FOR	FOR	Elected
Beer, Kenneth	Appointed in April 2018	FOR	N/A	WITHHOLD	FOR	Withdrew
Bennett, Michael	Chairman; appointed by creditors in connection with 2016 restructuring	FOR	N/A	FOR	WITHHOLD	Withdrew
Griffin, William	Interim CEO; appointed by creditors in connection with 2016 restructuring	FOR	N/A	FOR	FOR	Elected
Kornder, David	Appointed by creditors in connection with 2016 restructuring	FOR	N/A	FOR	FOR	Appointed
ICAHN NOMINEES						
Alexander, Robert	Independent	Pick 2 of 4	FOR	WITHHOLD	FOR	Elected
Christodoro, Jonathan	Former Icahn employee	WITHHOLD	FOR	FOR	WITHHOLD	Elected
Dunlap, Nancy	Independent	Pick 2 of 4	FOR	WITHHOLD	WITHHOLD	Withdrew
Frates, Jonathan	Icahn employee	WITHHOLD	FOR	WITHHOLD	WITHHOLD	Appointed
Graziano, Nicholas	Icahn employee	WITHHOLD	FOR	WITHHOLD	WITHHOLD	Withdrew
Lipinski, John (Jack)	Independent; SandRidge offered board seat in settlement negotiations	Pick 2 of 4	FOR	FOR	FOR	Elected
Read, Randolph	Independent; SandRidge offered board seat in settlement negotiations	Pick 2 of 4	FOR	FOR	FOR	Elected

Icahn capitalized on the split recommendation, encouraging stockholders to vote for the four Icahn nominees who were recommended by at least one of the leading proxy advisory firms.

Icahn's strategy ultimately succeeded. All four of the Icahn nominees that received the recommendation of either proxy advisory firm were elected and the incumbent directors that failed to receive the recommendation of both proxy advisory firms were not elected. Six nominees (four Icahn and two incumbents) were clearly elected and, considering the results for the seventh seat were too close to call as of the close of the polls, SandRidge and Icahn negotiated a settlement to expand the board to eight seats and appoint one additional incumbent and one additional Icahn nominee. This resulted in a five- three split, with Icahn nominees controlling the board. In voting for all of the recommended Icahn nominees, stockholders appear to have ignored the proxy advisors' strong warning that Icahn should not receive board control and deserved only three, or a minority, of the board's seats.

Again, this experience does not dictate whether a universal proxy card is appropriate in other circumstances, but does caution that a universal proxy is not a "silver bullet" for companies facing majority- or full-board proxy contests, and that using a universal proxy can result in unpredictable outcomes.

Conclusion

Universal proxy cards may provide a strategic advantage to public companies in majority- or full-board proxy contests by permitting stockholders to mix-and-match company and activist director nominees as an alternative to supporting an activist's change in control slate. However, current US proxy rules do not permit use of a universal proxy card without the consent of all director nominees named in the universal proxy. Despite recent indications of interest in universal proxy cards, it is unclear when the SEC may adopt rules requiring universal proxy cards in contested elections. A company's governing documents may enable that company to avail itself of the potential strategic benefits of a universal proxy card in the event of a proxy contest. Accordingly, public companies should consider their defensive posture with respect to activism and, with assistance from their outside legal counsel, the paths to utilizing a universal proxy outlined above, prior to the initiation of an activist campaign.

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Were Reports on the Demise of the Universal Proxy Premature?

Posted by Cydney Posner, Cooley LLP, on Friday, October 12, 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 Universal Proxies by Scott Hirst (discussed on the Forum here).

The specter of the possible imposition of mandatory universal proxy has long been with us. The SEC apparently considered requiring universal proxies back in 1992 and, in 2014, the Council of Institutional Investors filed a rulemaking petition asking the SEC to reform the proxy rules to facilitate the use of universal proxies in proxy contests. Then, in 2016, the SEC proposed amendments to the proxy rules that would have mandated the use of universal proxy cards in contested elections. And there it sat. With the change of administrations in the White House, followed by the change of administrations at the SEC, the proposal for universal proxy fell off the SEC's near-term agenda and was relegated to the long-term agenda. Moreover, disfavored by House Republicans, universal proxy would have been prohibited by various bills, including the Financial Choice Act of 2017 (which passed the House but not the Senate). (See this PubCo post.) Then, in July of this year, "several people familiar with the matter" advised *Reuters* that SEC Chair Jay Clayton "has in fact shelved the proposal." (See this PubCo post.) The specter of mandatory universal proxy had been transfigured into more of a spectral presence.

> A universal proxy is a proxy card that, when used in a contested election, includes a complete list of board candidates, thus allowing shareholders to vote for their preferred combination of dissident and management nominees using a single proxy card. In the absence of universal proxy, in contested director elections, shareholders can choose from both slates of nominees only if they attend the meeting in person. Otherwise, they are required to choose an entire slate from one side or the other. Because a later-dated proxy revokes an earlier-dated one under state law, it's not easy to split votes between slates. One impediment to the use of a universal proxy is the "bona fide nominee" requirement of Rule 14a-4(d)(1), which requires that a nominee consent to be named in the proxy and, if elected, to serve as a director.

But perhaps that conclusion was just a bit premature? In July, Clayton announced that the SEC would be holding a roundtable (now scheduled for November 15) to discuss the proxy process. His lengthy statement announcing the roundtable enumerated a variety of potential agenda topics, and buried under the broad-spectrum caption of "Other Commission Action" was the topic of universal proxy. (See this PubCo post.)

And then, at the recent meeting of the SEC's Investor Advisory Committee meeting, there seemed to be some consensus developing on the potential value of universal proxy cards, even though concerns remain that it could favor one party over the other. One participant observed that, although the historic view has been that universal proxy cards help only the dissident shareholders in a proxy contest, in his experience, that has not necessarily been the case. In the example given, ISS might recommend in favor of two of dissident candidates only, but shareholders desiring to follow the ISS recommendation would, in the absence of universal proxy, be compelled to choose one full slate or the other—and that could end up being the dissident slate—or engaging in "bullet" voting for only the two directors.

An investor-favorable participant seemed to be conceding points in a behind-the-scenes negotiation over what a rulemaking might look like when he agreed that, in a solicitation by dissidents, a threshold solicitation of at least 75% of the shares and more than ten persons could be required to trigger a mandate for universal proxy, a higher threshold than the majority requirement currently in the SEC proposal. (An issuer-favorable participant advocated that, to be fair, dissidents should have to solicit all shareholders, as the company is required to do.) Yet another participant noted that, should universal proxy be resuscitated, the SEC should require companies to disclose what happens when an incumbent director refuses to serve if a dissident is elected. Another issue raised was the need to ensure that shareholders do not vote for too many directors, which would disqualify the proxy card unless a chance to cure is offered. In sum, there were, curiously, a slew of "comments" offered on a proposal that was thought to be moribund at best.

This white paper from MacKenzie Partners discusses the resuscitation of universal proxy this year—not through SEC action, but rather through private ordering. According to the paper, universal proxy "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." What's more, the paper indicates, in these instances, private ordering was initiated by issuers rather than activists. That data supports a thesis of the paper—"that the universal proxy card can, in certain situations, be more advantageous for issuers than for activists." The paper provides the following hypothetical illustrations:

> "Suppose that a shareholder voting in a proxy contest wishes to support some board-level change, but is wary of potentially ceding majority control of the board to an activist investor. Under the current rules, shareholders in this situation have only a limited choice, each with its own inherent risks. Voting on the dissident's card for three out of seven nominees can ensure that the board undergoes some level of change; however, because voting on the dissident card deprives four of management's nominees of votes, it can inadvertently lead to an unwanted change-in-control. On the other hand, a vote on management's card, withholding votes from certain disfavored incumbent directors, only increases the chances that there are spots left open for some dissident nominees; it does not guarantee that the dissident nominees that are ultimately elected are the ones that the shareholder actually supports…. The universal proxy can also benefit management by disadvantaging the dissident. For example, suppose there are ten board seats up for election, and the dissident nominates a short slate of four. Two of its nominees are highly-qualified, while the other two are less so. With the universal ballot, shareholders

> can more easily avoid supporting the dissident's less-qualified nominees, thereby reducing the likelihood that the entire short slate will be elected."

On occasion in the past, the paper reports that shareholders have used a little "self-help," manipulating the proxy cards by scratching out and writing in names and special instructions, but these cards may be subject to challenge or processed incorrectly.

In 2018, however, universal proxy was "adopted" in three proxy contests, although only one actually went to a vote. The paper suggests that that event may open the door for future use. In the first instance, a recently public company faced an election contest related to half the board from a well-known hedge-fund activist with "an incredibly strong track record of placing directors on boards." That risk led the company to agree to use a universal proxy; however, the proxy contest ultimately settled before either side filed a preliminary proxy statement. In the next instance, an Israeli semiconductor company was faced with a proxy contest for a board majority from the same activist. In this case, because of Israeli law, the company opted to submit the question of the use of a universal proxy card directly to shareholders at a meeting in advance of the director election vote. The proposal received overwhelming support from shareholders; however, a settlement was reached in that case also.

Universal proxy was actually used in one proxy contest. In that case, the dissident nominated a full slate of five directors. The company's initial response was to expand the board to seven, in the hope of preventing a complete change of control at the board level. However, the dissident just expanded its slate to seven directors. The paper notes that the company was emerging from bankruptcy, and, as a result, its shareholder base consisted largely of hedge-fund creditors that had converted their debt holdings to equity, which left the company more vulnerable in a proxy contest. However, as a result of a possible oversight, the paper suggests, the dissident's nominees had consented to be named as nominees in the company's proxy statement, which allowed the company to use a universal proxy card without separately getting their consent. Accordingly, the company designed a proxy card that included its five nominees and the dissident's seven nominees, recommending that shareholders vote only for its five nominees and "two of the three other nominees that were deemed independent" of the dissident. According to the paper, 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."

Notwithstanding the use of a universal proxy card, strategic maneuvering continued, as the company "became aware of rumors that [the dissident] was attempting to persuade other shareholders to reallocate their votes among their chosen candidates towards those who were not supported by ISS and Glass Lewis, with the goal of bolstering his prospects of achieving majority control of the board." The dissident also sent out its own proxy card with its nominees. At the end of the day, the company and the dissident settled, with the company having three seats and the dissident five. The paper observes that, although this loss of majority control

> "may have appeared to represent a significant loss for [the company] and perhaps even a setback for the use of the universal proxy,…it should be noted that, had the company used a traditional proxy card, it is highly likely that even more shareholders would have used [the dissident's] gold proxy card to vote for some or all of his nominees, increasing the possibility that [the dissident] would have won control of the entire board. In that sense, the first use of the universal proxy card in the United States was a qualified

> success. Its use allowed shareholders greater flexibility in selecting their preferred candidates, and likely dissuaded some holders from voting for[the dissident's] nominees on his card. Furthermore, despite the historical protestations of Broadridge, the universal proxy card did not present any significant logistical challenges with respect to vote processing. And in its first use at a US company, the universal proxy card proved its benefit to management in certain cases as many had theorized, rather than being a one-sided dissident-friendly tool."

Whether the SEC moves ahead with its universal proxy proposal remains to be seen. But the paper suggests that the devil may well be in the details that remain to be worked out, which must be consistent and not disadvantage either party. These include presentation and formatting requirements, procedures for electronic tabulation, processes to address multiple dissidents submitting competing slates, proxy contests run concurrently with shareholder proxy access campaigns and voting errors that may arise where a card is voted for more nominees than there are seats, potentially disenfranchising the shareholder. The paper indicates that the SEC is well aware of the potential significance of the adoption of universal proxy, and several respondents to the proposal had "urged caution, warning of the risks of unintended consequences from introducing far-reaching changes into a process that works 'reasonably well.'" In conclusion, the paper suggests that

> "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. 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; by remaining something that is privately negotiated rather than mandated will allow 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 legislative initiative."

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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.

Tab V: Boards

The 2018 U.S. Spencer Stuart Board Index

Posted by Julie Hembrock Daum, Laurel McCarthy, and Erin Van Gessel, on Tuesday, November 13, 2018

Editor's note: Julie Hembrock Daum is a Consultant, Laurel McCarthy is a Senior Associate, and Erin Van Gessel is a Board Practice Analyst at Spencer Stuart. This post is based on a Spencer Stuart memorandum by Ms. Hembrock Daum, Ms. McCarthy, Ms. Van Gessel, and Ann Yerger.

In response to a variety of pressures—including an increasingly complex business environment with an unprecedented pace of change and disruption; a growing number and variety of business risks; and intensifying investor focus on the composition, diversity and quality of the boardroom—S&P 500 boards are reshaping, slowly. The 2018 U.S. *Spencer Stuart Board Index*(SSBI), our 33rd annual analysis of boardroom trends, finds that boards are adding directors with new skills, qualifications and perspectives. But change remains gradual, due to persistent low boardroom turnover.

SSBI Findings: Boards are Changing, but Progress is Slow

Highlights from this year's SSBI include:

- S&P 500 boards appointed 428 new independent directors in the 2018 proxy year, up 8% from last year and the highest number since 2004.
- A majority (57%) of S&P 500 boards appointed at least one new director; 22% appointed two or more directors. Overall, the average S&P 500 company added 0.88 new directors (largely unchanged from 2017), replacing 0.84 directors who departed over the year.
- Experience as a CEO or top corporate executive is no longer a must-have credential for board service. Only 35% of the new S&P 500 directors are active or retired CEOs, chairs, vice chairs, presidents or COOs, down from nearly half (47%) a decade ago.
- Board experience is also no longer a pre-requisite. One-third of the incoming class are serving on their first public company board.
- Directors with financial backgrounds are a priority, representing 26% of the new S&P 500 directors in 2018, up from 18% in 2008. Demand is high for experienced CFOs/financial executives and investment professionals.
- Tech savvy, "digital directors" are a hot commodity, and boards are tapping younger "next gen" candidates with these skills. Seventeen percent (17%) of the incoming class are 50 or younger.
- Female representation among new S&P 500 directors rose to 40%, the highest since Spencer Stuart began tracking this data in 1998. Despite this record, low overall turnover yielded an incremental increase in the percentage of women on S&P 500 boards: 24% of all S&P 500 directors are women, up from 22% in 2017 and 18% in 2013.

- Minority men (defined as African-American, Hispanic/Latino or Asian) experienced a slowdown, representing 10% of the new independent directors, down from 14% last year.
- This slowdown also can be seen in the representation of minorities at the top 200 S&P 500 companies. Today, 17% of the independent directors of the top 200 companies are male or female minorities, unchanged from last year and up only slightly from 14% in 2008.
- Mandatory retirement policies continue to proliferate, and retirement ages continue to rise. Of the 71% of S&P 500 boards with age caps, 43.5% set the retirement age at 75 or older, compared with just 11% in 2008.
- Mandatory retirement policies are clearly an important mechanism for driving the refreshment we are tracking in S&P 500 boardrooms. Three-quarters of the independent directors who left S&P 500 boards in the past year served on boards with mandatory retirement ages. The age limits influenced a majority of these departures.
- For the second year in a row, half of S&P 500 boards split the chair and CEO roles. Independent board chairs continue to gain momentum, with slightly more than 30% of S&P 500 boards chaired by an independent director, up from 28% last year and 16% in 2008.
- Although the roles and responsibilities of an independent chair of the board and a lead director are frequently similar, their compensation is vastly different. Independent chairs receive, on average, an additional $165,000 in annual pay, while lead directors are paid an average yearly supplement of around $40,000.

Looking ahead, absent changes in boardroom trends and refreshment practices, future turnover rates of S&P 500 boards will remain low. With independent directors averaging 63 years of age and mandatory retirement ages continuing to rise, many directors have a long runway until they are likely to retire. Only 16% of directors on boards with retirement policies are within three years of the age cap, while 28% of directors on boards without mandatory retirement policies are 70 or older.

Survey of S&P 500 Nominating and Governance Committee Members: Gender Diversity Tops List of Priorities

Results from our survey of more than 170 nominating and governance committee members of S&P 500 companies support our expectation of continued low boardroom turnover. On average, the surveyed nominating and governance committee members anticipate appointing/replacing one director each year over the next three years.

The survey shows that board composition has been a top-of-mind issue at S&P 500 companies. The top three issues addressed by the surveyed directors over the past year were: boardroom succession planning (96%), board diversity (93%) and new director skills (86%).

Clearly the surveyed committee members see their work in the diversity area as unfinished, since 74% said boardroom diversity will be a key focus over the next few years.

Gender diversity is a leading area of emphasis. Despite the fact that 87% of S&P 500 boards have two or more women directors, and 10 have 50% or more women directors, gender diversity is the top current priority of the surveyed S&P 500 directors, prioritized by 62% of the respondents. Minority representation was the fourth-ranked priority, prioritized by 43% of the surveyed directors.

Other priority skills and backgrounds of the surveyed directors include:

- Active CEO/COO (49%)
- Technology experience (48%)
- Retired CEO/COO (41%)
- Global perspective (41%)
- Digital experience (40%)

The high surveyed demand for active CEOs/COOs runs against limited supply. Today only 45% of S&P 500 CEOs serve on an outside board, down from 51% a decade ago. And the 2018 SSBI finds that active or retired top executives comprise a decreasing share of director appointments, as boards cast a wider and deeper net to identify director talent and enhance boardroom diversity.

Finding talent that checks all the priority boxes is difficult at best, and the surveyed directors report that boards are exploring different channels for talent. Two-thirds of the surveyed directors reported considering “next gen” candidates who are 50 years old or younger, particularly as they seek directors with technology or digital backgrounds.

When it comes to board effectiveness, the surveyed nominating and governance committee members reported the following focus areas over the next few years: board evaluations (75%), board diversity (74%) and board leadership (48%).

Our review of S&P 500 board composition and governance in 2018 revealed a number of parallels between trends around board composition this year and trends affecting the boardroom in recent years, particularly the desire to refresh boardroom skills. Our survey of S&P 500 nominating & governance committee members demonstrates that many boards are proactively seeking to grow and evolve, albeit slowly. In many ways, this year’s *U.S., Spencer Stuart Board Index* highlights the push-and-pull of corporate boardrooms: there is demand for novel director skills and backgrounds, yet parameters around director qualifications and director refreshment stifle immediate change in the boardroom.

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Director Skills: Diversity of Thought and Experience in the Boardroom

Posted by Subodh Mishra, Institutional Shareholder Services, Inc., on Wednesday, October 10, 2018

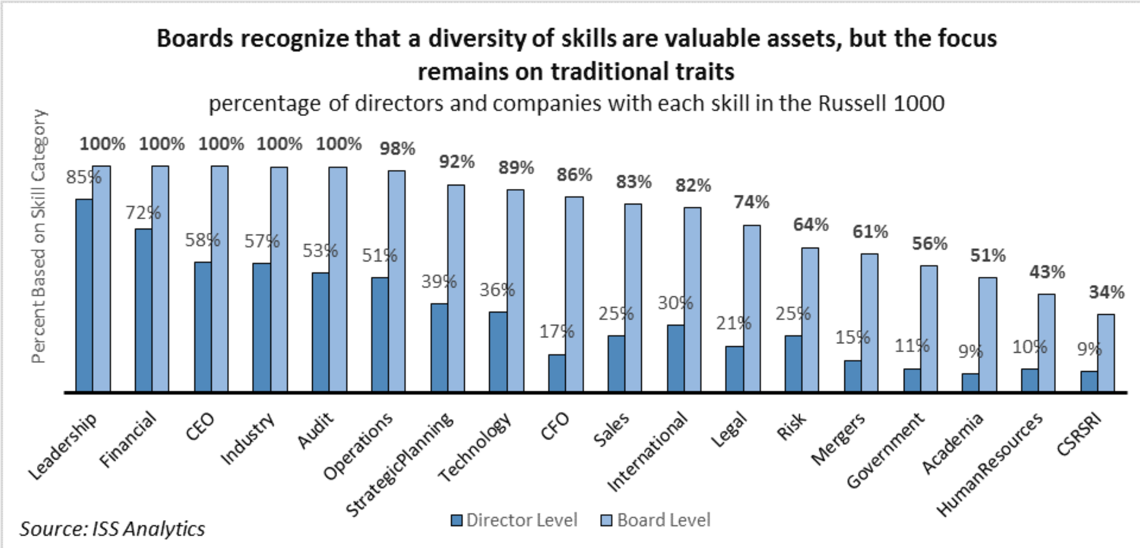
Editor's note: Anthony Garcia is Associate Vice President at ISS Custom Research. This post is based on an ISS memorandum by Mr. Garcia.

While Mike D of the Beastie Boys was "bustin' out trap kits" to demonstrate his skill as a rapper, nominating committees were more focused on the education, background, and experiences of potential candidates for the board of directors. And while this approach yields sufficiently qualified board candidates, boards may benefit from taking a closer look at the particular set of skills that a director would bring to the board, or in Mike D's terms, what skills will pay the bills.

The questions are: what are those skills, and, perhaps more importantly, do those skills translate to better practices at the company? In looking at the role of the board in terms of (1) serving as the fiduciary to shareholders and (2) adopting policies to oversee risk, an increase in the number of unique skills in the boardroom translates to better board practices on governance, environmental, and social issues.

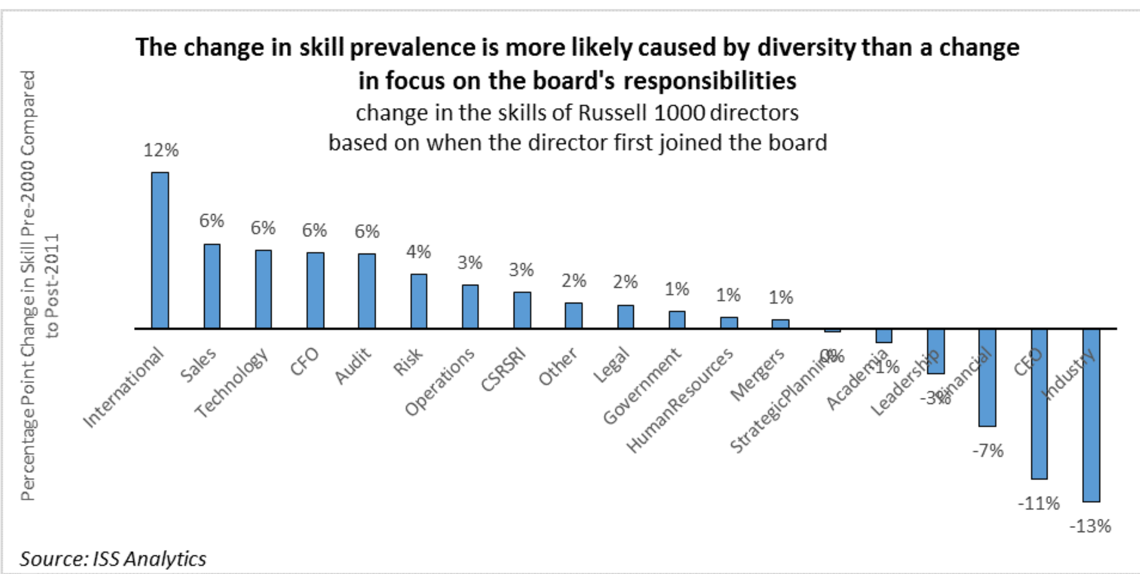
Some critical director skills are missing from many company boards

The charts below look at each skill individually based on its prevalence at the nominee- and board-level. The nominee-level view shows the proportion of directorships with each particular skill, while the board-level view looks at whether the company includes at least one nominee with a particular skill and is based on the percentage of companies with each skill on their board. Almost every director has at least some form of professional skill that they bring to the board and many also have experience in a leadership position. While there is a strong correlation between the director-level and board-level ranks, there are some skills, such as international experience and risk management, which are more represented on the individual director-level compared to the board-level. Therefore, while the marketplace overall may be emphasizing these skills in the boardroom, not all companies are following the trend. Furthermore, skills such as human resources and corporate social responsibility, which likely have the strongest correlation to the current focus on E&S issues, remain some of the least prevalent skills both at the director- and board-level.



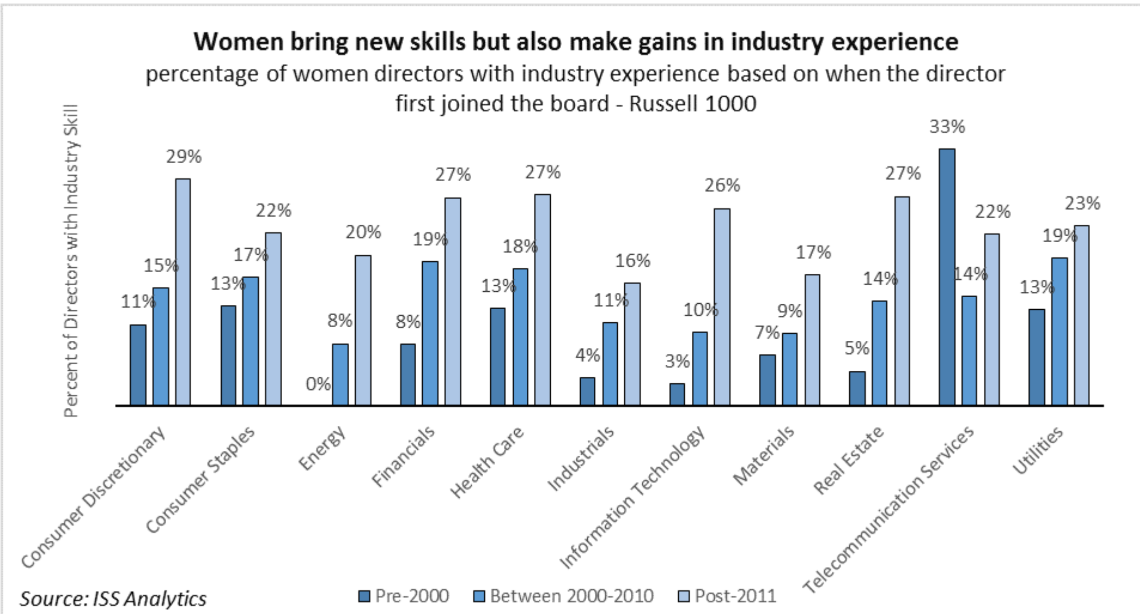
Recently appointed directors bring more non-traditional skills to the board

Although the responsibilities of the board have continued to proliferate, the focus remains on traditional skillsets such as leadership, financial, industry, and CEO experience. Skills such as risk management, corporate social responsibility (CSR), legal background, and human resources have shown only marginal gains. The chart below focuses on the change in the prevalence of skills comparing directors that first joined the board prior to 2000 to directors that joined the board after 2011. The bars in the chart represent the change in percentage points in skill prevalence from pre-2000 to post-2011 director appointees. The decrease in the “traditional” skills does not mean that industry knowledge and leadership experience are no longer desirable skills for a director, but rather that companies are taking a more holistic view of skills on both a director- and board-level basis.

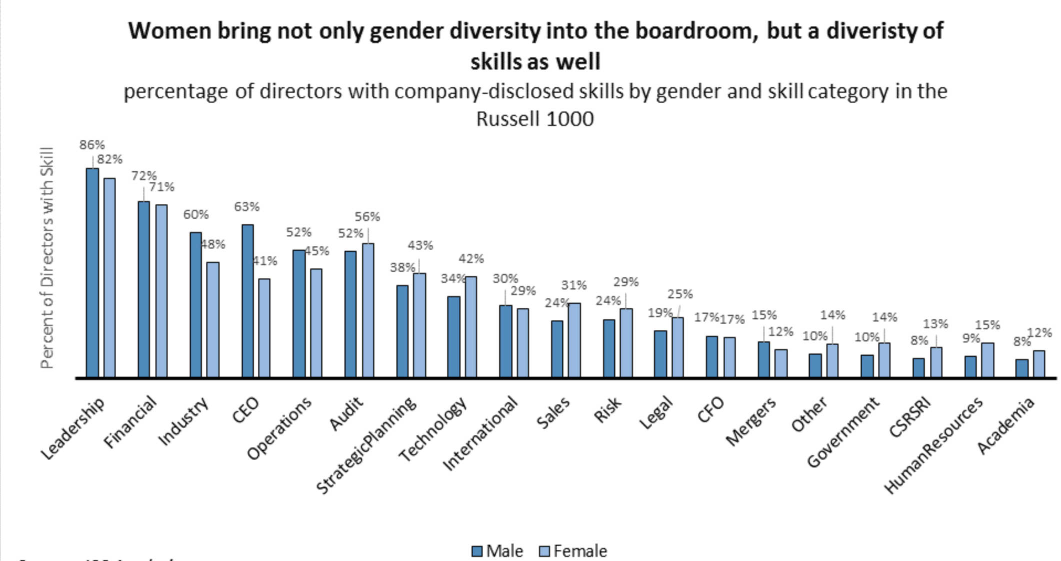


Women directors are more qualified than men in many skills categories

Given that there is not a cap on the number of skills a nominee can have, the decreases in leadership, financial background, industry knowledge, and CEO experience does not perfectly correlate to the increased prevalence among other skills. Rather, the change in skills may be more closely linked to the changing composition of the board—specifically, as the proportion of board seats held by women increases. Of the 13 skill categories that are more prevalent among recently appointed directors, women directors surpass men in skill prevalence for 9 of the skill categories (69%). In particular, women surpass men in the following categories that have seen an increase (including both traditional and non-traditional board skillsets): audit, strategic planning, technology, sales, risk management, legal, government, CSR, and human resources. A higher proportion of female directors also come from academia, one of the categories with less prevalence among recently appointed directors. The skill that saw the greatest growth—international experience—is also likely correlated with ethnic diversity.



A common retort by companies in relation to challenges to increasing gender diversity on the board is a lack of suitable candidates with the necessary experience. Every sector, except for the energy sector, has at least 20% women directors in total with industry experience, but no sector has reached 30% gender diversity on the board. Industry experience is on the rise as a particular skill among women directors. In every sector but telecommunication services, the percent of women directors with industry experience has increased from pre-2000 levels.

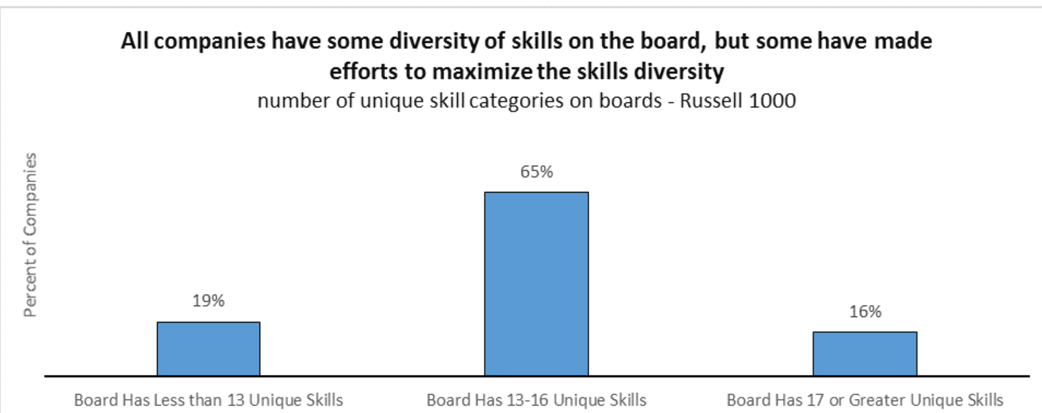


Source: ISS Analytics

How director skills translate to board performance

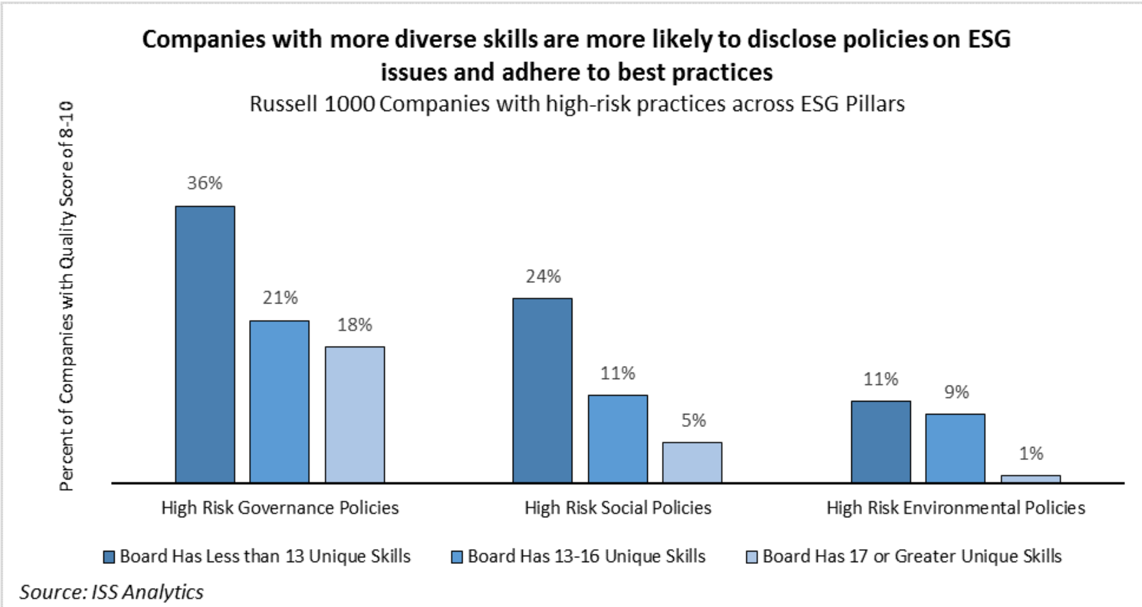
Board performance can be evaluated in two ways—the board's decisions in acting as the fiduciary for shareholders and the board's stewardship managing the company's actions on behalf of shareholders. The board's performance in stewardship can be evaluated through the governance, environmental, and social pillars of the ISS QualityScore as a proxy for ways in which the board acts on behalf of shareholders. This assessment includes the policies the board proactively adopts to manage risk and transparency to shareholders regarding the company policies and practices. On all three pillars, companies with greater diversity of skills have better performance.

Nearly all companies (98%) have at least half (10) of the board skills tracked by ISS, and most companies have between 60%-90% of skills. The chart below buckets the Russell 1000 companies into three categories based on the number of unique skills present on the board. The breakout creates two equal-sized tails that highlight the differences in quality score for companies that "lack" diversity of skills relative to other large- and mid-cap companies and those that have the highest levels of skills diversity.



Source: ISS Analytics

ISS's QualityScore captures both quantitative and qualitative aspects of governance, environmental and social issues, and provides a 1-10 score that indicates a company's risk where 1 indicates best-practices and 10 indicates relatively higher risk. The chart below analyzes the percent of companies with high-risk practices, a quality score of 8-10, across governance, social, and environmental pillars. Companies with less diversity of skills on the board have higher rates of risk across all three pillars.



Hallmarks of an effective skills matrix

The SEC adopted rules requiring boards to disclose whether the audit committee includes at least one financial expert as part of implementation of Sarbanes-Oxley. While there are also exchange-requirements for companies to have a compensation and nominating committee, the requirements for those committees is focused on independence of the members rather than his or her skillset. These basic requirements are akin to the minimum standards for graduating high school and being a college applicant; investors may begin to review qualifications more critically and evaluate which nominees are truly stand-out candidates for admission to the Board of Directors.

- **A matrix that does more than "check the box":** The NYC Fund's Boardroom Accountability Project 2.0 has focused on having companies disclose a "matrix" of skills, as well as race and gender, of the directors. The Project has a "compendium of best practices" that provides examples of the formats and details that are considered within the scope disclosure best-practices. With regard to race and gender, some of the examples disclosed gender and racial information in aggregate format while others listed the race and gender for each board member. With regard to skills, some companies simply listed the skills of each nominee; some provided a brief description of the underlying qualifications for the skill; some also broke out the director's biography categorically based on the identified skills; the best examples also highlighted the relevance of the particular skill in the context of the company's business.

- **Standardized skill disclosure:** There is guidance for what constitutes a financial expert for Sarbanes-Oxley compliance. While being a former or current CEO is straightforward answer for whether a director has that skill, something like technology is much less clear. Would working at a company in the information technology sector suffice? Does the director need to be a Chief Technology officer? Setting market standards would reduce the uncertainty and expense for each company to take on the responsibility individually and would also increase investor confidence in analyzing a board based on skills.
- **Skills mapped to specific responsibilities:** The analysis shows that having a particular skill on the board will reduce ESG risks. However, a more in-depth assessment would also consider the skills that exist on the board's committees and map those skills to the responsibilities of key committees. For example, if the board gives the audit committee oversight of cybersecurity, has the board included any audit committee members that have technology or risk management experience?

Skill refreshment considered as part of board refreshment

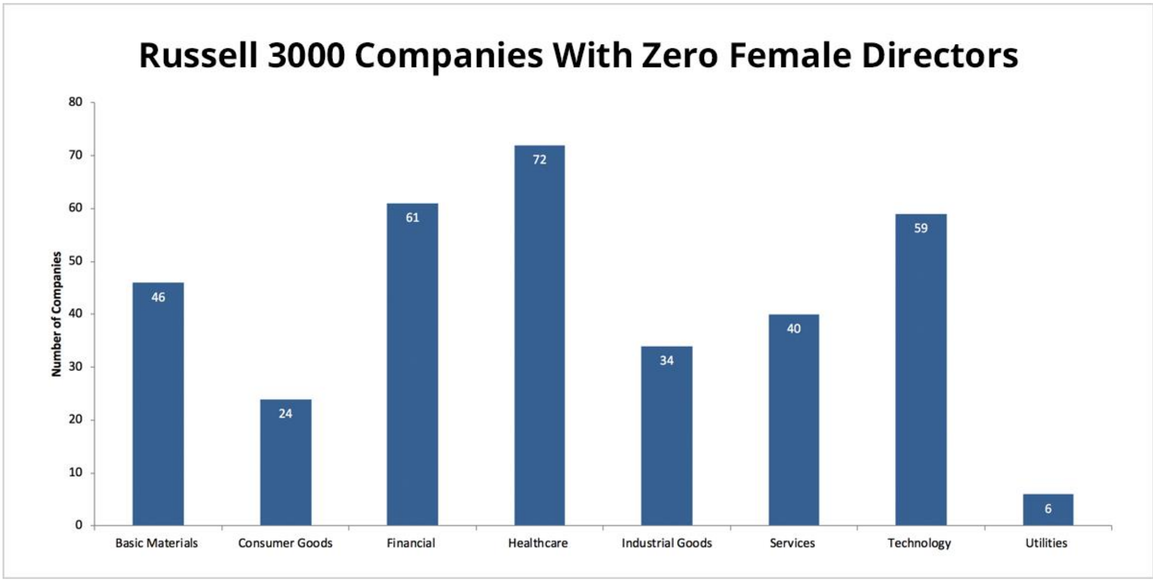
Tracking skills may help identify when refreshment is necessary—whether refreshment comes in the form of adding a new director to the board or replacing a director for one with a skillset that is unique among the rest of the board. Companies should look beyond whether a particular candidate is qualified to serve on the board and more critically evaluate the value that director can bring based on the current makeup of the board skillset. The skill-based approach may also help with the business-case justification for increasing diversity on the board.

Boardrooms Without Female Representation

Posted by Lyla Qureshi, Equilar, Inc., on Monday, January 7, 2019

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

Board diversity is a governance issue that has been getting a large amount of attention for the past couple of years. This year, gender diversity, particularly in relation to board member appointments, has been in the limelight. This heightened focus comes in part thanks to SB-826, a recently-passed California bill that will mandate that public companies headquartered in the state must place at least one woman on their board by the end of 2019. Furthermore, the legislation directs publicly listed companies to have two women on boards with five members, and three on those which have six or more members by 2021. To find out where the current Russell 3000, not just California, stands in terms of board gender diversity, Equilar conducted a study to examine which companies have not had a woman on their board.



Out of the entire Russell 3000 index, 344 companies have not had a female board member in the history of the Equilar database, which goes back to the year 2000. Additionally, the two sectors with the highest count of companies without a female on their board are the financial and technology sectors, with each having approximately 48 companies with all male boards. Healthcare, as well as the services sector, both had at least 40 companies with all male boards for their entire Equilar database history. On the flip side, companies that are a part of the utilities sector account for approximately 1.4% of the companies with all-male boards.

According to The Guardian, one of the reasons cited by companies for not recruiting females to their boards is the fact that the make-up of boards is not a priority for shareholders. However, that excuse may not necessarily hold true. For instance, BlackRock, one of the largest shareholders of American companies, stated in the beginning of this year that they would like to see at least two female board members at companies in which it invests. As mentioned in *The Wall Street Journal*, Michelle Edkins, Global Head of Investment Stewardship at BlackRock, wrote, “We believe that a lack of diversity on the board undermines its ability to make effective strategic decisions. That, in turn, inhibits the company’s capacity for long-term growth.” Yet another reason provided by companies to justify male-dominated boards is due to an alleged dearth of qualified female candidates and “over-boarding” of women who are experienced. Research conducted on this indicates that rather than a lack of expertise, what women tend to lack is board experience. This is because many businesses prefer veteran female directors over novices. Women trying to enter the world of board memberships have a tough time landing their first board position; however the same is not true for men. While speaking with *The Wall Street Journal*, Bill George, former head of Medtronic PLC, said, “To gain their first corporate board seat, women still have to overcome strong cultural issues that most men don’t have to overcome.” Furthermore, men also have the advantage of having a wider network made up of other powerful, well-positioned men. Coco Brown, founder of Athena Alliance, told The Journal, “Women on the whole are outside the trusted networks of public company boards. So they end up with the bar that requires board experience.”

Although the numbers provided above are not encouraging, what is positive is that there were approximately 44 new companies that added a female to their board in the second quarter of 2018. An interesting trend observed in the proxies of these companies is that almost all of the documents had a disclosure regarding diversity in them. Out of the 44 companies in discussion, 38 had text that addressed the topic of diversity, while 29 of those 38 disclosures had text pertaining specifically to gender diversity. The disclosures stated that the company recognized the importance of diversity and relayed the fact that they were cognizant that changes must be made to the organization in order show how truly committed they are to rectifying the male-dominated board structure. The appointments of female directors by these companies shortly after the release of their proxies showed that the companies followed through with their promise of making their board more gender balanced.

Although the numbers reported in this study with respect to the prevalence of all-male boards paint a bleak picture regarding gender equity in American boardrooms, the increased focus on gender-balanced boards has resulted in companies making concrete changes, as witnessed by the rise in female board members this year alone. In a study earlier this year, Equilar reported that the percentage of women on Russell 3000 boards increased from 16.9% to 17.7% between March 31 and June 30, 2018. Despite the fact that for some the pace of change is not fast enough, one hopes that if present efforts to ensure equal gender representation on boards continue, gender-balanced boardrooms will become a reality in the near future.

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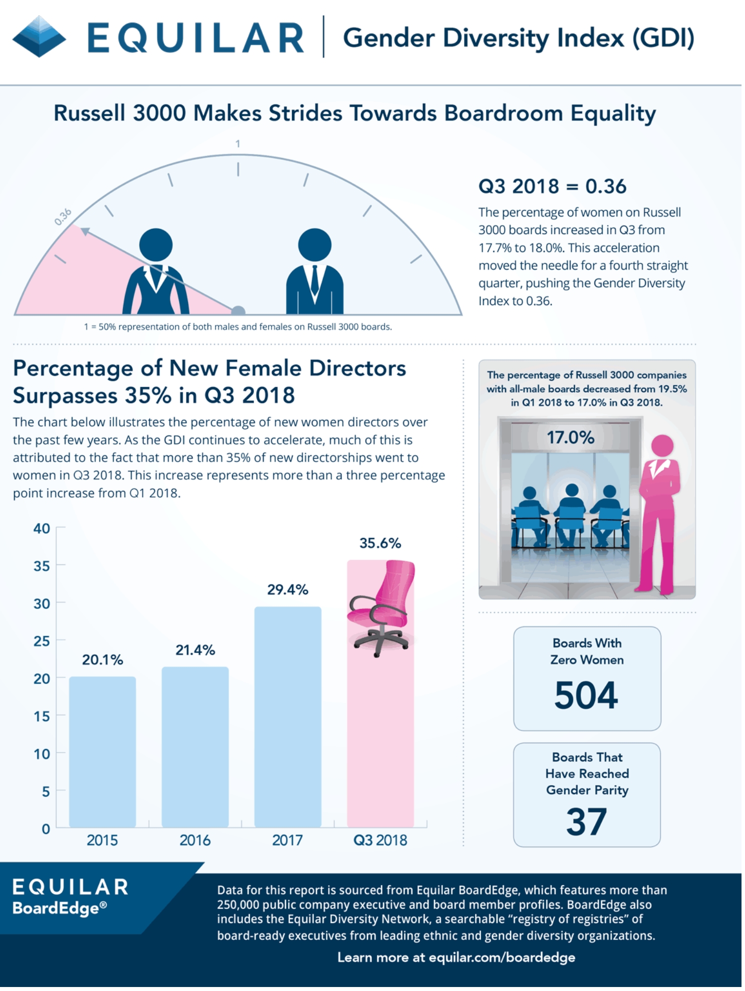
Q3 2018 Gender Diversity Index

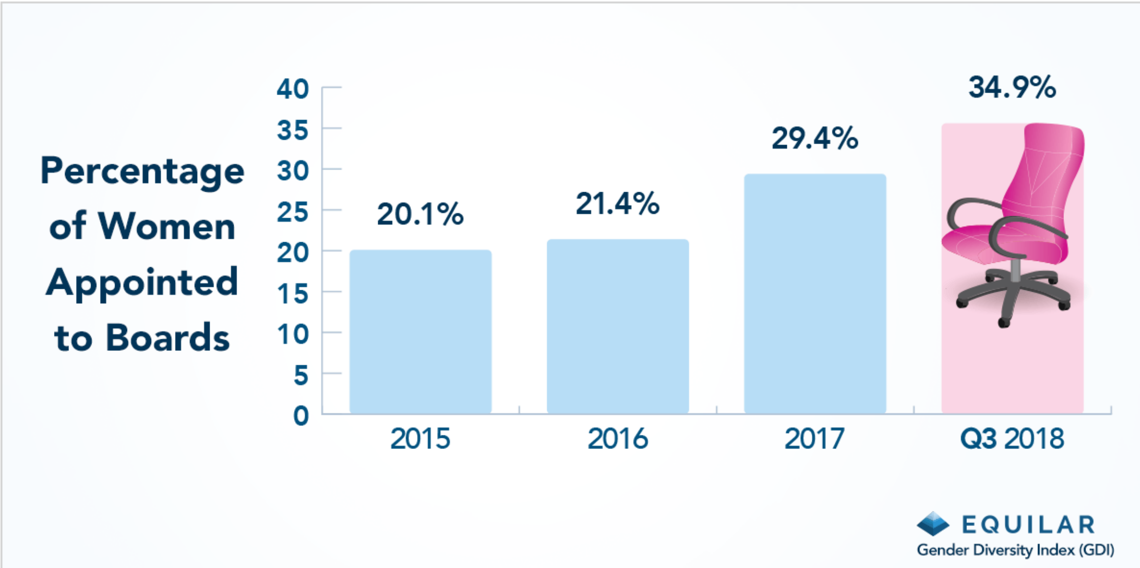
Posted by Amit Batish, Equilar Inc., on Saturday, January 26, 2019

Editor's note: Amit Batish is Content Manager at Equilar Inc. This post is based on an Equilar memorandum by Mr. Batish, with data analysis contributed by Courtney Yu, Lyla Qureshi, and Hailey Robbers.

For the fourth consecutive quarter—an entire year—the Equilar Gender Diversity Index (GDI) increased. The percentage of women on Russell 3000 boards increased from 17.7% to 18.0% in Q3 2018. This acceleration moved the needle, pushing the GDI to 0.36, where 1.0 represents parity among men and women on corporate boards.



Over the last year, the percentage of new directorships that went to women continued to rise each quarter. Q3 2018 was no different—35.9% of new board seats were filled by women. This has certainly been a lead driving factor in the consistent increase in the GDI.



"In Q3 of 2018, over 30% of newly-elected directors were women, which we believe indicates that companies are changing their approach to diversity," said Brigid Rosati, Director of Business Development at Georgeson. "It seems that companies are beginning to understand better the benefits that a more diverse board can bring, but are also in some cases responding to signs of increased interest from investors, including in the way they vote in director elections."

Many corporate leaders are also making a concerted effort to implement various initiatives across their organizations to drive awareness on the topic. Last year, PwC U.S. Chairman Tim Ryan launched CEO Action for Diversity & Inclusion, a CEO-driven business commitment to advance diversity and inclusion within the workplace. Currently, 550 CEOs have signed the pledge.

"Companies more generally are realizing the value of diversity and inclusion initiatives," said Blair Jones, Managing Director at Semler Brossy Consulting Group. "More diverse teams make better decisions."

Investors and Proxy Advisors Take Action

Over the past year, the investor community has placed a heightened emphasis around gender diversity. In February of 2018, BlackRock—the world's largest money manager—publicly stated that companies in which it invests should have at least two female board members. Michelle Edkins, Global Head of Investment Stewardship at BlackRock, wrote a letter to Russell 1000 that have fewer than two women on the board to ask them to disclose their approach to boardroom and employee diversity, The Wall Street Journal reported.

"We believe that a lack of diversity on the board undermines its ability to make effective strategic decisions," wrote Edkins in the letters reviewed by the Journal. "That, in turn, inhibits the company's capacity for long-term growth."

Furthermore, the two major proxy advisory firms—Glass Lewis and ISS—have both updated their proxy advisory guidelines to reflect a greater focus around board diversity. Glass Lewis will now generally recommend a vote against the nominating committee chair of a board that has zero female board members, while ISS plans to enforce the same policy in 2020.

“Given these developments, companies that lack board gender diversity should consider refreshing their board to add at least one female director in the near term,” said Rosati. “Beyond this, we believe that continued media coverage and scrutiny means that we will see continued pressure from investors towards companies with zero women on their boards.”

California Legislation Leads the Charge for Progress

The State of California recently passed a piece of legislation—SB 826—that will require public companies headquartered in California to have a minimum of one female on its board of directors by December 31, 2019. That minimum will be raised to at least two female board members for companies with five directors or at least three female board members for companies with six or more directors by December 31, 2021. Violators of this legislation will be subject to financial consequences.

California is the first state in the nation to pass a mandate of this kind, and, most likely, not the last. The past year has shown exceptional signs of progress, and with California leading the way with an official quota, gender diversity will only continue to become a point of focus at boardrooms across corporate America.

“The law is a reflection of a common concern–impatience with the slow pace of change in the boardroom,” said Susan Angele, Senior Advisor of Board Governance at KPMG’s Board Leadership Center. “Boards today need a broad range of perspectives around the table, and the spotlight on gender diversity will continue to increase—not only in California but with institutional investors and other stakeholders.”

The Future State of Board Assessment

The Q3 2018 GDI is indeed a promising sign that boards are taking adequate measures to address the lack of gender diversity in the composition of their boards. The combination of pressure from investors and proxy advisors, as well as legislative quotas, is sure to lead to a continued trend in this direction.

However, there is still an overwhelming number of Russell 3000 companies that have zero women on their boards. According to the GDI analysis, 504 Russell 300 boards lack a female director—an exceptionally high figure.

As we approach 2019, there is no doubt that boards that fall into this bucket will face some level of scrutiny from investors. Companies that want to address this issue—and address it thoroughly—must prioritize practices that promote diversity and the value it brings to a boardroom.

“If you want the most talented board, you cannot limit the talent pool,” H. Rodgin Cohen, Senior Chairman at Sullivan & Cromwell, said in a recent interview for Equilar C-Suite magazine. “If you want the best board, you need to have a meaningful number of women or else you're just not getting the best people that you could have."

About Equilar Gender Diversity Index

The Equilar GDI reflects changes on Russell 3000 boards on a quarterly basis as cited in 8-K filings to the SEC. Most indices that track information about board diversity do so annually or even less frequently, and typically with a smaller sample size, sometimes looking back more than a full year by the time the information is published. While this data is reliable and accurate, the Equilar GDI aims to capture the influence of the increasing calls for diversity from investors and other stakeholders in real time.

The Equilar GDI is powered by Equilar BoardEdge, a database of more than 250,000 public company board members and executives. BoardEdge includes exclusive features that show how board members and companies are connected to each other, as well as the Equilar Diversity Network (EDN), a "registry of registries" of board-ready executives from leading ethnic and gender diversity partnerships, organizations, and publications.

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The Board, CEO Misconduct, and Corporate Culture

Posted by Laurie Hays, Edelman, on Saturday, January 12, 2019

Editor's note: Laurie Hays is Managing Director for Special Situations at Edelman. This post is based on an Edelman memorandum by Ms. Hays.

More than 400 business executives and employees including prominent CEOs have been accused of misconduct including sexual harassment in the last 18 months. In many instances, the resulting crises have fallen squarely in the lap of boards of directors. Clearly, it is time for boards to play a more active role overseeing corporate culture and conduct.

Investors increasingly view corporate culture as a risk factor. A new survey by Edelman finds that investors recognize the impact of a healthy culture and engaged employees on corporate performance. Nearly two-in-three investors surveyed believe maintaining a healthy company culture and enforcing a corporate code of conduct at all levels of the company impact their trust significantly in that company.

And an online poll by the National Association of Directors (NACD) revealed that almost half of directors said their board's tendency to focus on known risks—those management already has identified—creates a major barrier to the board's ability to oversee disruptive risks. Less than 20 percent expressed confidence in management's ability to address such disruptive risks.

CEOs own company culture, to be sure. Case in point: When Lou Gerstner took over IBM in 1993, he sought to inject new thinking into the staid workforce. He sported blue rather than white dress shirts and growled at long presentations. Jerry York, his irascible CFO, used the F-word a lot. Almost overnight, IBMers discarded their white shirts and their use of transparencies (pre-PowerPoint). Several of their wives wondered why they started using profanity.

In this age of #MeToo, the stakes are higher than shirt colors and the F-word. Directors have every reason to worry about whether they are asking the right questions about culture and getting the full picture. "Boards need to be very clear about what they want to know," maintains Margaret (Peggy) Foran, Prudential Financial's chief governance officer and an advisor to several boards.

She says management increasingly must be held accountable for issues of corporate culture, whether it's sexual harassment accusations, turnover rates, exit interview themes from departing employees and the like.

For part of her edification, Ms. Foran looks at Glassdoor, the website where current and former employees anonymously review companies and their management. There, she gets an unedited view of the middle ground and sees what types of complaints make their way online.

For most boards, asking a CEO whether they or other senior management have any conduct vulnerabilities proves uncomfortable. Hiring a private eye to spy on the C-suite doesn't seem appropriate. Plus, loyal board members tapped by the CEO or friends on the board aren't apt to identify problems. And many directors distracted by day jobs don't have time do the work.

Certainly, some companies manage to figure out what's going on without the media telling them. A recent example: Intel dismissed CEO Brian Krzanich after a probe into a relationship with an employee with the curt explanation that he violated the company code of conduct, and very little media attention has emerged since.

Other situations play out in the media because executives, including directors, don't pay enough attention or take complaints and accusations seriously enough. A corporate press release that contends a company is seriously looking into a situation has to demonstrate action or the situation won't be credible to employees, shareholders or customers.

Here are 10 best practices that can be embedded into a company playbook for turning the #MeToo moment into constructive reform before it turns into a major governance crisis for the board:

1. Insert into the CEO's performance and compensation metrics the need to cultivate a healthy, diverse culture where employees feel respected and real opportunities exist for promotion irrespective of gender or race. A summary at year-end of progress on the culture front should be included in the annual report for investors. It's not personal, it's mission-critical.
2. Expect the board's risk or audit committee to oversee culture just as it would oversee cybersecurity. The committee can receive quarterly reports on behavioral misconduct issues, pay and review promotions, and separation agreements with particular attention to "boy's club" patterns. Also important: Diverse membership on the board's risk committee.
3. Establish a culture ombudsperson who reports to the board with a dotted line to help oversee Human Resources. As a credible resource for employees, many HR departments have been seriously damaged by #MeToo revelations because they didn't act unless the CEO was on board. The ombudsman can receive complaints if victims are too afraid to talk to HR or management.
4. Retain third-party experts to conduct regular and anonymous "climate" surveys that seek to determine how employees feel they are being treated. Make the survey results available internally and discuss them. If allegations arise, the outside parties should investigate them and report back to the board. Listen for any "rumor" mill because often where there's fire, there's smoke.
5. Mandate in-person training for all employees on respectful conduct at work and decide how management will address issues that surface in the climate survey. Incorporate bystander training/peer feedback to thwart offensive behaviors. Bystander reporting can help directors grasp the extent of an issue, especially given what often is significant underreporting by victims.
6. Provide directors, managers and the workforce with training into unconscious biases in the workplace—those learned stereotypes that are unintentional, deeply engrained and able to sway behavior—to address behavioral misconduct and to adjust their own lens.

7. Employ strategic employee communications that don't dance around the facts and that make clear management actually is addressing a situation seriously. Explain in detail how complaints are handled, including protections for victims and complainants, the range of disciplinary actions that can be taken and why outcomes generally are kept confidential.
8. Provide confidential counseling services to employees who believe they can't perform at their best because of what they are experiencing directly or observing around them.
9. Listen carefully and consider outside help if the organization lacks women and/or minorities in senior management. While executive coaching is often provided for women and minorities to help them advance, coaching of white men and managers as well as a genuine desire to determine where star talent lies are even more essential for change to happen.
10. Deeply implant the realization that a respectful workplace is the best step toward organizational success. If this is hard to appreciate, pretend a whistleblower has brought to the board's attention the theft of millions of dollars from company coffers. That's how much losing talented employees will cost in today's tight labor market and fierce war for talent if such promising employees depart because they can't bear to come to work or they file lawsuits for alleged discrimination, harassment or misconduct.

#MeToo is not vanishing. So, if boards don't take heed, that reputation-damaging news article about a company's or executive's claimed misconduct could land in your inbox any day.

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Corporate Governance Update: Shareholder Activism Is the Next Phase of #MeToo

Posted by David A. Katz and Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, on Friday, September 28, 2018

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

As the #MeToo movement continues to make itself felt in all facets of American life, public company boards of directors that are newly focused on the issue of workplace harassment have seen corporate responses evolve. In recent months, many boards have overseen the addition of anti- harassment policies to corporate codes of conduct, the establishment of procedures for addressing allegations, and the enhancement of employee training at all levels. Directors are taking proactive steps toward educating themselves and looking deeply into the issues involved, and many have highlighted it as a priority for the senior management team. Boards that have successfully installed the nuts and bolts of good governance in this area can now step back and consider the larger project of gender equality in corporate America, in which sexual harassment, corporate culture, gender pay equity, and gender diversity are related issues. Shareholder activity in all four of these areas—which we will call collectively, "corporate equality"—has markedly increased, and boards looking ahead to the next phase of corporate governance activism should take note of this trend and try to be proactive as opposed to reactive.

Board Accountability for Corporate Culture

Earlier this year, pension fund giant CalPERS revised its corporate governance principles, adding a new policy emphasizing the board's role "in setting a high-performance corporate culture," and urging every public company board to "develop and disclose its efforts towards establishing effective corporate culture, including its anti-harassment policy." The new policy supports disclosure of all settlements, including sexual harassment settlements, involving an executive or member of the board. CalPERS also added language to its policy on human capital management practices to specifically emphasize the importance of preventing "harassment of any kind including sexual harassment." CalPERS's governance policy supporting compensation clawbacks in the event of executive misconduct, and urging corresponding disclosure to shareholders, includes a specific reference to sexual harassment misconduct.

BlackRock, in a statement released in March 2018, elaborated on its approach to human capital management, which it identifies as one of its engagement priorities for the year. Noting that human capital management is an investment issue with meaningful financial impact, BlackRock emphasized that human capital management "is both a board and a management issue." The statement set forth a list of discussion points on which it intends to engage with boards this year in order to promote board accountability, including the role of the board in overseeing the company's strategy "to create a healthy culture and prevent unwanted behaviors." BlackRock's discussion points also include human capital risk management, diversity in board and workforce composition, and potentially linking human capital management performance metrics to executive compensation.

It has always been the responsibility of the board to set the "tone at the top" for the company and convey the importance of such tone to the senior management team. Effective boards convey their priorities clearly and hold their senior management team accountable. CalPERS's policy updates and BlackRock's statement regarding human capital management make clear that powerful shareholders increasingly will hold boards to account for deficiencies in corporate culture that manifest themselves in pervasive harassment, discrimination, lack of workforce diversity, and gender pay inequality.

Shareholder Activism

Trillium Asset Management filed a first-of-its-kind proposal earlier this year at Nike, Inc., urging the board to improve its risk oversight with respect to workplace sexual harassment, to focus on its deficiencies in gender diversity and pay disparity, and to produce a report describing its efforts in harassment prevention and creation of a more gender-balanced workforce. The proposal, which also urged Nike to consider company culture and diversity metrics in evaluating the performance of senior executives, was withdrawn upon Nike's commitment to consider Trillium's request and to meet quarterly to discuss the results. Trillium also has filed shareholder proposals at numerous companies in the past five years pushing for increased workplace diversity.

The first shareholder proposals regarding sexual harassment online were filed jointly in January 2018 by Arjuna Capital and the New York State Common Retirement Fund. The resolutions at Facebook and Twitter requested that each company produce a detailed report regarding the scope of platform abuses, the efficacy of enforcement of their content policies, and the risks posed by content management controversies. The filers expressed concern that weak anti-harassment policies and minimal enforcement create "a threat to women and a danger to long-term shareholder value."

Arjuna Capital has focused heavily on the gender pay gap in the financial, tech, and consumer retail industries. Six shareholder proposals filed in 2017 at the largest U.S. financial institutions asking for detailed reports on the percentage pay gap between male and female employees were unsuccessful, but this year, nine out of nine financial institutions targeted—including Citibank, JP Morgan, Bank of America, Wells Fargo, and American Express—have agreed to disclose and close their gender (and in some cases, racial) pay gaps. In July, Arjuna Capital announced that it had engaged 23 companies on the issue of pay equity, including many of the largest tech and retail companies in the United States, and had reached agreement with 21 of them.

As in recent years, 2018 also saw significant shareholder activity relating to gender diversity on boards. Influential investors such as BlackRock, State Street Global Advisors, CalSTRS, and CalPERS have incorporated board diversity into their voting policies, and shareholders have shown a willingness to vote against boards that do not show a commitment to diversity. State Street, for example, has indicated that in the 2018 proxy season it voted against certain directors at more than 500 companies for failure to address board diversity. Chairmen of all-male boards received average opposition votes of over 15 percent this year, as compared to 3.6 percent for the same position at boards with 20 percent female membership.

In the S&P 500, 49 percent of boards now have three or more women directors, and for the first time, the rate of increase in board diversity accelerated in 2018.

While relatively few activists have so far been filing the majority of shareholder proposals aimed at corporate equality, that does not mean that it is a fringe movement. The success of Arjuna Capital's 2018 campaign demonstrates the rapidly growing influence of shareholders in pushing companies to adopt socially progressive policies. Activists like Natasha Lamb of Arjuna may be the tip of the spear, but established and powerful shareholders such as CalPERS and BlackRock strongly endorse the connection between corporate equality and long-term value. In contrast to past eras, when it was difficult for activists to gain traction with companies on social issues, and companies were able to exclude or ignore these proposals without public backlash, the cultural context of the current #MeToo movement makes that approach risky and potentially damaging to the company.

In the current climate, public companies have little choice but to engage with shareholders, offer increased disclosure, and work toward developing policies to promote equality in the workplace. Under shareholder pressure, some of the largest and best-known U.S. companies have engaged and acceded to activist demands. The theme of corporate equality has resonance in all aspects of American culture at this moment, and it is on its ascendancy. Boards should take note of this trend and understand that they are increasingly likely to be held accountable for any notable failure to be leaders on this issue—not in the Delaware courts, perhaps, but in the court of public opinion, where a guilty verdict may be unfounded yet still financially significant. It is no small task and will require ongoing attention both to the details of governance as well as to the big picture.

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How to Fire an Accused CEO: Moonves Departs CBS

Posted by Julian Hamud and Maria Vu, Glass, Lewis & Co., on Sunday, October 7, 2018

Editor's note: Julian Hamud is a Director and Maria Vu is a Senior Analyst at Glass, Lewis & Co. This post is based on their Glass Lewis memorandum.

In a climate where Weinstein clauses are shaping M&A and the latest Kevin Spacey feature nets less than $1,000 on opening weekend, many shareholders and activists were puzzled by the persistence of Leslie Moonves. CBS's former president, CEO and chairman held onto his position for over six weeks despite a *New Yorker* article outlining accusations of sexual misconduct from half a dozen women.

The accusations stacked on to the pressures of CBS's roiling, board-driven litigation with its controlling shareholders, the Redstone family and their holding company National Amusements. Rumors of negotiations and a potential exit trickled out as the public became further incensed at reports that Moonves could be paid hundreds of millions for leaving despite the salacious circumstances surrounding his impending ouster. Monday brought a tipping point for both conflicts. Just as six additional women stepped forward to round out a dozen allegations of misconduct, CBS announced that Mr. Moonves had finally stepped down and $20 million would be paid to #metoo related organization; and, the battle between CBS and the Redstones came to a settlement.

Why now? (Why not weeks ago?)

In contrast to the swift removal of executives at several other major corporations on the heels of similar allegations, many questioned CBS's apparent lethargy amid whispers of possible severance payments. Mr. Moonves's contract did not include exceptional provisions that have driven negative severance situations at other firms, but as with the departure of Steve Wynn from the eponymous resort firm, the sheer size of the payments could have driven damaging delays and forced the board to negotiate.

However, the contemporaneous developments around the intercompany litigation and the CEO transition offers another explanation: rather than sloth on part of the board, the delay to Mr. Moonves's departure may have reflected a desire for a neat resolution to several issues at once. While the former CEO was not the most vocal opponent of the Redstones' plans and was not named as a plaintiff in the suit, he was integrally linked to the efforts to keep CBS a separate entity. Rather than draw out the resolution of the conflict and keep headlines in the papers, the board chose to rip off the bandage.

Seeking Certainty

While the timing of departure is now set, the cost remains to be determined. Mr. Moonves was previously one of the most highly compensated public executives in the US, if not the world, and his employment agreement provided for substantial and stringent severance terms. As of year-end, his total estimated severance package for termination “without cause” was pegged at over $117 million in cash plus vesting of over $64 million in stock; in addition, CBS could ultimately be on the hook for Mr. Moonves’s legal expenses in an investigation or subsequent arbitration. For scale, CBS had around $252 million in cash on hand at June 30, 2018.

The nine-figure separation benefits are a far cry from the $0 send-off that many activists have supported, which also reflects the total that would be paid if he were terminated for “cause.” The split between such a clear-cut firing and the more nebulous “without cause” separation is common for US executives, and this instance was not uniquely structured. The triggers constituting “cause” included eight conditions such as material fraud or a violation of the sexual harassment policy, all of which are common categories among public companies.

Monday’s separation agreement split some of the difference between the two scenarios and plainly lays out a “bona fide” dispute about his severance rights. The settlement fixes the potential separation payment at $120 million cash with no equity acceleration, likely reflecting a compromise in the total package that would avoid incrementally increasing in his equity stake as the company cut ties. However, the check is not in the proverbial mail—if the investigation (and all-but-inevitable subsequent arbitration) support a termination for cause, the money will be returned to the company. If CBS is ultimately not able to terminate him for cause, the princely sum is released to Mr. Moonves. The settlement also keeps his entitlement to advancement of attorney’s fees and stipulates that he will provide advisory services for up to a year for no compensation beyond office services and security. Interestingly, the vaunted $20 million payout to #MeToo-related charities is to be made by CBS, and the as-yet-unnamed charities are to be cosigned by Mr. Moonves.

The Cost of Confidentiality

The separation agreement is a multimillion concession from Mr. Moonves against an excessive contract, but still unlikely to placate CBS’s critics or even shareholders. The board’s caution, however, may have been choosing the frying pan over the fire. A more direct approach could have started an uglier fight, as played out last month at Barnes & Nobles—or rather in a courthouse, after the beleaguered bookseller’s former CEO, Demos Parneros, filed suit in search of restitution. Parneros was terminated for “cause,” with the board citing violations of company policy “not due to any disagreement with the Company regarding its financial reporting, polices or practices or any potential fraud.” Compared with his employment agreement, this cryptic assurance left a less-than-rosy list of misconduct, negligence, and substance abuse as possible triggers for the firing. Media reports focused on (or at least postulated) sexual harassment as a driving factor, in turn undergirding Parneros’ legal action.

While the suit’s demand for $4 million cash plus equity pales in comparison to Moonves’s potential entitlement, the cost of airing the company’s dirty laundry may end up exceeding any financial penalties imposed by the court. Parneros’s 19-page filing was much less cryptic than the company’s firing announcement, with thinly veiled references to failed merger talks and clear personal attacks. It repeatedly cited the firm's largest shareholder and former CEO, Leonard Riggio, as a source of instability and painted him as a boorish bully to current employees.

It's a situation that any board would want to avoid, and indeed many US executive severance provisions come complete with a litany of non-disparagement and non-disclosure arrangements. Mr. Moonves's aforementioned contract demanded particular confidentiality, including painstakingly drafted prohibitions around interviews or books and any derogatory statements about CBS. Mr. Parneros's agreement included some similar covenants, but without any severance paid or equity left to vest, the restrictions were left largely toothless.

Of course, a turnaround CEO with one year's tenure is not in the same position as an industry mogul who had shepherded a firm for over 20 years; a struggling retailer is not in the same position as a growing media giant. Adding fuel to the fire, the perennial public fascination with Hollywood intrigue and the premium on a firm's reputation in the industry could have pushed CBS's board from decisive action towards grudging compromise even without a clean exit. The separation agreement emphasized confidentiality to the maximum extent legally allowable and maintained many of the restrictive covenants in his employment agreement. Meanwhile the concurrent litigation had separately put the Redstone family in a rare spotlight while airing out many previously confidential details of National Amusements' interest in CBS. For the reputation of the firm and all the individuals involved, an investigation behind closed doors and a relatively tidier transition may have seemed well worth the price tag.

Coming Up Next….

At this point, shareholders and activists may have to content themselves with Mr. Moonves's exit and trust in the rigor of the investigation. A nine-figure sum hanging on a final report and the possibility of arbitration is an uncomfortable position even for a company of CBS's size. The settlement agreement also leaves CBS's future uncertain, with the long touted Viacom-recombination plans on pause and a window open for alternative strategies (or strategic partners).

The transition and the CEO search will test both the firm's succession planning and the reconstituted board's effectiveness. Shareholders would do well to review the terms of any successor's contract, and to keep an eye on how the board addresses COO-come-interim-CEO Joseph Ianniello. Thanks to a key man clause, Mr. Ianniello could resign with full benefits if someone other than himself or Mr. Moonves was named CEO of CBS. This arrangement leaves the refreshed board saddled with choosing between the succession planning decisions of their predecessors or cutting more checks and stomaching more uncertainty in the search.

More broadly, shareholders should be mindful of how firms respond to the raised stakes around executive conduct and company culture. For any company, the situation is a reminder that skeletons can lurk deep in closets and can be shaken out in the least opportune circumstances, with or without a Weinstein clause.

Bringing the #MeToo Movement into the Boardroom

Posted by Arthur H. Kohn, Pamela L. Marcogliese, and Kimberly R. Spoerri, Cleary, Gottlieb, Steen & Hamilton LLP, on Wednesday, March 21, 2018

Editor's note: Arthur H. Kohn, Pamela L. Marcogliese, and Kimberly R. Spoerri are partners at Cleary, Gottlieb, Steen & Hamilton LLP. This post is based on a Cleary Gottlieb publication by Mr. Kohn, Ms. Marcogliese, Ms. Spoerri, and Vanessa C. Richardson.

Maintaining a workplace environment free of discrimination, sexual harassment and other misconduct is critical to both the short-term productivity and long-term health of a business. Reports of sexual harassment allegations at public corporations can have material negative effects on stock price, with some corporations seeing double digit single day drops after accusations are made public. As we have written elsewhere, the primary obligation to manage these risks on a day-to-day basis falls to executive leadership.[1] But the #MeToo movement also has raised questions about the role of boards of directors to provide oversight of management and, to the extent that senior management may be a source of the problem, the board's obligation to take more direct action.

This post discusses some key issues for General Counsel to consider as they advise corporate boards about how to navigate their responsibilities in this environment.

Sexual Harassment Issues Can Create Significant Risks for Boards

1) Shareholder Derivative Lawsuits

As most directors know, a *Caremark* claim is a claim that a board of directors breached its fiduciary duties because it was on notice of risky corporate conduct and consciously disregarded its duty to exercise oversight, exposing the company to financial risk. *See In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996) (directors allegedly breached duty of care by inadequately supervising employee conduct, leading company to pay substantial fines). *Caremark* claims are notoriously difficult to plead successfully.[2] "[O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." *Caremark*, 698 A.2d at 971; *see also White v. Panic*, 793 A.2d 356 (Del. Ch. 2000) (finding complaint failed to state derivative claim that directors breached their fiduciary duties by failing to implement mechanisms to control corporate officer's sexual harassment). Nonetheless, some scholars have argued that multiple allegations of sexual

[1] Confronting Sexual Harassment in Today's Workplace: 8 Questions Companies Should Be Asking Themselves, Cleary M&A and Corporate Governance Watch (Feb. 6, 2018)

[2] Delaware courts describe *Caremark* as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *Stone v. Ritter*, 911 A. 2d 362, 372 (Del. 2006).

harassment may build a pattern of “red flags” that expose boards to liability for failing to respond to misconduct or consciously allowing that type of behavior to continue.[3] Furthermore, even without a finding of liability, these lawsuits can be embarrassing, distracting, and costly to resolve.

2) Disclosure Claims

In certain cases, a public company may have an obligation to publicly disclose harassment claims, lawsuits or settlements, to the extent that the matter is likely to have a quantitatively or qualitatively material impact on the company. Such disclosures can negatively affect stock price and leave the company vulnerable to shareholder lawsuits alleging disclosure violations. Companies may also face investigations or civil charges from the SEC for failing to disclose information regarding harassment allegations or settlements that it determines are material to investors in the aggregate.

3) Reputational Harm, Additional Regulatory Scrutiny, Increased Vulnerability to Activists and Other Potentially Negative Effects

Beyond risks directly tied to litigation, sexual harassment allegations against a senior executive generally result in harmful media coverage and long-standing reputational damage for the corporation and, potentially, members of its board of directors. Coverage of the allegations may affect recruitment or retention of employees. Sexual harassment allegations may also cause additional regulatory scrutiny of pending M&A transactions or other material projects. Although it is unlikely that even widespread misconduct would be enough to alter the eventual outcome and result in a denial of regulatory approval for a transaction or project, such allegations can make an already burdensome process even more expensive and time-consuming. In addition, failure to appropriately manage issues of workplace harassment may expose a board to increased pressure from opportunistic activists looking to exert influence while a company may be more vulnerable following negative press or a drop in stock price. Activists could use such a period of turmoil as leverage to push for their own agenda.

Proactive Steps Boards Should Consider in Light of the #MeToo Movement

1) Sexual Harassment Policies And Training Procedures

As much as with any other area of compliance, it is important that the board set a tone at the top that sexual harassment is not acceptable and that inappropriate behavior will be promptly investigated and result in appropriate consequences. To do that effectively, a board must be sufficiently informed as to the soundness of company-wide sexual harassment policies and training procedures, as well as to the vigilance of their enforcement. Therefore, boards that have not recently reviewed these policies should do so promptly, and all boards should have a practice of periodically reviewing them to ensure that they continue to reflect best practices as they evolve, particularly regarding reporting channels, victim anonymity, and prohibitions on retaliation, among other key features.

Among the issues for a board to consider carefully is the question of what types of allegations should be escalated to the board’s attention. We recommend that any allegations involving a

[3] Daniel Hemel & Dorothy Shapiro Lund, “It May Not Matter What the Weinstein Company Knew,” The Atlantic (Oct. 14, 2017).

member of senior management should be brought to the board's attention, as well as any widespread allegations about a group or an area within the company. A board should demand sufficient information from management to understand and assess potential problems.

In a recent letter to the former lead independent director of Wells Fargo, the Federal Reserve Board emphasized the director's alleged lack of initiative in pressing for information about compliance issues at the bank, and stated that taking initiative in ferreting out information, including "an alternative view [to that of] management" was a core part of the director's "oversight" responsibility.[4] Similarly, independent directors can play an important role in seeking information about discrimination, sexual harassment and other misconduct.

2) Clawback and Related Policies

Boards should consider what contractual and compensation incentives exist to motivate compliance with the company's behavioral expectations. Some companies have revised clawback policies and definitions of "cause" to encompass reputational and economic harm that might arise from violations of company policies concerning workplace conduct. Boards are exploring these options because reputational harm is real harm, even if it is sometimes hard to quantify, and because they are seeking to counter any public perception that the corporation is being "soft" on executives whose behavior violated its policies, because of shortsightedness, a conflict of interest or other factors.

3) Difficult Board Independence Situations

At least annually, a board should complete questionnaires that elicit information about, and should deliberate concerning, director independence. Typical director and officer questionnaires are too long and technical to be the sole vehicle for making independence determinations, which should be intensely fact-specific and nuanced.

To illustrate the difficulty of these determinations, conflicts issues have arisen from situations where a director is an employee of a non-profit organization to which the company is a major donor (*see In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917 (Del. Ch. 2003)); where a director is an executive at another company where the senior executive serves as a director (*see Del. City. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015)); or where a director and the senior executive have interlocking business relationships such as shared investments or co-ownership of property (*see Sandys v. Pincus*, 152 A.3d 124 (Del. 2016)). Although personal friendships are not usually considered to compromise independence (*see Beam v. Stewart*, 845 A.2d 1040 (Del. 2004)), even friendships may raise concerns if the relationship between the director and the senior executive is particularly lengthy or robust. CalPERS and ISS have suggested that director independence may be compromised after tenures of 12-15 years.

A board must be particularly cognizant of director independence issues when it has received specific allegations of harassment by a member of senior management and is considering creating a special committee to investigate those claims. Any director selected to serve on such a committee should be above any suspicion of a conflict that could compromise her independence. A truly independent committee will also be an important factor in demonstrating that the board is

[4] Letter from Federal Reserve Board to Stephen Sanger Re: Accountability as Lead Independent Director of Wells Fargo & Company Board of Directors (Feb. 2, 2018).

in a position to exercise business judgment, such that shareholders will not be able to bring derivative claims without first making a demand to the board.

4) Refreshing Board Membership

Over the last few years, investors have been increasingly focused on board composition—including diversity, skill set and tenure on the board. For example, State Street Global Advisors, The Vanguard Group, Inc., and BlackRock, Inc. have each announced a commitment to board gender diversity (although this focus has not yet trickled down to management). In another example, CalPERS and ISS have amended their policies to scrutinize director independence after certain tenure periods. Lack of refreshment is also a key criticism used by activist investors, often as leverage for other issues on their agenda. As we have written elsewhere, activist investors are increasingly using perceptions of weaknesses by companies on "social good" matters to build support within the institutional shareholder community for their campaigns.[5]

Within this existing context, the #MeToo movement may provide yet another reason for boards to consider reviewing their membership and recruiting new board members. New members are more likely to bring fresh perspectives to a discussion of the challenges facing the business, may be perceived as more independent, and may be better positioned to exercise oversight and provide direction for senior management. Boards should continue to take steps to evaluate the composition of their board and may want to take steps to preempt any criticism.

5) Reflecting on the New Environment

Political and cultural developments have arguably created a new environment for public corporations and their boards, in which sensitivities to social issues that are related, but not central, to typical business issues have to be adjusted. Institutional shareholders, executives and corporations have reacted to these developments in high-profile ways,[6] and other constituencies—such as regulators, customers and employees—may add their voices in particular circumstances. Because by assumption social issues are generally not related to routine business decisions, boards may find that they are not able to effectively apply the same decision-making framework that has served them well when considering business issues to social issues. That is, the normal weighting of considerations impacting a decision, including how to react to the #MeToo movement, may need refinement.

[5] Ethan Klingsberg, "The Schizophrenic Investor Landscape: The Significance for Boards and Managements of the JANA/CalSTRs Letter to Apple," Cleary M&A and Corporate Governance Watch (Jan. 8, 2018).

[6] *See*, *e.g.*, Laurence D. Fink, Chairman and CEO, Blackrock, Inc. (2018 Annual Letter to CEOs) ("Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that that will help them achieve their goals?"); The C.E.O. Who Stood Up to President Trump: Ken Frazier Speaks Out, David Gelles, New York Times (Feb. 19, 2018) ("Before announcing his decision to resign from the president's manufacturing council, Mr. Frazier consulted with the Merck board. 'I wanted to say that this was a statement I was making in terms of my own values, and the company's values, and there was unanimous support for that,' he said. 'My board supported that 100 percent.'"); How Banks Could Control Gun Sales if Washington Won't, Andrew Ross Sorkin, New York Times (Feb. 19, 2018) ("Jamie Dimon, chief executive of JPMorgan Chase, which issues credit cards and owns a payment processor, has talked about how he and his bank have "a moral obligation but also a deeply vested interest" in helping "solve pressing societal challenges."); and Amazon, Berkshire Hathaway and JPMorgan Team Up to Try to Disrupt Health Care, Nick Wingfield, Katie Thomas and Reed Abelson, New York Times (January 31, 2018) ("The companies said the initiative, which is in its early stages, would be 'free from profit-making incentives and constraints.' . . . [Mr. Buffett] believes the condition of the country's health care system is a root cause of economic inequality.").

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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The Role of the Lead Independent Director

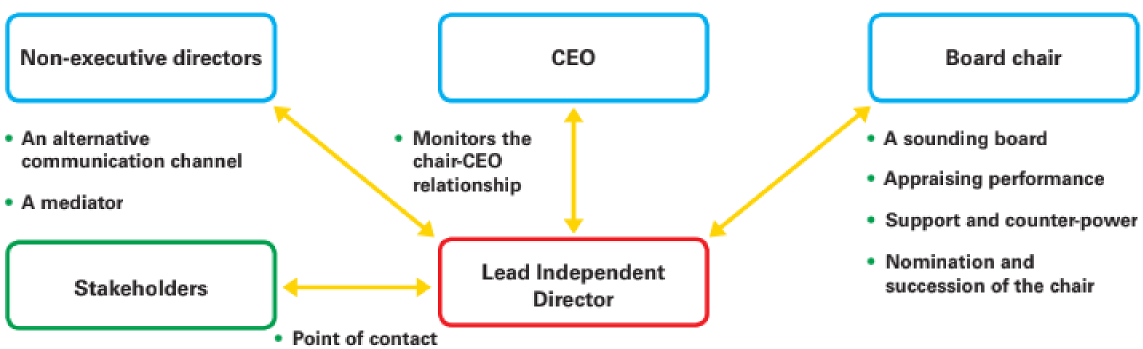
Posted by Marion Plouhinec, Legal & General Investment Management Ltd., on Sunday, November 25, 2018

Editor's note: Marion Plouhinec is Corporate Governance Analyst at Legal & General Investment Management Ltd. This post is based on her LGIM memorandum.

Often referred to as "Lead Independent Director" (LID), "senior independent director" or sometimes "independent deputy chair", **the LID plays an essential and indispensable role on the board**. Legal & General Investment Management (LGIM) expects all companies to appoint a LID, whether or not such a role is incorporated within national corporate governance codes.

Where the board chair is not independent, including when the role is combined with that of the Chief Executive Officer (CEO), a LID's presence on the board is vital to ensure there is an independent counter-balance to the chair.

The Role of the LID



Investors Value the Lead Independent Director Role

The LID is a highly versatile intermediary between the chair, the board and the board's stakeholders. In normal times they contribute to the good relationships and functions of the board, but in periods of stress the LID is expected to the assist in facilitating the resolution of any situation.

> ***As the board chair is to the CEO, so the LID is to the board chair.***

The LID provides an important point of contact for principal shareholders to raise issues and concerns in normal times or where contact through the channels of board chair, CEO or other executive directors has failed to resolve or where such contact is inappropriate.

Supporting the Board Chair

The role of the LID is to **support** the chair. They are an **alternative communication channel for board members**. This can be especially useful when they have concerns which they believe have not been properly considered by the chair or board as a whole. The LID should also act as a **mediator** to facilitate the resolution of any disputes involving the board chair.

Appraising the Performance of the Board Chair

The LID must keep a keen eye on **whether the chair is still** they contribute to the good relationships and functions of **performing their role to the board's satisfaction** without losing objectivity or independence. They monitor the relationship between the chair and the CEO, and ensure that it is a well-functioning working relationship without becoming too close or powerful.

One of the LID's key responsibilities is to **lead the performance evaluation of the chair**; including making sure that a regular external board evaluation is undertaken. LGIM also encourages the LID to actively seek the views of the non-executive directors (NEDs) by meeting them alone and schedule meetings annually to appraise the performance of the chair, taking into account the views of the executive directors.

Nomination and Succession of the Board Chair

The need to change a chair ideally comes about as part of the natural evolution of a board and with the understanding and support of the outgoing chair. The LID has the important task of **leading the search for a new chair**.

Sometimes the LID is the most obvious candidate to the succession of the chair, or may wish to put themself forward. If this is the case, the LID should be clear about this at the start of the process and remove themself from the search process.

As in any succession process, the LID may have the delicate task to deal with a chair who is reluctant to leave or who is unfit for the job. Chair terms of appointment should be examined to ensure that they do make both the LID's powers and the process for removal of the chair sufficiently clear.

For more details on LGIM's views on the nomination of the chair, please consult our recent article on the topic, which is available on our website.

The Nomination of the LID

Given the key responsibilities of the LID, the nomination and succession committee should play a role in their appointment, whether internally or externally appointed. **We find that there is a conflict to a LID being appointed directly and only by a board chair as they must be able to ultimately challenge the chair**. LGIM expects the LID to:

- **Be independent at the time of appointment and throughout their position.** This is essential to ensure they exercise their duties efficiently and free from any conflicts.
- Preferably be an internal appointee from among the existing NEDs given the high requirement for knowledge and understanding of the company and board dynamics that is usually gained by prior service on the board.
- Have a **complementary set of skills and experience to the board chair's own** to be able to serve as a useful sounding board. The LID is not expected to lead the board, instead they must have the ability to exercise independent judgment, back the board chair where they are in agreement and know when to assume certain responsibilities.
- **Have strong interpersonal skills** as the LID is expected to take the lead in evaluating the chair's performance, and to serve as an intermediary for the other directors.
- Be in a position to **become more knowledgeable** about the company, its performance, its markets and its stakeholders than the other NEDs.

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Today's Independent Board Leadership Landscape

Posted by Steve W. Klemash, Jamie C. Smith, and Kellie C. Huennekens, EY Center for Board Matters, on Tuesday, November 20, 2018

Editor's note: Steve W. Klemash is America's Leader, Jamie C. Smith is Associate Director, and Kellie C. Huennekens is Associate Director, all at EY Center for Board Matters. This post is based on their EY memorandum.

Board leadership structures have evolved dramatically over the past 20 years. Today, 92% of S&P 1500 companies have independent board leadership, up from just 10% in 2000. This change corresponds to a rise in independent directors, as well as the continuing separation of chair and CEO roles.

Today, 60% of S&P 1500 companies have separate individuals serving as chair and CEO, more than doubling the 27% that separated the roles in 2000. But while the shift towards independent board leadership is clear, the form that leadership takes, and the responsibilities assigned to those leaders, differ among companies.

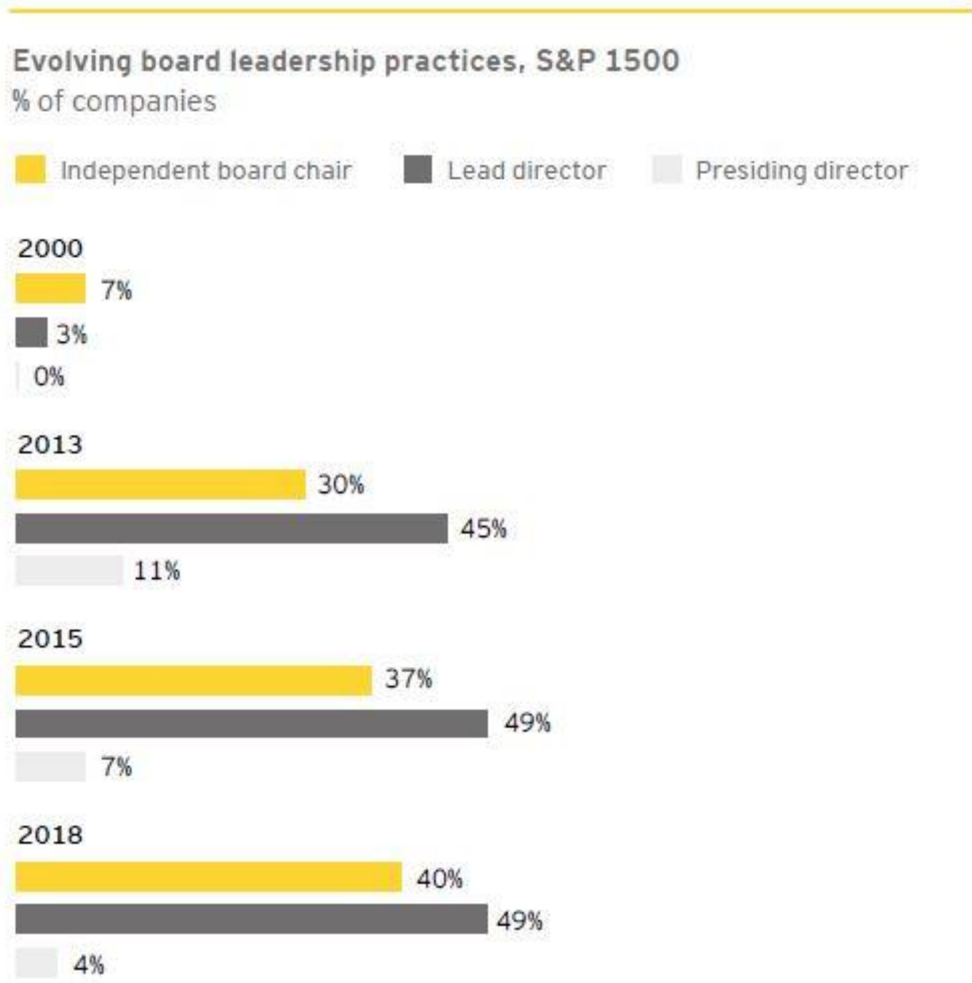
We reviewed S&P 1500 companies and found that, among the various independent leadership structures, independent board chairs have been experiencing the fastest increase since 2000. We also found marked differences between the levels of authority commonly assigned to the different independent leadership roles, as well as emerging disclosure and engagement trends that raise the profile and highlight the strength of independent board leaders.

Continuing trend toward independent chairs

When it comes to independent board leadership, views on best practice vary. Corporate disclosures differ on why one type of leadership structure may be more effective for a particular company. Also, what works best may change over time based on company-specific circumstances and board dynamics. Views among investors differ too. For some investors, there is no substitute for an independent board chair, while others find lead directors to be sufficient provided the responsibilities are clearly defined and robust.

The evolving independent board leadership landscape reflects this varied approach. While overall more S&P 1500 companies are appointing independent chairs, S&P 500 companies are still far more likely to have lead directors. The practice of appointing presiding directors, who are often viewed as having a more passive role, continues to decline.

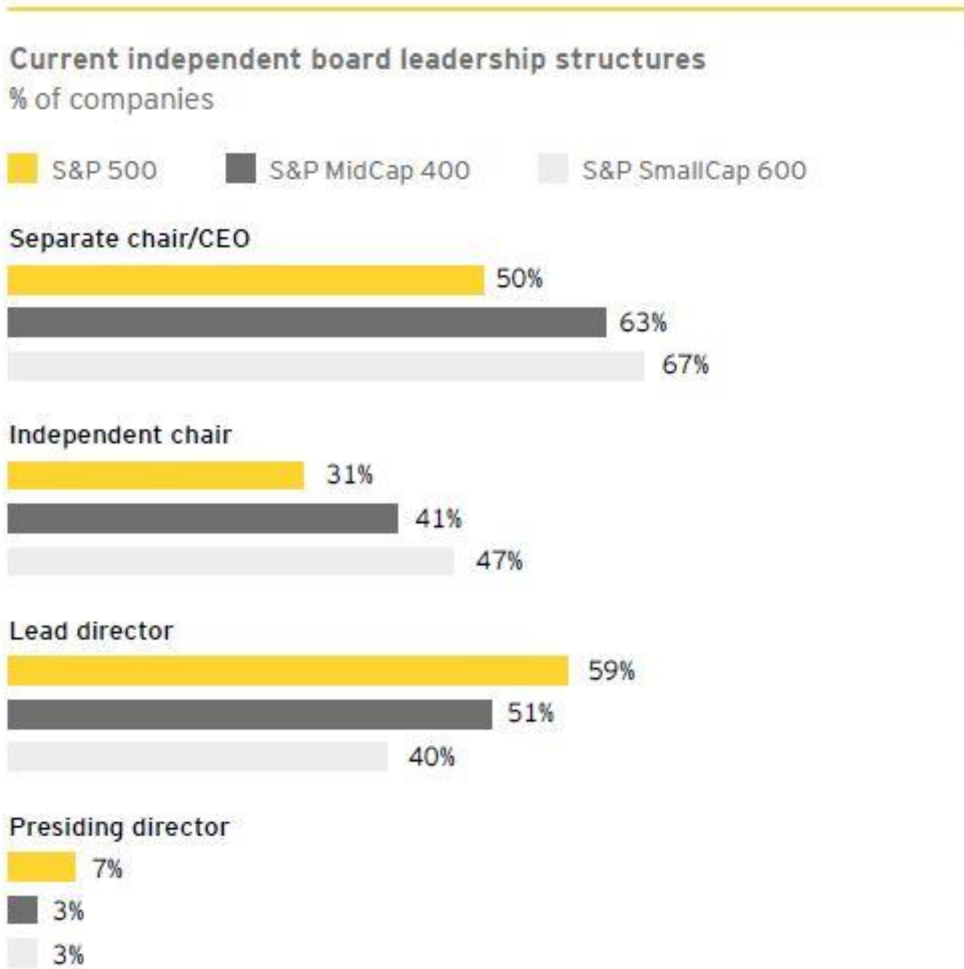
Boards should use the annual self-evaluation process or a time of transition as an opportunity to reconsider the appropriate board leadership structure given the company's specific circumstances.



Increase in independent board leaders parallels rise in independent directors

The shift to independent board leaders goes hand-in-hand with another governance shift over the same time period: a significant increase in independent directors. In 2000, 65% of S&P 1500 directors were considered independent vs. 83% in 2018.

Most S&P 1500 boards today include only one or two directors who are not independent, going well beyond listing standards that require a majority of independent directors. Even controlled companies, which are not required to have a majority independent board, usually comply with or exceed this threshold.



Year 2000 data throughout report based on Board Practices/Board Pay 2002, Investor Responsibility Research Center, 2002.

A note about the data

Not all companies have independent board leadership, and a small number of companies have both independent chairs and lead or presiding directors. While a majority of S&P 1500 companies separate the chair and CEO positions, most have a non-independent director (often a current or former company executive) serving as chair.

Title matters: how key responsibilities differ

Lead director positions serve as a kind of compromise in terms of board leadership structures. They maintain the unified leadership of the combined CEO/chair while providing an independent counterbalance to management's leadership on the board. They do not command the same authority as a board chair, but their role is generally more robust than that of a presiding director.

Our review of the key responsibilities assigned to independent chairs, lead and presiding directors at companies in the 2018 Fortune 100 illustrates this differentiation among the roles. The role of independent chair is distinct in regard to responsibilities related to calling and chairing meetings of the full board and shareholder meetings. Most lead directors have many of the same powers as that of an independent chair, such as calling and chairing meetings of the independent directors and approving board meeting agendas, schedules and information. The authority of presiding directors is generally more limited.

Lead directors do not command the same authority as a board chair, but their role is generally more robust than that of a presiding director.

Fortune 100 independent board leadership responsibilities*	Chair	Lead director	Presiding director
Authority to call shareholder meetings	▲		
Chair shareholder meetings**	▲		
Chair board meetings**	▲		
Authority to call meetings of all directors	▲		
Authority to call meetings of the independent directors	▲	▲	▲
Chair meetings of the independent directors	▲	▲	▲
Serve as liaison between management and independent directors	▲	▲	▲
Approve board meeting agendas and schedules	▲	▲	△
Approve information sent to the board	▲	▲	△
Be available, when appropriate, for consultation and direct communication with shareholders	▲	▲	△
Lead CEO performance evaluation (often in coordination with compensation committee)	△	△	
Lead annual board performance evaluation (often in coordination with nominating/governance committee)	△	△	

** Based on the most recent proxy statements, corporate governance guidelines and bylaws of 86 public Fortune 100 companies that file proxy statements. Yellow triangles indicate that a majority of companies with such position specifically assigned the responsibility; gray triangles indicate that at least a quarter of companies with such position assigned the responsibility.*

*** Reflects primary responsibility for chairing board and shareholder meetings. Most lead and presiding directors have responsibility for presiding over board meetings in the chair's absence, and some lead directors have responsibility for presiding over shareholder meetings in the chair's absence.*

Spotlighting independent board leaders in disclosures and engagement

U.S. Securities and Exchange Commission rules require companies to disclose in the proxy statement their board leadership structure, including why that structure was determined to be appropriate for the company, how the structure and the board's risk oversight responsibilities relate to each other, and whether the same person serves as CEO and board chair. Where the CEO and chair positions are combined, companies must disclose whether they have a lead independent director and, if so, explain the specific role the lead director plays in the leadership of the board.[1]

Companies continue to identify ways to use the proxy as an effective tool for engagement and communication with stakeholders. One way they are accomplishing this is with letters to shareholders from the independent board leader, or the full board itself, which communicate the board's message around prominent governance topics such as board composition and

[1] SEC Proxy Disclosure Enhancements Rule, 16 December 2009.

effectiveness, board oversight of strategy, shareholder engagement, and key governance and pay changes.

Having such a letter come from the independent board leader highlights that individual's role and can showcase the strength and authority of that independent position vis-a-vis the CEO. In 2018, 15% of S&P 500 companies included a letter to shareholders either from the independent board leader alone or jointly from the independent board leader and the CEO, which is three times the number in 2015. Around 60% of these letters were from lead directors and around 40% were from independent chairs, which may reflect additional efforts by lead directors to more clearly demonstrate independent leadership on a board that is chaired by the CEO.

Direct engagement with shareholders, as appropriate, is another avenue for building shareholder trust in the strength of independent board leadership, including by raising the profile of the independent board leader and showcasing that individual's qualifications and expertise. And the practice is on the rise: this year 14% of S&P 500 companies disclosed that the board's independent leader was directly involved in engagement conversations with shareholders over the past year, up from 4% in 2015. More than a third (36%) of the lead directors, and almost half (47%) of the independent chairs involved in these engagement conversations also wrote letters to shareholders in the proxy statement.

Other emerging trends that highlight the strength of independent board leadership include discussion in the proxy statement of how the current independent board leader is uniquely qualified for the role based on his or her relevant expertise and leadership qualities, and key focus areas or activities of that leader over the previous year.

Where are the women?

Only 8% of independent board leadership positions at S&P 1500 companies are held by women (with only 21% of S&P 1500 directorships overall held by women). And title matters: lead director roles are almost twice as likely to be held by women as independent board chairs.

Questions for the board to consider

- How is the independent board leader selected and their performance evaluated? Are those processes robust?
- Do the key responsibilities assigned to the independent board leader sufficiently empower that individual to provide strong independent leadership? And are those responsibilities clearly defined in the company's governance documents and communicated to investors?
- Does the board understand how key shareholders view its leadership structure? And how is it addressing any related shareholder interests or areas of focus?
- Are there opportunities to better communicate the strengths of the board's current leadership structure and the effectiveness of the current independent board leader?
- What is the process for evaluating the board's leadership structure? Are there opportunities to enhance that evaluation?

Effective Board Evaluation

Posted by Steve Klemash, Rani Doyle, and Jamie C. Smith, EY Center for Board Matters, on Thursday, October 25, 2018

Editor's note: Steve W. Klemash is Americas Leader; Rani Doyle is Executive Director; and Jamie C. Smith is Associate Director, all at the EY Center for Board Matters. This post is based on their EY publication.

Investors, regulators and other stakeholders are seeking greater board effectiveness and accountability and are increasingly interested in board evaluation processes and results. Boards are also seeking to enhance their own effectiveness and to more clearly address stakeholder interest by enhancing their board evaluation processes and disclosures.

The focus on board effectiveness and evaluation reflects factors that have shaped public company governance in recent years, including:

- Recent high-profile examples of board oversight failures
- Increased complexity, uncertainty, opportunity and risk in business environments globally
- Pressure from stakeholders for companies to better explain and achieve current and long-term corporate performance
- Board evaluation requirements outside the US, in particular the UK
- Increased focus on board composition by institutional investors
- Activist investors

In view of these developments, we reviewed the most recent proxy statements filed by companies in the 2018 Fortune 100 to identify notable board evaluation practices, trends and disclosures. Our first observation is that 93% of proxy filers in the Fortune 100 provided at least some disclosures about their board evaluation process. This publication outlines elements that can be considered in designing an effective evaluation process and notes related observations from our proxy statement review.

Planning and designing an effective evaluation process

Prior to designing and implementing an evaluation process, boards should determine the substantive and specific goals and objectives they want to achieve through evaluation.

The evaluation process should not be used simply as a way to assess whether the board, its committees and its members have satisfactorily performed their required duties and responsibilities. Instead, the evaluation process should be designed to rigorously test whether the board's composition, dynamics, operations and structure are effective for the company and its business environment, both in the short- and long-term, by:

- Focusing director introspection on actual board, committee and director performance compared to agreed-upon board, committee and director performance goals, objectives and requirements
- Eliciting valuable and candid feedback from each board member, without attribution if appropriate, about board dynamics, operations, structure, performance and composition
- Reaching board agreement on action items and corresponding timelines to address issues observed in the evaluation process
- Holding the board accountable for regularly reviewing the implementation of evaluation-related action items, measuring results against agreed-upon goals and expectations, and adjusting actions in real-time to meet evaluation goals and objectives

In determining the most effective approach to evaluation, boards should determine who should lead the evaluation process, who and what should be evaluated, and how and when the evaluation process should be conducted and communicated.

Leading the evaluation process

Leadership is key in designing and implementing an effective evaluation process that will objectively elicit valuable and candid director feedback about board dynamics, operations, structure, performance and composition.

A majority (69%) of Fortune 100 proxy filers disclosed that their corporate governance and nominating committee performed the evaluation process either alone or together with the lead independent director or chair. These companies also disclosed that evaluation leaders did or could involve others in the evaluation process, including third parties, internal advisors and external legal counsel. Twenty-two percent of Fortune 100 proxy filers disclosed using or considering the use of an independent third party to facilitate the evaluation at least periodically.

Determining who to evaluate

Board and committee evaluations have long been required of all public companies listed on the New York Stock Exchange. Today, board and committee evaluations are best practice for all public companies.

Approximately one-quarter (24%) of Fortune 100 proxy filers disclosed that they included individual director self-evaluation along with board and committee evaluation. Ten percent of Fortune 100 proxy filers disclosed that they conducted peer evaluations. Individual director self and peer evaluations are discussed below.

Prioritizing evaluation topics

Board, committee and individual director evaluation topics should be customized and prioritized to elicit valuable, candid and useful feedback on board dynamics, operations, structure, performance and composition. Relevant evaluation topics and areas of focus should be drawn from:

- Analysis of board and committee minutes and meeting materials

- Board governance documents, such as corporate governance guidelines, committee charters, director qualification standards, as well as company codes of conduct and ethics
- Observations relevant to board dynamics, operations, structure, performance and composition
- Company culture, performance, business environment conditions and strategy
- Investor and stakeholder engagement on board composition, performance and oversight

Forty percent of Fortune 100 proxy filers disclosed the general topics covered by the evaluation. These disclosures typically focus on core board duties and responsibilities and oversight functions, such as:

- Strategy, risk and financial performance
- Board composition and structure
- Company integrity, reputation and culture
- Management performance and succession planning

Asking focused evaluation questions to elicit valuable feedback

About 40% of Fortune 100 proxy filers disclosed use of questionnaires in their evaluation process, with 15% disclosing use of only questionnaires and 25% disclosing use of both questionnaires and interviews. Questionnaires are a key tool in the evaluation process, but must be thoughtfully and carefully drafted to be effective. Questionnaire responses can be provided without attribution, which can promote candid and more detailed feedback.

Questionnaires are helpful because each director receives the same question set—even if there are separate questionnaires for the board, its committees and individual directors. This approach facilitates comparison of director responses and can help indicate the magnitude of any actual or potential issues as well as variances in director perspective and perception.

Evaluation questionnaires often put questions in the form of a statement, such as “The board is the right size,” which calls for a response along a numerical scale. The larger the numerical scale, the more variance, which allows for a relatively more nuanced response. More specific and candid feedback can be obtained by prompting directors to provide detailed freestyle commentary to explain a response on a numerical scale or to a “yes” or “no” question.

Well-drafted, targeted questions—or questions in the form of a statement—should be written specifically for the board, its committees and individual directors, as applicable, with the goal of eliciting valuable and practical feedback about board dynamics, operations, structure, performance and composition. High-quality feedback is what enables boards and directors to see how they can better perform and communicate, with the result that the company itself better performs and communicates.

Template evaluation questionnaires often do not demonstrate the strong potential of a well-drafted questionnaire. Many template questionnaires seem overlong and include unnecessarily hard- to-answer or unclear questions, such as “Does the board ensure superb operational execution by management?” These types of questions don’t seem to lend themselves to eliciting practical feedback. Complicated or unclear questions should be revised to be more practical or omitted from the questionnaire. Overlong questionnaires should be streamlined to be more relevant and effective in eliciting valuable and useful information.

Template evaluation questionnaires also often include numerous questions about clearly observable or known board and director attributes, practices and requirements. A short set of common examples includes:

- I attend board meetings regularly
- Advance meeting materials provide sufficient information to prepare for meetings, are clear and well-organized, and highlight the most critical issues for consideration
- I come to board meetings well-prepared, having thoroughly studied all pre-meeting materials
- The board can clearly articulate and communicate the company's strategic plan
- The board discusses director succession and has implemented a plan based upon individual skill sets and overall board composition

When evaluation questionnaires include numerous questions on observable practices or required duties and responsibilities, the evaluation becomes more of a checklist exercise than a serious effort to elicit valuable and useful information about how to improve board dynamics, operations, performance and composition. Overlong, vaguely worded, generic, checklist-type questionnaires can lead to director inattention and inferior feedback results, further impairing the evaluation process.

More effective questionnaires are purposefully and carefully drafted to focus director attention on matters that cut to the core of board and director performance. This may be facilitated when the questions focus succinctly on agreed-upon board goals and objectives or requirements and director qualifications considered together with the company's performance and short- and long-term strategy.

For example, a written evaluation questionnaire need not ask whether the board and its directors have discussed and made a plan for director succession because the directors already know the answer. A better approach might be to recognize that such action did not take place and to ask each director, during a confidential interview process, "What factors or events distracted or prevented the board from discussing and implementing a plan for director succession?" Candid responses to that interview question should provide feedback that can uncover practices or leadership that should change in order to improve board performance.

Conducting confidential one-on-one interviews to elicit more candid feedback

Conducting well-planned, skillful interviews as part of the evaluation process can elicit more valuable, detailed, sensitive and candid director feedback as compared to questionnaires. The combined use of questionnaires and interviews may be most effective and, as noted above, was the approach disclosed by about one-quarter of Fortune 100 proxy filers. Fifteen percent of Fortune 100 proxy filers disclosed use of interviews only.

Interviews are particularly effective when there is an actual or potential issue of some sensitivity to address, as directors may prefer to discuss rather than write about sensitive topics. If boards believe interviews will be helpful, they should carefully consider who should conduct them—with the key criteria being that the interviewer is:

- Well-informed about the company and its business environment as well as board practices
- Highly trusted—even if not well-known—by the interviewees
- Skilled at managing probing and candid conversations

Special considerations may arise when the interviewer is also part of the evaluation process. Where sensitivities like this are perceived, using an experienced and independent third-party interviewer can be effective.

While interviews do not enable anonymity, a trusted and skilled interviewer may still confidentially elicit valuable and sensitive feedback. Interviewer observations and interviewee feedback can be presented to the board without attribution.

Individual director self and peer evaluations

Individual self and peer evaluations—whether through questionnaires or interviews—can improve an evaluation process, especially one that is already generally successful as applied to the board as a whole and its committees. When directors understand and see value in evaluations at a collective level, they often perceive enhanced value in individual evaluations—both of themselves and of their peers.

Self-evaluations call for directors to be introspective about themselves and their performance and qualifications. Interestingly, simply being asked relevant questions about performance can lead directors to strive harder. The goal of self-evaluation is to enable directors to consider and determine for themselves during the evaluation process—and every other day—what they can proactively do to improve personal performance and better contribute to optimal board performance. Approximately one-quarter of Fortune 100 proxy filer boards included individual director self-evaluation in their evaluation process.

Peer evaluations increasingly are seen as critical tools to develop director skills and performance and promote more authentic board collaboration. A successful peer evaluation can also help improve director perspective. While some suggest that peer evaluations, even if provided anonymously, can be uncomfortable to provide and receive, a key characteristic of an effective board is that the board's culture inspires and requires active, candid, relevant and useful participation from all members, as well as healthy debate and rigorous and independent yet collaborative decision-making. Where the board culture and dynamic are healthy, directors should see peer evaluation as important and beneficial guidance and coaching from esteemed colleagues. Ten percent of Fortune 100 proxy filer boards included peer evaluations in their evaluation process.

Using a third party

Use of third-party experts, such as governance advisory firms or external counsel, to facilitate the evaluation process is increasing. Twenty-two percent of Fortune 100 proxy filers disclosed having a third party facilitate their evaluation at least periodically, typically stated as every two or three years.

A third party can perform a range of evaluation services, from leading the evaluation process to conducting interviews to providing evaluation questions and reviewing questionnaire responses. Third parties can also help oversee implementation of evaluation action items.

Where the third party is independent of the company and the board, its participation in the evaluation process can meaningfully enhance the objectivity and rigor of the process and results. Third-party experts can provide new and different perspectives, both gained from work with other companies as well as simply being from outside the company, which can lead to improved action-item development and evaluation results.

The use of a third party may be especially helpful when:

- The board wants to test or improve its existing evaluation process
- Directors may not be forthcoming and candid with an internal evaluator
- The board believes an independent third party can objectively bring new perspectives and issues to the board's attention
- The board is new or has undergone a significant change in composition and its directors are not yet poised to conduct an effective evaluation
- The board has not seen significant change in composition over a period of time and new perspective is desired on board composition and performance

- The company and its board are facing and addressing a crisis

Intra-year evaluations and feedback

Board evaluations generally are performed annually. Common evaluation topics, however, relate to board practices and director attributes that are observable either in real-time, over a three- or six-month period, or with reference to board agendas and minutes. In such cases, boards should formally encourage real-time or prompt feedback to constructively address actual or potential issues. Indeed, doing so allows directors themselves to embody the "see something, say something" culture needed to promote long-term corporate value.

The concept of real-time or intra-year evaluation of board and director composition and performance is not new, even if not now widely practiced. A few (just under 10%) of proxy filers in the Fortune 100 disclosed that they carry out phases of the evaluation process on an ongoing basis, at every in-person meeting, quarterly, biannually or otherwise during the year.

Disclosing the evaluation process and evaluation results

A vast majority, 93%, of Fortune 100 proxy filers provide at least some disclosure about their evaluation process, but we observed wide variances in the scope and details of the disclosures.

Given the attention to board effectiveness, we expect companies will expand their disclosures relating to board evaluation and effectiveness.

About 20% of Fortune 100 proxy filers disclosed, at a high level, actions taken as a result of their board evaluation. Some examples include:

- Enhanced director orientation programs
- Changes to board structure and composition
- Changes to director tenure or retirement age limits
- Expanded director search and recruitment practices
- Improvements to the format and timing of board materials
- More time to review key issues like strategy and cybersecurity
- Changes to company and board governance documents
- Improved evaluation process

Companies with more detailed disclosures often use graphics to explain their evaluation process, such as in this example:

Our board's evaluation process

Determine format
The formal self-evaluation may be in the form of written or oral questionnaires, administered by the board members, management or third parties. Each year, our governance and nominating committee discusses and considers the appropriate approach and approves the form of the evaluation.

Conduct evaluation
Members of our board and each board committee participate in the formal evaluation process, responding to questions designed to elicit information to be used in improving board, committee and director effectiveness.

Review feedback
Director feedback provided during the formal evaluation process is discussed during board and committee meetings, in executive session or with management present when appropriate.

Respond to evaluation feedback
Following discussion of director feedback, the board and its committees work with each other and management to take specific steps to improve policies, processes and procedures to improve board, committee and director effectiveness.

Conclusion

Investors, regulators, other company stakeholders and governance experts are challenging boards to examine and explain board performance and composition. Boards should address this challenge—first and foremost through a tailored and effective evaluation process. In doing this, boards can work to identify areas for growth and change to improve performance and optimize composition in ways that can enhance long-term value. Boards can also describe evaluation processes and high- level results to investors and other stakeholders in ways that can enhance understanding and trust.

Observations about Fortune 100 company board evaluation practices

Observation	% of total*
Performed individual director self-evaluation, in addition to board and committee evaluation	24%
Used or considered using a third party at least periodically to facilitate the evaluation	22%
Used both questionnaires and individual director interviews to conduct the evaluation	26%
Provided board evaluation disclosures in their proxy statement	93%
Identified in the proxy statement general topics covered in the evaluation	40%
Disclosed in the proxy statement general actions taken as a result of the evaluation	21%

** Data based on the most recent proxy statements available for the 86 public companies on the 2018 Fortune 100 list.*

Questions for the board to consider

- Has the most recent evaluation process enabled the board and individual directors to identify actions to optimize board and director performance and board composition?
- Has the company considered disclosing the evaluation process and summarizing the nature of actions taken to enhance stakeholder understanding of the board's work and value?
- Does the board as a whole and each director have a common and clear understanding of the term "effectiveness" as applied to the board as a whole, its committees and each director individually?
- Has the board formulated clear goals, objectives and standards for itself, its committees and each director that can be referenced during and outside of the evaluation process? If the board has director qualification standards, should they be expanded in more specific ways to include standards and requirements that each director must consistently meet to earn renomination?
- Does the evaluation process include components that occur on a biannual, quarterly and/or real-time basis? If not, why not?

- Is the evaluation process appropriately synergized with the board's annual governance review, orientation and education programs, director nomination process, succession planning and stakeholder engagement programs?
- Does the evaluation process provide validation to each director that he or she is the right director at the right time for the right company?

Tab VI: Engagement Between Issuers and Investors

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

Engaging with Rakhi Kumar of State Street Global Advisors

Posted by Andrew Letts, CamberView Partners, on Tuesday, September 11, 2018

Editor's note: Andrew Letts is a partner at CamberView Partners. This post is based on a CamberView memorandum that features an interview with Rakhi Kumar, Senior Managing Director at State Street Global Advisors.

Andrew Letts: Rakhi, thank you for taking the time to speak with us. Many of the people who will read this will be familiar with your team's work. We're hoping to take a deeper dive into how the investment stewardship team evaluates companies and the approaches you take. To start off, let's go back a few years. When I was at State Street Global Advisors, you and I did a lot of work together on the governance issues of the day, topics such as board tenure, executive compensation and sustainability. Since you took over the investment stewardship team in 2014, how would you characterize the evolution of State Street's approach to these issues?

Rakhi Kumar: The main evolution I would point to is that we have established a prioritization framework, where we take a risk-based approach to both sector and thematic reviews. We are trying to mitigate ESG risk in our portfolio and we are trying to be more active and focused about how we do that. In engagement, we talk about the topics we want to discuss and we speak with the issuers that we want to meet with—85 percent of our engagements are proactive and about issues that are important to us.

I think the other main differentiator for State Street is that we share our views through thought leadership in which we aim to inform and improve ESG practices at our investee companies. We take difficult "gray areas" in ESG such as effective board leadership or incorporating sustainability into strategy and try to provide a framework for companies and directors on how we as investors analyze these complex issues.

Andrew: We're right at the start of the fall off-season when companies, investors and proxy advisors are thinking about what's ahead for the coming year. What are the topics that are top of mind for you as we head into 2019?

Rakhi: During the off-season, we only engage on our priority issues, we don't engage for the sake of engagement. All of the consultations we'll have in the off-season will be centered around strategy. Long-term strategy is the starting point of any conversation. Within that, there are three areas we'll be focusing on: how are boards effectively helping management achieve their strategic goals, how are companies integrating sustainability into long-term strategic planning and how is compensation aligned to strategy.

Andrew: How effective are companies at engaging with State Street?

Rakhi: I think many companies are good at engaging, but it depends. We often have companies come to us with a deck made for every investor that doesn't include the business and strategic overview to contextualize those three elements I mentioned before. Many come with elements like a skills matrix which have boxes ticked on every director without the context of why those skills are important in the broader context of strategy.

Overall, companies need to understand that governance and sustainability can't be done in a vacuum—it is all linked to the business and strategy. A good engagement allows us to evaluate how the board operates and how the board oversees governance and sustainability in that context.

Andrew: What are you tired of seeing or hearing when you engage?

Rakhi: As a long-term investor, what is exhausting is when companies want to meet every year when there's nothing to discuss or when they know something is upcoming but they don't tell you and then want to speak to you again in-season. Another practice that some companies do is to not bring forward a director during proxy season and then after a bad vote, a director wants to hear what we have to say.

Andrew: Many companies view engagement and sitting down with investors on a regular cadence as a way to establish a relationship. How important or appreciated is that on the investor side?

Rakhi: I think it's important for investors to have a relationship with the companies they are invested in. We want to build a relationship with the board. On priority engagements, we ask to meet with the Lead Independent Director or the responsible board member because we're trying to hear what actions they are taking and because we think it's more impactful and responsive to raise issues at this level.

As we move to engaging more when there isn't a vote at hand, we like having a director on the call. These meetings are an opportunity for us to evaluate and get comfort with a director so that we can have a "trust" lens as well. But, it's a two-way street—with engagement culture on the rise in the U.S., companies should be asking themselves "what do we need to get out of this relationship?"

Andrew: Is it helpful for you to meet with a company that doesn't have any issues, but is best-in-class in terms of sustainability disclosure or processes?

Rakhi: We typically do that when we are taking on new thematic issues. For example, with supply chain management, we met in the first year with some of our top holders that we felt managed that issue well. They helped us understand the problem. Year two was about learning from those companies with strong practices and being able to evaluate companies who have different practices.

Here's an example: during our conversations about supply chain risk, someone told us it's actually ludicrous that anyone would know all the risk in their supply chain because it's so complex. The takeaway we had from that conversation was that if you have such a complex supply chain that you can't identify the risks, then maybe you need to simplify your supply chain. You may actually be creating more risk in the system.

This is one reason why we prioritize thought leadership, whether in our annual report or speaking to the broader market. We view it as a way to help educate companies and boards on what issues, concerns and approaches they should be considering.

Andrew: In State Street's recently-released annual stewardship report, you discuss that the investment stewardship team engaged with over 100 companies in 2017 on climate change. You also noted that few companies could effectively communicate how they integrate climate risk into their long-term strategy. What do you look to hear from a company or a director when you talk about that?

Rakhi: Through engagement we're trying to understand the impact of board discussion around climate change on long-term strategy and capital allocation. We frequently hear from directors that "climate change is important, we debate it and discuss it" and that's often where the feedback stops.

Our question is—you discussed it, what were the results and actions from that discussion? That is where you start seeing how companies incorporate sustainability or climate change into strategy. If the result is no impact, that's fine, but it's important to know that it didn't change your thinking. Bottom line, you can't have that conversation without understanding the outcome of those discussions.

Andrew: Without naming names, what companies have knocked it out of the park in terms of explaining climate risk to you?

Rakhi: You see this more in Europe than in the U.S. In the U.S., companies are starting to talk about climate change but still defend their current strategy. The conversation seems to be that companies know investors want to talk about climate change, but when they are pushed on what they are doing about it, the answer tends to be "it doesn't impact us'.

When European companies are telling us they are pivoting because of climate change, we have to ask what are they seeing that's so different—is it regulation or something else? They're all global companies—why are some companies reacting one way and others another way?

Andrew: Let's talk for a few minutes about your expanded role at State Street in driving ESG investing. One recurring theme in your stewardship report was how your work is tied into collaborative initiatives such as the Investor Stewardship Group (ISG). Which of the frameworks and organizations that are out there have been the most impactful on your work?

Rakhi: The Principles for Responsible Investment (PRI), the UK stewardship code and the ISG principles are the primary documents I would cite. In particular, I think the ISG is a very meaningful framework because it's the only way to establish minimum standards in the market given our regulatory system. This is a grassroots effort and it's still very early days for what the ISG can do, but it is a growing effort—we will be meeting in October to discuss membership and governance issues and ways to ensure that this group has more of a voice. The ISG principles are something that boards and the market more broadly need to understand because it is the best assessment for what investors expect at the minimum from issuers.

Andrew: From where you sit, how have you seen interest in ESG investing evolve?

Rakhi: Asset owner inquiries about what we're offering are on the rise. Different regions are on different paths but in general we're seeing ESG moving from "thou shalt not do" something (like invest in sin stocks) to "thou shall do something" (integrate ESG into my entire portfolio). That's because it isn't about ESG for the sake of ESG—it's the material risk posed by ESG.

As the long—term research continues to show that ESG helps from a risk/return perspective, we are going to see more growth in the demand for integrated ESG solutions. This is where the Sustainability Accounting Standards Board (SASB) comes in. They provide a materiality map, which is something companies need to learn about. It's surprising to me how many board members are not aware of SASB and the growing importance of ESG scores in driving investment. I would definitely say that from an ESG messaging perspective, ESG scores are going to be as important in driving investor dollars into shares as credit scores are for fixed income.

Andrew: So is SASB the solution or is there going to be another framework that overrides everything?

Rakhi: We think SASB is a significant part of the solution—it was developed by investors and has an investor perspective of ESG risks. The other framework is the Global Reporting Initiative (GRI), which looks at materiality from a stakeholder perspective focus. I think the one point that companies need to recognize is that while you can say that these frameworks are not perfect, whether its GRI or SASB, you have to start disclosing somewhere.

Andrew: Let's talk about activism—in recent years, State Street has discussed settlements in activist situations and expressed a viewpoint that companies should think about engaging with their investors to seek their opinion about the preferred course of action. Do you think that call has been heeded or is there room to do better?

Rakhi: By and large I think there's been a bit more noise around proxy contests this past year. However, I don't think it's had any impact on changing the terms and conditions of settlements. I think what it has done is companies will wait until the end and then, based on where votes are coming down, the contest will get settled. No one wants to take that public risk that they may lose. I feel like at least we're seeing a bit more pushback from management and more back and forth going on.

Andrew: When companies are in activist situations and are engaging with State Street, they are often looking for an indication from you about whether you are supportive of their side. What advice do you have for issuers looking for that kind of guidance or communication?

Rakhi: Let me step back a little bit by saying activism is no longer just about strategy. A few years ago we would say to companies—focus on strategy. But some recent activism situations have made clear that activists are becoming more sophisticated. It's not just about why one strategy isn't working, it's about telling us why the other strategies being proposed are not going to work in a changing environment. It's the board's job to recognize that, to do scenario planning and to be able to communicate why the alternative strategies are not right. I don't see that happening as effectively.

In some cases, we have companies coming in and asking us what to do. I think that's the board delegating its responsibility. The whole point of principal/agent is that we appointed directors because we don't have visibility into day-to-day operations.

Andrew: How do you view the growing trend of sustainability topics such as diversity being incorporated into activism and activists" theses?

Rakhi: To me, it's not just about being sustainable, it's about strategy. When it comes down to a proxy contest, strategy is number one because everything else can be changed. If a dissident says they don't have a woman on the board, that can be easily fixed by adding a woman.

One thing we don't give credence to is when people say they only took action because of an activist. As you used to tell me, sometimes activists do their job by showing up. I don't minimize making a change like adding a woman to a board because an activist shows up. Proxy advisors may knock that, but to me, the board was responsive and took action, so, hey, I'm happy.

Andrew: Tell us more about what's happening on the fixed income credit front—what is State Street's approach to integrating ESG into the fixed income process?

Rakhi: As an index investor, we get paid last, which means that we can't be agnostic of how the company is managing its long-term balance sheet. We've seen many instances of that happening and the classic example is in M&A activities. In one transaction, a company was looking to purchase another company, which pushed back and resulted in the acquirer taking on a lot of debt to pay for the acquisition. In a few years, a commodity cycle went belly up, they had too much debt and lost shareholder value.

That taught us we can't ignore the balance sheet when we're looking at a company. As an index investor, you can't say, for example, companies need to give me a dividend because eventually that decision will impact how much debt they're going to have and affect their ability to leverage up and down or do an M&A transaction at the opportune time. It's important to have a discussion at the board level about how they balance those needs because debt holders get paid before us.

Andrew: As a bondholder, you don't have the hammer of a voting right. How does that shape those conversations?

Rakhi: The conversations we've had are at the time when we make the decision to invest—that's when you have the most impact. ESG risks are as important to shareholders as they are to bondholders. Moody's and S&P are ramping up their ESG operations to further incorporate sustainability risks into their bond ratings—that's probably where this should be playing out.

In the absence of an annual vote, it's hard for bondholders to influence companies. But, we've had the fixed income team come in and ask questions during equity holder engagements and we've often found that while our PMs (who are long-only) and debtholders take different angles, they are concerned about the same things.

Andrew: Shifting to executive compensation, earlier this year State Street announced a new "abstain" policy that would be a middle ground between "for" or "against" in say-on-pay votes. Did those votes achieve what you had hoped for or is it too early to tell?

Rakhi: Because of the new policy, our unqualified support for pay proposals has fallen in general. Overall unqualified support from a global perspective fell from 83 to 78 percent. In the U.S. there were 2,300 executive compensation votes—of that, 59 total votes (2.5%) were abstains, compared to 139 votes "against" (6%).

Companies should view this as qualified support. The improvement here has been that it allows us to provide more transparency into the vote decision. I think it makes us better analysts because we're starting to go into the angles of what our comfort level is. It allows us to make a more nuanced vote decision instead of binary black and white. Its only 2 percent of votes, but those are difficult votes. The abstain gives us a greater ability to articulate our concerns and it has also been very helpful internally in improving the way we analyze votes.

Andrew: In situations where you are abstaining, do you let companies know that you expect changes?

Rakhi: To the extent that we are engaging with the company, we won't let them know how we'll vote but we do communicate what our concerns are. Like with companies where we withhold support, we will monitor responsiveness of the board to our vote.

Andrew: Last question, talk show host time—what is the most important thing that the person who is sitting in your seat in 20 years will need to think about?

Rakhi: The toughest question is who to hire. The demand for talent in this field is increasing—you need to have the right background in investments, business, and strategy and understand governance and environmental and social issues. I'm hoping it'll be an easier decision for that person but you're only as good as your team.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Talking Governance with Donna Anderson

Posted by Michael Flaherty and Patricia Figueroa, Gladstone Place Partners, LLC, on Thursday, January 10, 2019

Editor's note: Michael Flaherty and Patricia Figueroa are Senior Vice Presidents at Gladstone Place Partners, LLC. This post is based on their Gladstone Place memorandum.

Donna Anderson leads the policy formation process for proxy voting at T. Rowe Price, an active mutual fund manager with more than $1 trillion of assets under management. Barely a decade ago, the proxy voting process for public company annual meetings was largely seen as a back-office, box-ticking function. Now, with investment assets growing and with investors across the globe pressing companies and boards to promote long-term strategic policies focused on benefitting the environment, society and governance, heads of governance such as Anderson are in an increasingly important and powerful position. She sat down with GPP's Michael Flaherty and Patricia Figueroa [in December 2018].

GPP: T. Rowe has separated the ESG oversight duties, with you owning the governance part and your colleague owning the environment and social parts (Anderson previously oversaw all three). Why did you separate those out?

Anderson: My colleague you reference is Maria-Elena Drew, who joined T. Rowe Price in 2017 in the new role of director of research for Responsible Investing. She is based in our London office. We do view environmental and social factors as related but very separate disciplines from governance factors. One reason for that is that there's a natural cadence to the corporate governance year because there's a proxy vote. There is a certain amount of time-based screening and analysis that takes place naturally. The other major differentiator is everything that I need is a required public disclosure, and on the E and S side, the work is still very much around identifying and obtaining the data you need, then determining what's relevant.

GPP: What are the key corporate governance issues on the horizon, call it the next 12-18 months, that companies and investors should be thinking about?

Anderson: We believe it's our responsibility as an asset manager to safeguard our clients' interests through active ownership, monitoring, and mutual engagement with issuers. At the same time, we think we owe it to our portfolio companies to be consistent on issues over time. We try not to be trendy in our approach. I spend all my time on a company level. In terms of what I am hearing on the trend front, it has been conversations around share buybacks and the effects of the tax law change. Some of the research that SEC Commissioner Robert Jackson has put out about the intersection of executive compensation, insider sales and buybacks is, for sure, going to keep bubbling up. (An example can be read **here**). That's not necessarily our issue but it's definitely on the minds of some investors.

GPP: What mistakes do you think companies are making when it comes to trying to win your support?

Anderson: One issue seems to be that an inordinate amount of companies fear that they're going be the next activist target. Mathematically speaking, the probability is not likely, but many companies behave in a way that would lead you to believe that they think they're going to be next. And we see some behavior that indicates that companies are behaving in a conservative or defensive way with regards to things like capital allocation, for instance, or deferring actions that they want to do out of fear of activism, whether that fear is realistic or not. I think that is troubling.

The buyback is a good example. There are some companies that are really good at a more tactical approach to a buyback. They really know the value of their shares and they know where they can create value by repurchasing shares opportunistically. And so, when we ask these companies—"How do you think about the timing of the buyback relative to other choices?"—they'll say, "What we'd love to be able to do is build up a little cash, to be more tactical with the buyback, but if we build up a 'lazy' balance sheet, we'll get attacked by an activist." And then we look at the stock and see they have a very stable base of long-term, long-only shareholders, plus high inside ownership. So why are they worried about extra cash temporarily sitting on the balance sheet? It's irrational to shut down avenues of value creation out of fear of what amounts to a low-probability event.

GPP: Other mistakes?

Anderson: The other thing on my mind from a governance-practitioner level, is this: we are over engaging. The signal-to-noise ratio is dropping fast. There are just so many companies doing maintenance engagement for objectives that they don't seem clear about, and I am not clear about. They've been told to do this by their own boards or by their advisers. But why? We've been engaging like this for several years now. It's only growing—it's spreading to midcaps, it's spreading to other markets. I am really wondering about the collective return on investment on that time.

Sometimes the invitations are so vague, it's not clear that they want a call. They just say "Hey, we're here if you need us." We tend to decline those. But if a company says they wish to speak with us and if we have an investment there, we don't triage those engagement requests. Our guidance says we do not think that a frequency-based approach to engagement is necessary (To read about T. Rowe's engagement policy, click here). It makes more sense in our view to be more event-based. If there's something you want to tell us or there's something you want consultation on, let's focus more on those kinds of conversations. Or, for instance, if we're a new investor in the name, absolutely, let's spend an hour together. But because we're active managers, because we have global industry analysts all over the world talking to these companies many times a year, the need for a separate, parallel governance engagement with us is different than with other investors.

GPP: What do you think of the Calif. law mandating women on boards for certain companies headquartered in the state?

Anderson: I have mixed feelings. We have seen markets that have hard targets on gender diversity on boards that create unintended consequences, so there's definitely some concern about that.

On the other hand, the only things that seem to work are soft or hard requirements. In the absence of requirements, the pace of change is glacial. So, I really am kind of mixed on it. But I do think the ball is rolling in terms of U.S. board diversity. Investors have finally coalesced around that issue and backed that up with their votes. And so, we've seen a hockey stick in that the pace of change. It was very slow for a long time and now that's clearly changed.

GPP: What unintended consequences are you referring to in terms of more women on boards?

Anderson: For example, you're seeing a lot of women over-boarded now in markets where quotas are mandated. All of a sudden, you saw women go from zero boards to six. And that's not the point. That creates a negative, unintended consequence, and a lot of investors tend to vote against directors who get over committed.

GPP: Will this push for more women on boards lead to more board diversity broadly? For example, race, ethnicity?

Anderson: Board diversity is an important issue for a growing number of investors, including T. Rowe Price. In our view, when a board lacks diversity, it doesn't reflect the diversity of its stakeholders—employees, customers, suppliers, communities, or investors. This represents a potential risk to a company's competitiveness over time. We do use gender as an initial screen. But then, of the companies that screen out as having no diversity in that realm, we go in and look and see if there is something explaining that. Are there other forms of diversity that are quite clear? And we do mean outward signs of diversity here. Not, one went to Harvard, one went to Yale. I mean, true elements of diversity. But the business context is important. For instance, we have a company that does all of its manufacturing on one continent and all of its sales and marketing in North America. And so, the board is half and half. And they do happen to be all male but it's clearly a diverse board and clearly reflects the needs of the business, so that's a situation where we don't consider it a bad structure. If there is still no evidence of diversity after those two screens, that's when we begin engaging.

GPP: What are the most effective ways that a company can engage with you?

Anderson: We do get a lot of companies that put out their soap box, talk for 45 minutes, and then we hang up. That's not the kind of engagement we're looking for. An ideal engagement takes place when the company has done its preparation, I've done my preparation, and we can get straight to the issues that either side is worried about. And then, we have a mutual understanding of how we want to proceed. And they don't make me flip through a deck. That's all they need to put me in a happy place.

GPP: T. Rowe's threshold for calling a special meeting is 25 percent of the shareholder base. How did you come up with that number? How do you justify it?

Anderson: Over the years, we have participated in attempts to call a special meeting. It should be available, but it should be hard. Most things can wait until the next AGM. And if the circumstances are such that you're calling a special meeting, we want that to be a high hurdle. We think it's in our interest for the hurdle to be high, but it should not be impossible. With the benefit of many years of experience, we have come to believe that 25 percent is the appropriate level. I think at 10, it would be happening too frequently.

GPP: What do you think of the trend of virtual annual meetings?

Anderson: I think it's just way too early to be getting paranoid about virtual meetings. This may make us outliers, I don't know, but there are great technology solutions. There's great potential in this idea, especially for a firm like T. Rowe Price and other institutional investors. Speaking for myself, I don't leave my desk from April until the end of June. I would love to able to participate in more meetings but I can't travel for them, so why aren't virtual meetings seen as an avenue to increase the overall impact and effectiveness of the proceedings and the dialogue in annual meetings? I don't understand the notion that virtual meetings are somehow being used against shareholders. It should probably be the way moving forward for a lot of companies.

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BlackRock Investment Stewardship Engagement Priorities for 2019

Posted by Michelle Edkins, BlackRock, Inc., on Thursday, January 31, 2019

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

BlackRock, as a fiduciary investor, undertakes all investment stewardship engagements and proxy voting with the goal of protecting and enhancing the long-term value of our clients' assets. In our experience, sustainable financial performance and value creation are enhanced by sound governance practices, including risk management oversight and board accountability.

2019 Engagement Priorities

We are committed to providing transparency into how we conduct investment stewardship activities in support of long-term sustainable performance for our clients. Each year we prioritize our work around engagement themes that we believe will encourage sound governance practices and deliver the best long-term financial performance for our clients. Our priority themes for 2019 are a continuation and evolution of those identified last year and are set out below. We hope that highlighting our priorities will help company boards and management prepare for engagement with us and provide clients with insight into how we are conducting stewardship activities on their behalf. Some governance issues are perennial, such as board quality and performance, although the areas of focus may change over time. These will always be a core component of the Investment Stewardship team's work. Other priorities are evolving and are informed by regulatory and other market developments.

Governance

Quality leadership is essential to performance. Hence, board composition, effectiveness, diversity, and accountability remain a top priority.

Corporate Strategy and Capital Allocation

A clear articulation of corporate strategy and capital allocation provide a clear sense of the direction a company intends to take.

Compensation that Promotes Long-Termism

Executive pay policies and outcomes should link closely to long-term strategy, goals, and performance.

Environmental Risks and Opportunities

Disclosure provides enhanced understanding of board and management oversight of policies, risk factors and opportunities that drive long-term financial performance.

Human Capital Management

In a talent constrained environment, companies should focus on sound business practices that create an engaged and stable workforce.

Our Engagement Philosophy

BlackRock's Investment Stewardship team engages with portfolio companies to encourage them to adopt corporate governance and business practices aligned with long-term financial performance. The team is comprised of more than 40 professionals across all regions (with team members in New York, San Francisco, London, Tokyo, Singapore, Hong Kong, and Sydney), taking a local approach with companies while benefiting from global insights. It is positioned within the firm as an investment function. The team collaborates closely with the members of BlackRock's 125 investment teams to ensure team members have a long-term value mindset and to share their perspective on governance practices. The team engages with companies in the same long-term frame, irrespective of whether a holding is in alpha-seeking, factor, or indexing strategies. As a growing number of our clients invest through index-based strategies, engagement is an important mechanism to provide feedback or signal concerns about governance factors affecting long-term performance, absent the option to sell.

We initiate many of our engagements because companies have not provided sufficient information in their disclosures to fully inform our assessment of the quality of governance. We ask companies to review their reporting in light of their investors' informational needs. In our view, companies that embrace corporate governance as a strategic objective—as opposed to a compliance function—are more likely to generate sustained financial returns over time.

BlackRock takes an engagement-first approach, emphasizing direct dialogue with companies on governance issues that have a material impact on financial performance. We seek to engage in a constructive manner and ask probing questions, but we do not to tell companies what to do. Where we believe a company's governance or business practices fall short, we explain our concerns and expectations, and then allow time for a considered response. As a long-term investor, we are willing to be patient with companies when our engagement affirms they are working to address our concerns. However, when we do not see progress despite ongoing engagement, or companies are insufficiently responsive to our efforts to protect the long-term economic interests of our clients, we may signal our concern by voting against management.

In practice, we assess whether to initiate an engagement or accept an invitation to engage with individual companies based on a range of material factors including our prior history of engagement with the company, our thematic priorities, level of concern on specific governance issues, observation of market events, and assessment that engagement will contribute to outcomes that protect and enhance the economic value of our clients' investments. We strongly encourage companies to provide a detailed agenda when sending us a request for engagement.

Governance

Board composition, effectiveness, and accountability remain a top priority. In our experience, most governance issues, including how relevant environmental and social factors are managed, require board leadership and oversight. We encourage engagement protocols that foster constructive and meaningful dialogue, including making independent directors available in those situations where a director is best placed to explain and justify a company's approach. As we believe that the board should be a competitive advantage, we will seek to better understand how boards assess their effectiveness and performance, along with the skills and expertise needed to take a company through its future (rather than prior) multi-year strategy. In that context, we want to see disclosure regarding the board's position on director responsibilities and commitments, turnover, succession planning, and diversity. With regard to director responsibilities, we will seek better disclosure relating to a board's involvement in crisis management (e.g. cyber events, sudden departures of senior executives, negative media coverage, preparations to mitigate proxy contests) given the likelihood that such events are often material and can significantly detract from a board's ability to carry out its other responsibilities. In relation to board qualifications and effectiveness, we will continue to engage with companies to better understand their progress on improving diversity in the boardroom. In our view, diverse boards make better decisions. BlackRock recognizes that diversity has multiple dimensions, including personal factors such as gender, ethnicity, and age; as well as professional characteristics, such as a director's industry, area of expertise, and geographic location. If there is no progress on enhancing diversity at the board level within a reasonable time frame, we may hold nominating and / or governance committees accountable for an apparent lack of commitment to board effectiveness. Further, we will encourage governance structures that enhance accountability (e.g. proxy access in the U.S.), limit entrenchment (e.g. regular election of directors and board evaluations), and align voting rights and economic interests (e.g. one share, one vote).

Corporate Strategy and Capital Allocation

For several years we have asked companies to articulate their strategic frameworks for long-term value creation and to affirm that their boards have reviewed those plans. Investors expect the board to be fully engaged with management on the development and implementation of the strategy, particularly when the company needs to enhance its competitiveness and / or pivot in light of unanticipated developments. This demonstrates to investors that boards are engaged and prepared, when necessary, to transition and adapt in a fast moving business environment.

Corporate strategy disclosures should clearly explain a company's purpose, i.e. what it does every day to create value for its stakeholders. In our view, companies that better articulate their purpose and connect it with their long-term strategy are more likely to have engaged employees, loyal customers, and other supportive stakeholders. This gives the company a competitive advantage and a stronger foundation for generating superior financial returns.

Companies should succinctly explain the long-term strategic goals the board and management are working towards, the applicable measures of value-creation and milestones that will demonstrate progress, and steps taken if any obstacles are anticipated or incurred.

This explanation should be refreshed periodically and adapted to reflect the changing business environment and how it might affect how a company prioritizes capital allocation, including capital investments, research and development, technological adaptation, employee development, and capital return to shareholders.

Compensation that Promotes Long-Termism

We are interested in how boards establish and explain performance metrics and hurdles in the context of the aforementioned long-term strategy setting. We expect executive incentives to use performance measures that are closely linked to the company's long-term strategy and goals. This should ensure that executives are rewarded for delivering strong and sustainable returns over the long-term, as opposed to short-term hikes in share prices. To this end, we expect companies to clearly articulate the company's balance and prioritization between "input" metrics that are within management's control relative to "output" metrics such as earnings per share or total shareholder return. Where pay seems out of line with performance, we expect the company to provide detailed justification in its public disclosures. We may seek to engage with independent directors where concerns persist. We may ask the board to explain the extent to which it considers internal pay equity and the broader macroeconomic context when setting pay. We believe that companies should use peer groups to maintain an awareness of peer pay levels and practices so that pay is market competitive, while mitigating potential ratcheting of pay that is disconnected from actual performance. We may vote against the election of compensation committee members in instances, including but not limited to, where a company has not persuasively demonstrated the connection between strategy, long-term shareholder value creation, and incentive plan design.

Environmental Risks and Opportunities

In our Global Corporate Governance & Engagement Principles we explain that sound practices in relation to the environmental factors inherent to the business model can be a signal of operational excellence and management quality. Environmental factors relevant to the long-term economic performance of companies are typically industry-specific, although in today's dynamic business environment some, such as regulation and technological change, can have a broader impact. Previously, this priority was entitled "climate risk disclosure" given our involvement in the below-referenced Task Force on Climate-related Financial Disclosures (TCFD). This year, we expanded on this priority because many of our engagements encompass a broader set of environmental factors, ranging from climate risk, energy consumption and efficiency, water and waste management, emissions, and natural resource management. Corporate reporting should help investors and others understand the company's approach to these factors and how risks are integrated and opportunities realized. For industries facing ongoing challenges which may adversely affect a company's business strategy and operational results, we expect disclosure relating to board and committee oversight and enterprise risk management practices. In this context, we expect disclosure of the company's governance of these factors, if and how they are incorporated into the long-term strategy and risk management processes, and any metrics identified targets, along with the performance against them. This helps shareholders assess how well management is dealing with these material factors relevant to the business. Any global standards used by the company to report on such factors should also be disclosed and discussed.

We recognize that the proliferation of reporting standards creates challenges for companies and for investors. Companies report "survey fatigue" and investors find it difficult to navigate inconsistent and incomplete data. We will continue to encourage standard-setters to work together and to seek input from companies and investors. We are active in the Sustainability Accounting Standards Board (SASB) and the TCFD. We find the SASB's industry-specific guidance in the context of its environmental pillar (as identified in its materiality map) beneficial in helping companies identify and discuss their governance, risks assessments, and performance against these key performance indicators (KPIs).

We will continue our multi-year engagements on climate risk as we believe its impacts have the potential to affect companies' business models and operations. The aims of our climate risk engagements are twofold: (1) to encourage companies to provide disclosure that helps investors and others understand how a company assesses, manages, and adapts to those risks, and (2) to understand how those risks are likely to impact the business in the medium- to long-term.

To that end, BlackRock continues to be a member of the industry-led Financial Stability Board's TCFD. The TCFD published in June 2017 its recommendations around four thematic areas that represent core elements of how organizations operate—governance, strategy, risk management, and metrics and targets. This framework offers companies and investors a starting point to assess, report, and price climate-related risks and opportunities. In our view, the TCFD recommendations, which include sector-specific supplemental guidance, provide a relevant roadmap for companies and help achieve comparability and consistency of reporting.

Human Capital Management

Most companies BlackRock invests in on behalf of clients publicly state that their success is heavily dependent on their employees or talent. Often they also report that they are operating in a talent constrained environment, or put differently, are in a war for talent. It is therefore important to investors that companies establish themselves as the employer of choice for the workers on whom they depend. A company's approach to human capital management (HCM)—employee development (including transitioning their skills to the work of the future), diversity and a commitment to equal employment opportunity, health and safety, labor relations, and supply chain labor standards, amongst other things—will vary across sectors but are a factor in business continuity and success. In light of evolving market trends, like shortages of skilled labor, uneven wage growth, and technology, that are transforming the labor market, many companies and investors consider having a high standard of HCM a potential competitive advantage. Our HCM engagement commentary explains that we seek disclosure around a company's approach to ensuring the adoption of the sound business practices likely to create an engaged and stable workforce. We expect such disclosure to provide us with an understanding of if and how boards oversee and work with management to improve performance in these areas. While reporting is still evolving, we believe in the benefit of companies moving towards a more robust disclosure of HCM metrics. For instance, the SASB provides industry-specific HCM metrics. Useful industry-specific metrics can provide companies and investors insight into the return on investment related to talent and enable companies to understand if they are outliers relative to peers from the perspective of long-term performance. Comprehensive disclosure on the issue provides investors with a sense of the company's culture, long-term operational risk management practices and, more broadly, the quality of the board's oversight. In our engagement with companies on HCM, we discuss their views on the current and prospective disclosure requirements, as well as their policies and approach to ensuring the company attracts, retains and develops the workers / employees on which its business performance depends.

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.

Open Letter: Commonsense Corporate Governance Principles 2.0

Posted by Margaret Popper, Sard Verbinnen & Co, on Tuesday, October 23, 2018

Editor's note: The Commonsense Principles of Corporate Governance were developed, and are posted on behalf of, a group of executives leading prominent public corporations and investors in the U.S. The Open Letter and the Principles 2.0 are also available here and here.

A little more than two years ago, we published the Commonsense Principles of Corporate Governance That work represented a collaborative effort—a search for common ground—by representatives of some of America's largest corporations and institutional investors. We said then, and it is no less true today, that the long-term prosperity of millions of American workers, retirees and investors depends on the effective governance of our public companies. We hoped that our Principles would be part of a larger dialogue about the responsibilities and need for constructive engagement of those companies, their boards and their investors. We think that has been the case. Other groups have published their own works on the subject. Among them are an investor-led effort by the Investor Stewardship Group (ISG) called the Framework for U.S. Stewardship and Governance, a business-led effort by the Business Roundtable (BRT) called Principles of Corporate Governance, and a piece by the International Business Council of the World Economic Forum called The New Paradigm.

This dialogue is critical. In the last 20 years, we have seen a precipitous decline in the number of public companies in our country—a phenomenon that is distinctly and uniquely American. While the reasons for that decline may be complex and varied, one reason cited by a number of commentators is that our country's public market participants are too short-term oriented, thus discouraging companies with a longer-term view from going public. We need to fix that problem, so that all Americans have the opportunity to participate in the economic growth generated by our country's innovation and ingenuity.

Today, we endorse the ISG Framework, the BRT Principles and The New Paradigm as counterweights to unhealthy short-termism. Indeed, a number of the companies and organizations represented in those efforts were also part of ours. Moreover, in light of the work of the ISG, the BRT the World Economic Forum and others, and after further reflection on our own Commonsense Principles, we decided to re-convene and revise the Principles—we call them Commonsense Principles 2.0. Ultimately, we hope that the many sets of corporate governance principles currently in circulation can be harmonized and consolidated, and reflect the combined views of companies and investors. We do worry that dueling or competing principles could impede, rather than promote, healthy corporate governance practices.

We are also today making a commitment to apply the Commonsense Principles 2.0 in our businesses—and we hope others will do so as well. Columbia Law School's Millstein Center for Global Markets and Corporate Ownership has agreed to publish the Principles and maintain, on its website (https://millstein.law.columbia.edu/content/commonsense-principles-20), a list of companies and investors that have committed themselves to them. We recognize that there is significant variation among our public companies, and that not every principle will be applied in the same fashion (or at all) by every company, board or institutional investor—and the Principles themselves say and allow for precisely that. But we intend to use them to guide our thinking, and would encourage others to do the same.

As we have said before, this is not an academic exercise. Americans depend on our public companies for jobs, savings for college, savings to buy a home, and retirement. We ask others to join us in committing to these Principles and to a more secure financial future.

Tim Armour
Capital Group

Mary Barra
General Motors

Edward Breen
DowDuPont

Warren Buffett
Berkshire Hathaway

Jamie Dimon
JPMorgan Chase

Mary Erdoes
J.P. Morgan Asset Management

Larry Fink
BlackRock

Alex Gorsky
Johnson & Johnson

Mark Machin
Canada Pension Plan
Investment Board

Lowell McAdam
Verizon Communications

Bill McNabb
Vanguard

Brian Moynihan
Bank of America

Ronald O'Hanley
State Street

James Quincey
Coca-Cola

Brian Rogers
T. Rowe Price

Ginni Rometty
IBM

Charlie Scharf
BNY Mellon

Randall Stephenson
AT&T

David Taylor
Procter & Gamble

Jeff Ubben
ValueAct Capital

Theresa Whitmarsh
Washington State
Investment Board

* * *

The Open Letter and key facts about the Principles are also available here and here.

Commonsense Principles 2.0: A Blueprint for U.S. Corporate Governance?

Posted by Aabha Sharma and Howard Dicker, Weil, Gotshal & Manges LLP, on Tuesday, October 30, 2018

Editor's note: Aabha Sharma is an associate and Howard Dicker is a partner at Weil, Gotshal & Manges LLP. This post is based on their Weil memorandum.

On October 18, 2018, over twenty prominent executives, representing some of America's largest corporations, pension funds and investment firms, came together to sign Commonsense Principles 2.0. The signatories include, among other noteworthy individuals, Warren Buffett, Jamie Dimon and Larry Fink.[1] In an open letter, the signatories make "a commitment to apply the Commonsense Principles 2.0 in our businesses" and "hope others will do so as well." Moreover, while recognizing that there is significant variation among public companies, and that not every principle will be applied in the same manner, the signatories expressed their intent to use the principles to guide their thinking, and encouraged others to do the same.[2]

The Commonsense Principles 2.0 are an updated version of the Commonsense Corporate Governance Principles launched in July 2016. A text comparison of the two versions is available here. While many of the recommendations have remained the same, there are significant changes as well, including in the areas of director elections, shareholder engagement, shareholder rights and the role and responsibilities of investors, including in the proxy voting process. Moreover, the updated principles are not only intended for public companies and their boards of directors, but also for their *institutional* shareholders—both asset managers and asset owners. Key recommendations from the Commonsense Principles 2.0 (many of which are the same as in the 2016 principles) are as follows:

Board of Directors—Duties, Composition and Internal Governance

The Commonsense Principles 2.0 puts a spotlight on director duties of loyalty and care. Directors, who should be "shareholder-oriented," are accountable to shareholders and owe duties of loyalty and care to the company. Moreover, a significant majority of the board (and all members of the audit, compensation and nominating and governance committees) should be independent, consistent with the New York Stock Exchange rules or similar standards. Independent directors should be "strong and steadfast . . . and willing to challenge the CEO and other directors constructively."

[1] Business Roundtable and The Conference Board Governance Center have also endorsed the principles. The Council of Institutional Investors "praised" the principles.

[2] The signatories of the Commonsense Principles 2.0 are "calling on all companies and institutions that believe in the cause of good governance" to sign on to the principles at Columbia Law School's Ira M. Millstein Center for Global Markets and Corporate Ownership website.

The framework for director elections is expanded upon in the updated principles, providing that it is a "fundamental right of shareholders to elect directors whom they believe are best suited to represent shareholder interests." Additional recommendations include that: in uncontested elections, directors failing to receive majority vote should resign, which resignation the board ordinarily should accept, but if not, should clearly explain its rationale to shareholders; a director ordinarily should refrain from joining a board unless committed to serving for at least three years; one-year director terms may help promote board accountability to shareholders, but if a company chooses otherwise, the board should explain its rationale; and long-term shareholders should recommend potential directors for the board's consideration if they know the individuals well and believe they would be additive to the board.

Shareholder Engagement

Emphasizing that it is "important that companies engage with shareholders and receive feedback about matters relevant to long-term shareholder value," the Commonsense Principles 2.0 incorporates additional guidelines regarding shareholder engagement. In the event a company receives a shareholder proposal, it should consider engagement with the proposing shareholder early in the process, preferably before the proposal appears in the proxy. Moreover, if the proposal receives majority shareholder support, the company should consider further engagement with shareholders and either implement the proposal (or a comparable alternative) or promptly explain why doing so would not be in the best long-term interests of the company.

Similarly, in connection with a management proposal, the company should consider engagement with shareholders early in the process. If the proposal is defeated or receives significant shareholder opposition, the company should consider further shareholder engagement and formulate an appropriate response, taking into consideration how a majority of shareholders voted.

Shareholder Rights

The Commonsense Principles 2.0, unlike in the 2016 principles, takes a position on proxy access—recommending that public companies should allow for some form of proxy access, subject to reasonable requirements that do not make proxy access unduly burdensome for significant, long-term shareholders. Additionally, dual class voting is not considered best practice, but if adopted, the company ordinarily should have specific sunset provisions, based upon time or a triggering event, to eliminate it. Similarly, the principles acknowledge that the use of poison pills and other anti-takeover measures can diminish board and management accountability to shareholders. If a poison pill or other anti-takeover measure is adopted, the company should put the item to a shareholder vote and clearly explain why its adoption is in the best interests of shareholders.

Public Reporting

The Commonsense Principles 2.0, encouraging transparency with respect to quarterly financial results, recommends that while in certain instances it may be acceptable to use non-GAAP measures, companies should provide a bridge from non-GAAP items to the most comparable

GAAP items—and *all* compensation, including equity compensation, should be reflected in any non-GAAP measurement of earnings in the same way it is reflected in GAAP earnings.

At the same time, a "company should not feel obligated to provide quarterly earnings guidance—and should determine whether providing quarterly earnings guidance for the company's shareholders does more harm than good." Moreover, a "company should take a long-term strategic view, as though the company were private, and explain clearly to shareholders how material decisions and actions are consistent with that view."

Board of Directors Leadership

Recognizing that independent leadership of the board is "essential" for effective oversight, the Commonsense Principles 2.0 recommends that the board's independent directors decide, based upon the circumstances, whether it is appropriate for the company to have separate or combined chair and CEO roles. If a board decides to combine the chair and CEO positions, it is critical that the board has a strong designated lead independent director and governance structure. Moreover, the board should periodically review its leadership structure and explain clearly to shareholders why it has separated or combined the roles, consistent with the board's oversight responsibilities.

Management Compensation

The Commonsense Principles 2.0 recommends that management compensation be comprised of both current and long-term components, and companies should consider paying a substantial portion (for some companies, as much as 50% or more) of compensation for senior management in the form of stock, performance stock units or similar equity-like instruments. The principles do note, however, that compensation should not be entirely formula based, and companies should retain discretion to consider factors that may not be easily measured.

Role of Investors in Corporate Governance

The updated principles elaborate upon the role of asset managers and incorporates recommendations regarding the role of institutional asset owners. Acknowledging the ability to influence public company corporate governance practices, asset managers are encouraged to exercise their voting rights thoughtfully, actively engage early on with companies and evaluate the performance of directors.

In line with growing concerns regarding conflicts of interests on the part of proxy advisory firms when making voting recommendations, as discussed in our Alert available here, the Commonsense Principles 2.0 makes specific recommendations regarding the proxy voting process. To the extent asset managers use proxy advisor recommendations in their decision-making processes, they should disclose that they do so, and should be satisfied that the information upon which they are relying is accurate and relevant. Moreover, proxy advisors whom they use should have in place processes to avoid or mitigate conflicts of interest. Asset managers should also make public their proxy voting process and voting guidelines, have clear engagement protocols and procedures and disclose their policies for dealing with potential conflicts in their proxy voting and engagement activities.

Recognizing that institutional asset owners, such as pension plans and endowments, are in a position to influence public companies either directly or through their interactions with asset managers, the updated principles recommends that they use their position to advance long-term oriented corporate governance. Examples include through the use of benchmarks and performance reports consistent with the asset owner's strategy and investment time horizon; dialogue with asset managers concerning corporate governance issues; and the evaluation of asset managers regarding how they discharge their role in corporate governance matters.

Other Recommendations

The Commonsense Principles 2.0 sets out recommendations on additional corporate governance issues not covered above, including board committee structure, director tenure, board agendas and management succession planning.

There are currently various other organizations that have put forth corporate governance principles addressing the role and responsibilities of public companies, their boards of directors and their shareholders, each with their own perspectives. Acknowledging that competing principles could impede, rather than promote, healthy corporate governance practices, the signatories ultimately hope that the many existing sets of corporate governance principles can be "harmonized and consolidated, and reflect the combined views of companies and investors."

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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A Practical Guide to Virtual-Only Shareholder Meetings

Posted by Steven M. Haas and Charles L. Brewer, Hunton & Williams LLP , on Friday, November 17, 2017

Editor's note: Steven M. Haas is a partner and Charles L. Brewer is an associate at Hunton & Williams LLP. This post is based on a Hunton & Williams publication by Mr. Haas and Mr. Brewer. This post is part of the Delaware law series; links to other posts in the series are available here.

Last year, a record number of public companies held virtual-only shareholder meetings, which are now permitted in Delaware, Virginia, and numerous other states. Despite some shareholder opposition, we believe this trend is likely to continue. This post provides a comprehensive overview of practical issues that a company must consider in deciding whether to switch to, and then how to implement, virtual-only shareholder meetings.

Whether to Hold a Virtual-Only Shareholder Meeting

Proponents of virtual-only shareholder meetings argue that they are more efficient and convenient for both corporations and shareholders, may result in higher levels of attendance by shareholders, and permit an equivalent level of engagement between shareholders and corporations' directors and officers as in-person meetings. Virtual-only meeting advocates also note that uncontested shareholder meetings are poorly attended and almost always perfunctory rather than substantive. Moreover, they argue that most corporations provide substantive performance updates to their investors through quarterly earnings calls, not annual shareholder meetings. In short, advocates believe that the time and costs of conducting an in-person meeting outweigh the benefits.

Critics of virtual-only shareholder meetings believe that nothing can replace the opportunity for shareholders to sit in the same room as a corporation's directors and officers and "look them in the eye." Critics also believe that corporations may use virtual-only meetings to "cherry pick" favorable questions at the expense of pointed or negative questions. These criticisms have led to unfavorable press for some companies holding virtual-only meetings. In addition, critics note that corporations interested in virtual-only meetings could instead hold hybrid meetings, which would result in many of the benefits of virtual-only meetings while avoiding the drawbacks.

Corporations will need to consider how their shareholder base may react to a virtual-only meeting. Because of the potential for investor backlash, corporations may want to engage privately with key institutional shareholders to gauge their reaction to a virtual-only meeting. Some shareholders—including the New York City Comptroller—have indicated they will vote against directors whose corporations held virtual-only meetings in the prior year. The Council of Institutional Investors has stated that corporations "should hold shareowner meetings by remote communication (so-called 'virtual' meetings) only as a supplement to traditional in-person shareowner meetings, not as a substitute.” Moreover, some companies have received shareholder proposals calling for them to hold only in-person shareholder meetings. Thus, the decision to hold a virtual-only meeting could have serious consequences in the form of negative media attention and votes “against” directors. On the other hand, it seems that some institutional shareholders do not view virtual-only meetings as a significant issue, at least in uncontested elections.

Because so many companies held virtual-only shareholder meetings in 2017, we believe 2018 could be a pivotal year for the future of virtual-only meetings since we will see how many investors register their displeasure by voting against directors who authorized virtual-only meetings. For that reason, many companies considering virtual-only meetings may defer their decision to 2019 in order to see how investors react this year.

As set forth in a report by the Best Practices Working Group for Online Shareholder Participation in Annual Meetings (the “*Best Practices Working Group*”), there is no one correct approach to holding shareholder meetings. We believe that corporations will need to determine on a case-by-case basis whether in-person, hybrid or virtual-only meetings are most appropriate under the circumstances.

Preliminary Considerations for Holding a Virtual-Only Shareholder Meeting

Statutory Requirements

Not all states permit corporations to hold virtual-only shareholder meetings. In states that do permit virtual-only meetings, corporations will need to review the applicable statutory requirements carefully before attempting to replace an in-person shareholder meeting with a virtual-only meeting. This post focuses on Virginia and Delaware, but note that other states may have materially different or additional requirements for virtual-only meetings that this post does not address.

The statutory requirements for holding shareholder meetings in Virginia and Delaware are substantially the same. In both states, corporations holding a virtual-only meeting must take reasonable measures to (i) verify that each shareholder participating remotely is in fact a shareholder or a shareholder’s proxy and (ii) give each shareholder a reasonable opportunity to participate in the meeting and vote on matters submitted to the shareholders, including an opportunity to read or hear the proceedings of the meeting substantially concurrently with the proceedings.

Organizational Documents and Board Authorization

In addition to reviewing the applicable statutory requirements, corporations must confirm that their certificates or articles of incorporation and bylaws permit virtual-only shareholder meetings. Many bylaws may require a physical location and would therefore need to be amended to allow for a virtual-only meeting. For example, a corporation’s bylaws might be amended to provide that meetings shall be held “at such place *or no place, solely by means of remote communication*, as may be fixed by the Board of Directors.”

Furthermore, both Virginia and Delaware require that boards "authorize" remote participation by a corporation's shareholders. Thus, the board should adopt a resolution authorizing remote participation in the meeting. A board-adopted bylaw that expressly authorizes virtual meetings may satisfy this requirement, but having the board adopt a specific authorizing resolution for each virtual-only meeting is usually prudent.

Federal Securities Laws and Stock Exchange Rules

Other than with respect to proxy solicitations and shareholder proposals made under Rule 14a-8 of the Securities Exchange Act of 1934 (discussed below), federal securities laws generally do not address how corporations should conduct shareholder meetings. Furthermore, the Securities and Exchange Commission has allowed at least two corporations to exclude from their proxy materials a shareholder proposal that the corporation hold in-person rather than virtual-only annual meetings. In each case, the corporation was permitted to exclude the proposal under Rule 14a-8(i)(7) as relating to the corporation's ordinary business operations.

Both the New York Stock Exchange and Nasdaq require listed companies to hold annual meetings, but they generally do not prescribe how annual meetings must be conducted. Nasdaq, however, does require that shareholders "must be afforded the opportunity to discuss Company affairs with management" at each annual meeting. Depending on how the virtual meeting is to be conducted, a Nasdaq-listed corporation may want to contact Nasdaq to discuss compliance with this rule.

Proxy Contests and Other Contentious Votes

Shareholder meetings that involve a proxy contest or other contentious vote likely will be held in person rather than virtually. The greater complexity, need for discussion at the meeting, larger number of votes likely to be cast during the meeting, and increased chance that an adjournment could be necessary all weigh heavily in favor of holding an in-person meeting if the corporation expects a close or contested vote. Moreover, while many institutional investors may not object to a virtual-only format for a routine annual meeting, they could be quite opposed to this decision in a contested election, given the criticisms noted above. For these and other reasons, some providers of virtual meeting platforms will not host contested shareholder meetings.

Conducting a Virtual-Only Shareholder Meeting

After confirming that the laws of its state of incorporation and its organizational documents permit virtual-only shareholder meetings, a corporation interested in holding a virtual-only meeting must consider how to comply with the applicable statutory requirements. For essentially all public corporations, this will mean engaging an outside service provider. Because corporations must provide the ability for shareholders to vote securely, it is likely impractical, if not impossible, for most public corporations to hold a virtual-only meeting without third-party assistance. An experienced service provider like Broadridge or Computershare can provide a robust and usually cost effective platform to host a virtual-only meeting more easily than a corporation could develop the technology and related expertise necessary to host a virtual-only shareholder meeting on its own. For privately-held companies, whether a third-party service provider is necessary will depend on the circumstances.

Meeting Format: Audio-Only or Video

The most fundamental decision a corporation must make regarding a virtual-only shareholder meeting is whether it will be audio-only or include video. An audio-only meeting is substantially similar to an earnings call, with the key addition of shareholder authentication and voting through a secure website.

Speakers are heard but not seen, although the corporation can supplement the audio-only meeting with a contemporaneous slide presentation. A meeting that includes video will involve a live video feed of the corporation's participants. The proceedings will generally resemble an in-person shareholder meeting, with the obvious exception that no shareholders would be in physical attendance.

Corporations holding virtual-only meetings have overwhelmingly chosen audio-only meetings. Holding an audio-only meeting is cheaper and technologically easier than also broadcasting live video. A live video feed requires, among other things, cameras and a larger production team. An audio-only meeting may also reduce the chance that the media would widely report any disruption of the meeting, since video can be more interesting and reportable than audio alone. On the other hand, broadcasting live video, which would allow shareholders to observe the corporation's representatives as they answer shareholder questions, could help assuage critics' fears that virtual-only meetings are intended to insulate a corporation's directors and officers from its shareholders. Thus, a live video feed could result in less criticism that a corporation is "hiding" from shareholders by holding a virtual-only meeting.

Voting

Corporations must be able to verify that each remote participant is a shareholder or a proxyholder. As discussed above, most public corporations that hold virtual-only shareholder meetings delegate this process to a third-party service provider. Shareholder verification typically occurs by including a unique code in each shareholder's proxy materials that he or she can use to log in to the meeting website. If a shareholder casts a vote during the meeting, his or her unique code allows the proxy solicitor to ensure that the shareholder's proxy, if one was submitted, is replaced by the shareholder's vote cast during the meeting.

Safeguarding Against Technological Problems

Before holding a virtual-only shareholder meeting, each company will want to do a "dry run" of the meeting with its virtual meeting platform provider. The company should also have contingency plans to deal with a technological failure, such as a power or network outage. These contingency plans should include scenarios in which there is a brief outage where the meeting can be promptly reconvened, and a prolonged outage that requires the meeting to be reconvened on a later day. As discussed below, the corporation should also have a contingency plan in case a technological failure interferes with the ability of a shareholder to present his or her proposal.

To minimize the risk of a technological failure disrupting the meeting, corporations should structure the agenda of any virtual meeting to bring matters to a vote, close the polls, and adjourn the formal part of the meeting as quickly as possible. With the formal part of the meeting done, the corporation can then turn

Shareholder Questions

Although not as fundamental to shareholder meetings as voting, question and answer sessions give most shareholders their only opportunity to engage directly with a corporation's directors and officers. At traditional, in-person shareholder meetings, corporations generally allow shareholders to pose questions directly to the directors and officers. The appropriate directors or officers then respond immediately to the questions asked. Some shareholders believe that this "live" format is the best way to ensure a candid (i.e., unscripted) response to shareholder questions. Along similar lines, the Best Practices Working Group noted that corporations should ensure that they are not "using technology to avoid opportunities for dialogue that would otherwise be available at an in-person shareholder meeting."

For virtual-only shareholder meetings, corporations have a number of options regarding how shareholder questions can be presented, including:

- **Live Questions via Telephone.** Corporations can structure the meeting similarly to an earnings call, with an operator managing a queue of shareholders who will ask questions via telephone using a dial-in number. This is the most similar to in-person meetings, and we expect that many shareholders—particularly activist retail shareholders—would prefer this option.
- **Live Questions via Text.** Virtual meeting platforms offered by third-party service providers allow shareholders to submit questions in text during the meeting. These questions typically are not seen by other shareholders. Compared to the telephone option, shareholders may view this as less effective for presenting potentially negative questions. It also gives the corporation some discretion in choosing which questions to answer.
- **Pre-Submitted Questions.** Corporations may require that shareholders submit all questions in advance, either through pre-recorded audio or video files or in writing. This option gives the corporation the most discretion regarding which questions to answer. In addition, some critics argue that it results in less candid answers because the corporation will prepare a scripted response in advance of the meeting. Corporations that require pre-submitted questions believe that a prepared response—which can be more substantive and complete than unprepared remarks—is more useful to shareholders without any loss of candor.

Unless a corporation chooses to permit live questions via telephone, it will usually need to engage in some editorial control over the questions its directors and officers answer. At a minimum, the corporation (and shareholders) would want to eliminate duplicate questions and questions that are off-topic or inappropriate. But some shareholders believe that corporations will "cherry pick" favorable questions and downplay, rephrase, or ignore questions that are seen as overly negative or hostile. Corporations can take steps to alleviate this concern by providing transparency into how they select shareholder questions, including by committing to respond to all reasonable questions at the meeting or, if too many questions are received, to post all questions on a website available to shareholders and respond to them after the meeting.

To date, virtual-only shareholder meetings have not resulted in a marked increase in the number of shareholder questions as compared to in-person meetings. Because many more shareholders can attend virtual-only meetings than in-person meetings, however, this trend may change in the future. Furthermore, live questions via text and pre-submitted questions offer anonymity to shareholders that could result in more aggressive or confrontational shareholder questions.

Shareholder Proposals

Under Rule 14a-8 of the Securities Exchange Act of 1934, shareholders who have owned at least $2,000 in market value, or 1 percent, of a corporation's securities "entitled to be voted on the proposal at the meeting" for at least one year may submit proposals for inclusion in a corporation's proxy statement.

Rule 14a-8 requires that either the proponent or his or her qualified representative present the proposal at the shareholder meeting. If permitted by the corporation, proponents may appear through electronic media rather than in person.

Corporations that intend to hold a virtual-only shareholder meeting, therefore, must determine how shareholder proposals will be presented. Options include:

- providing a dedicated dial-in number for the shareholder or the shareholder's designated representative to speak (similar to an earnings call);
- permitting proponents to provide an audio or video recording of their presentation, which the corporation would play during the meeting; or
- designating a representative of the corporation to read the proposal or an introduction to the proposal submitted in advance by the proponent.

Among virtual meetings held in 2016, Broadridge reported that most corporations preferred to provide a separate dial-in number for proponents. The corporation should also have a backup plan to present the shareholder proposal on the proponent's behalf if the proponent has a technical issue that prevents him or her from presenting the proposal personally. For example, the proponent can provide the corporation with a copy of his or her remarks that can be read by the corporation's representative in the event the dedicated dial-in number does not work.

Pre-Meeting Communication

As explained above, many decisions need to be made in advance of a virtual-only shareholder meeting with regard to voting, shareholder questions, and shareholder proposals. Corporations will reach different decisions on these issues in light of their particular shareholder base and their historical practices for holding shareholder meetings. Regardless of the result of any particular decision, however, corporations should publish their procedures for shareholder participation in virtual-only meetings just as they would for in-person meetings. Corporations should adhere to those procedures to ensure that all shareholders receive—and feel that they have received—a meaningful opportunity to participate in the shareholder meeting even though it occurred virtually rather than in-person. Thoughtful, specific procedures may help forestall any complaints shareholders have regarding a virtual-only meeting taking the place of an in-person meeting.

Recap of Key Issues

As explained above, there are numerous issues that need to be considered before holding a virtual-only meeting, including:

- whether to engage with institutional shareholders before deciding to hold a virtual-only meeting;
- whether holding a virtual-only meeting will result in significant “withhold” votes or votes “against” the directors;
- whether to permit non-shareholder attendees, such as analysts, employees, or the media, to view the meeting;
- how to structure the agenda of the meeting in order to conclude the formal business as soon as possible;
- what contingency plans to prepare to address a technological failure, including contingency plans for a short network outage, a prolonged network outage, and the inability of a shareholder proponent to present his or her proposal, as well as state law issues regarding whether notice of the reconvened meeting must be given;
- whether a recording or transcript of the meeting will be available after the meeting and, if so, for how long;
- how shareholders will present shareholder proposals, such as through a designated dial-in number or a pre-recorded audio or video statement;
- how shareholders can ask questions, including in advance, by text, or “live,” and if “live,” how to deal with disruptive or otherwise inappropriate behavior;
- how to decide which shareholder questions will be answered, including how to deal with duplicate or inappropriate questions, how to respond to questions submitted by text or in advance if there is not enough time to answer them during the meeting, and the level of transparency to provide to explain how questions will be chosen;
- how to maintain the required record of any vote or action taken by remote communication;
- how to ensure the inspector of elections is familiar with virtual meeting voting procedures and has access to the voting portal to confirm proper opening and closing of the polls; and
- what information to include in the corporation’s proxy materials regarding its switch to a virtual-only shareholder meeting, and whether to publicize shareholders’ ability to attend the meeting virtually in other locations (e.g., on the corporation’s website).

Conclusion

We hope it is clear from the foregoing discussion that making the switch from an in-person to a virtual-only shareholder meeting can be a lengthy process, with many issues that must be considered and decided well in advance of the meeting date. Experienced legal counsel and third-party service providers can help corporations analyze the issues, but each corporation considering whether to hold a virtual-only meeting will need to take into account its historic practices with respect to shareholder meetings, its shareholders’ previous level of engagement, and whether it expects shareholders to protest its adoption of virtual-only meetings.

In addition, as virtual-only meetings become more popular, particular practices may coalesce regarding how to address the issues described in this post. Corporations and their advisors will need to continue monitoring the best practices in corporate governance and adjust their meeting procedures accordingly.

* * *

The complete publication, including footnotes, is available here.

Virtual-Only Shareholder Meetings: Streamlining Costs or Cutting Shareholders Out?

Posted by Robert Richardson, Glass, Lewis & Co., on Tuesday, November 28, 2017

Editor's note: Robert Richardson is manager of North American Proxy Research at Glass, Lewis & Co. This post is based on a Glass Lewis publication by Mr. Richardson.

In a fast-paced technological world, where efficiency and streamlining are often viewed as key drivers of success, it's no surprise that companies have started to livestream their shareholder meetings and to allow investors to participate remotely. Adding an online component can broaden the franchise, giving shareholders the chance to attend the "hybrid" physical/online meeting even if they can't travel to it.

However, more and more companies are going a step further—not just adding an option for online participation, but removing the in-person alternative. The 2017 U.S. proxy season saw 163 companies hold virtual-only shareholder meetings, an increase from 122 virtual-only meetings held during the 2016 U.S. proxy season.

Virtual-only meetings are held exclusively online with no in-person participation or physical location. They have been met with skepticism and resistance alike from investors, as well as the Council of Institutional Investors (CII). In a press release announcing its intention to engage with investee companies over the issue, the NYC Comptroller expressed concerns that some companies "are likely using online-only meetings to insulate themselves from uncomfortable interactions with concerned shareholders," and announced its intention to vote against directors at companies that hold virtual-only meetings. CII took a more diplomatic tone in a letter to Broadridge, acknowledging potential benefits but maintaining that "[i]nvestors expect virtual meeting technology to enhance the ease of attendance and the quality of the meeting without harming its integrity…."

So, why are companies increasingly moving towards virtual-only?

The advantages of such meetings are clear from an issuer perspective. Hosting virtual-only meetings can cut out some of the standard costs of holding annual in-person shareholder meetings, as online meetings are typically less expensive and time-consuming. Renting function rooms and catering costs are among some of the expense factors that would be eliminated. And as the NYC Comptroller suggests, it also gives the company more control over the proceedings, potentially reducing the chances that the board or management will be embarrassed by a tough shareholder query.

And that's where investor concerns come in. While an online meeting may increase the number of attendees, it can also serve to reduce those attendees' level of participation. For example, a trend in virtual-only meetings is for shareholders to submit their questions to the company prior to convening the meeting. There is a fear that this allows the company the discretion to filter shareholder questions to its own taste, resulting in some of the more difficult or controversial questions getting bumped down the priority list or even ignored. Even if fair play were guaranteed, for the less tech-savvy shareholder, removing the opportunity to voice concerns in a public, in-person, forum, where that individual is more at ease, could be construed by some as an infringement on shareholder rights.

So far, those looking to push back against the trend have been largely stymied. The 2016 proxy season saw several virtual-only companies receive shareholder proposals seeking the return of a traditional, physical meeting format. These proposals were granted "no-action" requests from the SEC, citing a company's right to govern the format of annual meetings. With virtual-only meetings apparently not going away, the discussion may be shifting towards finding a virtual-only format that protects the quality of the meeting. For example, CII's aforementioned letter to Broadridge set out a range of features that should be offered to virtual meeting attendees, including a transparent system for monitoring submitted questions, and the opportunity to virtually "approach the dais" and speak to company representatives following the meeting.

As more and more companies move towards virtual-only meetings, the debate on how (and whether) they should be conducted looks set to continue. In the meantime, absent an accepted best practice format, investors may get less access to the board, management, and other shareholders at virtual-only meetings—making pre-meeting preparation, including engagement with issuers and between investors, all the more important.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Proxy Access Proposals

Posted by Stephen T. Giove, Arielle L. Katzman and Daniel Yao, Shearman & Sterling LLP, on Friday, October 19, 2018

Editor's note: Stephen T. Giove is partner and Arielle L. Katzman and Daniel Yao are associates at Shearman & Sterling LLP. This post is based on their Shearman memorandum. Related research from the Program on Corporate Governance includes Private Ordering and the Proxy Access Debate by Lucian Bebchuk and Scott Hirst (discussed on the Forum here).

In our fourth annual review of proxy access practices, we explore recent developments relating to adopt" and "fix-it" shareholder proposals, headline and key second-tier terms and amendments to adopted by-laws.

Proxy Access—The March Forward Continues but at a Slower Pace

The proxy access adoption trend continued in 2018, although at a more modest pace. An additional 53 companies adopted proxy access by-laws in the first six months of 2018 compared to 87 in the first six months of 2017. In total, well over 500 companies, and over two-thirds of the S&P 500, have adopted proxy access by-laws. While the New York City Comptroller and other prolific shareholder proponents, including John Chevedden and James McRitchie, submitted fewer proxy access shareholder proposals in 2018 than in 2017, the volume of proxy access proposals was still substantial as compared to other corporate governance proposals. After three extremely active years, it appears that proxy access no longer leads the list of governance topics of shareholder

PROXY ACCESS ADOPTION

303 OF THE **337***

companies that received "adopt" proposals in 2015-2018 adopted a proxy access by-law

This represents a

90%*

adoption rate

*Excludes companies that received an "adopt" proposal and were acquired or filed for bankruptcy before adopting (12 companies) or had such a proposal receive a majority vote in favor for the first time in 2018 but have not yet adopted a proxy access by-law (one company).

All data in this article is for all U.S. listed public companies and is as of June 30, 2018, unless otherwise noted.

NUMBER OF COMPANIES THAT HAVE ADOPTED PROXY ACCESS

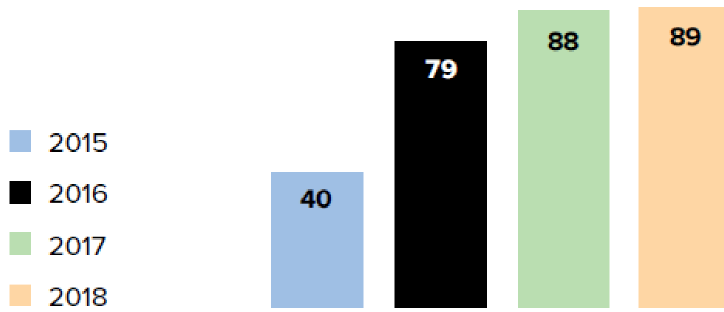
533

U.S. Listed Public Companies

67%

of the S&P 500

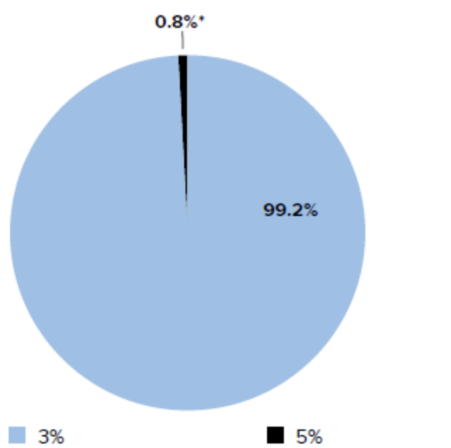
Top 100 Companies



Headline Terms of Proxy Access By-Laws

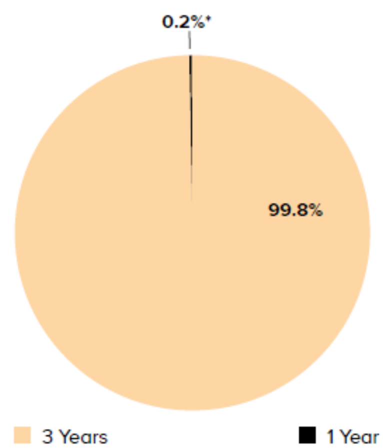
The most common formulation of the headline terms permits shareholders owning at least 3% of company stock for at least three years to submit proxy access nominees up to a maximum of 20% of the board/minimum of two directors with up to 20 shareholders being able to aggregate their holdings to meet the minimum ownership requirements. The short hand for proxy access by-laws with this formulation is 3/3/20/20.

Minimum ownership amount (%)



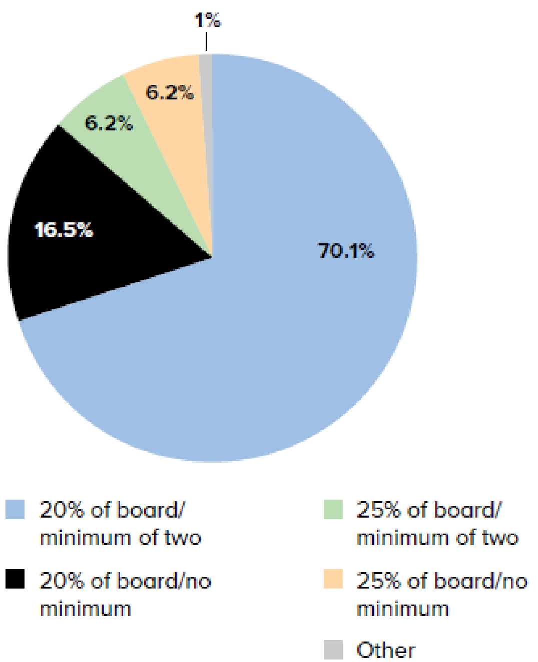
*Four companies have 5% minimum ownership thresholds.

Minimum period as shareholder (in # of years)

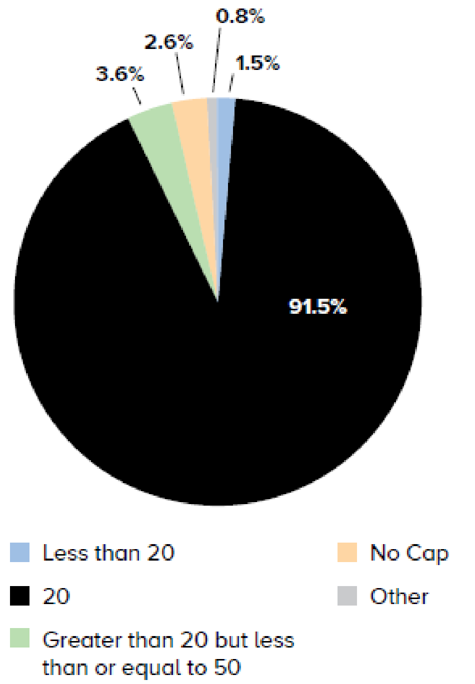


*One company has a one year minimum holding period.

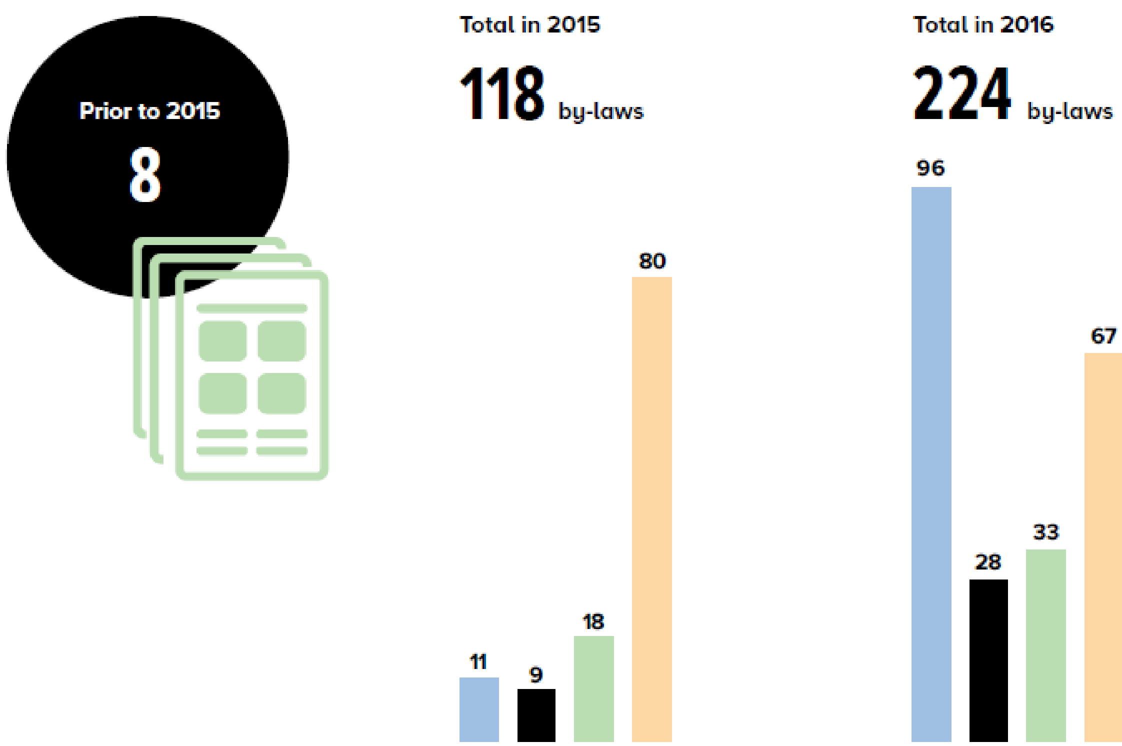
Maximum percentage of board/minimum number of directors

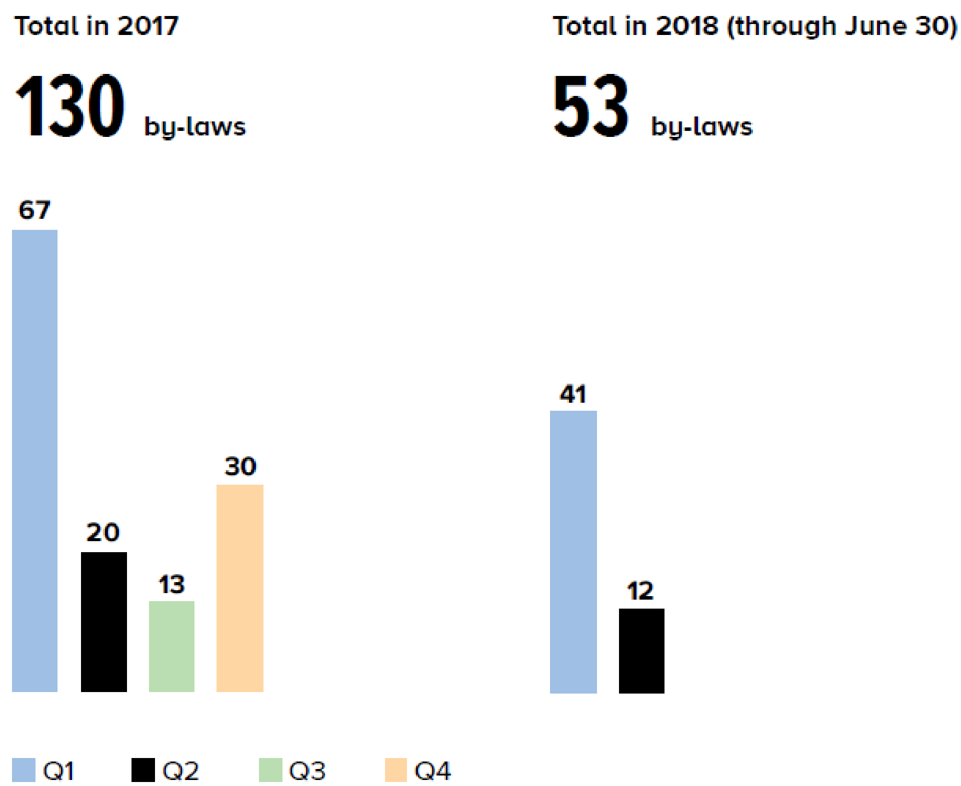


Maximum number of shareholders that can be aggregated



Proxy Access Adoption Over Time

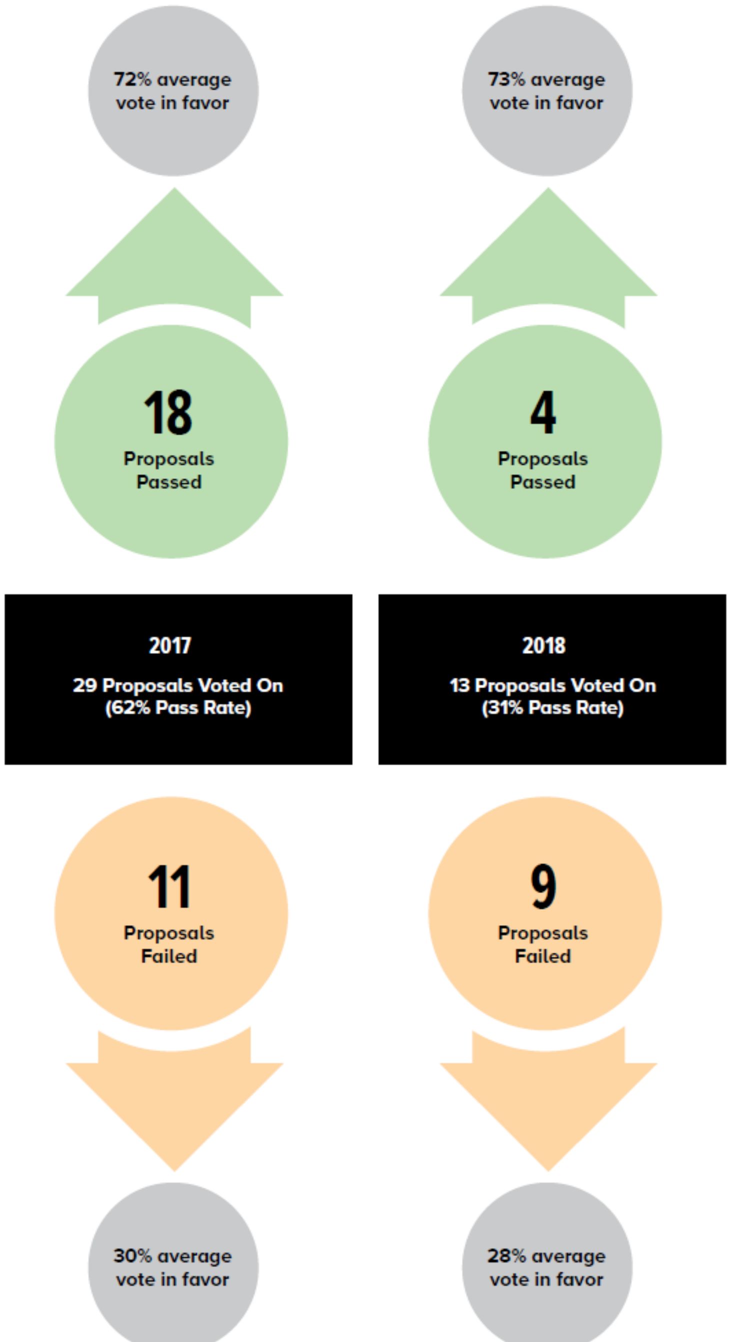




Shareholder Proposals—“Adopt” Proposals

Through June 30, 2018, this year had a much smaller number of shareholder proposals seeking adoption of proxy access as compared to 2017 (22 in 2018 through June 30, 2018 versus 100 through August 31, 2017). Of these “adopt” proposals, which are typically precatory, 13 proposals came to a vote in 2018, compared to 29 in the relevant period in 2017. John Chevedden and James McRitchie and their related proponents remained the most prolific proponents with 12 proposals submitted in the aggregate in 2018, which comprised over 50% of adopt proposals. As was the case last year, the number of shareholder proposals voted on compared to the number submitted remained low because many companies adopted proxy access and negotiated withdrawals of the proposal. Of the shareholder proposals that did come to a vote in 2018, four proposals passed with an average vote in favor of 73%, while nine proposals failed with an average vote in favor of 28%; in each case, the voting percentages in favor are essentially unchanged from last year. The low average vote in favor at several of these companies where proposals failed can be explained by the presence of large insider positions.

The decrease in the overall number of “adopt” shareholder proposals was due to a number of factors, including a greater number of companies choosing to adopt proxy access by-laws in the absence of a shareholder proposal and a switch in the focus of individual shareholder proponents from “adopt” proposals to “fix-it” proposals, which seek to amend the terms of a company’s existing proxy access by-law.



Second-Tier Terms—Overview

In this article, we refer to by-law terms beyond the headline terms as “second-tier terms.”

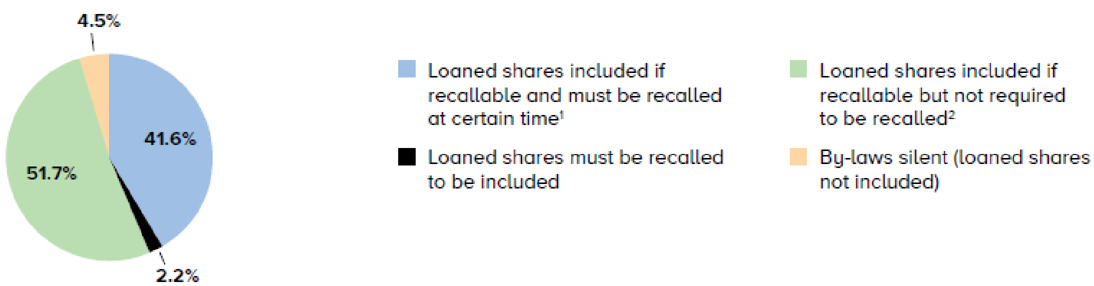
Institutional investors have become focused on second-tier terms. In July 2017, the Council for Institutional Investors updated its “Proxy Access: Best Practices” white paper and expanded the number of second-tier terms it considers when assessing a company’s proxy access by-law. Some common second-tier terms include:

1. **Loaned shares.** Whether shareholders are able to count loaned shares towards the minimum percentage ownership requirement
2. **Treatment of investment funds.** Whether investment funds consisting of multiple entities are able to aggregate their shares and be treated as one shareholder for purposes of the shareholder cap found in most proxy access by-laws
3. **Restrictions on renomination.** Whether proxy access candidates who fail to achieve a specific percentage of votes (usually 25%) are prevented from being re-nominated for a number of years (usually two years) after their initial nomination
4. **Compensation arrangements.** Whether proxy access candidates can receive candidacy fees (and director fees) paid by shareholders, and whether such fees need to be disclosed to the company
5. **Interplay of proxy access and advance notice.** Whether there is a limitation on nominees pursuant to proxy access when nominations are made through advance notice
6. **Other proxy access interplays.** Whether there is a limitation on proxy access nominees when a director previously elected pursuant to proxy access is nominated by the company or when an agreement with a shareholder is entered into pursuant to which such shareholder is granted the right to a board seat

Second-Tier Terms—Deeper Dive

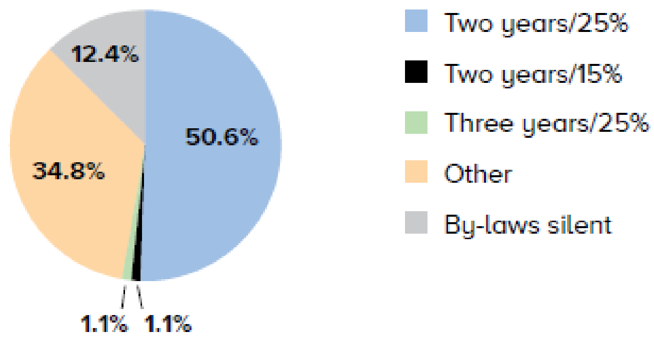
Of the Top 100 Companies, 89 companies have adopted proxy access by-laws. Within those 89 proxy access by-laws, we examined the presence of the following second-tier terms.

Loaned Shares
Extent to which loaned shares are included in minimum percentage ownership calculation

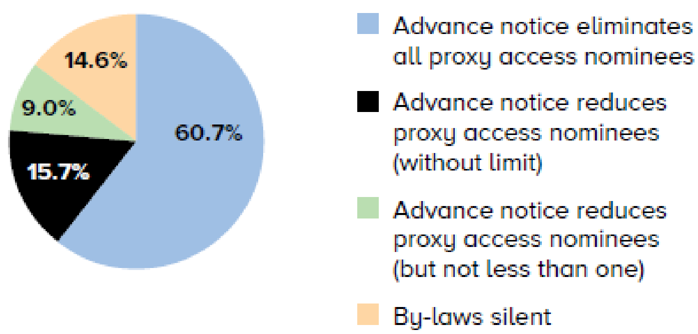


1 Of the 37 proxy access by-laws that permit inclusion of loaned shares if recalled, five companies require recall within three days, 31 companies require recall within five days and one company requires recall within a reasonable period of time.
2 Of the 46 proxy access by-laws that permit inclusion of loaned shares if recallable, 15 companies have a three-day recall period, 27 companies have a five-day recall period, and four companies have no time limit on the recall period.

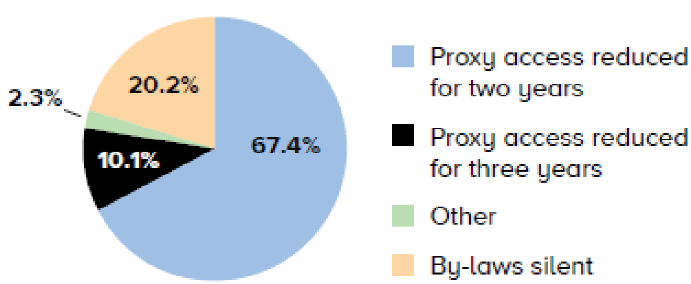
Restrictions on Renomination
Nominee is ineligible for a specified number of years if nominee failed to receive a specified % of votes



Interplay with Advance Notice
Impact on proxy access if advance notice is used

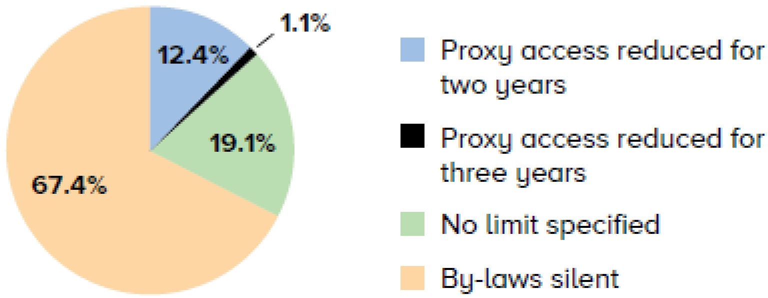


Prior Election of Nominee
Impact on proxy access if director previously elected pursuant to proxy access is nominated by the company



Agreement with Shareholder

Impact on proxy access if agreement with a shareholder is entered into and such shareholder is granted the right to a board seat



"Fix-It" Proposals

2018 saw a marked decrease in the number of "fix-it" proposals (proposals that seek to amend the terms of a company's existing proxy access by-law) as compared to the number of such proposals in 2017, which follows a significant increase in such proposals in 2017 as compared to 2016. Only 28 "fix-it" proposals were received in 2018 compared to 64 proposals in 2017 and 11 proposals in 2016. Although only two "fix-it" proposals have passed (both in 2016), these proposals continue to merit attention as companies commence preparation for the 2019 proxy season and shareholder proponents continue to submit these proposals.

Companies have overwhelmingly adopted proxy access by-laws with 3/3/20/20 terms, in contrast to the "3/3/25/no cap" terms that many shareholders are seeking. Shareholder proponents have not acquiesced to the status quo; they continue to advocate for "fix-it" proposals that are designed to bring 3/3/20/20 by-laws closer to the 3/3/25/no cap by-laws they espouse, as well as requesting more shareholder-friendly second-tier terms. "Fix-it" proposals generally fall into three categories: "tailored," "two-term"/"three-term" and "shareholder cap" proposals.

"Tailored" proposals request amendments to several (typically four or five) terms of a company's by-laws. The terms include both headline and second-tier terms, such as the counting of loaned shares or treatment of investment funds. Only 16 tailored proposals have been submitted to date and none were submitted in 2018. Of those 16 proposals, seven were excluded or withdrawn, two passed with a 67% average vote in favor and seven failed with a 33% average vote in favor. The two "tailored" proposals that passed in 2016 were submitted at companies that had adopted by-laws with a 5% minimum percentage ownership threshold and to date, remain the only "fix-it" proposals that have passed. Not surprisingly, both companies subsequently amended their proxy access by-laws.

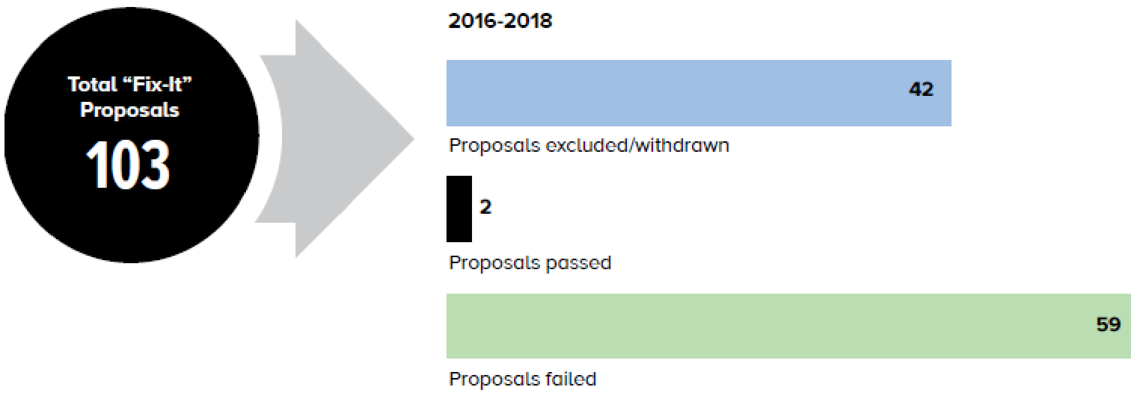
"Two-term" and "Three-term" proposals target companies on two or three issues, which typically include the percentage of the board electable pursuant to proxy access, the shareholder aggregation cap and the restrictions on renominations of failed proxy access candidates. While several companies attempted to exclude these proposals through the SEC's no-action process, all such attempts have been unsuccessful.

There were 21 two-term proposals between 2016 and 2018. Of those 21 proposals, one was withdrawn while the remaining proposals all failed with a 27% average vote in favor.

There were 12 three-term proposals between 2016 and 2018. Of those 12 proposals, one was excluded, none passed and 11 proposals failed with a 29% average vote in favor.

"Shareholder cap" proposals only seek to amend the limitation on the number of shareholders that can aggregate their holdings to satisfy the minimum percentage ownership requirement. In 2018, shareholder cap proposals sought to remove an aggregation cap (as opposed to 2017 proposals which generally sought to increase the shareholder aggregation cap to 40 or 50 shareholders). All 10 proposals voted on in 2018 failed with a 26% average vote in favor.

There were 54 shareholder cap proposals between 2016 and 2018. Of those 54 proposals, 33 were excluded or withdrawn, none passed and 21 failed with a 27% average vote in favor.



Amendments

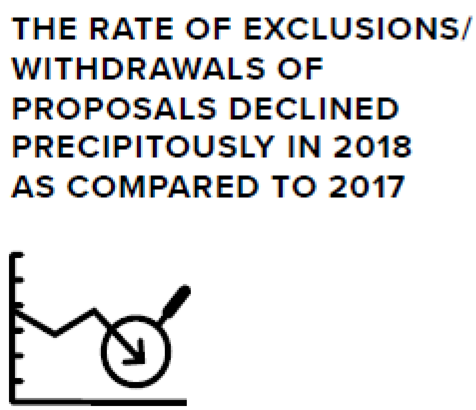
To date, 37 companies have amended their proxy access by-laws, although only one of these amendments occurred in 2018. While some amendments have been made prior to an upcoming vote on an "adopt" or "fix-it" proposal and some have been made in response to shareholder proposals that have passed, it is likely that at least a few amendments have been made in response to behind-the-scenes pressure from institutional investors seeking more favorable terms.

Exclusions and Withdrawals

The rate of exclusions/withdrawals of shareholder proposals declined precipitously in 2018 as compared to 2017 (from approximately 70% to approximately 20%). In 2018, among the 28 "fix-it" proposals, one was excluded and one was withdrawn. Among the 22 adopt proposals in 2018, six were excluded and three were withdrawn.

This decline in withdrawals/exclusions may be attributed to a refinement in shareholder proposals prior to submission, leaving a pool of proposals less vulnerable to exclusion and withdrawal. For example, the decline in "fix-it" proposals can be attributed to the SEC's decision in 2017 to generally allow companies to exclude "shareholder cap" proposals requesting an increase to 40 or 50 shareholders under Rule 14a-8(i)(10), so long as the company's proxy access by-law already had an aggregation cap of 20 shareholders and the company could represent as to certain facts about its shareholder base.

> ## Fast Facts
> **Time from Adoption to Amendment**
>
> Among the **37** companies that have amended their proxy access by-laws, there was an average of 311 days between the initial adoption of the by-law and an amendment
>
> More than **900** annual meetings have been held by companies with a proxy access by-law since 2011
>
> Only **1** nomination has been attempted (and was disqualified by the company in question)
>
> **ZERO** proxy access candidates have appeared in a company proxy statement



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The complete Shearman and Sterling Corporate Governance and Executive Compensation Survey is available [here].