Harvard Corporate Governance Roundtable

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Tab I: Current Legal Developments and Proposals

Harvard Law School Forum on
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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.

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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.

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Comment Letter Regarding Mandatory Arbitration Bylaw Proposal at Johnson & Johnson

Posted by Jeff Mahoney, Council of Institutional Investors, on Friday, March 1, 2019

Editor's note: Jeff Mahoney is General Counsel of Council of Institutional Investors. This post is based on a comment letter from CII to Chairman Jay Clayton of the U.S. Securities and Exchange Commission.

I am writing on behalf of the Council of Institutional Investors (CII). CII is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management exceeding $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $25 trillion in assets under management.[1]

On November 9, 2018, Hal Scott, Trustee of The Doris Behr 2012 Irrevocable Trust, submitted a proposal for the consideration and vote of shareholders at the 2019 annual meeting of Johnson & Johnson (J&J).[2] The proposal requests that "the Board of Directors [of J&J] take all practicable steps to adopt a mandatory arbitration bylaw."[3] In response, by letter of December 11, 2018, counsel for J&J requested that the staff of the Division of Corporation Finance of the U.S. Securities and Exchange Commission (SEC or Commission) concur with J&J's view that it may exclude the shareholder proposal submitted by Mr. Scott from J&J's proxy materials pursuant to Rule 14a-8(i)(2) [4] because implementation of the proposal would cause J&J to violate federal law.[5]

[1] For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at http://www.cii.org.(go back)

[2] Letter from Hal Scott, Trustee, The Doris Behr 2012 Irrevocable Trust to Mr. Thomas J. Spellman III, Assistant General Counsel and Corporate Secretary, Johnson & Johnson (Nov. 9, 2018), https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2018/dorisbehr121118-14a8-incoming.pdf.(go back)

[3] *Id.* (attachment).(go back)

[4] Shareholder Proposals, 17 C.F.R. § 14a-8(i)(2) (as amended Sept. 16, 2010) (a company may exclude a proposal if "the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject"), *available at* https://www.law.cornell.edu/cfr/text/17/240.14a-8.(go back)

[5] Letter from Marc S. Gerber, Skadden, Arps, Slate, Meagher & Flom LLP to U.S. Securities and Exchange Commission, Division of Corporation Finance, Office of Chief Counsel 3 (Dec. 11, 2018), https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2018/dorisbehr121118-14a8-incoming.pdf.(go back)

We respectfully request that the SEC grant J&J no-action relief consistent with prior no-action positions,[6] and the SEC's long-held view that including shareowner arbitration clauses in the governing documents of U.S. public companies is contrary to public policy.[7]

As you may recall from your participation at our spring 2018 conference, many CII members strongly oppose shareowner arbitration clauses between U.S. public companies and investors. Our long-standing membership approved policy addressing this issue states: "[C]ompanies [should not] attempt to bar shareowners from the courts through the introduction of forced arbitration clauses."[8]

Our policy is based on the view that shareowner arbitration clauses in public company governing documents represent a potential threat to principles of sound corporate governance that balance the rights of shareowners against the responsibility of corporate managers to run the business.[9]

More specifically, among the many problems that our members have identified with shareowner arbitration clauses is the fact that disputes that go to arbitration rather than the court system generally do not become part of the public record and, thereby, may lose their deterrent effect.[10]

As Hillary Sale, a law professor at Georgetown University recently commented: Because arbitration is private, "[w]e won't have a good understanding of when companies are committing fraud or in fact behaving in an above-board manner."[11]

[6] *See* Gannett Co., Inc., SEC No-Action Letter (Feb. 22, 2012) (permitting Gannett to omit a proposal from its proxy materials in reliance on rule 14a-8(i)(2) that would amend its bylaws to provide that certain controversies or claims, including those arising under the federal securities laws, shall be settled by arbitration), https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2012/2donaldvuchetich022212-14a8.pdf; Pfizer Inc., SEC No-Action Letter (Feb. 22, 2012) (permitting Pfizer to omit a proposal from its proxy materials in reliance on rule 14a-8(i)(2) that would amend its bylaws to provide that certain controversies or claims, including those arising under the federal securities laws, shall be settled by arbitration), https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2012/donaldvuchetich022212-14a8.pdf.(go back)

[7] *See* Thomas L. Riesenberg, Commentary, Arbitration and Corporate Governance: A Reply to Carl Schneider, 4 Insights 8 (Aug. 1990) (indicating that it would "be contrary to the public interest to require investors who want to participate in the nation's equity markets to waive access to a judicial forum for vindication of federal or state law rights, where such waiver is made through a corporate charter rather than an individual investor's decision"); *cf.* Alison Frankel, A Delaware Death Blow for Mandatory Shareholder Arbitration, Reuters, Dec. 19, 2018 (commenting on a recent decision by Vice-Chancellor Travis Laster of the Delaware Chancery Court, in the case of Sciabacucchi v. Salzberg, et. al., C.A. No. 2017-0931 (Del. Ch. Dec. 19, 2018), that may prevent Delaware corporations from effecting "mandatory shareholder litigation of federal securities claims though corporate charters or bylaws, regardless of what the Securities and Exchange Commission has to say about the issue"), https://www.reuters.com/article/us-otc-forumselection/a-delaware-death-blow-for-mandatory-shareholder-arbitration-idUSKCN1OI2HB.(go back)

[8] Council of Institutional Investors, Corporate Governance Policies § 1.9 Judicial Forum (updated Oct. 24, 2018), https://www.cii.org/files/10_24_18_corp_gov_policies.pdf.(go back)

[9] *See, e.g.,* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Keith F. Higgins, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, et al. 1 (Dec. 11, 2013), https://www.cii.org/files/issues_and_advocacy/correspondence/2013/12_11_13_CII_letter_to_SEC_forced_arbitration.pdf; cf. Letter from State Financial Officers Foundation to Chairman Clayton (Nov. 13, 2018) (setting forth four "specific concerns in allowing companies to impose forced arbitration clauses that limit class action claims on investors"), https://secureoursavings.com/wp-content/uploads/2018/11/SFOF-Letter-to-SEC-Chairman-Clayton-1.pdf.(go back)

[10] *See, e.g.,* Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Mr. Craig S. Phillips, Counselor to the Secretary, U.S. Department of Treasury 8 (Aug. 23, 2017), https://www.cii.org/files/August%2023%202017%20Letter%20to%20Treasury%20v3.pdf.(go back)

[11] Dave Michaels, Johnson & Johnson Drafted Into Fight Over Shareholder Lawsuits, *Wall St. J.*, Dec. 13, 2018, https://on.wsj.com/2EAZGnY; see N. Peter Rasmussen, Corporate Transactions Blog, Mandatory Arbitration Proposal Creates Strange Bedfellows, *Bloomberg L*. (Jan. 8, 2019) (quoting Securities and Exchange Commission Commissioner Robert J. Jackson, Jr. that "as compared to closed-door arbitration proceedings, 'a public hearing gives judges a chance to tell corporate insiders what the law expects of them'"), https://www.bna.com/mandatory-arbitration-proposal-b57982095134/; cf. Carol V. Gilden, Partner, Cohen Milstein, A Clear and Present Danger: The Continued Threat of Forced Arbitration, *Shareholder Advoc*. 5 (Winter 2019) (quoting James D. Cox, Professor of Law, Duke Law

We also agree with SEC Commissioner Robert J. Jackson, Jr, that the existence of private shareowner actions is a necessary supplement to the Commission's limited enforcement resources. [12] Those actions aid the SEC in identifying and addressing corporate wrongdoing and poor corporate governance practices, and decisions by courts in private actions have developed much of the law governing securities fraud.[13]

As you may also recall from your participation at CII's spring 2018 conference, you indicated that the SEC's long-standing view on shareowner arbitration clauses in the context of a U.S. company's initial public offering registration statement would not be changed without a "fair" process that included "input from all interested constituents."[14] Similar assurances were subsequently provided in writing to the Honorable Carolyn B. Maloney of the U.S. House of Representatives.[15]

In sum, consistent with CII membership approved policies described above, we strongly support the J&J request for no-action relief.

School: '"In the classic work, *Democracy in America,* Alexis de Tocqueville wrote nearly 200 years ago that a central strength of the democracy in America was our country's commitment to access to justice through mechanisms such as . . . making the courts available for everyone [and] [m]andated arbitration of investor and shareholder claims would be a grave departure from what makes America exceptional.'"), https://www.cohenmilstein.com/sites/default/files/A%20Clear%20and%20Present%20Danger.pdf.(go back)

[12] *See* N. Peter Rasmussen; *see, e.g.,* Brief Amici Curiae of the Council of Institutional Investors et al. at 6, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. 2014) (quoting Securities and Exchange Commission Chairman Arthur Levitt, Jr. that '"[p]rivate rights of action are not only fundamental to the success of our securities markets, they are an *essential complement* to the SEC's own enforcement program'"), https://www.cii.org/files/issues_and_advocacy/legal_issues/02_05_14_CII_amicus_curiae_brief_halliburton.pdf.(go back)

[13] *See* N. Peter Rasmussen; *see also* Letter from Michael Pieciak, NASAA President, Commissioner, Vermont Department of Financial Regulation to the U.S. Securities and Exchange Commission 4 (Jan. 30, 2019) ("Class action litigation . . . contributes materially to the development of the common law.") (on file with CII).(go back)

[14] Council of Institutional Investors, Spring 2018 Meeting, Plenary 1: Interview with the SEC Chair (Mar. 12, 2018), https://www.youtube.com/watch?v=CV7rb-b4sEM.(go back)

[15] Letter from Jay Clayton, Chairman, United States Securities and Exchange Commission to The Honorable Carolyn B. Maloney, U.S. House of Representatives 2 (Apr. 24, 2018) ("I would expect that any decision would involve Commission action (and not be made through delegated authority) and that the Commission would give the issue full consideration in a measured and deliberative manner."), https://maloney.house.gov/sites/maloney.house.gov/files/MALONEY%20ET%20AL%20-%20FORCED%20ARBITRATION%20-%20ES156546%20Response.pdf.(go back)

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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.

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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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Rule 14a-8 Exceptions and Executive Compensation

Posted by Cydney Posner, Cooley LLP, on Tuesday, March 12, 2019

Editor's note: Cydney S. Posner is special counsel at Cooley LLP. This post is based on a Cooley memorandum by Ms. Posner. Related research from the Program on Corporate Governance includes The Case for Increasing Shareholder Power by Lucian Bebchuk.

In October last year, Corp Fin issued a new staff legal bulletin on shareholder proposals, 14J, that examined the exception under Rule 14a-8(i)(7), the "ordinary business" exception, addressing, among other topics, the application of the rule to proposals related to executive or director comp. Post-shutdown, Corp Fin has now posted several no-action responses that consider the exception in that context. Do they provide any color or insight?

Executive comp or ordinary business?

One of the issues addressed in the SLB is how the staff approaches the application of Rule 14a-8(i)(7) to proposals that, in addition to implicating executive/director comp, also involve ordinary business matters. The question the staff then asks is: what is the real underlying focus of the proposal? Is it really concerned primarily with senior executive and/or director compensation, or is it just styled as an executive comp proposal, but "its underlying concern relates primarily to ordinary business matters that are not sufficiently related to senior executive and/or director compensation"? The goal is to avoid elevating form over substance so that "a proposal is not included simply because it addresses an excludable matter in a manner that is connected to or touches upon senior executive or director compensation matters." Elsewhere in the SLB, the staff notes that, in "determining whether the focus of a proposal is senior executive and/or director compensation or, instead, an ordinary business matter, we consider both the resolved clause and supporting statement as a whole."

In this letter to AT&T, the company received a proposal asking the board "to amend the compensation of the CEO and CFO to include the company's long-term issuer debt rating from S&P Global and Moody's, in an advisory manner, as an incentive metric weighting." The supporting statement, which discussed at length the company's debt load relative to that of several European countries, as well as its debt growth rate, cash flows and debt ratings, was probably very influential, if not determinative. The company argued that "[a]lthough the resolution is framed as a request to include the Company's credit rating as a performance metric for the CEO's and CFO's incentive compensation, the Proposal as a whole has nothing to do with executive compensation…. The Proposal focuses only on the Company's amount of indebtedness and its credit ratings by Moody's and S&P. *As* a result, the Proposal is effectively a shareholder referendum on management's decisions on managing the Company's debt levels and cash resources. The underlying concern of the Proposal is not senior executive compensation." Rather, the executive compensation aspect was simply "window dressing." The

staff agreed that the proposal could be excluded under Rule 14a-8(i)(7) because it was related to the Company's ordinary business operations. "In this regard," the staff wrote, "we note that, although the Proposal relates to executive compensation, the focus of the Proposal is on the ordinary business matter of management of existing debt."

Executive comp or comp also available to the general workforce?

SLB 14J advises that where the focus of the proposal is "on aspects of compensation that are available or apply only to senior executive officers and/or directors," companies may generally not rely on Rule 14a-8(i)(7) to exclude the proposal. However, where the proposal relates to forms of compensation to senior executives/directors that are "also broadly available or applicable to the general workforce," the proposal "does not generally raise significant compensation issues that transcend ordinary business matters." Accordingly, the SLB imposes a two-part test: "a proposal that addresses senior executive and/or director compensation may be excludable under Rule 14a-8(i)(7) *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."* [Emphasis added.]

Verizon received a proposal requesting that the Board's Human Resources Committee publish a report "assessing the feasibility of integrating cyber security and data privacy performance measures into the Verizon executive compensation program which it describes in its annual proxy materials." The supporting statement discussed performance metrics that were used to determine executive comp and argued that "[c]yber security and data privacy are vitally important issues for Verizon and should be included too, as we believe it would incentivize leadership to reduce risk, enhance financial performance, and increase accountability." The company contended that the proposal related to general employee compensation because it applied to a broader group of "nearly 300 'key employees at the senior management level' and was not limited only to senior executive officers and/or directors." To be sure, the company maintained, "as a practical matter," the bonuses of other management employees were ultimately based on the same metrics.

The proponent, however, took a different turn, focusing less on whether the metrics applied beyond the group of executives and stressing instead the importance of the underlying policy issue: the "overriding consideration for the 14a-8(i)(7) analysis continues to be whether the proposal focuses on a significant issue that transcends ordinary business matters…. As such, the central issue presented in this no-action letter request is whether a report 'assessing the feasibility of integrating cyber security and data privacy performance measures into the Verizon executive compensation program' focuses on an issue that *transcends ordinary business matters.*" In addition, the proponent argued, the issue was significant to the company's business and, as a result, it was appropriate to link this significant policy issue to executive compensation. Where the proposal "focuses on issues that do not transcend the ordinary business of the company, then it may be necessary to look at whether it is applicable to the general workforce. But that is not the case here." In essence, the proponent argued, in its request for no-action, the company was missing the boat: the "analytical through-line from the Commission's Release No. 34-40018 (May 21, 1998) all the way through Staff Legal Bulletin 14J in 2018 is the question whether the proposal focuses on a significant policy issue confronting the company." Ultimately, the proponent hoped to persuade the staff that "SLB 14J is not applicable to the 2019 Proposal." In response, the company then pointed out that the staff had not found cybersecurity and privacy

to be transcendent policy issues; however, the staff had "treated senior executive compensation as a significant social policy issue since 1992."

In denying relief to the company, the staff did not appear to buy the company's contention that the proposal targeted compensation was broadly applicable to the general workforce. But neither did the staff appear to be persuaded by the proponent's contention that the proposal involved a transcendent policy matter. Rather, in denying relief to the company, the staff highlighted the focus of the proposal on executive compensation: "We note that the Proposal transcends ordinary business because it focuses on the performance measures used by the Human Resources Committee to determine the value of the compensation awards of the named executive officers as disclosed in the Company's proxy materials."

In this letter, Verizon was again unable to obtain no-action relief from the staff to exclude a proposal related to executive comp, but for a different reason. In this instance, the proposal requested that "the board to seek shareholder approval of any senior executive officer's golden parachute "with an estimated 'total value' exceeding 2.99 times the sum of the executive's base salary plus target short-term bonus, including the value of unearned equity as to which vesting is accelerated or performance conditions are waived." In essence, the proposal would amend the company's existing golden parachute policy to require the inclusion of equity in the calculation when vesting is accelerated. Here too Verizon contended that the proposal addressed an aspect of senior executive compensation that is also available or applicable to the general workforce, citing as virtually identical the specific example in SLB 14J regarding golden parachutes. The proponent, however, maintained that the precise subject of the proposal was "not golden parachutes *per se*, but 'excess' golden parachutes for a very small number of Verizon executives, namely, its 'senior executive officers.'" In addition, the "size of golden parachutes to senior executives has mushroomed," and "public concern over 'excessive' golden parachutes…has only increased." The staff denied relief. Whether or not the company had adequately shown that the proposal addressed forms of compensation to senior executives that were also broadly available or applicable to the general workforce, the company had failed to carry its burden on the second part of the test: the no-action request failed to "include a discussion that demonstrates that senior executive officers' eligibility to receive the severance or termination payments does not implicate significant compensation matters."

Micromanagement

Another aspect of the SLB addressed the staff's decision to reverse prior policy and allow the issue of micromanagement to be applied, under Rule 14a-8(i)(7), to exclude proposals related to executive comp. As explained in SLB 14J, a proposal may be considered to "micromanage" the company where it probes "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." With regard to proposals addressing senior executive and/or director compensation, where they "seek intricate detail, or seek to impose specific timeframes or methods for implementing complex policies," the staff may now agree that they can be excluded under Rule 14a-8(i)(7) on the basis of micromanagement. The SLB emphasized that "micromanagement addresses the manner in which a proposal raises an issue, and not whether a proposal's subject matter itself is proper for a shareholder proposal under Rule 14a-8."

The staff agreed that exclusion would be appropriate on the basis of micromanagement under Rule 14a-8(i)(7) in substantially the same proposals submitted to AbbVie and Johnson & Johnson. In both cases, the companies received proposals requesting the board "to adopt a policy that no financial performance metric shall be adjusted to exclude legal or compliance costs when evaluating performance for purposes of determining the amount or vesting of any senior executive incentive compensation award." In its supporting statement, the proponent contended that "senior executives should not be insulated from legal risks, particularly on matters that are core to the company's business. These considerations are especially critical at [the company] given the potential reputational, legal and regulatory risks it faces over its role in the nation's opioid epidemic." The companies first argued that, while the proposal was "framed in terms of executive compensation, the incentive compensation that is the subject of the request is broadly applicable to [the company's] workforce and, as such, does not raise a significant policy issue." In addition, the companies both contended that, in seeking to prohibit them from adjusting financial performance metrics on specified bases—a complex process that typically involves specific judgments concerning whether and how, if at all, to adjust financial performance metrics—the proposals sought to micromanage the companies: the "Proposal's attempt to categorically prohibit any adjustment whatsoever of the broad categories of expenses covered by the Proposal without regard to circumstance and without any reasonable exceptions would impose specific methods for implementing complex policies and therefore, probes too deeply into matters of a complex nature upon which shareholders, as a group, are not in a position to make an informed judgment."

In response, the proponent argued that the proposal related only to executive comp and that it implicated significant comp matters in any event. Moreover, the proponent contended, the request in the proposal was not complex or prescriptive at all: the proposal "would affect a single aspect of this process, asking the Committee not to exclude the impact of [legal and compliance costs and settlements] in the calculation of [earnings and EPS] metrics for senior executive incentive pay purposes. That change would require only that the amount of [legal and compliance costs and settlements be added back to earnings,] a single arithmetic operation." In both cases, the micromanagement argument won the day. According to the staff, the proposal "micromanages the Company by seeking to impose specific methods for implementing complex policies. Specifically, the Proposal, if implemented, would prohibit any adjustment of the broad categories of expenses covered by the Proposal without regard to specific circumstances or the possibility of reasonable exceptions."

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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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Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks

Posted by William H. Hinman, U.S. Securities and Exchange Commission, on Saturday, March 16, 2019

Editor's note: William H. Hinman is Director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. This post is based on his recent remarks at the 18th Annual Institute on Securities Regulation in Europe, available here. The views expressed in this post are those of Mr. Hinman and do not necessarily reflect those of the Securities and Exchange Commission or its staff.

Good morning. Thank you, John [White] for that kind introduction and to the Practicing Law Institute and Allen & Overy for hosting this event. I am pleased to be here with you today. [1]

Today [March 15, 2019] I would like to discuss how the U.S. securities disclosure requirements, which are largely principles-based, apply in areas where the disclosure topics may be complex, associated with uncertain risks and rapidly evolving. Sounds like Brexit might fit that description, and I don't think I could come to London this week without spending some time discussing it. I realize that you all may be worn out on the subject, and the U.S. regulatory perspective on this topic may seem of secondary or tertiary interest to those of you living through these events. However, I would note that over half of the world's largest companies [2] have their primary listing in the U.S. and a larger proportion trade and report in compliance with our requirements. Given that these companies typically have extensive international operations, including in the U.K. and EU, we have a keen interest in the quality of disclosure that is being provided by the many issuers for which Brexit may have a material impact.

As you know, our disclosure requirements are intended to provide investors with the material information they need about companies and their securities offerings to make informed investment and voting decisions. Robust disclosure decreases information asymmetries and is the foundation of reliable price discovery. When investors have confidence that they are receiving full and transparent disclosure, markets operate more efficiently and the cost of capital is reduced. I think the strength the U.S. markets have displayed over time shows that there is much that is right about our disclosure system and the information it generates and on which market participants rely.

Our disclosure regime emphasizes materiality. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make

[1] The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners or other members of the staff.

[2] PricewaterhouseCoopers, Global Top 100 Companies by Market Capitalisation (March 2018), *available at* https://www.pwc.com/gx/en/audit-services/assets/pdf/global-top-100-companies-2018-report.pdf.

an investment decision. [3] Principles-based disclosure requirements articulate an objective and look to management to exercise judgment in satisfying that objective by providing appropriate disclosure when necessary. Management's Discussion and Analysis (MD&A) [4] and Risk Factors [5] are examples of such disclosure requirements and are well-suited to elicit disclosure about complex and evolving areas. Ideally, MD&A allows investors to see a company's results and prospects through the eyes of management. A well written MD&A allows investors to understand how management is positioning the company in the face of uncertainties, like those associated with rapidly evolving topics such as Brexit. Risk factor disclosure should address the most significant things that make an investment in a company and its securities subject to uncertainties or risk. Concise and focused disclosure explaining how each risk affects the company is most useful for investors. Companies should take care not to bury the reader in generic boilerplate or laundry lists of risks that might apply to any company. In addition, companies need to keep in mind that Commission rules also require them to disclose any further material information necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. [6] The flexibility of our principles-based disclosure requirements should result in disclosure that keeps pace with emerging issues, like Brexit or sustainability matters, without the need to for the Commission to continuously add to or update the underlying disclosure rules as new issues arise.

Brexit Disclosure

For several months, Chairman Clayton [7] and I have highlighted the need for more robust public company disclosure about how companies are considering Brexit and its possible impact on their business and operations. Today, I would like to focus on the Brexit-related disclosures that we've seen to date, explain how our principles-based disclosure requirements can be applied to Brexit and share with you the types of issues the Division of Corporation Finance may consider when evaluating Brexit-related disclosure in periodic reports in the coming months.

We frequently conduct cross-industry surveys to evaluate the quality of disclosures on complex and evolving topics to inform our filing review process, and I thought Brexit disclosure was an appropriate topic for us to examine. So what did we find? We saw a wide range of disclosures, even within the same industry. Some companies provided generic disclosure, merely stating that Brexit presents a risk, that the outcome is uncertain and that it could materially and adversely impact the business and its operations. In my opinion, this type of disclosure does little to explain to investors the potential specific impact of Brexit on a company's business and operations and is insufficient to guide investors in a meaningful manner.

On a positive note, we've also seen some thoughtful and appropriately detailed disclosures of how Brexit may impact companies. Not surprisingly, we have seen foreign private issuers [8]—companies likely impacted most directly—provide tailored disclosure at a higher rate than U.S. domestic registrants. This suggests that many of you in the audience have done a commendable

[3] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).
[4] Item 303 of Regulation S-K [17 CFR 229.303].
[5] Item 503(c) of Regulation S-K [17 CFR 229.503(c)].
[6] Rule 408 of the Securities Act [17 CFR 230.408]; Rule 12b-20 of the Exchange Act [17 CFR 240.12b-20].
[7] Chairman Jay Clayton, SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks (Dec. 6, 2018), ***available at*** https://www.sec.gov/news/speech/speech-clayton-120618.
[8] Rule 405 of the Securities Act [17 CFR 230.405]; Rule 3b-4 of the Exchange Act [17 CFR 240.3b-4].

job advising your clients. And of course, it may reflect the higher expected impacts of Brexit among the community of non-U.S. issuers. That said, we anticipate that there will be international effects that non-U.K. and non-EU issuers will not escape. As Brexit becomes more imminent, and perhaps in response to our public requests for more robust disclosure, we are encouraged to observe that a higher percentage of companies appear to be including tailored Brexit disclosures in their 2018 annual reports. While this is encouraging, we believe there is room for continued improvement.

As you all know too well, there is tremendous uncertainty associated with Brexit, including whether it will be delayed beyond March 29, 2019 to permit further negotiations, or whether it will be reversed or sharply modified through a second referendum or other arrangements. In addition, there is a lack of clarity on what the actual effects of Brexit will be on companies, their investors and on global financial markets. Despite this uncertainty, the reality for many companies is that Brexit is already here. I would think that management and boards have not thrown up their hands in light of the uncertainties and declared that "nothing can be done"—they have been preparing for the variety of outcomes well in advance of March 29. Businesses have not been able to take a wait-and-see approach. Rather, they've had to prepare for a range of outcomes. Your clients likely have made a number of important decisions to mitigate the risk of whatever outcome they may face and investors should know not only the nature and extent of those risks, but also what companies have done to prepare.

As we review disclosures in this area, we appreciate that each company has its own considerations. For example, the Brexit-related disclosure for a large international bank will be different than a multi-national automobile manufacturer, and largely unlike that of a pharmaceutical or life sciences company. Given the differences across industries and companies, there is no one specific data point or prescriptive piece of information that all companies could provide to disclose material information relating to their Brexit-related risks.

Rather, investors are better served by understanding the lens through which each company's management looks at its exposure. How does management assess and analyze Brexit-related risks and the potential impacts on the company and its operations? What is management doing to mitigate and manage these risks? What is the nature of the board's role in overseeing the management of these risks? Depending on the facts and circumstances of each company, the answers to these questions should provide material information to investors seeking to understand the risks attendant to Brexit for that company. One analytical tool to evaluate disclosure in this context is to consider how management discusses Brexit-related risks with its board of directors. Obviously not all discussions between management and the board are appropriate for disclosure in public filings, but there should not be material gaps between how the board is briefed and how shareholders are informed. For those of you involved in crafting disclosure documents, you can ask yourself a straightforward question: would these disclosures satisfy the curiosity of a thoughtful, deliberative board member considering the potential impact of Brexit on the company's business, operations and strategic plans?

I would like to share some observations of disclosure topics that companies may consider in this context. These are the types of questions that I expect we will have in mind when evaluating Brexit-related disclosures in 2018 annual reports. This list is by no means exhaustive, and the materiality and usefulness of Brexit-related disclosure will always depend on the particular facts and circumstances of the company.

1. Is the business exposed to new regulatory risk given the uncertainty of which set of laws and regulations will apply and whether transition agreements will be in place? We have seen useful, tailored disclosure by some financial institutions that addresses the regulatory risks associated with the potential loss of passporting arrangements that currently permit U.K. entities to provide services to businesses and customers throughout the EU. Similarly, some firms have provided disclosure explaining specific efforts undertaken to re-locate their U.K. operations, or to merge with or acquire EU subsidiaries, to mitigate the regulatory risks of Brexit. Banking and financial services are obviously not the only industries subject to regulatory risk in light of Brexit. Biopharmaceutical companies with substantial U.K. operations face risks concerning how their products and clinical trials will be regulated. Airlines face risks that potential restrictions on flying rights or changes in administration of antitrust laws may negatively impact their joint ventures. For companies in these industries and others affected by regulatory risk, we would expect tailored disclosure explaining these risks where appropriate.
2. Are there significant supply chain risks due to the potential disruption to the U.K.'s access to free trade agreements with other nations and any resulting changes in tariffs on exports and imports? Will potential changes to customs administrations and delays materially impact a company's business, particularly if the business relies on just-in-time supply chains? We believe that companies are actively considering the potential impact of these matters on their business, and we look forward to seeing disclosures that provide insight as to how management is assessing and mitigating these risks.
3. Does the company face a material risk of losing customers, a decrease in sales or revenues or an increase in costs due to tariffs or other factors? Is demand for the company's products especially sensitive to exchange rates or changes in tariffs? Discussion and analysis of these types of questions regarding known trends, demands, commitments, events and uncertainties are critical for investors to understand the extent to which a company's reported financial information is indicative of future results. To the extent management sees the potential impact of Brexit in terms of anticipated costs, reductions in forecasted sales or changes in working capital, it may be appropriate in some cases to include estimates or ranges of quantitative changes, as well as qualitative disclosures.
4. Does the company have exposure to currency devaluation, foreign currency exchange rate risk or other market risk? Given the potential for heightened foreign exchange volatility, we are aware of reports that companies are increasing their hedging activities. We will look at quantitative and qualitative disclosures about market risk to better understand each company's approach to market risk management in this area.
5. What is the company's exposure to contractual risk in the face of Brexit? Has the company undertaken a review of its existing contracts with counterparties in the U.K. or the EU to determine whether renegotiation or termination is necessary in light of contractual obligations? To the extent these discussions involve material contracts, we would expect disclosure to reflect these discussions.
6. Do Brexit-related issues affect financial statement recognition, measurement or disclosure items, such as inventory write-downs, long-lived asset impairments, collectability of receivables, assumptions underlying fair value measurements, foreign currency matters, hedge accounting or income taxes? We expect that boards and audit committees are considering these reporting implications and that these considerations will be discussed in company disclosures, as appropriate.

These are just examples, and how these risks will affect a company's business and how management seeks to mitigate the risks will vary greatly across companies. We have even seen some companies disclose the absence of any actual or anticipated material impact of Brexit on their business. We therefore expect to see a wide range of disclosures about Brexit. However, to the extent material, each company's Brexit disclosure should provide tailored insight into how management views the risks posed to the business and operations and what actions they are taking to address these risks.

Sustainability Disclosure

Another set of issues that illustrates the utility and importance of flexible, principles-based disclosure requirements is the array of issues under the umbrella of environmental, social, and governance, or sustainability, issues. Sustainability disclosure continues to be of interest to investors and other market participants, and the very breadth of these issues illustrates the importance of a flexible disclosure regime designed to elicit material, decision-useful information on a company-specific basis. We understand that investors continue to engage with companies on sustainability topics and that market participants across the globe are giving significant thought to the types of sustainability disclosures the market is seeking as it strives to efficiently allocate capital.

We recognize that market participants have raised questions about the sufficiency of sustainability disclosures, and I think this is a complicated issue. While many market participants have expressed a desire for more specific sustainability disclosure requirements, others have concerns that specific sustainability disclosure requirements could result in disclosure that might not be considered material to a reasonable investor. In addition, market participants who do support additional sustainability disclosure requirements do not themselves uniformly recommend additional disclosure on the same sustainability issues. We hear differing views on whether disclosure requirements should be principles-based or prescriptive, and whether they should utilize a specific set of reporting standards to enhance comparability.

So it appears to me that the market is still evaluating what, if any, additional disclosure on these topics would provide consistently material and useful information. The marketplace evolution of sustainability disclosures is ongoing—companies certainly provide more sustainability information than they did ten years ago—and allowing this evolution to continue should provide market participants with a continued opportunity to sort out the types of information they find useful. Had we leapt into action and issued prescriptive sustainability disclosure requirements when people first began calling for them, I believe we would have stymied that evolution and stifled efforts to develop useful disclosure frameworks. Substituting regulatory prescriptions for market-driven solutions, especially while those solutions are evolving, in my view, is something we need to manage with utmost care. In the meantime, we are watching carefully as market-led approaches develop in this area, and we actively compare the information companies voluntarily provide—typically outside of their SEC filings—with the disclosure we see filed with us.

As we approach this or other disclosure topics, I am always cognizant that imposing specific bright-line requirements can increase the costs associated with being a public company and yet not deliver the relevant and material information that market participants are seeking. Adding requirements to the disclosure regime that do not deliver benefits that justify their costs

decreases the attractiveness of our public markets, which in turn can reduce the number of public investment options available to all investors.

As I've mentioned, an important objective of our disclosure framework is to allow investors to see the company through the eyes of management. I encourage companies to consider their disclosure on all emerging issues, including risks that may affect their long-term sustainability. And as they do so I would suggest they ask themselves whether their disclosure is sufficiently detailed to provide insight as to how management plans to mitigate material risks and how their decisions in the area of risk could be material to the business and their investors. Again, this is a process where I believe it is helpful to think about how management engages with board members on the topic.

Let me spend a couple of minutes discussing climate-related disclosures more specifically. Extreme weather events and the continued interest of investors and other market participants in climate-related disclosures have led to a lot of discussion about what companies should disclose about climate or weather-related matters. The Commission published an interpretive release in 2010 that discussed how our existing disclosure requirements may apply to climate-related issues and reminded companies of the need to regularly assess their disclosure obligations as they pertain to climate-related issues. [9] That guidance remains a relevant and useful tool for companies when evaluating their disclosure obligations concerning climate change matters. For example, the guidance discusses how companies with businesses that may be vulnerable to severe weather or climate-related events should consider disclosing material risks of, or consequences from, these events. This remains true today. As another example, it notes that if a company determines that its physical plants and facilities are exposed to extreme weather risks and it is making significant business decisions about relocation or insurance, then, when these matters are material, companies should provide disclosure.

One item the 2010 guidance does not touch upon is the board's risk management role in this area. Item 407(h) of Regulation S-K [10] and Item 7 of Schedule 14A [11] require a company to disclose the extent of its board's role in the risk oversight of the company, such as how the board administers its oversight function and the effect this has on the board's leadership structure. The Commission has previously highlighted that this should provide investors with important information about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company. [12] To the extent a matter presents a material risk to a company's business, the company's disclosure should discuss the nature of the board's role in overseeing the management of that risk. The Commission last noted this in the context of cybersecurity, when it stated that disclosure about a company's risk management program and how the board engages with the company on cybersecurity risk management allows investors to better assess how the board is discharging its risk oversight function. [13] Parallels may be drawn to other areas where companies face emerging or uncertain risks, so companies may find this guidance useful when preparing disclosures about

[9] Commission Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106 (Feb. 8, 2010) [75 FR 6290].

[10] Item 407(h) of Regulation S-K [17 CFR 229.407(h)].

[11] Item 7 of Schedule 14A [17 CFR 240.14a-101].

[12] *See* Proxy Disclosure Enhancements, Release No. 33-9089 (Dec. 16, 2009) [74 FR 68334] ("[D]isclosure about the board's involvement in the oversight of the risk management process should provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company.").

[13] Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Release No. 33-10459 (Feb. 21, 2018) [83 FR 8166].

the ways in which the board manages risks, such as those related to sustainability or other matters.

Conclusion

I appreciate the opportunity to share my thoughts on how our principles-based requirements can be applied to complex, evolving disclosure topics and I hope you enjoy the remainder of the conference.

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D.C. Speaks Up: A Push for Board Diversity from the SEC and Congress

Posted by Howard Dicker, Ade Heyliger and Aabha Sharma, Weil, Gotshal & Manges LLP, on Monday, February 25, 2019

Editor's note: Howard Dicker and Ade Heyliger are partners and Aabha Sharma is an associate at Weil, Gotshal & Manges LLP. This post is based on their Weil memorandum.

On February 6, 2019, the SEC Staff issued a new interpretation relating to director qualifications and diversity which could impact proxy statement disclosures for the upcoming proxy season, and potentially D&O questionnaires as well. On the same day, companion bills were introduced into both the U.S. House of Representatives and Senate that would require every public company to disclose in proxy statements: (i) data regarding the racial, ethnic and gender composition of its board of directors, director nominees, and executive officers, as well as the status of any such person as a veteran, in each case, based on voluntary self-identification; and (ii) whether the board has a policy or strategy to promote racial, ethnic and gender diversity among directors, nominees or executive officers. The SEC's interpretation and the Congressional "Corporate Diversity Bill" are the latest evidence that efforts over the past two years for enhanced board diversity are gaining considerable momentum.[1]

Board Diversity Disclosure—SEC's New CDI

The Division of Corporation Finance (Division) of the U.S. Securities and Exchange Commission this week addressed board diversity disclosure through two identical Compliance & Disclosure Interpretations (CDIs) under Regulation S-K—116.11 and 133.13. The CDI addresses what type of disclosure is required in connection with Items 401(director qualifications) and 407 (director nominee qualifications) when board members or nominees have "consented" to the company's disclosure of certain "self-identified" diversity characteristics, such as their race, gender, ethnicity, religion, nationality, disability, sexual orientation, or cultural background.

The Division provides that to the extent the board or nominating committee, in determining the specific experience, qualifications, attributes, or skills, considered the self-identified diversity

[1] We have previously discussed how boards are under mounting pressure from institutional shareholders, pension funds and proxy advisory firms to increase board diversity. With State Street's policy to vote against the entire nominating committee of a company with no female directors in the absence of successful dialogue (as discussed in our Alert available here), the New York City Comptroller's engagement with nominating committee chairs of 151 public companies seeking disclosure of the skills, race and gender of each board member in a standardized "matrix" format, and ISS and Glass Lewis voting policies holding nominating committee chairs accountable for a lack of board gender diversity (as discussed in our Alert available here), one thing is clear—the spotlight on board diversity shines bright. Additionally, as discussed in our post on the Forum here, California last year became the first U.S. state to require listed companies with a principal executive office in California to have a minimum number of women on their boards. New Jersey, following California's example, recently proposed a similar bill.

characteristics, it would expect the company's disclosure to include, but not necessarily be limited to, "identifying those characteristics and how they were considered" (the "qualifications" disclosure required by Item 401). Moreover, it would expect any description of diversity policies followed by the company under Item 407 to include a discussion of how the company considers the self-identified diversity attributes of nominees as well as any other qualifications its diversity policy takes into account, such as diverse work experiences, military service, or socio-economic or demographic characteristics.

An interesting aspect arising from the CDI is that directors and director nominees would need to both "self-identify" with certain diversity characteristics, as well as "consent" to the company's disclosure of these characteristics. Currently, it is not common practice for director questionnaires or similar forms to ask directors and nominees to identify diversity characteristics, diminishing the opportunity for self-identification. Moreover, even if a director or nominee chooses to self-identify and consents to the disclosure of this information, under the CDI, the company would only be *required* to disclose those diversity characteristics *if* the board considered such characteristics in concluding that the individual should serve as a director, or otherwise has a policy that includes the consideration of such diversity in identifying director nominees. Even then, it appears that the company would only be required to disclose how it considered these diversity characteristics, and would not necessarily be required to disclose the type of board *composition* data the Congressional bill seeks to have disclosed (see below). However, companies with policies that actively consider and promote the disclosure of such diversity among its board members should review their questionnaires and consider adding a diversity self-identification question and option for directors and nominees to consent to the release of such information.

Improving Corporate Governance Through Diversity Act of 2019

As discussed in our Alert available here, certain Democratic members of the U.S. Congress have been pushing for years for greater board diversity disclosure. It thus comes as no surprise that as the Democratic Party takes command of the House of Representatives, those efforts are ramping up, the latest being the *Improving Corporate Governance Through Diversity Act of 2019*, introduced this week by Representative Gregory W. Meeks, with a companion bill simultaneously introduced by Senator Bob Menendez in the Senate.

The bill, which garnered the support of the Council for Institutional Investors and the U.S. Chamber of Commerce, would require public companies to disclose annually in their proxy statements data on the racial, ethnic, and gender composition, as well as veteran status, of its board of directors, director nominees and executive officers based on voluntary self-identification. Moreover, disclosure regarding the adoption of any board policy, plan or strategy to promote racial, ethnic, and gender diversity would be required. In addition to these disclosure requirements, the bill directs the SEC's Office of Minority and Women Inclusion to publish best practices for corporate reporting on diversity. Interestingly, while the spotlight on diversity has mostly focused on the board up-to-date, the bill goes a step further to also cover executive officers.

We expect the push for board diversity to continue, or even accelerate, in the upcoming year. Directors and senior management therefore should be prepared to respond to the many forces seeking change, including by taking a proactive approach to evaluating their own board

composition, as well as considering how to best tell the “company’s story” through proxy statement disclosures.

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SEC Staff Roundtable on Short-Term/Long-Term Management of Public Companies, Our Periodic Reporting System and Regulatory Requirements

Posted by Jay Clayton, U.S. Securities and Exchange Commission, on Tuesday, May 21, 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.

Our capital markets benefit from a level of retail investor participation that is unparalleled among the world's large industrialized countries. Our Main Street investors who, day in and day out, put their hard-earned money to work for the long term are the reason why we have the deepest, most dynamic and most liquid capital markets in the world.

Today's Main Street investors have a substantial responsibility to fund their own retirement and other financial needs. As a result of increased life expectancy and a shift from defined benefit plans (e.g., pensions) to defined contribution plans (e.g., 401(k)s and IRAs), the investing interests and needs of our Main Street investors have changed. Put simply, our Main Street investors are more than ever focused on long-term results. We also must recognize that our Main Street investors who have entered retirement or have another expense, such as paying for tuition or an unforeseen event, need liquidity. In other words, at some point, long-term investors do become sellers.

The SEC's disclosure rules should reflect and foster these needs—long-term perspective and liquidity when needed. Our public capital markets have a thirst for high-quality, timely and material information regarding company performance and corporate events. Our disclosure rules reflect that thirst for information and, in turn, the confidence of market participants in the quality and timeliness of public company disclosure fosters liquidity. But we should ask ourselves whether our disclosure framework and other regulations have encouraged a focus by companies—and not just securities traders—on the short-term over the long-term.

In December 2018, the Commission published a request for comment soliciting input on the nature, content, and timing of earnings releases and quarterly reports made by reporting companies.[1] The request for comment highlighted questions that have been raised regarding the adequacy and appropriateness of mandated quarterly reporting and the prevalence of optional

[1] Request for Comment on Earnings Releases and Quarterly Reports, Release No. 33-10588 (Dec. 18, 2018) [83 FR 65601 (December 21, 2018)]. The comment letters received in response to the request for comment are *available at* https://www.sec.gov/comments/s7-26-18/s72618.htm.

quarterly guidance. The request also asked for comments on whether and how our reporting system may be causing companies to disproportionally focus their time and resources on short-term results. I have directed the SEC staff to host a roundtable this summer to hear from investors, issuers, and other market participants about the impact of short-termism on our capital markets and whether our reporting system, or other aspects of our regulations, should be modified to address these concerns.

An undue focus on short-term results among companies may lead to inefficient allocation of capital, reduce long-term returns for Main Street investors, and encumber economic growth. While the problems associated with short-termism have garnered increased attention, there is a need for further dialogue on the causes of and potential solutions to the issue. The SEC staff roundtable will seek to explore the causes of short-termism and to facilitate conversations on what market-based initiatives and regulatory changes could foster a longer-term performance perspective in American companies.

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

Potential Topics for Consideration

- The role, if any, that short-termism plays in the declining number of public companies. In particular, examining how the pressure on public companies to take a short-term focus in our markets may discourage private companies from going public could provide valuable insight into how to make our public markets more attractive and increase investment options for Main Street investors.
- Our ability to reduce burdens for companies while facilitating better disclosure for long-term Main Street investors. For example, I am interested in exploring whether the information typically included by companies in earnings releases could be allowed to satisfy certain quarterly reporting obligations and whether there are ways that quarterly disclosures could be streamlined. This is particularly the case in the first fiscal quarter when the the quarterly report often comes closely on the heels of the annual report.
- The potential for certain categories of reporting companies, such as smaller reporting companies, to be given flexibility to determine the frequency of their periodic reporting.
- Market practices that could be oriented to encourage longer-term thinking and investment at public companies. For example, it would be informative to explore the extent to which certain activist practices, such as “empty voting” (e.g., acquiring voting rights over shares but having little or no economic interest in the shares), are factors that drive short-term focus.

Roundtable Details

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

Members of the public who wish to participate in the event should contact SEC staff at roundtable@sec.gov. Members of the public who wish to provide views on the impacts of short-termism on our markets and whether our reporting system, or other aspects of our

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

Electronic Comments:

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

Paper Comments:

Send paper comments to Vanessa A. Countryman, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, D.C. 20549-1090.

All submissions should refer to File Number S7-26-18, and the file number should be included on the subject line if email is used.

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SEC Roundtable on Short-Termism and Periodic Reporting System

Posted by David A. Katz and Victor Goldfield, Wachtell, Lipton, Rosen & Katz, on Thursday, May 30, 2019

Editor's note: David A. Katz and Victor Goldfield are partners at Wachtell, Lipton, Rosen & Katz. This post is based on their Wachtell Lipton memorandum. Related research from the Program on Corporate Governance includes The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here) and Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law by Leo E. Strine (discussed on the Forum here).

In a welcome development, SEC Chairman Jay Clayton has announced that the SEC Staff will hold a roundtable this summer to discuss the impact of short-termism on the management of public companies and the interplay with the SEC's periodic reporting system and regulatory requirements. The roundtable "will seek to explore the causes of short-termism and to facilitate conversations on what market-based initiatives and regulatory changes could foster a longer-term performance perspective in American companies."

Noting that Main Street investors are largely responsible for funding their own retirement and other financial needs, together with the increase in life expectancies, there should be an even greater focus on long-term results, while maintaining liquidity as needed:

> Our public capital markets have a thirst for high-quality, timely and material information regarding company performance and corporate events. . . . But we should ask ourselves whether our disclosure framework and other regulations have encouraged a focus by companies—and not just securities traders—on the short-term over the long-term. . . .
>
> An undue focus on short-term results among companies may lead to inefficient allocation of capital, reduce long-term returns for Main Street investors, and encumber economic growth. While the problems associated with short-termism have garnered increased attention, there is a need for further dialogue on the causes of and potential solutions to the issue.

While it will be up to the SEC Staff to develop the specific agenda for the roundtable, Chairman Clayton noted a few topics he thought should be addressed:

- Has short-termism contributed to the declining number of public companies, and particularly whether the pressure on short-termism has discouraged private investors from taking companies public?

- Can the SEC reduce reporting burdens for public companies while facilitating better disclosure for long-term investors considering, among other things, whether quarterly earnings releases could satisfy some quarterly reporting obligations and whether it is possible to streamline quarterly requirements?
- Can certain public companies, particularly smaller ones, be given the option to determine the frequency of their periodic reporting?
- How can market practices be changed to promote long-termism and further public company investment? Chairman Clayton asked specifically "the extent to which certain activist practices, such as 'empty voting' (*e.g.*, acquiring voting rights over shares but having little or no economic interest in the shares), are factors that drive short-term focus."

We are hopeful that the SEC Staff will also use the roundtable to explore whether the Schedule 13D ten-day filing window has outlived its usefulness and should be closed. In addition, the SEC Staff should consider whether other disclosure requirements should be mandated for Schedule 13D and 13G and Form 13F filers, including investment companies and investment advisors, on topics such as: their basic investment strategy as to long-term growth, environmental matters, social matters (particularly as to human capital) and governance; their investments in activist funds; and whether they have adopted the stewardship and engagement principles endorsed by the Investor Stewardship Group or *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth* proposed by the World Economic Forum, and, if not, the governance, stewardship and engagement principles the entity follows.

We are optimistic that the upcoming SEC Staff roundtable can be a catalyst to move markets, investors and companies away from short-termism and towards long-term value creation that benefit the United States' economy and create greater prosperity for all of the constituencies involved. Together with other SEC initiatives, such as disclosure simplification reform and a renewed focus on proxy advisor regulation, the roundtable demonstrates the SEC's ongoing commitment to ensuring that the securities laws are designed to meet the needs of modern capital markets.

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Bill Proposal—Corporate Executives Criminally Accountable for Negligent Conduct

Posted by Lev L. Dassin, Jennifer Kennedy Park, and David E. Wagner, Cleary Gottlieb Steen & Hamilton LLP, on Thursday, April 18, 2019

Editor's note: Lev L. Dassin and Jennifer Kennedy Park are partners, and David E. Wagner is an associate at Cleary Gottlieb Steen & Hamilton LLP. This post is based on their Cleary memorandum.

On April 3, 2019, Senator (and Democratic Presidential contender) Elizabeth Warren announced proposed legislation—dubbed the "Corporate Executive Accountability Act"—that would effect a dramatic change in white collar criminal law by permitting prosecution of corporate executives for negligent conduct. Under traditional criminal law principles, defendants must typically have at least knowledge with respect to the conduct that constitutes the crime. However, under Senator Warren's proposed law, executives of large companies could be criminally prosecuted (and fined and/or jailed if convicted) if they are found to have acted negligently in failing to prevent criminal acts committed by the companies they supervise. The bill is unlikely to be enacted, but it nonetheless represents a significant policy indication from a Presidential candidate.

In an op-ed published in *The Washington Post* in parallel to the bill's announcement, Senator Warren expressed the view that "[i]t's time to reform our laws to make sure that corporate executives face jail time for overseeing massive scams."[1] In her words, the bill would "expand[] criminal liability to any corporate executive who negligently oversees a giant company causing severe harm to U.S. families." She predicts that "[i]f top executives knew they would be hauled out in handcuffs for failing to reasonably oversee the companies they run, they would have a real incentive to better monitor their operations and snuff out any wrongdoing before it got out of hand."

The Corporate Executive Accountability Act would apply to executives of companies with annual revenue exceeding $1 billion. Specifically, the bill would apply to such a company's president, vice presidents, and any other officer or person who performs a policy making function,[2] so long as "by reason of the position of the individual in the corporation, [he or she] has the responsibility and authority to take necessary measures to prevent or remedy violations."

[1] Elizabeth Warren, "Corporate executives must face jail time for overseeing massive scams," *The Washington Post* (April 3, 2019), https://www.washingtonpost.com/opinions/elizabeth-warren-its-time-to-scare-corporate-america-straight/2019/04/02/ca464ab0-5559-11e9-8ef3-fbd41a2ce4d5_story.html?utm_term=.d41130dcc928.

[2] The bill incorporates the definition of "executive officer" from 17 C.F.R. § 240.3b-7.

The bill would make it unlawful for such an executive "to negligently permit or fail to prevent" one or more of three types of violations:

1. any federal or state crime for which the company is convicted or enters into a deferred prosecution agreement ("DPA") or a non-prosecution agreement ("NPA");
2. any federal or state civil violation for which the company is found liable or settles and that "affects the health, safety, finances, or personal data of" at least 1 percent of the United States population or at least 1 percent of the population of any state; or
3. any federal or state criminal or civil violation for which the company is convicted or found liable and which was committed while the company was operating under any judgment, DPA or NPA relating to a different criminal or civil violation.

Senator Warren's proposal includes penalties of a fine and/or imprisonment for up to 1 year for a first offense, and a fine and/or imprisonment for up to 3 years for a second offense. The full text of the Corporate Executive Accountability Act is available here.

If enacted, the bill would constitute a dramatic departure from the typical requirements for a criminal conviction. Traditionally, crimes require both a wrongful action and a particular mental state—the *mens rea*, or guilty mind. The required mental state is usually (at a minimum) knowledge with respect to the actions that constitute the crime. The Supreme Court has observed that "[t]he contention that an injury can amount to a crime only when inflicted by intention . . . is as universal and persistent in mature systems of law as belief in freedom of the human will and a consequent ability and duty of the normal individual to choose between good and evil."[3] Negligence—which is the mental state required for conviction under the Corporate Executive Accountability Act—is a much lower threshold, requiring only that a person act unreasonably, and is usually reserved for the context of civil liability.

Imposing criminal liability on corporate executives not personally involved in or aware of wrongdoing is not, however, unprecedented. In fact, Senator Warren has cited the Food, Drug, and Cosmetic Act and the Clean Air Act as examples of other laws that do this. The legal doctrine is known as the Responsible Corporate Officer Doctrine (or the *Park* doctrine, after a 1975 Supreme Court decision[4]). The Responsible Corporate Officer Doctrine extends criminal liability to executives whose subordinates engage in criminal activity, even if the executives are not aware of it, so long as the executives can be deemed responsible for the actors who commit the crime. However, historically this doctrine has been applied narrowly in the context of offenses against the public health and welfare. The Corporate Executive Accountability Act would expand the Responsible Corporate Officer Doctrine to any crime committed by a company, regardless of whether the crime affects the public health or welfare or impacts the general public at all. Moreover, the Responsible Corporate Officer Doctrine extends liability only to "those who by virtue of their managerial positions or other similar relation to the [wrongdoer] could be deemed responsible for [the criminal act]."[5] But the Corporate Executive Accountability Act would focus on negligence, not on whether the executive was responsible for the part of the company that committed the crime. Conceivably, the Corporate Executive Accountability Act could expand the scope of liability to sweep in managers not responsible for the part of the company that engaged

[3] *Morissette v. United States*, 342 U.S. 246, 250 (1952).
[4] *United States v. Park*, 421 U.S. 658 (1975).
[5] *Park*, 421 U.S. at 670.

in the criminal conduct, so long as the managers could be said to have been negligent in failing to prevent the criminal activity.

In addition to the Corporate Executive Accountability Act, Senator Warren has also announced another bill called the “Ending Too Big to Jail Act.” The Ending Too Big to Jail Act would effect three primary changes in the law relating to corporate wrongdoing. First, the bill would reconstitute the Special Inspector General for the Troubled Asset Relief Program (“SIGTARP”) to create a permanent law enforcement agency within the Treasury Department charged with investigating fraud committed by financial institutions. Second, the bill would require certain executives of financial institutions with assets greater than $10 billion to annually certify that they “have conducted due diligence and found that there is no criminal conduct or civil fraud in the financial institution . . . that has not been disclosed in full to the Department of Justice or the applicable regulator.” Third, the Ending Too Big to Jail Act would require courts to make a determination that DPAs are in the public interest before approving them. Senator Warren previously introduced the Ending Too Big to Jail Act in March 2018, but the bill died in committee. The full text of the Ending Too Big to Jail Act is available here.

If enacted, Senator Warren’s bills would accomplish a radical re-working of white collar criminal law. Enactment of these bills seems unlikely in the near future. However, the bills are an important indication of how at least one major Presidential candidate would propose to shift the direction of white collar criminal law.

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The SEC's Current End Game on Proxy Advisory Firms

Posted by Cydney Posner, Cooley LLP, on Thursday, April 25, 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 newest SEC Commissioner, Elad Roisman, who has reportedly gotten the nod to head up the SEC's efforts regarding proxy advisory firms, told the U.S. Chamber of Commerce in late March that he expects the SEC to issue new guidance, sometime after proxy season this year, regarding the use by institutional investors of proxy advisory firm recommendations, as reported in *The Deal*. And, according to the *WSJ*, Roisman has "also questioned whether it was appropriate for the SEC to exempt proxy advisers from some regulations on investment advice, including whether they can both advise a company and make recommendations to its shareholders at the same time." However, as discussed in this PubCo post, the question of whether proxy advisory firms, such as ISS and Glass Lewis, have undue influence over the voting process and should be reined in has long been something of a political donnybrook. With the issue of proxy advisory firm regulation so politically freighted, will the SEC limit the scope of its effort to guidance to institutional investors or, more controversially, go further and impose regulation on proxy advisors, as many companies have advocated?

In 2004, the staff of the Division of Investment Management issued two no-action letters, *Egan-Jones Proxy Services* (May 27, 2004) and *Institutional Shareholder Services, Inc*. (Sept. 15, 2004), which provided staff guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms. Frequently disparaged (see this PubCo post), those two letters were withdrawn by the staff in September 2018, in anticipation of the SEC's proxy roundtable.

SideBar

By way of background, as fiduciaries, investment advisers owe their clients duties of care and loyalty with respect to services provided, including proxy voting. Accordingly, in voting client securities, an investment adviser must adopt and implement policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of its clients. The two now-withdrawn no-action letters indicated that one way advisers could demonstrate that proxies were voted in their clients' best interest was to vote client securities based on the recommendations of an independent third party—including a proxy advisory firm—which served to "cleanse" the vote of any conflict on the part of the investment adviser. Historically, investment advisers *have* frequently looked to proxy advisory firms to fill this role. As a result, the staff's guidance was often criticized for having "institutionalized" the role of—and, arguably, the over-reliance of investment advisers on—proxy advisory firms, in effect transforming

them into *faux* regulators.

As discussed in this Cooley Alert, in response to frequently voiced criticisms that proxy advisory firms wielded too much influence—with too little accountability—in corporate elections and other corporate matters, in 2014, the SEC's Divisions of Investment Management and Corp Fin issued Staff Legal Bulletin No. 20, "Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms," which sought to reinforce the responsibilities of investment advisers as voters by reinvigorating their due diligence and oversight obligations with respect to any proxy advisory firms on which they relied. In that guidance, the staff indicated additional steps that an investment adviser could take to demonstrate that proxy votes were cast in accordance with clients' best interests. In addition, investment advisers were advised to "adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients," including measures to identify and address the proxy advisory firm's conflicts on an ongoing basis. For example, the investment adviser was advised to ascertain, among other things, "whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues." However, the SLB left the two no-action letters in effect, and calls for regulation of proxy advisory firms have continued unabated. (See this PubCo post.)

In the staff statement, the staff indicated that the notice of withdrawal of the two letters was provided to facilitate the discussion at the SEC's 2018 Proxy Roundtable and that it intended to use information and feedback learned at the Roundtable in making recommendations to the SEC with respect to proxy advisory firms, including with regard to SLB 20 (discussed in the SideBar above). (Note that, in remarks yesterday to the SEC Speaks conference, SEC Commissioner Hester Peirce indicated that, with respect to those two no-action letters, in her view, "the letters should never have been issued, and it certainly is time to reassess the industry that grew up around those no-action letters with their purportedly limited reach.")

As it turned out, the panel's discussion at the Proxy Roundtable regarding the power of proxy advisors was remarkably tepid. Surprisingly, there did not seem to be much call for registration or other regulation of proxy advisors, possibly because of the fear of rising costs associated with registration and further regulation. (See this PubCo post.) (Note, however, that, legislators seem to regularly introduce legislation, to no avail, that would require the SEC to regulate proxy advisers. See, for example, the Corporate Governance Fairness Act, introduced in 2018.)

SideBar

At the proxy roundtable, in addition to proxy advisory regulation, the discussion regarding proxy advisory firms addressed robo-voting, conflicts of interest and difficulty in correcting erroneous records. Investment advisors on the panel made the case, with regard to the recommendations of proxy advisors, that 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 was customized. An active fund manager indicated that it needed proxy advisors for its 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.
>
> With regard to 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, had a novel take on the issue: in his view, the real conflict of interest lay 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 regarding social issues that, in Gramm's view, are not in the interests of shareholders. The problem, as he saw it, arises out of the SEC's position that allowed index and other investment funds to fulfill their fiduciary responsibilities by following the advice of proxy advisors. 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. (There was a lot more to it, including allusions to the Enlightenment and the flat-earth society. See this PubCo post.) The State Street representative agreed that it did have a fiduciary responsibility, but that it believed that ESG affects sustainable long-term economic value and shareholder returns and that its strategy involved taking these issues into account. Another issue discussed was the difficulty experienced by smaller companies in attempting to correct the record when errors are made in the proxy advisors' analyses.

Of course, beyond the Roundtable, others have expressed strong views advocating proxy advisor regulation. As discussed in the *WSJ*, lobbyists such as the U.S. Chamber of Commerce and the National Association of Manufacturers, as well as Nasdaq and the NYSE have "mounted a well-funded offensive against the industry." In addition, the *WSJ r*eported, over 300 companies "signed on to a February Nasdaq, Inc. letter calling for the SEC to take 'strong action to regulate proxy advisory firms.'" These corporate groups, the *WSJ* reported, "are pushing the SEC to allow companies more leeway to address the firms' recommendations before they are sent to shareholders, a process that would also allow them to flag any errors in the recommendations. Some corporate groups, including NAM, want the SEC to consider new registration requirements for proxy advisers and add new disclosure requirements related to possible conflicts of interest."

There is, however, prominent opposition to that position. In remarks yesterday at the same SEC Speaks conference, Investor Advocate Rick Fleming identified proxy advisory firm regulation as one of ideas percolating at the SEC that he was "less enthusiastic about" (to put it mildly):

> "I think it is fair to say that investors are wary about efforts to regulate proxy advisors. As many of you know, asset managers who hold shares in a wide range of companies face a logistical challenge in voting on numerous items each proxy season. Investment advisers are also required to vote shares in a way that is faithful to the fiduciary duties they owe their clients. To satisfy this obligation in a cost-effective way, many asset managers use the services of a proxy advisor. In addition to assisting with vote execution and regulatory

> reporting across markets globally, the advisors monitor the issues that are up for a vote, collect and analyze information and data, and give asset managers advice on how to vote their shares in accordance with the asset managers' expressed wishes.
>
> "Some have criticized proxy advisors and allege that they have conflicts of interest in their business models, factual errors in their analytical processes, and a political agenda that supports social policies at the expense of investment returns. All of these things would cause me great concern, except for one thing—the investors who are paying for this service are not the ones who are expressing those concerns. Indeed, at the Roundtable on the Proxy Process that the Commission held last November, I think the investors made it pretty clear that they are relatively happy with the services they receive from proxy advisors. This is not to suggest that proxy advisors are perfect, but to the extent that any problems exist, it seems that their paying customers should be the ones to raise them….
>
> "To be clear, some investors have expressed concerns that fund advisors may cast proxy votes in opposition to the stated objectives of the fund or in ways that are contrary to the interests of the investors in the fund. But, to the extent this is occurring, it involves a question of whether the fund adviser is satisfying its fiduciary duty to the investors in the fund, and the Commission already has authority to deal with that issue. It doesn't require additional oversight of the proxy advisors who generate advice in accordance with the fund adviser's instructions.
>
> "So, if investors aren't calling for increased regulation of proxy advisors, what is driving the push for regulation?… In my view,… the simple fact of the matter seems to be that proxy advisors have given asset managers an efficient way to exercise much closer oversight of the companies in their portfolios, and those companies don't like it. That's understandable, and it is also understandable that companies, rather than directly asking the SEC to suppress shareholder voting or give companies more of a say in the advice that is given, would try to cloak their arguments under the mantle of investor protection. But the investors themselves—again, the ones paying for proxy advice—are not asking for protection. In fact, I keep hearing opposition from investors to proposals that might lead to interference in the proxy voting process."

Fleming's views echo those of SEC Commissioner Robert Jackson, who has indicated that he feared that the SEC's "efforts to fix corporate democracy will be stymied by misguided and controversial efforts to regulate proxy advisors." In effect, he was concerned that the focus on regulating proxy advisors was a shiny object that might well deflect attention from the serious problems affecting the corporate voting system. (See this PubCo post.)

According to *The Deal*, while the precise kind of guidance the SEC would issue is not yet known, the SEC "generally wants to make it easier for investors lacking resources to research voting topics at their portfolio companies, to be permitted not to vote altogether. In an interview with The Deal after his comments, Roisman suggested he was concerned about the use of proxy advisers by some investors, suggesting that some shareholders appear to be adopting policies set by proxy advisers, rather than coming up with their metrics….It is also possible that the SEC could move forward with a regulatory proposal imposing tougher restrictions on proxy advisers. The agency could require proxy advisers to provide draft recommendation reports to companies

before publication for clients, so that businesses can submit comments and criticism, to accompany the initial recommendation report publication."

SideBar

To address one of the complaints often raised about proxy advisors—and perhaps to deter regulatory action by the SEC—Glass Lewis has introduced a pilot for a new service, the Report Feedback Statement. The new service is designed to allow companies and proponents of shareholder proposals to provide feedback—unfiltered, provided that it complies with the RFS Etiquette Guide—about GL's analysis of their proposals directly to GL's "research and engagement team, which will in turn distribute them to clients within our research and voting platforms. Glass Lewis' investor clients will benefit by conveniently receiving unfiltered commentary on our analysis from subject companies and shareholder proponents. That real-time perspective will provide an additional dimension for their consideration and will be easily accessible, with reasonable time to review, even within the peak of proxy season." While there are some processes in place to address correction of factual errors (although many would argue about the effectiveness of these processes), the new service will allow comments to be submitted over differences of opinion, even when the facts are not in dispute.

GL advises subscribers to "limit their statements to their views on Glass Lewis' research, and…refrain from, directly or indirectly, commenting on the views, analysis and vote recommendations of other proxy advisors, and from providing a comparative analysis between the research published by Glass Lewis and the research published by another proxy advisor." In addition, subscribers are required to complete the following steps prior to submitting their Statements:

- "The subscriber has consulted with legal counsel to ensure the submission of its Report Feedback Statement complies with Regulation FD and any other regulatory requirements applicable to the subscriber and its disclosure of information.
- All information included in the Report Feedback Statement is 'publicly available' information, meaning the information has been disseminated in a manner making it available to investors generally as Glass Lewis will not consider, nor distribute material non-public information.
- A good faith effort has been made to ensure that all the information contained in the Report Feedback Statement is accurate.
- None of the statements included in the Report Feedback Statement defame, disparage, disrespect or offend Glass Lewis, its subsidiaries, owners, and employees, or any third party.
- The individual submitting the Report Feedback Statement is an authorized representative of the subscriber, with the authority to submit the Report Feedback Statement on behalf of the subscriber."

As reported in this post from FW Cook, the fees include the cost of acquiring a copy of the relevant Proxy Paper report (on a one-time basis or via subscription) and a distribution fee of $2000 for each Statement submitted. Time will tell whether the new service, and other efforts like it, will be enough to head off potential regulation from the SEC.

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On Proxy Advisors and Important Issues for Investors in 2019

Posted by Rick A. Fleming, U.S. Securities and Exchange Commission, on Sunday, April 21, 2019

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

Good afternoon. I hope you are enjoying this year's edition of SEC Speaks, which gives the public a good overview of all the work that is going on at the Commission. [1] In the Office of the Investor Advocate, we track all of these issues, as well as the activities of the self-regulatory organizations, and this conference can give you some idea of the breadth of issues that are covered by the phenomenal staff in my Office. We also try to provide an important outreach mechanism so that Commissioners and staff can hear directly from investors and their representatives, and I particularly want to commend SEC Ombudsman Tracey McNeil and her counsel, Dan Morris, for putting together an event last week that allowed SEC staff to interact with 60 law students and faculty who represent investors of limited means in law school advocacy clinics.

Like all the speakers at this conference, I remind you that the views I express are my own and do not necessarily reflect the views of the Commission, the Commissioners, or my colleagues on the Commission staff.

This year, there are many important things happening at the Commission, and not just with Regulation Best Interest. In a 15-minute speech, I can't possibly react to every issue that will be raised during this two-day conference, so I would like to highlight just a few items that are on the Commission's agenda this year. From an investor's perspective, there are some really exciting ideas on that agenda, but there are also a few things that are cause for concern.

Let's start with the good news. And for that I should begin by applauding Brett Redfearn and his staff in the Division of Trading and Markets. With the support of Chairman Clayton and the Commissioners, Brett has taken bold steps to address some complex issues that have frustrated investors for years. And on behalf of investors, I want to thank Brett for standing strong for them in the face of opposition that is sometimes aggressive.

[1] The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners or other members of the staff.

As an example, the Commission has heeded the call of the Investor Advisory Committee, [2] the Equity Market Structure Advisory Committee, [3] and numerous other market participants [4] to construct a transaction fee-and-rebate pilot. [5] This pilot will test whether the 30 mil fee cap adopted in Reg NMS [6] has led to a system of fees and rebates that distort the incentives of market participants, presenting broker-dealers with a potential conflict of interest that could compromise their duty to pursue best execution on behalf of their clients. In addition, Brett has pushed two other important but lesser-known rules across the finish line. The first of these created a new Form ATS-N to require enhanced disclosure about the operations of Alternative Trading Systems, sometimes known as dark pools, that trade NMS equity securities. [7] This new rule will give investors and their intermediaries the information needed to assess the operations and order routing of an ATS and, ultimately, to help achieve best execution of their stock orders. Similarly, amendments to Rule 606 of Reg NMS will require brokers to disclose more information about their equity order routing practices so that institutional investors have better tools to evaluate the level of execution quality they are receiving. [8]

On top of these achievements, the Division of Trading and Markets continues to pursue an agenda that should please investors. [9] For example, amendments to Rule 15c2-11 [10] could help to deter fraud against retail investors by curbing the trading of unlisted, over-the-counter securities when little or no relevant information about the issuer is publicly available. Likewise, updates to the definition of a "penny stock" and the related sales practice rules [11] could strengthen investor protections in a risky corner of the market. And a refresh of the antiquated transfer agent rules [12] could curb abuses such as the improper removal of restrictive legends, a practice that facilitates the illegal public distribution of securities.

The Commission's anticipated improvements to equity market structure also would benefit retail investors, either directly or as participants in pooled investment vehicles such as mutual funds or pension funds. Investors ultimately bear the costs of the fees that equity exchanges charge their members for market data, so investors would benefit from proposals to enhance the transparency around the exchanges' proprietary data fees, improve the governance of NMS plans, and update

[2] *See* SEC, Recommendation of the Investor Advisory Committee in support of the Transaction Fee Pilot for NMS Stocks (Sept. 13, 2018), https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-transaction-fee-pilot-for-nms-stocks.pdf.

[3] *See* SEC, Recommendation of the Equity Market Structure Advisory Committee for an Access Fee Pilot (July 8, 2016), https://www.sec.gov/spotlight/emsac/recommendation-access-fee-pilot.pdf.

[4] *See*, *e.g.*, Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to Brent J. Fields, Secretary, SEC, dated May 10, 2018, Letter from Joseph Brennan, Principal & Global Head of Equity Investment Group, Vanguard, to Brent J. Fields, Secretary, SEC, dated May 25, 2018, and Letter from Kevin Duggan, Managing Director, Execution & Treasury, Capital Markets, Ontario Teachers' Pension Plan, et al., to Brent J. Fields, Secretary, SEC, dated May 25, 2018, *available at*https://www.sec.gov/comments/s7-05-18/s70518.htm.

[5] *See* Final Rule, Transaction Fee Pilot for NMS Stocks, Exchange Act Release No. 84875 (Dec. 19, 2018), 84 Fed. Reg. 5202 (Feb. 20, 2019) (File No. S7-05-18), https://www.federalregister.gov/d/2018-27982.

[6] CFR § 242.610(c).

[7] *See* Final Rule, Regulation of NMS Stock Alternative Trading Systems, Exchange Act Release No. 83663 (July 18, 2018), 83 Fed. Reg. 38768 (Aug. 7, 2018) (File No. S7-23-15), https://www.federalregister.gov/d/2018-15896.

[8] *See* Final Rule, Disclosure of Order Handling Information, Exchange Act Release No. 84528 (Nov. 2, 2018), 83 Fed. Reg. 58338 (Nov. 19, 2018) (File No. S7-14-16), https://www.federalregister.gov/d/2018-24423.

[9] *See* Chairman Jay Clayton and Brett Redfearn, Director, Division of Trading and Markets, SEC, Equity Market Structure 2019: Looking Back and Moving Forward, New York, NY (March 8, 2019), https://www.sec.gov/news/speech/clayton-redfearn-equity-market-structure-2019.

[10] 7 CFR § 240.15c2-11.

[11] 7 CFR § 240.3a51-1, 17 CFR § 240.15g-9.

[12] *See* Advance Notice of Proposed Rulemaking and Concept Release, Transfer Agent Regulations, Exchange Act Release No. 76743 (Dec. 22, 2015), 80 Fed. Reg. 81948 (Dec. 31, 2015), https://www.federalregister.gov/d/2015-32755.

the required "core data" that is widely distributed by central securities processors (or the "SIP"). [13] I am also interested in the idea of suspending the "unlisted trading privileges," or UTP, of non-listing exchanges in an effort to improve liquidity in thinly traded shares. [14] While I doubt that concentration of trading on one venue will, by itself, solve the problem of illiquidity, I believe it holds promise for the host exchange to experiment with ideas like batch auctions that may further improve the trading environment, particularly for smaller public companies and their investors.

As I have just outlined, investors have reason to hope for positive developments in the coming year at the Commission. And I love the part of my job where I get to be a cheerleader for these types of good ideas. But, as you can imagine, there are other ideas that have been suggested for the Commission to consider, [15] and I am less enthusiastic about some of those things. Let me comment briefly about one of those.

I think it is fair to say that investors are wary about efforts to regulate proxy advisors. As many of you know, asset managers who hold shares in a wide range of companies face a logistical challenge in voting on numerous items each proxy season. Investment advisers are also required to vote shares in a way that is faithful to the fiduciary duties they owe their clients. To satisfy this obligation in a cost-effective way, many asset managers use the services of a proxy advisor. In addition to assisting with vote execution and regulatory reporting across markets globally, the advisors monitor the issues that are up for a vote, collect and analyze information and data, and give asset managers advice on how to vote their shares in accordance with the asset managers' expressed wishes.

Some have criticized proxy advisors and allege that they have conflicts of interest in their business models, factual errors in their analytical processes, and a political agenda that supports social policies at the expense of investment returns. [16] All of these things would cause me great concern, except for one thing—the investors who are paying for this service are not the ones who are expressing those concerns.

Indeed, at the Roundtable on the Proxy Process that the Commission held last November, I think the investors made it pretty clear that they are relatively happy with the services they receive from proxy advisors. [17] This is not to suggest that proxy advisors are perfect, but to the extent that any problems exist, it seems that their paying customers should be the ones to raise them. Investors certainly don't want those problems to be "solved" by injecting costly inefficiencies into an already-cumbersome process or by giving companies more opportunities to influence the advice that is given to investors about how they should vote. [18] Investors can already get a company's

[13] *See supra* note 9.

[14] *Id.*

[15] *See* Chairman Jay Clayton, SEC, SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks, New York, NY (Dec. 6, 2018), https://www.sec.gov/news/speech/speech-clayton-120618. *See also* Tom Quaadman, Executive Vice President, Chamber of Commerce Center for Capital Markets Competitiveness, to Brent J. Fields, Secretary, SEC, dated Nov. 12, 2018, and Timothy M. Doyle, Vice President of Policy and General Counsel, American Council for Capital Formation, to Brent J. Fields, Secretary, SEC, dated Nov. 14, 2018, *available at* https://www.sec.gov/comments/4-725/4-725.htm.

[16] *See* Testimony of The Hon. Daniel M. Gallagher and Thomas Quaadman before the Senate Committee on Banking, Housing, and Urban Affairs at a hearing entitled "Proxy Process and Rules: Examining Current Practices and Potential Changes," Dec. 6, 2018, *available at*https://www.banking.senate.gov/hearings/proxy-process-and-rules-examining-current-practices-and-potential-changes.

[17] See the Transcript of the Commission's Roundtable on the Proxy Process, Nov. 15, 2018, https://www.sec.gov/files/proxy-round-table-transcript-111518.pdf.

[18] It has been suggested that companies should be given an opportunity to correct errors in the proxy advisors' analysis, and at least one commenter has a provided a list of such "errors." See, for example, Frank M. Placenti, "Are Proxy Advisors Really a Problem?," Oct. 2018, http://accfcorpgov.org/wp-

response to a shareholder proposal in a company's amended proxy statement or additional soliciting material. What they want from a proxy advisor, and what they are paying for, is independent advice that fits within the parameters they have established for how they want to vote on various matters.

To be clear, some investors have expressed concerns that fund advisors may cast proxy votes in opposition to the stated objectives of the fund or in ways that are contrary to the interests of the investors in the fund. [19] But, to the extent this is occurring, it involves a question of whether the fund adviser is satisfying its fiduciary duty to the investors in the fund, and the Commission already has authority to deal with that issue. It doesn't require additional oversight of the proxy advisors who generate advice in accordance with the fund adviser's instructions.

So, if investors aren't calling for increased regulation of proxy advisors, what is driving the push for regulation? To me, and to many interested observers, the answer is pretty obvious, as reflected in a few recent headlines:

- Companies Call for Oversight of Firms That Advise Shareholders (*Wall Street Journal*) [20]
- Corporate America Loves Deregulation. Then Why Is It Pushing for These Rules? (*CNN Business*) [21]
- What's Behind a Pitch for the Little-Guy Investor? Big Money Interests (*New York Times*) [22]

In my view, and as these articles suggest, the simple fact of the matter seems to be that proxy advisors have given asset managers an efficient way to exercise much closer oversight of the companies in their portfolios, and those companies don't like it. That's understandable, and it is also understandable that companies, rather than directly asking the SEC to suppress shareholder voting or give companies more of a say in the advice that is given, would try to cloak their arguments under the mantle of investor protection. But the investors themselves—again, the

content/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf. The actual list is available here: http://accfcorpgov.org/wp-content/uploads/2018/10/Analysis-of-Proxy-Advisor-Factual-and-Analytical-Errors_October-2018.pdf. In my view, however, much of what the report author identified as "errors" would more appropriately be characterized as differences of opinion. Moreover, the Commission historically has been reluctant to allow companies to influence the research provided to investors. Consider, for example, the rules currently in place for sell-side research, which generally aim to prevent issuers from influencing the research produced by investment firms. FINRA Rule 2241 requires broker-dealers to adopt and maintain written policies and procedures "reasonably designed to promote objective and reliable research that reflects the truly held opinions of research analysts and to prevent the use of research reports or research analysts to manipulate or condition the market or favor the interests of the member or a current or prospective customer or class of customers." I ask, why should the principle be any different when it comes to the independence of voting recommendations? *See* Letter from Donna F. Anderson, Head of Corporate Governance, and Eric Veiel, Co-Head of Global Equity, T. Rowe Price, to Brent J. Fields, Secretary, SEC, https://www.sec.gov/comments/4-725/4725-4792350-176928.pdf (making this argument).

[19] *See* Lewis Braham, "Fund Sustainability Ratings Tell Half the Story," Barron's, Oct. 9, 2017, https://www.barrons.com/articles/sustainability-ratings-tell-half-the-story-1507350027.

[20] Gabriel T. Rubin, "Companies Call for Oversight of Firms That Advise Shareholders," The Wall Street Journal, Mar. 19, 2019, https://www.wsj.com/articles/companies-target-firms-that-advise-shareholders-11552987800.

[21] Matt Egan, "Corporate America loves deregulation. Then why is it pushing for these rules?," CNN Business, Mar. 29, 2019, https://www.cnn.com/2019/03/29/investing/regulation-proxy-advisory-reform-sec/index.html?utm_medium=social&utm_term=image&utm_source=twbusiness&utm_content=2019-03-29T11%3A20%3A02.

[22] Andrew Ross Sorkin, "What's Behind a Pitch for the Little-Guy Investor? Big Money Interests," The New York Times, July 24, 2018, https://www.nytimes.com/2018/07/24/business/dealbook/main-street-investors-coalition.html.

ones paying for proxy advice—are not asking for protection. In fact, I keep hearing opposition from investors to proposals that might lead to interference in the proxy voting process. [23]

There are plenty of things that need to be fixed in the proxy process. For example, there seems to be growing consensus that the basic "plumbing" of the voting system can be made more efficient and reliable by giving greater attention to issues like vote confirmation and reconciliation of records. [24]But, absent a groundswell of concerns expressed by actual investors, I sincerely hope that the Commission will not prioritize a rulemaking that could impair the independence of proxy advice or lead to even greater inefficiencies in proxy voting. As a practical matter, it is hard to imagine, based on the feedback I've seen to date, that a serious economic analysis could justify a rulemaking to cure a purported harm when the investors—the supposed victims of the harm—have denied that a significant problem exists.

Again, no one is claiming that proxy advisors are perfect, but in light of all the important things that the Commission could spend its time on—including the initiatives I highlighted earlier—I would respectfully suggest that imposing new regulations on proxy advisers should be given a low priority.

Thank you.

[23] *See, e.g.,* Letter from Jeff P. Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Michael Crapo, Chairman, Senate Committee on Banking, Housing, and Urban Affairs et al., Dec. 5, 2018, available at https://www.cii.org/correspondence.

[24] *See* John Coates, Report to SEC Investor Advisory Committee, Dec. 13, 2018, webcast available at https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac121318 ("The SEC had a full day of proxy-related discussion a few weeks ago, and…there seems to be pretty general consensus that things can be improved in terms of vote confirmations and reconciliation of records to allow for efficient and reliable voting and improving the ability of retail and other shareholders to vote through a universal proxy."); SEC Roundtable on the Proxy Process, Panel One—Proxy Voting Mechanics and Technology, Nov. 15, 2018, transcript available at https://www.sec.gov/files/proxy-round-table-transcript-111518.pdf.

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Providing Retail Investors a Voice in the Proxy Process

Posted by J.W. Verret (George Mason University), on Thursday, April 25, 2019

Editor's note: J.W. Verret is Associate Professor at George Mason University Antonin Scalia Law School and Managing Director of Veritas Financial Analytics LLC. This post based on a survey report that Professor Verret designed in collaboration with Spectrem Group, available here.

As the SEC continues its consultation into the proxy process, in particular its consideration of the role of proxy advisory firms in that process, it's more important than ever to understand how this process affects average retail investors and what, if any, changes they'd like to see. To that end, I collaborated with wealth management research specialist Spectrem Group, to design a survey of retail investor to hear directly from the ultimate stakeholders of proxy voting.

This survey of more than 5,000 retail investors—including those accessing the capital markets through pension funds or private retirement accounts—reveals that retail investors are indeed concerned about the growing influence of the proxy advisory firms and that their concerns are only magnified as they learn more about this opaque part of the proxy process.

Below are the recommendations provided within the report—which can be accessed here.

Recommendations—by J.W. Verret

1. Conflicts of Interest at Proxy Advisors

In determining what regulatory steps to take, it's worthwhile to reiterate *"those who have put or are putting $50, $100, $200 a month away for years and years"* are the most critical audience of consideration. This survey provides a rich resource for the SEC by soliciting views on the issue of proxy advisors directly from retail investors.

If ISS and Glass Lewis were conflict free, offered robust recommendations based on increasing shareholder value and did not obtain demand for their services in part through regulatory pressure, then there would be little reason for the Commission to take action on these issues. Unfortunately, that is not the case.

Conflicts of interest at the two dominant firms in the proxy advisory industry manifest themselves in two primary ways. The first and more subtle conflict is the influence of proxy advisors' clients on the recommendations issued. Substantial income is provided by "socially responsible" investing funds to proxy advisors, which are in turn incentivized to favor proposals that are

backed by these clients. When retail investors were apprised of this problem, they strongly demanded responsive action from the Commission.

These conflicts of interest are exacerbated by the level of market power the top two firms enjoy. Retail investors expressed concern about this as well. Twenty-nine percent of participants expressed some familiarity with the dominant proxy advisory firm, ISS. Fifteen percent expressed some familiarity with the second-largest proxy advisor, Glass Lewis. When told that some are concerned that ISS and Glass Lewis represent a duopoly in the market, limiting new competitor entrants, an overwhelming 76 percent of respondents expressed some level of concern.

While it would not be appropriate for the SEC to directly regulate the market share of proxy advisory firms, this research does suggest retail investors would welcome Commission attention to rules that may entrench the dominant position of these firms, in addition to devoting attention to conflicted advisory fees that further cement the dominant position of ISS in the market.

The current dynamic for proxy advisors deviates from a focus on shareholder value, generating private benefits to a subset of investors at the expense of the average diversified investor. This has implications for another of the roundtable's areas of focus: the role of shareholder proposals in the proxy process. In effect, proxy advisors have been granted the ability to wield the aggregate influence of their clients to the benefit of a particular type of investor—potentially at the expense of the interests and expectations of retail investors.

The second and more obvious conflict that exists in the proxy advisory industry is the provision of consulting services to the same issuers about which recommendations are issued to investors. The implicit threat of receiving a negative recommendation from ISS is a cornerstone of the offering from that same company to publicly listed companies.

There are analogous concerns over conflicts of interest in other areas of financial services, particularly those stemming from the provision of consulting services. The investment community itself (including the Council for Institutional Investors and California Public Employees' Retirement System) has been steadfast in arguing against the provision of consulting services by a company's external auditor. Simply disclosing and "mitigating" the existence of a material conflict would not be seen as acceptable to auditors or credit rating agencies; it is unclear as to why it is sufficient for the proxy advisor industry. A proxy advisor simultaneously providing governance advisory services and recommendations is akin to an auditor providing an issuer with guidance on how to navigate an external audit.

The retail investor survey shows that retail investors do not take the same "see no evil, hear no evil" approach to conflicts of interest at proxy advisory firms, but instead quickly see the case for addressing conflicts of interest at proxy advisors and would welcome Commission action to address this issue. While additional disclosure about conflicts of interest may prove helpful, the substantial market power given to ISS through prior Commission action suggests prohibition may be warranted for conflicted consulting provision by proxy advisors.

The concerns of retail investors are compounded by their relative lack of involvement in the proxy process. Only 50 percent of respondents, 2,567, had ever voted their shares, though 68 percent expressed some level of interest in voting their shares in future meetings. Forty-nine percent

responded that they wanted more information from asset managers on how shares are voted; only 33 percent suggested current vote disclosure by asset managers was sufficient.

This result is consistent with the notion that retail shareholders don't tend to see active voting as beneficial. At the same time, when made aware of the potential that shares may be voted on their behalf in ways that conflict with their interest by asset managers, retail investors would prefer additional disclosure.

2. Proxy Advisor Disclosure

The objective of corporate governance is the enhancement and protection of shareholder value; however, it remains unclear what role shareholder value plays in the processes and methodologies of proxy advisors. In fact, the evidence appears to point to the contrary, as a lack of capacity and capability, conflicts of interest and ideological bias result in proxy advisor recommendations by ISS and Glass Lewis depleting shareholder value.

The retail investor survey shows that the social and political focus of many proxy advisory firms is inconsistent with the shareholder return focus of most retail investors. Further, many investors are eager for disclosure about how these conflicts of interest may be impacting their portfolios.

In two separate Stanford University studies, [1] researchers found that the recommendations of ISS negatively impacted shareholder value, with investors better off ignoring ISS. ISS also promulgates other corporate governance policies for which the empirical evidence is mixed, at best, including the right to nominate director candidates to the corporate proxy, [2] options repricing, [3] independent chairs [4] and Golden Parachutes. [5] While these policies are certainly favored by politically minded institutional investors—ISS's largest clients—they are not clearly linked to the enhancement of shareholder value and thus stronger returns to the ultimate beneficiaries of mutual funds.

In many ways, it would be unreasonable to expect the two dominant proxy advisors to be effective in providing accurate and nuanced corporate governance advice to investors. ISS's website states that it covers over 42,000 meetings a year for a client base in excess of 1,700, while Glass Lewis produces analysis on more than 20,000 companies. The combination of minimal resources and significant influence is cause for concern and should provide an impetus for greater SEC oversight in order to protect investors.

[1] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policy" (Rock Center for Corporate Governance at Stanford University Working Paper No. 119, Stanford, CA, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 2101453. David Larcker, "Do ISS Voting Recommendations Create Shareholder Value?" (Rock Center for Corporate Governance at Stanford University, Closer Look Series: Topics, Issues and Controversies in Corporate Governance and Leadership No. CGRP-13, Stanford, CA, April 19, 2011): 2, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1816543.

[2] See Thomas Stratmann and J.W. Verret, "Does Shareholder Proxy Access Damage Share Value in Small Publicly Traded Companies?," *Stanford Law Review* 64 (2011): 1431–68.

[3] The debate over whether options repricing is material to executive compensation packages is explored in Brian J. Hall and Thomas A. Knox, "Underwater Options and the Dynamics of Executive Pay-to-Performance Sensitivities," *Journal of Accounting Research* 42, no. 2 (May 2004): 365–412.

[4] See generally Roberta Romano, *Foundations of Corporate Law*, 2nd ed. (New York: Thomson Reuters/Foundation Press, 2010) 410–25

[5] See generally Richard A. Lambert and David F. Larcker, "Golden Parachutes, Executive Decision Making and Shareholder Wealth," *Journal of Accounting and Economics* 7 (1985).

By policy, Glass Lewis does not provide issuers with any opportunity to review recommendations and is only piloting their RFS process, while ISS limits the opportunity to only the largest companies in the United States. Eighty-one percent of survey respondents expressed some level of concern when presented with a study suggesting that major proxy advisors did not provide issuers with an opportunity to comment on adverse proxy recommendations in 84 percent of cases.

This concern from retail shareholders is unsurprising—ISS itself accepts that the review process is of benefit to multiple stakeholders:

"ISS believes that this review process helps improve the accuracy and quality of its analyses, an outcome that is in the best interests of both the institutional investors for whom the analyses are prepared, as well as for the companies that are the subject of these reports." [6]

BlackRock, the world's largest asset manager, also expressed a preference for the SEC to explore technology solutions such as a digital portal for the review of draft company reports, which would provide companies with at least two business days to correct errors prior to the report's publication to shareholders and allow companies to submit a rebuttal to be included in the final report. [7]

When asked how much time issuers should be granted to review proxy advisor recommendations and remedy potential errors, the largest share of respondents (29 percent) suggested an appropriate time period to be between one and two weeks. Seventy-nine percent of respondents expressed some level of support for the SEC addressing the concern that proxy advisors fail to engage with issuers.

With over half of U.S. annual general meetings taking place in a three-month period, both advisors must, by necessity, put in place rigid methodologies in order to produce the volume of reports they do. The problem with rigid methodologies is that they simplify the complexities of business reality and do not allow for case-by-case appraisals of company practices and disclosure.

The inability of the two dominant proxy advisors to offer company- and circumstance-specific recommendations, and the limited empirical evidence supporting those recommendations, calls into question whether ERISA and mutual fund fiduciaries are fulfilling their obligations in relying on the proxy advisor advice of ISS and Glass Lewis.

Eighty-four percent of respondents stated they were concerned with the practice of robo-voting, with only 3 percent of investors failing to indicate support for the SEC to address this issue. Eighty-six percent of respondents supported SEC action to improve transparency in proxy advisors, and 83 percent of respondents offered some level of support for Commission action to address the problem of errors in proxy advisor recommendations.

Disclosure can only help shine the light on what proxy advisors are actually delivering. Retail investors may have the right idea. Fewer votes on wasteful ballot issues may be the right approach, in which case intermediary institutions will have less need for proxy advisors. This is

[6] https://www.issgovernance.com/iss-draft-review-process-u-s-issuers/
[7] https://www.sec.gov/comments/4-725/4725-4656351-176506.pdf (November 16, 2018)

particularly true when the dominant players in this industry are motivated by conflicts that run counter to the interests and expectations of most retail investors—the ultimate beneficiaries for whom the SEC wants to improve the proxy process.

3. Clarification of Fund Fiduciary Duties with Respect to Share Voting

While there are times when active share voting can generate value for investors, it remains unclear whether that is always the case system-wide. Institutional investors should be able to establish a default voting process that votes with management, absent a clear red flag suggesting further inquiry is necessary. Based on the SEC's current guidance, it is not clear that institutional investors could establish such a policy. The SEC could remedy that problem with a change in its mutual fund voting guidance.

The Commission observed in its original release that "there may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client." While it would appear the Commission is indicating it does not require active voting by mutual funds, in fact the adopting release taken as a whole suggests a presumption in favor of active voting management, with the burden on funds to show that active voting is not beneficial.

A large percentage of shareholder proposals, on which proxy advisors provide recommendations, are defeated. Indeed, in 2017, only 5 percent of all shareholder proposals received a majority vote of support; 95 percent of them were rejected. [8]

The SEC should elaborate on language in its original adopting release to swap the presumption in favor of active voting by management to instead permit fund managers to refrain from voting—unless it is clearly demonstrated that the benefits of actively voting exceed costs. It should instead explicitly permit funds to adopt voting policies that reflect the lack of value in many voting contests. Asset managers should be able to adopt policies that eschew voting in general in instances of shareholder proposals, or adopt policies tailored to vote with management unless red flags listed by the fund's management are triggered (such as a recent restatement).

An externality of the SEC's interpretation is the prevalence of robo-voting, an issue cited by retail investors as the most concerning. By appearing to remove the ability of institutional investors to adopt policies that allow for defaulting their vote in favor of management, regulatory guidance has channeled the collective influence of those same investors into the hands of two proxy advisors—neither of which owns a single share in a public company nor has a fiduciary obligation to any retail investor. In practice, through robo-voting, investors can default voting to proxy advisors but not to management.

The Commission should also make clear that if fund managers adopt voting policies intended to further political or social causes important to the fund's managers or controlling shareholder—which have not been shown to enhance shareholder value—those fund managers may violate their fiduciary duties to the fund's beneficiaries.

[8] See James R. Copland and Margaret M. O'Keefe, *Proxy Monitor 2017: Season Review*, at http://www.proxymonitor.org/Forms/pmr_15.aspx.

These conflicts could be manifested in many ways, including informal pressure during board elections or merger approvals. The most direct way they appear is via shareholder proposals, most of which are fairly characterized as displays of personal, political or social policy preferences with little relationship to shareholder value. Proxy Monitor observes that “proposals related to social or policy concerns with a limited relationship to share value constituted 56 percent of all shareholder proposals in 2017.” [9] Given that institutional shareholders and the proxy advisors they employ should vote their shares in line with the interests of their clients and retail investors, the onus to clearly articulate a link between any proposal and shareholder value should set a high bar. Proxy Monitor tracks that from 2006 through 2015, companies received 1,347 shareholder proposals related to social or political matters. None of those proposals received a majority of shareholder support, [10] yet they place a cost on companies and other shareholders.

The complete publication is available here.

[9] *Id.*
[10] *Id.*

Tab II: Engagement Between Issuers and Investors

What we do. How we do it. Why it matters.

Vanguard Investment Stewardship Commentary

April 2019

Glenn Booraem, Vanguard Investment Stewardship Officer

- As the industry's only mutually owned investment company, Vanguard takes seriously its responsibility to represent the interests of the more than 20 million people who invest in Vanguard funds. As more investors have flocked to Vanguard and especially to the index funds pioneered by its founder, the late John C. Bogle, we have grown only more steadfast in our sense of responsibility for our clients and our safeguarding of their interests.

- In this commentary, we look at the history of corporate governance, the vast improvements in it over the past few decades, and opportunities for further improving governance and investment stewardship.

- We also seek to reframe the conversation about sustainable investing. When a Vanguard fund—particularly an index fund—invests in a company, we expect that the fund may hold shares of that company conceivably forever. The way a board governs a company—including its oversight of material environmental and social risks—should be aligned to create sustainable value long into the future.

- Finally, we differentiate Vanguard's role as a provider of both index and actively managed funds by exploring the different approaches that index and active managers may take to investment stewardship.

Vanguard®

Over the past several decades, investors have increasingly turned to index funds as a way to invest for a secure financial future. Investors have recognized the benefits of buying and holding the entire market through these low-cost, highly diversified, tax-efficient funds. The increasing reliance on index funds has spurred greater interest in how stewards of index fund assets—such as Vanguard—fulfill their obligations to the funds and their shareholders.

Academics, regulators and other policymakers, and investors have increasingly debated two issues related to this obligation:

- **Corporate governance**—the balance of rights and responsibilities between corporate boards and companies' shareholders.
- **Investment stewardship**—the ways that asset managers/asset owners care for the assets entrusted to them by investors/beneficiaries.

We believe that good governance and effective stewardship can add value over the long term for all shareholders. This is evident as we review the history of governance, including high-profile failings and the significant improvements that have been enacted in their wake.

Vanguard's Investment Stewardship program represents the interests of the more than 20 million people around the globe who invest in Vanguard funds. Vanguard offers investors both index funds and actively managed funds, including active funds managed by 25 third-party investment advisors, such as Wellington Management Company LLP, headquartered in Boston, Mass., and Baillie Gifford Overseas Ltd., a U.K.-based asset manager. The roles of index fund managers and active fund managers differ, and on the next page we detail our plans to further integrate the investment management and stewardship capabilities of the external advisors of Vanguard's active funds.

Finally, this commentary delves into future opportunities for improving governance and stewardship, including the convergence of global standards and practices, the alignment of global reporting frameworks, and a greater appreciation of the views of long-term shareholders

Where we've been

Good governance is good for investors . . .

A large and growing body of knowledge points to the positive relationship between good governance and good outcomes for shareholders. Some studies look at the return profiles of companies with strong governance versus those with weak governance; some look at the relationships between stock market valuations and overall assessments of governance quality. Others review more nuanced topics such as the passage of shareholder proposals calling for better governance structures, or the impact of antitakeover measures on shareholder value.* And although no one simple metric translates directly into basis points of company outperformance, the body of evidence, in the aggregate, tilts very much in the positive direction.

. . . and governance has improved

Corporate governance has evolved and improved over the past several decades. Many of the changes—whether driven by corporations, regulators, or investors—aimed to prevent painful history from repeating itself.

For example, in the 1980s, activist investors—known then as corporate raiders—waged a number of hostile takeovers at companies where they saw bad governance, bad management, inefficiency, and bloat. The activists took large ownership stakes, made changes to pump up a company's value in the short term, then sold their stakes for a quick profit. Corporate boards took notice and said, essentially, "If we don't want to be the target of the next hostile bid, we need to improve management and we need to improve governance." And soon, governance practices improved.

In the United States, the Enron, WorldCom, and Tyco corporate scandals of the early 2000s and the failures of risk oversight during the global financial crisis wiped out billions of dollars in value for investors. These events led to tighter listing standards at major stock exchanges and to legislation, such as the Sarbanes-Oxley Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act, that strengthened governance regulation.

* See References on page 15.

Same goals, different approaches

Vanguard plans to tighten the integration between portfolio management and proxy voting for our externally managed active funds. Here's what you need to know.

Although index funds still represent the majority of Vanguard's total assets under management, we have for many years worked with high-performing external investment managers to underpin our active product range. As of February 2019, Vanguard's 25 external fund managers oversaw more than $471 billion in equity assets across portions of 27 Vanguard funds.

Historically, proxy voting on behalf of all of Vanguard's index and active funds has been administered centrally by Vanguard's Investment Stewardship team. In the first half of 2019, the boards of trustees of Vanguard's externally managed funds instructed Vanguard to give full proxy voting privileges to the funds' external managers, creating a greater alignment of investment management and investment stewardship on a fund-by-fund basis. The transitions are expected to be completed by the end of 2019.

Crucially, nothing has changed about Vanguard's philosophy on proxy voting. Our Investment Stewardship program remains grounded in our four principles of good governance: board composition, oversight of strategy and risk, executive compensation, and governance structures.

We believe this move clarifies the roles and responsibilities of Vanguard's Investment Stewardship team and those of our external subadvisors. As we have increasingly collaborated with the carefully chosen external active managers overseeing Vanguard's active funds and as the governance ecosystem has evolved, it has become clear that integrating proxy voting and engagement activities with the manager's investment strategy is a value-add for our fund investors.

The approaches may differ on questions of detail and emphasis, but our actively and passively managed funds share a similar goal: to invest in companies that generate consistent, long-term value for their shareholders.

The type of fund can affect the approach to investment stewardship

	Average industry passively managed fund	Average industry actively managed fund	Vanguard actively managed funds
Average portfolio turnover	Low	High (relative to index funds)	Low (relative to average actively managed fund)
Holding period	Practically permanent owners	Temporary owners	Behaviorally long-term
Decision to add company	Company added to index by index provider	Manager views stock as undervalued	Manager views stock as undervalued
Decision to sell company	Company removed from index by index provider	Stock hits price target or falls out of favor with manager	Stock hits price target or falls out of favor with manager
Engagement program	Focuses on governance topics	Focuses on governance topics, earnings, and capital allocation decisions	Focuses on governance topics, earnings, and capital allocation decisions

Source: Vanguard.

Across Europe, Asia, and Australia, failures of governance that enabled financial scandals, environmental calamities, and the erosion of shareholder rights have inspired the adoption of more rigorous codes, standards, and regulations. This action has been significantly driven by Vanguard and other asset managers and asset owners advocating over time on behalf of their shareholders and beneficiaries.

At the same time, individual investors have been gaining more of a collective voice on governance matters through the mutual funds in which they're investing for retirement, education, and other long-term goals. Vanguard has worked closely with like-minded asset managers to reshape the governance ecosystem to serve in the best interest of long-term investors; we are among the founding signatories to major initiatives such as the Investor Stewardship Group's Framework for U.S. Stewardship and Governance and the Commonsense Corporate Governance Principles. We were also a driving force behind the Coalition for Inclusive Capitalism's EPIC initiative, which focused on identifying metrics that help companies articulate long-term value to investors and other stakeholders.

A decade of progress

The decade following the global financial crisis brought a sea change in governance practices across most developed markets. At the heart of the change has been better communication between investors and boards of directors. More asset managers have been forthcoming with their expectations of portfolio companies—moving beyond merely publishing their proxy voting guidelines, as required of mutual funds since 2003. At the same time, companies and boards have better used disclosure to explain their approach to governance. The past decade also gave rise to the now-widespread practice of shareholder engagement, with independent board members and/or leadership teams meeting with investors to discuss governance matters.

Better communication of expectations has yielded better governance. We've seen improvements to shareholder protections, such as more companies holding annual elections of directors using majority voting standards, and expanded adoption of proxy access and other shareholder-rights measures. The approach to executive compensation/remuneration has also evolved in many markets to align more with the interests of long-term shareholders, with wider adoption of performance-linked pay plans.

Vanguard has been among the firms driving this marketwide evolution. We have continually expanded our investment stewardship efforts, from a small group focused on guideline-driven voting nearly 20 years ago to a dedicated team of more than 30 multidisciplinary analysts today.

Vanguard continues to influence the governance ecosystem in ways that we believe benefit our fund shareholders over the long term. This influence has ranged from periodic open letters to corporate boards from Vanguard's CEO to an ever-expanding body of topical thought leadership and reporting on our investment stewardship efforts. Members of our senior leadership and Investment Stewardship team have been recognized every year since 2010 by the National Association of Corporate Directors as leading influencers shaping boardroom practices and performance.

Vanguard leaders also serve in advisory roles in many leading organizations shaping the global governance dialogue. For example, we are a founding member of the Investment Stewardship Group, an investor-led effort to develop baseline expectations of corporate governance for U.S. companies. The ISG and its members—60 U.S. and international institutional investors representing $31 trillion in U.S. invested assets—are encouraging companies to begin disclosing how their governance principles align with ISG's framework, and we've already seen evidence of the framework's early adoption.

As a result of this advocacy, we've also seen the role of corporate boards evolve. Higher expectations are placed on board members today. Decades ago, a board served largely to "review and approve." Now, directors play a more integral role in the oversight of strategy and risk. Boards are generally becoming more thoughtful about their composition and disclosing how the diverse range of skills, characteristics, and expertise in the boardroom evolves in alignment with a company's strategy. We have been encouraged by this trend.

Corporate governance over the past three decades

The timeline below reflects on key points in corporate governance history that profoundly shaped regulatory change and gave shareholders a powerful voice in influencing governance matters at the companies they invest in.

At the turn of the century, massive financial scandals at a number of large corporations exposed critical gaps in risk oversight and accountability within boards of directors. The widespread governance failures drew attention to a greater need for legislation to protect shareholders, hold executives and directors accountable for their companies' actions, and increase transparency.

These events reinforced the need for stronger governance practices and continue to influence the evolution of corporate governance.

1990s

1990–1999
Proxy changes

Throughout the 1990s, the U.S. Securities and Exchange Commission (SEC) adopts significant changes to proxy rules, increasing the information that companies must provide to shareholders.

1998
U.K. Corporate Governance Code

2000s

2001–2002
U.S. corporate scandals

Governance failures at Enron, WorldCom, Adelphia, and Tyco enable widespread accounting fraud.

2002
Sarbanes-Oxley Act of 2002

This federal law changes corporate governance and financial practices, notably requiring that company directors certify controls over financial reports.

2003
Proxy voting disclosure

The SEC adopts a rule requiring investment companies' disclosure of proxy voting records and policies.

2000s

2003
New U.S. exchange listing standards

New stock-exchange standards require that boards have independent audit and compensation committees and have a majority of independent directors.

2005
United Nations Principles for Responsible Investment

2008
Global financial crisis

The crisis exposes major gaps in companies' governance and risk oversight.

2010s

2010–2019
Rise of shareholder engagement

Investor–company engagement on governance topics becomes common practice.

2011
Say-on-Pay regulation

As part of the Dodd-Frank Act of 2010, the SEC requires a shareholder vote on executive compensation at least every three years.

2010s

2014–2017
Adoption of proxy access accelerates

A majority of S&P 500 companies adopt shareholders' right to place board nominees on ballots.

2014
Japan Stewardship Code

2016
Hong Kong Principles of Responsible Ownership

2017
Investor Stewardship Group

Vanguard and other institutional investors form the ISG, establishing a framework of corporate governance standards.

2018
Financial misconduct at Australian financial firms

Poor governance and risk oversight allow financial misconduct among top Australian banks, insurance companies, and financial advisors.

2019
EU Shareholder Rights Directive II

The directive calls for asset managers to disclose their engagement policies and significant votes, or explain why they can't meet the new requirements.

Source: Vanguard.

Why we care

Several years ago, before shareholder engagement was a common practice, our Investment Stewardship team reviewed the executive compensation plan of a large technology company. The plan raised some red flags for us. It wasn't shareholder-friendly, it was too large relative to its peers' compensation plans, and it lacked the kinds of long-term incentives that are good for Vanguard fund investors. We reached out to the company, expressed our concerns, and asked to meet with the board. We got no response. A few weeks later, the Vanguard funds cast an advisory vote against the CEO's pay package. The company called to ask us why. We again expressed our concerns. The company replied: "Vanguard runs index funds. We didn't think that you cared."

That comment and others like it serve as an important reminder for Vanguard. Most of the feedback that publicly traded companies receive is short-term in nature, such as quarterly earnings calls, analyst upgrades or downgrades, daily news developments, and intraday stock price fluctuations. Index funds are not part of that cacophony, so there is a risk that the long-term interests of index fund investors are ignored or misunderstood.

So why does Vanguard care about governance?

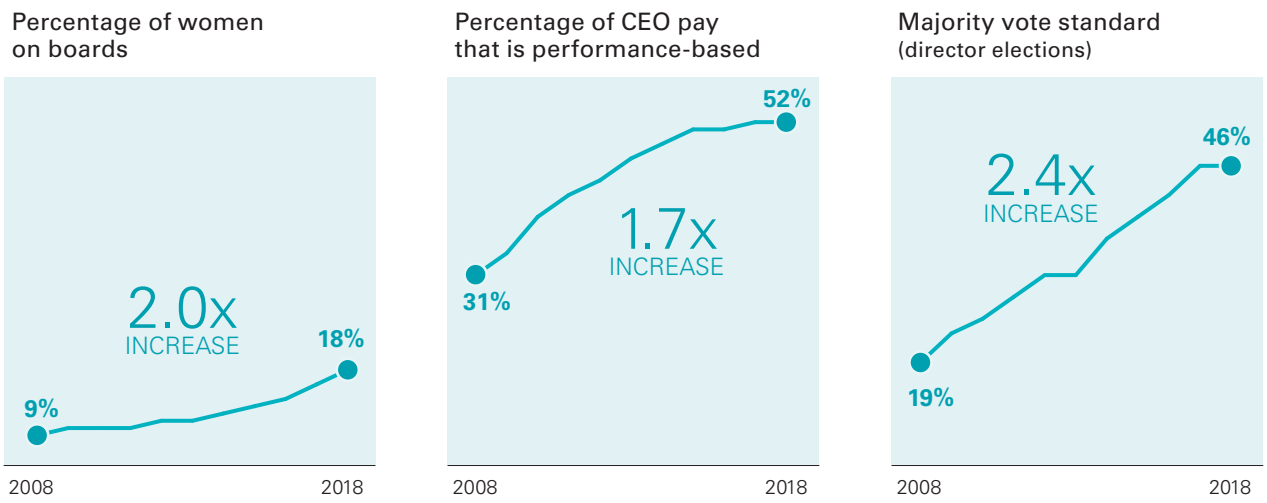
Vanguard is the ultimate long-term investor. Vanguard cares deeply about governance—maybe more than most. Our active funds are behaviorally long-term, and our index funds are structurally long-term, practically permanent owners of the companies in which they invest. An index fund typically owns all the stocks listed in its benchmark for as long as a company is included in the benchmark. Index fund managers don't sell out of a stock because they don't like it, nor do they buy more of a stock because they do like it. Because we do not control the composition of the benchmarks, Vanguard funds' vote and voice are the most important levers we have to protect our clients' investments and help build long-term value.

We take a stand for *all* investors. Vanguard's investment stewardship efforts are an important part of our mission, which is *to take a stand for all investors, to treat them fairly, and to give them the best chance for investment success*. Ultimately, we want governance practices to improve in investable markets around the world. We believe that a rising tide of good corporate governance will lift all boats.

We focus on the whole pie, not just the pieces. Vanguard funds invest in more than 13,000 companies in roughly 70 countries, and much of that reach is covered

Measurable improvements

The figures below show selected governance improvements over the last decade on issues including the growing number of women on company boards and executive compensation that is tied to long-term performance. But even with this progress, there is still work to be done.



Note: Data based on companies in the Russell 3000 Index cover the ten years ended December 31, 2018.
Sources: Vanguard and Institutional Shareholder Services.

in a series of broad-based stock market index funds. Managers of index funds don't pick winners or losers; we own shares in them all. The funds are designed to give everyday savers and investors access to diversified investments in thousands of companies at a very low cost. We believe that investors benefit from highly competitive markets in which individual firms must compete to win and stay relevant. This belief is reflected in our principles on executive compensation, which call for firms to incentivize long-term outperformance versus peers.

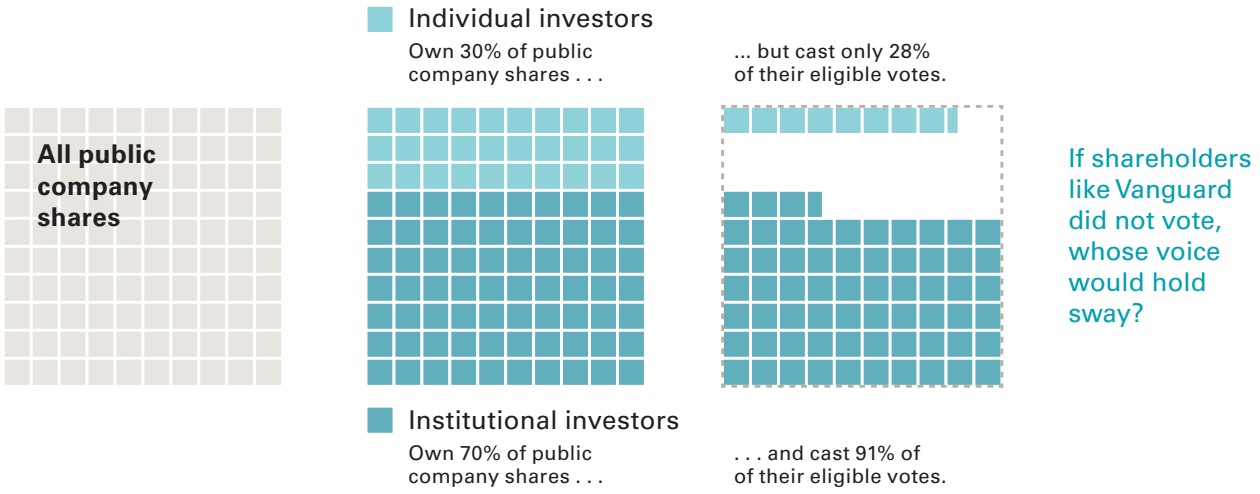
Unique ownership structure, unique perspective. Vanguard is the world's only mutually owned mutual fund company. Rather than being publicly traded or owned by a small group of individuals, Vanguard is owned by its U.S. funds, which in turn are owned by their investors. This unique structure aligns our interests with those of our investors and drives the culture, philosophy, and policies throughout the Vanguard organization worldwide. It is also worth noting that Vanguard invests money on *behalf* of fund shareholders. It's their money. Vanguard does not profit from the performance of any Vanguard fund or its holdings, and excess revenues generated are returned to shareholders through lower fund expenses or reinvestment in Vanguard funds and services.

Our shareholders expect it. In addition to professional investment management, what people expect when they invest in a mutual fund is professional investment stewardship. On one level, it provides service and convenience to our fund shareholders: Voting hundreds or thousands of company proxies each year could be an overwhelming task for any individual. More important, shareholders depend on Vanguard to establish and maintain governance principles and consistent voting guidelines that will protect their investments and promote long-term value. They count on Vanguard to know the issues, do the research, maintain vigilance, and be an effective steward.

We view it as our duty and responsibility. Vanguard does all of this—from proxy voting through engagement—because we believe it's aligned with our duty to shareholders. We adhere to the regulations for each of the markets in which we operate. We act in the best interest of Vanguard fund investors. Doing the right thing is part of our DNA.

What if Vanguard didn't vote?

In 2018, institutional investors (including mutual funds) collectively held 70% of public company shares in the United States and voted 91% of the shares they held. Individual investors who directly held stocks accounted for the remaining 30% of share ownership, yet they voted only 28% of the shares they held. Some interest groups have suggested that mutual funds muffle the voice of individual investors. The truth is, mutual funds are the voice of individual investors. If Vanguard didn't speak on behalf of its more than 20 million investors, whose voice would hold sway? That of activists? Company management? Proxy advisors?



Sources: Vanguard, based on data from "2018 Proxy Season Review," *ProxyPulse*, October 2018, 2–4, published by Broadridge and PwC; available at www.broadridge.com/_assets/pdf/broadridge-2018-proxy-season-review.pdf.

Four principles of good governance

Vanguard's investment stewardship activities are grounded in four principles of good governance:

Board composition

We believe good governance begins with a great board of directors. Our primary interest is to ensure that the individuals who represent the interests of all shareholders are independent, committed, capable, and appropriately experienced.

We also believe that diverse groups make better, more informed decisions and that, in turn, can lead to better results. That's why we want to see highly effective boards whose directors bring diverse perspectives to the table. We seek to understand, through disclosure, a board's mix of experience, professional expertise, tenure, and personal characteristics such as gender, race, age, and national origin and how that aligns with the company's strategy.

Boards must also continuously evaluate themselves and evolve to align with the long-term needs of the business.

Oversight of strategy and risk

Boards are responsible for effective oversight of a company's long-term strategy and any relevant and material risks.

In candid conversations, we try to assess how deeply the board understands strategy. We believe there should be a constant exchange of information between the board and management across a company. After all, we expect directors to bring a wealth of experience to the boardroom, and they can provide valuable counsel to company leaders who are executing on strategy.

Investors benefit when the market has better visibility into significant risks to the long-term sustainability of a company's business. Evaluation and disclosure of significant risks to a business arising from a variety of potential factors—competitive forces, regulation, government action, consumer demand and preferences, environmental considerations, and so on—result in a more accurate valuation of the company.

Accurate valuation over time is critical to ensuring that fund investors are appropriately compensated for the investment risks they assume in markets. Because index funds are price-takers, we need markets to be efficient and have all the material information necessary to appropriately price the stocks we're buying and selling every day.

Executive compensation

We believe that performance-linked compensation (or remuneration) policies and practices are fundamental drivers of sustainable, long-term value. We look for pay plans that incentivize outperformance versus industry peers over the long term. When shareholders do well, so should executives. When companies underperform, however, executives' pay should move in the same direction.

Governance structures

We believe companies need to have in place governance structures (for example, shareholder-rights and accountability measures) to ensure that boards and management serve in the best interest of the shareholders they represent. We view this as a safety valve to protect shareholder rights.

What we do, how we do it

Vanguard's Investment Stewardship program has three main components:

We advocate publicly for the highest standards of corporate governance worldwide. **We engage** in dialogue with boards and company leaders to understand their governance practices and to share our governance perspectives and expectations. And **we vote** in accordance with these governance principles to represent the long-term interests of Vanguard fund investors.

How we advocate

We do: Take a principles-based approach, work with governance-focused organizations to promote advancements in governance standards, report results to clients in a plain-talk fashion, and represent the voice of long-term investors to regulators and other policymakers.

We don't: Chase trendy fads or name and shame companies in the media.

Vanguard funds invest in more than 13,000 companies worldwide, and we aim to communicate our perspectives on governance matters as widely as possible to portfolio companies, clients, policymakers, industry groups, and academics. We have a responsibility to be a voice for better governance practices, and we do this by supporting governance-focused organizations, speaking at dozens of conferences each year, advocating for—and in some cases crafting—governance codes and standards, and sharing our perspectives through the media and our own published materials.

How we engage

We do: Focus on issues that are relevant to long-term value, seek to engage with independent directors, seek an understanding of long-term strategy, and ask companies to publicly disclose material risks to long-term value.

We don't: Offer opinions on company strategy, seek to influence it, or focus on short-term financial results.

Engagement benefits both shareholders and companies. It is the foundation of our Investment Stewardship program and is a year-round process that goes beyond our proxy voting at a company's annual meeting. Because our index funds are practically permanent owners of portfolio companies, we aim in our engagements to build a strong understanding of how companies govern their long-term strategy, but we do not seek to influence company strategy. We participate in the full range of engagement with directors and executives—from understanding high-level strategy to asking targeted questions on specific voting matters. This process unfolds over many exchanges and enables us to understand a company's corporate governance practices and long-term strategy and to monitor progress of those governance practices over time. Most of our engagements fall into one of three categories:

- Event-driven discussions may focus on a contentious ballot item or a company crisis. In these instances (such as a proxy contest, corporate action, shareholder proposal, or data breach), we want to hear all relevant perspectives before we vote.
- Topic-driven engagements discuss matters within the board's purview that materially affect a company's long-term value. These engagements are usually conducted with companies with which we would like to discuss one of our four principles in more depth or that have a record of underperformance and gaps in corporate governance.
- Strategic engagements are high-level discussions in which we can discuss a company's long-term strategy and industry dynamics. We seek to understand how the company's governance choices and practices, such as board composition, align with that strategy. This enables us to understand decisions in the context of the company's long-term goals.

What we want to know

Stakeholders are often curious about what takes place during an engagement with a portfolio company. Below is a list of typical questions we discuss with company leaders and board members. We also post these questions on our website, as they represent the kind of governance information we hope to learn about all of our portfolio companies, whether through public disclosure or individual company discussions.

Board composition:

1. Based on your company's strategy, what skills and experience are most critical for board members, now and in the future?
2. How does the board plan for evolution and future director selection (that is, for strategic board evolution)?
3. How do your company's disclosure and shareholder communications articulate board committee structure and oversight?
4. How does the board define and consider diversity in the director selection process?
5. How does the board assess director, committee, and board effectiveness over time?
6. How does your company ensure effective independent oversight through the composition of the board and selection of board and committee leaders?

Executive compensation/remuneration:

1. Describe your company's compensation philosophy and how the measures you've chosen align with long-term company strategy and shareholder value.
2. How does the compensation committee set goals for those measures? How does it determine that the goals are set at rigorous performance levels?
3. How does the compensation committee seek to align executive pay with the company's performance relative to peers and the market?
4. What is the process for selecting your company's peer group, and what factors in the selection process are most important?

Oversight of strategy and risk:

1. What is the company's long-term strategy, and how might your value proposition evolve over time?
2. What role does the board play in setting your company strategy?
3. How do the board and management team track and measure performance of the strategy?
4. What are the primary long-term risks to your company? What processes/systems are in place to mitigate risk?
5. How is the board involved in the oversight of company risks?
6. How are risks identified and elevated within the company? How is the board involved in that process?
7. How do the board and management determine the company's approach to risk disclosure?

Governance structures:

1. How does your company ensure that shareholders have a voice and a vote on governance matters?
2. How do the company's shareholders have basic foundational rights (such as annual election of directors and majority vote standard)?

Engagement matters: A case study

Vanguard is but one steward among many stewards and institutional investors who engage with portfolio companies.

Our engagement and boards' responsiveness to engagement have made a real difference for everyday investors. These benefits run the gamut from trimming tens of millions of dollars from an excessive CEO pay package at a single company to ensuring that billions of dollars of executive compensation/remuneration are more tightly aligned with company and shareholder return.

A recent case study supports the idea that continued engagement, while hard to measure, can result in outcomes that enhance and protect long-term value for shareholders:

Vanguard engaged with a U.S. consumer discretionary company more than a half-dozen times over two years to discuss a range of topics, including executive compensation. After the company announced plans to acquire a competitor, a sizable compensation package that extended the CEO's tenure was presented to shareholders. The board, which considered the CEO crucial to the company's continued growth, supported the decision. The plan was inconsistent with the governance principle that executive compensation should incentivize performance and be proportionate to expectations; accordingly, it was potentially detrimental to shareholder value. Its structure granted outsized rewards for easily achievable performance goals. The significant investment in a single person also raised questions about the strength of the company's succession plans. Shareholders expressed disapproval by voting against the plan at the company's annual meeting.

Throughout the following year, company leaders and board members sought shareholder feedback on revisions to the compensation plan. Just before the next annual meeting, the company announced a drastic reduction in its CEO's pay package, which would preserve tens of millions of dollars for shareholders. The new plan was approved by shareholder vote at the meeting.

How we vote

We do: Vote on a fund-by-fund basis in the best interest of each individual Vanguard fund, vote consistent with our published voting guidelines and our own research and analysis, and support shareholder proposals on topics relevant to long-term value creation.

We don't: Nominate directors or seek board seats, submit shareholder proposals, or vote in lockstep with proxy advisor recommendations.

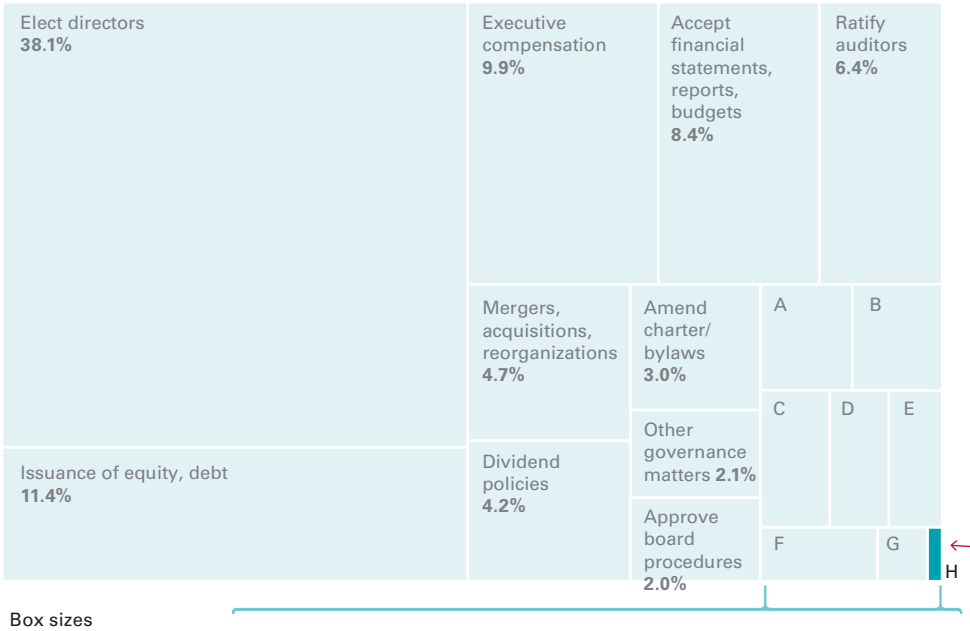
Our Investment Stewardship team consists of an experienced group of analysts that evaluates proposals in the proxies of the Vanguard funds' portfolio companies and casts votes on behalf of each fund in accordance with the voting guidelines the fund has adopted. Each fund's guidelines are designed to promote long-term shareholder value by supporting good corporate governance practices.

The guidelines frame the analysis of each proxy proposal, providing a basis for decision-making. The trustees of the fund boards periodically review and approve each fund's proxy voting guidelines so that they incorporate current governance standards and address relevant risks to long-term shareholder value. In evaluating votes, the Investment Stewardship team may consider information from many stakeholders, including the company's management and board, shareholder groups, and various research and data resources. Each fund's voting decision on each proposal will be based on its guidelines and an analysis of the proposal's impact on the fund's long-term value.

The Investment Stewardship team does not vote in lockstep with recommendations from proxy advisors (such as Institutional Shareholder Services [ISS] or Glass Lewis) for voting on behalf of the Vanguard funds. Data from proxy advisors serve as one of many inputs into our research process. Even when a fund's vote happens to be consistent with a proxy advisor's recommendation, that decision is made independently. In the 2018 proxy voting year, for example, Vanguard funds voted differently from ISS on 7% of ISS's "for" recommendations and 9% of its "against" recommendations. Those differences may seem small to some observers, but they must be viewed in the greater context of the full range of proposals that investors are asked to vote on, from electing directors to approving meeting minutes (see the figure below). Many items that are put to a vote are already part of investors' baseline expectations, so overlap in voting outcomes can be expected.

The nuts and bolts of proxy voting

During the proxy year ended June 30, 2018, Vanguard funds cast proxy votes on 168,786 individual ballot items. Although environmental and social proposals get a lot of attention, director elections, capitalization matters, and executive compensation issues accounted for the majority of our voting activity.



Most of what we vote on is routine

The majority of votes involve the election of directors along with routine business.

Much-discussed environmental and social issues make up a small percentage of votes cast.

Box sizes correspond to percentage of votes cast in each category.

A. Meeting procedurals (for example, open, approve minutes, adjourn) **1.8%**

B. Appoint internal statutory auditors **1.7%**

C. Approve/amend loan guarantee to subsidiary **1.7%**

D. Approve discharge of auditors, directors **1.5%**

E. Miscellaneous company-specific matters **1.3%**

F. Elect/approve board committees, roles **1.2%**

G. Governance structures and shareholder rights **0.5%**

H. Shareholder proposals, environmental and social **0.1%**

Source: Vanguard.

How Vanguard defines sustainable investing

Ask investors, regulators, industry experts, or asset managers to define sustainable investing, and you are likely to get a range of answers about directing investments to companies that align with certain views on environmental or social issues. Although Vanguard is intentional about developing products that take these factors into consideration, we view sustainable investing in a way that extends beyond a company's views on particular issues.

Our definition of sustainable investing starts with the premise that index funds can hold a company's stock in perpetuity—or as long as it's listed in an index. With such a long-term horizon, our funds must focus on how companies are set up for success—tomorrow, next year, and long into the future. "Long-term investing" and "sustainable investing" are synonymous.

At Vanguard, ESG starts with G

In investing, ESG commonly refers to environmental, social, and governance considerations. Each of these important areas must be overseen by a company's board, and that's why we view them through a governance lens.

We consistently engage with portfolio companies about climate risk, especially companies in carbon-intensive industries. We believe that climate risk can potentially have a long-term impact on companies in many sectors. But our discussions on these issues are anchored to a broader conversation about governance, in particular how a company's strategy and the related risks are governed by its board. Our index funds, by design, generally hold all the companies in their benchmark; these include winners and losers, leaders and laggards. This ownership across the spectrum gives us the opportunity to influence investor outcomes by directly engaging about material environmental and social risks with directors and executives at the companies in which our funds invest.

Our fund shareholders have entrusted their assets to Vanguard to create and protect sustainable, long-term value as they save for their important financial goals. Ensuring that the 13,000 global companies in which our funds invest on their behalf have a similar long-term mindset is central to our stewardship program. By advocating for policies and practices that support sustainable value creation over the long term, we believe we are giving our clients—and all investors—their best chance for investment success.

Looking ahead

In the first part of this commentary, we discussed several improvements in corporate governance in recent history. We'll conclude with a look at the future. Below, we note three areas in which governance can advance and the role that Vanguard intends to play as it acts on behalf of its funds.

Opportunities to improve governance

Greater global consistency in governance standards. Despite advancements we've seen around the world, local governance norms can differ widely. For example, if you ask what constitutes an independent board, the answer you get in countries across Europe will differ from the answer you get in the U.S., which in turn will differ from the answer you get in Asia. As global markets become more integrated and interconnected, so will investor expectations about governance. And Vanguard will be right there, advocating for that progress.

Alignment of global reporting frameworks. Many efforts are under way to improve the disclosure of relevant, material risks on sustainability topics. In fact, the industry is crowded with options. Several of these efforts reflect thoughtful research, analysis, and considerations for both issuers and investors. These frameworks are also being discussed by policymakers and regulators in different markets. Vanguard believes that reporting on material matters is an important part of corporate governance that boards should oversee and own. Our Investment Stewardship team looks for disclosure that is consistent and comparable over time. We have found the frameworks from the Sustainability Accounting Standards Board and the Task Force on Climate-related Financial Disclosures to be best in class, and we hope to see the market coalesce around a disclosure framework that is effective for all parties.

Greater appreciation for long-term investors. The concept of "long-termism" is being embraced by more and more public companies with a growing appreciation for their index fund investors. They know that Vanguard funds are—in every sense of the word—invested in their long-term success, since the funds are practically permanent owners. Vanguard encourages and hopes to see an evolving dialogue between public companies and their so-called permanent capital—a dialogue that occurs outside the quarterly cadence of active investors and that focuses on how companies are aligned with the best interests of long-term investors.

A pledge from Vanguard

We are not a public company, but we must continuously earn and maintain the public trust. We do that by taking a stand for all investors, by treating them fairly, and by giving them the best chance for investment success.

As steward for the assets of more than 20 million people worldwide, we have an obligation to report on the investment management and investment stewardship activities of Vanguard funds. We understand that people want to know how their funds are advocating, engaging, and voting on their behalf. As our Investment Stewardship program further evolves, we pledge to continue providing transparency about our stewardship activities to keep clients, portfolio companies, regulators, and other policymakers informed.

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2019 Proxy Voting and Engagement Guidelines: North America

Posted by Rick Lacaille and Rakhi Kumar, State Street Global Advisors, on Wednesday, March 27, 2019

Editor's note: Rick Lacaille is Executive Vice President and Global Chief Investment Officer and Rakhi Kumar is Senior Managing Director and Head of ESG Investments and Asset Stewardship at State Street Global Advisors. This post is based on a publication prepared by State Street Global Advisors.

State Street Global Advisors recently released their 2019 proxy voting and engagement guidelines. The guidelines consist of the 2019 Global Proxy Voting and Engagement Principles and six market specific proxy voting and engagement guidelines, including the North American guideline reproduced below. The guidelines are supplemented by the 2019 Global Proxy Voting and Engagement Guidelines for Environmental and Social Issues, which provides additional transparency into our approach to these important issues. The complete set of guidelines, including our Conflicts of Interest Policy and Issuer Engagement Protocol are available under the Voting Guidelines section of the Asset Stewardship website.

State Street Global Advisors' North America Proxy Voting and Engagement Guidelines[1] address areas, including board structure, director tenure, audit related issues, capital structure, executive compensation, as well as environmental, social, and other governance-related issues of companies listed on stock exchanges in the US and Canada ("North America"). Principally, we believe the primary responsibility of the board of directors is to preserve and enhance shareholder value and protect shareholder interests. In order to carry out their primary responsibilities, directors have to undertake activities that range from setting strategy and overseeing executive management to monitoring the risks that arise from a company's business, including risks related to sustainability issues. Further, good corporate governance necessitates the existence of effective internal controls and risk management systems, which should be governed by the board.

When voting and engaging with companies in global markets, we consider market specific nuances in the manner that we believe will most likely protect and promote the long-term economic value of client investments. We expect companies to observe the relevant laws and regulations of their respective markets, as well as country specific best practice guidelines and corporate governance codes. When we feel that a country's regulatory requirements do not

[1] These Proxy Voting and Engagement Guidelines are also applicable to SSGA Funds Management, Inc." SSGA Funds Management, Inc. is an SEC-registered investment adviser. SSGA Funds Management, Inc., State Street Global Advisors Trust Company, and other advisory affiliates of State Street make up State Street Global Advisors, the investment management arm of State Street Corporation.

address some of the key philosophical principles that we believe are fundamental to its global voting guidelines, we may hold companies in such markets to our global standards.

In its analysis and research about corporate governance issues in North America, we expect all companies to act in a transparent manner and to provide detailed disclosure on board profiles, related-party transactions, executive compensation, and other governance issues that impact shareholders' long-term interests. Further, as a founding member of the Investor Stewardship Group ("ISG"), we proactively monitor companies' adherence to the Corporate Governance Principles for US listed companies. Consistent with the "comply-or-explain" expectations established by the principles, we encourage companies to proactively disclose their level of compliance with the principles. In instances of non-compliance when companies cannot explain the nuances of their governance structure effectively, either publicly or through engagement, we may vote against the independent board leader.

State Street Global Advisors' Proxy Voting and Engagement Philosophy

Corporate governance and sustainability issues are an integral part of the investment process. The Asset Stewardship Team consists of investment professionals with expertise in corporate governance and company law, remuneration, accounting, and environmental and social issues. We have established robust corporate governance principles and practices that are backed with extensive analytical expertise to understand the complexities of the corporate governance landscape. We engage with companies to provide insight on the principles and practices that drive our voting decisions. We also conduct proactive engagements to address significant shareholder concerns and environmental, social, and governance ("ESG") issues in a manner consistent with maximizing shareholder value.

The team works alongside members of State Street Global Advisors's Active Fundamental and various other investment teams, collaborating on issuer engagements and providing input on company specific fundamentals. We are also a member of various investor associations that seek to address broader corporate governance related policy issues in North America.

State Street Global Advisors is a signatory to the United Nations Principles of Responsible Investment ("UNPRI") and is compliant with the US Investor Stewardship Group Principles. We are committed to sustainable investing and are working to further integrate ESG principles into investment and corporate governance practices, where applicable and consistent with our fiduciary duty.

Directors and Boards

State Street Global Advisors believes that a well constituted board of directors, with a balance of skills, expertise, and independence, provides the foundations for a well governed company. We view board quality as a measure of director independence, director succession planning, board diversity, evaluations and refreshment, and company governance practices. We vote for the election/re-election of directors on a case-by-case basis after considering various factors, including board quality, general market practice, and availability of information on director skills and expertise. In principle, we believe independent directors are crucial to robust corporate governance and help management establish sound corporate governance policies and practices. A sufficiently independent board will most effectively monitor management and perform oversight

functions necessary to protect shareholder interests. Further, we expect boards of Russell 3000 and TSX listed companies to have at least one female board member.

Director related proposals include issues submitted to shareholders that deal with the composition of the board or with members of a corporation's board of directors. In deciding the director nominee to support, we consider numerous factors.

Director Elections

Our director election guideline focuses on companies' governance profile to identify if a company demonstrates appropriate governance practices or if it exhibits negative governance practices. Factors we consider when evaluating governance practices include, but are not limited to the following:

- Shareholder rights
- Board independence
- Board structure

If a company demonstrates appropriate governance practices, we believe a director should be classified as independent based upon the relevant listing standards or local market practice standards. In such cases, the composition of the key oversight committees of a board should meet the minimum standards of independence. Accordingly, we will vote against a nominee at a company with appropriate governance practices if the director is classified as non-independent under relevant listing standards or local market practice and serves on a key committee of the board (compensation, audit, nominating, or committees required to be fully independent by local market standards).

Conversely, if a company demonstrates negative governance practices, State Street Global Advisors believes the classification standards for director independence should be elevated. In such circumstances, we will evaluate all director nominees based upon the following classification standards:

- Is the nominee an employee of or related to an employee of the issuer or its auditor?
- Does the nominee provide professional services to the issuer?
- Has the nominee attended an appropriate number of board meetings?
- Has the nominee received non-board related compensation from the issuer?

In the US market where companies demonstrate negative governance practices, these stricter standards will apply not only to directors who are a member of a key committee but to all directors on the board as market practice permits. Accordingly, we will vote against a nominee (with the exception of the CEO) where the board has inappropriate governance practices and is considered not independent based on the above independence criteria.

Additionally, we may withhold votes from directors based on the following:

- Overall average board tenure is excessive. In assessing excessive tenure, we give consideration to factors such as the preponderance of long tenured directors, board refreshment practices, and classified board structures

- Directors attend less than 75% of board meetings without appropriate explanation or providing reason for their failure to meet the attendance threshold
- CEOs of a public company who sit on more than three public company boards
- Director nominees who sit on more than six public company boards
- Directors of companies that have not been responsive to a shareholder proposal that received a majority shareholder support at the last annual or special meeting
- Consideration can be warranted if management submits the proposal(s) on the ballot as a binding management proposal, recommending shareholders vote for the particular proposal(s)
- Directors of companies have unilaterally adopted/ amended company bylaws that negatively impact our shareholder rights (such as fee-shifting, forum selection, and exclusion service bylaws) without putting such amendments to a shareholder vote
- Compensation committee members where there is a weak relationship between executive pay and performance over a five-year period
- Audit committee members if non-audit fees exceed 50% of total fees paid to the auditors
- Directors who appear to have been remiss in their duties

Director Related Proposals

We generally vote for the following director related proposals:

- Discharge of board members' duties, in the absence of pending litigation, regulatory investigation, charges of fraud, or other indications of significant concern
- Proposals to restore shareholders' ability in order to remove directors with or without cause
- Proposals that permit shareholders to elect directors to fill board vacancies
- Shareholder proposals seeking disclosure regarding the company, board, or compensation committee's use of compensation consultants, such as company name, business relationship(s), and fees paid

We generally vote against the following director related proposals:

- Requirements that candidates for directorships own large amounts of stock before being eligible to be elected
- Proposals that relate to the "transaction of other business as properly comes before the meeting," which extend "blank check" powers to those acting as proxy
- Proposals requiring two candidates per board seat

Majority Voting

We will generally support a majority vote standard based on votes cast for the election of directors.

We will generally vote to support amendments to bylaws that would require simple majority of voting shares (i.e. shares cast) to pass or to repeal certain provisions.

Annual Elections

We generally support the establishment of annual elections of the board of directors. Consideration is given to the overall level of board independence and the independence of the key committees, as well as the existence of a shareholder rights plan.

Cumulative Voting

We do not support cumulative voting structures for the election of directors.

Separation Chair/CEO

We analyze proposals for the separation of Chair/CEO on a case-by-case basis taking into consideration numerous factors, including the appointment of and role played by a lead director, a company's performance, and the overall governance structure of the company.

Proxy Access

In general, we believe that proxy access is a fundamental right and an accountability mechanism for all long-term shareholders. We will consider proposals relating to proxy access on a case-by-case basis. We will support shareholder proposals that set parameters to empower long-term shareholders while providing management the flexibility to design a process that is appropriate for the company's circumstances.

We will review the terms of all other proposals and will support those proposals that have been introduced in the spirit of enhancing shareholder rights.

Considerations include the following:

- The ownership thresholds and holding duration proposed in the resolution
- The binding nature of the proposal
- The number of directors that shareholders may be able to nominate each year
- Company governance structure
- Shareholder rights
- Board performance

Age/Term Limits

Generally, we will vote against age and term limits unless the company is found to have poor board refreshment and director succession practices. We will also vote against if the company has a preponderance of non-executive directors with excessively long tenures serving on the board.

Approve Remuneration of Directors

Generally, we will support directors' compensation, provided the amounts are not excessive relative to other issuers in the market or industry. In making our determination, we review whether the compensation is overly dilutive to existing shareholders.

Indemnification

Generally, we support proposals to limit directors' liability and/or expand indemnification and liability protection if he or she has not acted in bad faith, gross negligence, or reckless disregard of the duties involved in the conduct of his or her office.

Classified Boards

We generally support annual elections for the board of directors.

Confidential Voting

We will support confidential voting.

Board Size

We will support proposals seeking to fix the board size or designate a range for the board size and will vote against proposals that give management the ability to alter the size of the board outside of a specified range without shareholder approval.

Audit-Related Issues

Ratifying Auditors and Approving Auditor Compensation

We support the approval of auditors and auditor compensation provided that the issuer has properly disclosed audit and non-audit fees relative to market practice and the audit fees are not deemed excessive. We deem audit fees to be excessive if the non-audit fees for the prior year constituted 50% or more of the total fees paid to the auditor. We will also support the disclosure of auditor and consulting relationships when the same or related entities are conducting both activities and will support the establishment of a selection committee responsible for the final approval of significant management consultant contract awards where existing firms are already acting in an auditing function.

In circumstances where "other" fees include fees related to initial public offerings, bankruptcy emergence, and spin-offs, and the company makes public disclosure of the amount and nature of those fees which are determined to be an exception to the standard "non-audit fee" category, then such fees may be excluded from the non-audit fees considered in determining the ratio of non-audit to audit/audit-related fees/tax compliance and preparation for purposes of determining whether non-audit fees are excessive.

We will support the discharge of auditors and requirements that auditors attend the annual meeting of shareholders.[2]

Capital-Related Issues

[2] Common for non-US issuers; request from the issuer to discharge from liability the directors or auditors with respect to actions taken by them during the previous year.

Capital structure proposals include requests by management for approval of amendments to the certificate of incorporation that will alter the capital structure of the company.

The most common request is for an increase in the number of authorized shares of common stock, usually in conjunction with a stock split or dividend. Typically, we support requests that are not unreasonably dilutive or enhance the rights of common shareholders. In considering authorized share proposals, the typical threshold for approval is 100% over current authorized shares. However, the threshold may be increased if the company offers a specific need or purpose (merger, stock splits, growth purposes, etc.). All proposals are evaluated on a case-by-case basis taking into account the company's specific financial situation.

Increase in Authorized Common Shares

In general, we support share increases for general corporate purposes up to 100% of current authorized stock.

We support increases for specific corporate purposes up to 100% of the specific need plus 50% of current authorized common stock for US and Canadian firms.

When applying the thresholds, we will also consider the nature of the specific need, such as mergers and acquisitions and stock splits.

Increase in Authorized Preferred Shares

We vote on a case-by-case basis on proposals to increase the number of preferred shares.

Generally, we will vote for the authorization of preferred stock in cases where the company specifies the voting, dividend, conversion, and other rights of such stock and the terms of the preferred stock appear reasonable.

We will support proposals to create "declawed" blank check preferred stock (stock that cannot be used as a takeover defense). However, we will vote against proposals to increase the number of blank check preferred stock authorized for issuance when no shares have been issued or reserved for a specific purpose.

Unequal Voting Rights

We will not support proposals authorizing the creation of new classes of common stock with superior voting rights and will vote against new classes of preferred stock with unspecified voting, conversion, dividend distribution, and other rights. In addition, we will not support capitalization changes that add "blank check" classes of stock (i.e. classes of stock with undefined voting rights) or classes that dilute the voting interests of existing shareholders.

However, we will support capitalization changes that eliminate other classes of stock and/or unequal voting rights.

Mergers and Acquisitions

Mergers or the reorganization of the structure of a company often involve proposals relating to reincorporation, restructurings, liquidations, and other major changes to the corporation.

Proposals that are in the best interests of the shareholders, demonstrated by enhancing share value or improving the effectiveness of the company's operations, will be supported.

In general, provisions that are not viewed as economically sound or are thought to be destructive to shareholders' rights are not supported.

We will generally support transactions that maximize shareholder value. Some of the considerations include the following:

- Offer premium
- Strategic rationale
- Board oversight of the process for the recommended transaction, including, director and/or management conflicts of interest
- Offers made at a premium and where there are no other higher bidders
- Offers in which the secondary market price is substantially lower than the net asset value

We may vote against a transaction considering the following:

- Offers with potentially damaging consequences for minority shareholders because of illiquid stock, especially in some non-US markets
- Offers where we believe there is a reasonable prospect for an enhanced bid or other bidders
- The current market price of the security exceeds the bid price at the time of voting

Anti-Takeover Issues

Typically, these are proposals relating to requests by management to amend the certificate of incorporation or bylaws to add or to delete a provision that is deemed to have an anti-takeover effect. The majority of these proposals deal with management's attempt to add some provision that makes a hostile takeover more difficult or will protect incumbent management in the event of a change in control of the company.

Proposals that reduce shareholders' rights or have the effect of entrenching incumbent management will not be supported.

Proposals that enhance the right of shareholders to make their own choices as to the desirability of a merger or other proposal are supported.

Shareholder Rights Plans

US We will support mandates requiring shareholder approval of a shareholder rights plans ("poison pill") and repeals of various anti-takeover related provisions.

In general, we will vote against the adoption or renewal of a US issuer's shareholder rights plan ("poison pill").

We will vote for an amendment to a shareholder rights plan ("poison pill") where the terms of the new plans are more favorable to shareholders' ability to accept unsolicited offers (i.e. if one of the following conditions are met: (i) minimum trigger, flip-in or flip-over of 20%, (ii) maximum term of three years, (iii) no "dead hand," "slow hand," "no hand" nor similar feature that limits the ability of a future board to redeem the pill, and (iv) inclusion of a shareholder redemption feature (qualifying offer clause), permitting ten percent of the shares to call a special meeting or seek a written consent to vote on rescinding the pill if the board refuses to redeem the pill 90 days after a qualifying offer is announced).

Canada We analyze proposals for shareholder approval of a shareholder rights plan ("poison pill") on a case-by-case basis taking into consideration numerous factors, including but not limited to, whether it conforms to 'new generation' rights plans and the scope of the plan.

Special Meetings

We will vote for shareholder proposals related to special meetings at companies that do not provide shareholders the right to call for a special meeting in their bylaws if:

- The company also does not allow shareholders to act by written consent
- The company allows shareholders to act by written consent but the ownership threshold for acting by written consent is set above 25% of outstanding shares

We will vote for shareholder proposals related to special meetings at companies that give shareholders (with a minimum 10% ownership threshold) the right to call for a special meeting in their bylaws if:

- The current ownership threshold to call for a special meeting is above 25% of outstanding shares

We will vote for management proposals related to special meetings.

Written Consent

We will vote for shareholder proposals on written consent at companies if:

- The company does not have provisions in their bylaws giving shareholders the right to call for a special meeting
- The company allows shareholders the right to call for a special meeting, but the current ownership threshold to call for a special meeting is above 25% of outstanding shares
- The company has a poor governance profile

We will vote management proposals on written consent on a case-by-case basis.

Super–Majority

We will generally vote against amendments to bylaws requiring super-majority shareholder votes to pass or repeal certain provisions. We will vote for the reduction or elimination of super-majority vote requirements, unless management of the issuer was concurrently seeking to or had previously made such a reduction or elimination.

Remuneration Issues

Despite the differences among the types of plans and the awards possible there is a simple underlying philosophy that guides the analysis of all compensation plans; namely, the terms of the plan should be designed to provide an incentive for executives and/or employees to align their interests with those of the shareholders and thus work toward enhancing shareholder value. Plans that benefit participants only when the shareholders also benefit are those most likely to be supported.

Advisory Vote on Executive Compensation and Frequency

State Street Global Advisors believes executive compensation plays a critical role in aligning executives interest with shareholder's, attracting, retaining and incentivizing key talent, and ensuring positive correlation between the performance achieved by management and the benefits derived by shareholders. We support management proposals on executive compensation where there is a strong relationship between executive pay and performance over a five-year period. We seek adequate disclosure of various compensation elements, absolute and relative pay levels, peer selection and benchmarking, the mix of long-term and short-term incentives, alignment of pay structures with shareholder interests as well as with corporate strategy, and performance. Further shareholders should have the opportunity to assess whether pay structures and levels are aligned with business performance on an annual basis.

In Canada, where advisory votes on executive compensation are not commonplace, we will rely primarily upon engagement to evaluate compensation plans.

Employee Equity Award Plans

We consider numerous criteria when examining equity award proposals. Generally we do not vote against plans for lack of performance or vesting criteria. Rather the main criteria that will result in a vote against an equity award plan are:

Excessive voting power dilution To assess the dilutive effect, we divide the number of shares required to fully fund the proposed plan, the number of authorized but unissued shares and the issued but unexercised shares by the fully diluted share count. We review that number in light of certain factors, such as the industry of the issuer.

Historical option grants Excessive historical option grants over the past three years. Plans that provide for historical grant patterns of greater than five to eight percent are generally not supported.

Repricing We will vote against any plan where repricing is expressly permitted. If a company has a history of repricing underwater options, the plan will not be supported.

Other criteria include the following:

- Number of participants or eligible employees
- The variety of awards possible
- The period of time covered by the plan

There are numerous factors that we view as negative. If combined they may result in a vote against a proposal. Factors include:

- Grants to individuals or very small groups of participants
- "Gun-jumping" grants which anticipate shareholder approval of a plan or amendment
- The power of the board to exchange "underwater" options without shareholder approval. This pertains to the ability of a company to reprice options, not the actual act of repricing described above
- Below market rate loans to officers to exercise their options
- The ability to grant options at less than fair market value;
- Acceleration of vesting automatically upon a change in control
- Excessive compensation (i.e. compensation plans which we deem to be overly dilutive)

Share Repurchases If a company makes a clear connection between a share repurchase program and its intent to offset dilution created from option plans and the company fully discloses the amount of shares being repurchased, the voting dilution calculation may be adjusted to account for the impact of the buy back.

Companies will not have any such repurchase plan factored into the dilution calculation if they do not (i) clearly state the intentions of any proposed share buy-back plan, (ii) disclose a definitive number of the shares to be bought back, (iii) specify the range of premium/discount to market price at which a company can repurchase shares, and (iv) disclose the time frame during which the shares will be bought back..

162(m) Plan Amendments If a plan would not normally meet our criteria described above, but was primarily amended to add specific performance criteria to be used with awards that were designed to qualify for performance-based exception from the tax deductibility limitations of Section 162(m) of the Internal Revenue Code, then we will support the proposal to amend the plan.

Employee Stock Option Plans

We generally vote for stock purchase plans with an exercise price of not less than 85% of fair market value. However, we take market practice into consideration.

Compensation Related Items

We generally support the following proposals:

- Expansions to reporting of financial or compensation-related information within reason
- Proposals requiring the disclosure of executive retirement benefits if the issuer does not have an independent compensation committee

We generally vote against the following proposal:

- Retirement bonuses for non-executive directors and auditors

Miscellaneous/Routine Items

We generally support the following miscellaneous/routine governance items:

- Reimbursement of all appropriate proxy solicitation expenses associated with the election when voting in conjunction with support of a dissident slate
- Opting-out of business combination provision
- Proposals that remove restrictions on the right of shareholders to act independently of management
- Liquidation of the company if the company will file for bankruptcy if the proposal is not approved
- Shareholder proposals to put option repricings to a shareholder vote
- General updating of, or corrective amendments to, charter and bylaws not otherwise specifically addressed herein, unless such amendments would reasonably be expected to diminish shareholder rights (e.g. extension of directors' term limits, amending shareholder vote requirement to amend the charter documents, insufficient information provided as to the reason behind the amendment)
- Change in corporation name
- Mandates that amendments to bylaws or charters have shareholder approval
- Management proposals to change the date, time, and/or location of the annual meeting unless the proposed change is unreasonable
- Repeals, prohibitions or adoption of anti-greenmail provisions
- Management proposals to implement a reverse stock split when the number of authorized shares will be proportionately reduced and proposals to implement a reverse stock split to avoid delisting
- Exclusive forum provisions

State Street Global Advisors generally does not support the following miscellaneous/routine governance items:

- Proposals requesting companies to adopt full tenure holding periods for their executives
- Reincorporation to a location that we believe has more negative attributes than its current location of incorporation
- Shareholder proposals to change the date, time, and/or location of the annual meeting unless the current scheduling or location is unreasonable
- Proposals to approve other business when it appears as a voting item
- Proposals giving the board exclusive authority to amend the bylaws
- Proposals to reduce quorum requirements for shareholder meetings below a majority of the shares outstanding unless there are compelling reasons to support the proposal

Environmental and Social Issues

As a fiduciary, State Street Global Advisors takes a comprehensive approach to engaging with our portfolio companies about material environmental and social (sustainability) issues. We use our voice and our vote through engagement, proxy voting, and thought leadership in order to communicate with issuers and educate market participants about our perspective on important sustainability topics. Our Asset Stewardship program prioritization process allows us to proactively identify companies for engagement and voting in order to mitigate sustainability risks in our portfolio. Through engagement, we address a broad range of topics that align with our thematic priorities and build long-term relationships with issuers. When voting, we fundamentally consider whether the adoption of a shareholder proposal addressing a material sustainability issue would promote long-term shareholder value in the context of the company's existing practices and disclosures as well as existing market practice.

For more information on our approach to environmental and social issues, please see our Global Proxy Voting and Engagement Guidelines for Environmental and Social Issues available at https://www.ssga.com/about-us/asset-stewardship.html.

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Engaging With Your Investors

Posted by David Shammai and Kiran Vasantham, Morrow Sodali, on Sunday, April 28, 2019

Editor's note: David Shammai is Corporate Governance Director—Cross Border and Kiran Vasantham is Director of Investor Engagement at Morrow Sodali. This post is based on their Morrow Sodali memorandum.

In addition to traditional Investor Relations roadshows focused on financial performance, companies and boards are now expected to conduct governance and sustainability roadshows that reach out to institutional stewardship teams as well as portfolio managers.

For issuers, these engagements require the commitment of significant resources internally, including valuable board time. For investors, the expansion of stewardship activities means that even for those who increased the internal resources (see our earlier piece on Stewardship Principles), the escalating demand on capacity is forcing them to be more selective and raise expectations on the content and quality of engagements.

Based on Morrow Sodali's experience assisting companies with planning and organization of governance and ESG roadshows, we note factors that are key to successful engagements.

Clear objective

Starting with coherent strategic thinking internally, the company should define and communicate the objective of the engagement. It could be to showcase a new strategic direction, or developments in the business that are related to material ESG themes, or it could be part of an ongoing dialogue with investors about relevant issues. Historically, most roadshows were scheduled in anticipation of a forthcoming shareholders meeting, but we find that many shareholders are growing reluctant to take meetings—given that their voting policies are published in detail—purely on this basis, especially during the annual meeting season.

Mapping of shareholders

When the primary purpose of a roadshow relates to a shareholder meeting, whether to improve voting quorum or to canvass support, it makes sense to prioritize outreach by holdings. Companies should always consider investors' voting policies and should follow up on issues raised during previous engagements. However, when the engagement agenda is focused on ESG developments, companies may wish to cast the net wider, and target those investors that are long-term oriented and known to be focused on these issues. The guiding principle here should be to speak with existing shareholders, but also reach out to targeted shareholders the company wishes to have (or wishes to own more stock).

Deciding who to speak with—location, team members

Many institutional investors are making efforts to link internally their investment and stewardship teams. Companies should reach out to both investment and stewardship teams, as appropriate, but it is up to the investor to decide who is best to lead a specific engagement. We recommend that companies do their homework and ensure they are including all the appropriate contacts and positioning the engagement campaign so as to make it easier for the investors to decide who should be involved.

A key question for companies is whether members of the board of directors should be involved and if so, which directors are needed to address relevant issues. In addition, should members of management be included or not? For example, on compensation issues, investors may want to talk primarily to board compensation committee members. In other cases, HR should be included. The demands on investor resources mean that increasingly they view it as important to have direct dialogue with directors (see our Institutional Investor Survey 2019 more on why and how to do this) as well as relevant members of the management team (e.g. HR representatives on issues of human capital management).

On a practical note, Morrow Sodali often come across companies who apply a strong home bias in targeting their investors. Our experience indicates that cross-border ownership is increasingly common even in controlled companies. In those cases, we recommend roadshow itineraries should include markets where investors are located (e.g. London, Paris, Netherlands), regardless of where the company is domiciled.

Extensive preparation

Evolving stewardship responsibilities and regulatory requirements mean that the information investors are publishing about their voting and stewardship policies is more extensive than ever. We recommend that companies conduct meticulous preparation in advance of meetings, and tailor the meeting agenda and materials to meet investors' preferences. Because investors' time and resources are limited, engagements should do more than rehash publicly stated positions. The goal is to conduct an informed and informative dialogue.

Anecdotal evidence shows that, at times, preparation is needed just to secure some meetings. At Morrow Sodali, we are aware that some of the large investors have updated their access processes to ensure that requests for engagement pass a threshold of demonstrating preparedness as a condition to them being considered.

Follow up

This is perhaps stating the obvious but thinking about the next meeting and the next engagement means that companies have to maintain credibility and follow up as agreed. For example, when a consultation process culminates in new proposals, it is important to go back to the relevant investors and communicate the rationale for the chosen course of action—i.e. even, and perhaps especially, if the company felt it was not able to fully adopt the preference of the particular investor(s).

Why this is important?

Executing an effective investor engagement draws on precious corporate resources including valuable management and board time. It is important therefore that companies fully consider the benefits. Most immediately, this includes strengthening of the relationships with long-term minded owners—those shareholders most companies would wish to have more of. Regular face-to-face meetings with investors can be a critical part of this. Additionally, with the current level of activism, we find that for some clients, especially in Europe, the ability to draw on support from long-term shareholders has been a key component of activism defense. More fundamentally, there are several pieces of academic research suggesting that engagement enhances value, presumably by enhancing communication and helping to close any possible disconnects between valuations and prices.

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Synthesizing the Messages from BlackRock, State Street, and T. Rowe Price

Posted by Pamela L. Marcogliese, Elizabeth K. Bieber and Brennan K. Halloran, Cleary Gottlieb Steen & Hamilton LLP, on Thursday, February 28, 2019

Editor's note: Pamela L. Marcogliese is a partner, Elizabeth Bieber is an associate, and Brennan K. Halloran is a law clerk at Cleary Gottlieb Steen & Hamilton LLP. This post is based on their Cleary Gottlieb memorandum. Related research from the Program on Corporate Governance includes Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy by Lucian Bebchuk and Scott Hirst (discussed on the forum here).

It has become customary, over the last few years, for companies and other stakeholders to await annual letters from large institutional investors that provide insight into investor views about companies' long-term strategy, messaging, goals and shareholder engagement, among other topics.

BlackRock and State Street recently released their letters, and shared similar views: BlackRock reiterated its focus on the need for corporate purpose and the link to successful pursuit of profit and State Street focused on the need for a meaningful corporate culture as a significant driver of intangible value. In addition, in a recent interview with Gladstone Partners, Donna Anderson, the head of T. Rowe Price's governance policy and engagement, focused on the need to deliver financial results instead of worrying about fending off the next activist investor.

As the years pass, the letters and messages to companies have become more specific in the types of causes that each investor focuses on, and, in turn, expects companies to focus on. As companies hit record levels of engagement and the use of one-on-one governance roadshows becomes near-ubiquitous, companies are bringing together legal, finance, ESG and IR teams, as well as other members of senior management and directors to develop materials and messaging intended to demonstrate advanced levels of engagement and prove they are listening to their investors' concerns.

But, we are starting to see evidence, through the annual letters, interviews and other public-facing interactions, that investors have become more sophisticated about what they expect from companies, and how company-developed engagement should function. As a result, the recent letters and sentiments express nuanced and increasingly specific views about investor expectations, and companies that wish to court favorable impressions would be wise to understand the individual expectations.

On a practical level, that ideally results in taking investor concerns into consideration when crafting disclosure, ESG reports, investor day presentations, analyst calls and other forums for

public interaction. But it also means that companies ought to be thoughtful in their governance roadshows and tailor their presentations to what they now know individual investors are most focused on.

Show BlackRock The Company Has a Purposeful Mission

BlackRock made clear[1] that it wants to see that companies are not only delivering dividends to its shareholders, but also delivering figurative dividends to the world at large. In what is a more pointed version from prior Fink letters, this year BlackRock encourages companies to take up the mantle and to address a variety of "pressing social and economic issues." Such pursuit should be engrained into the fabric of each company, not peripheral to its profit motive. Indeed, Fink argues the drive for profit and the drive to better the world are "inextricably linked": and that this trend will continue in importance as millennials occupy more senior positions in leadership. Millennial customers want to buy from, millennial employees want to work for, and, increasingly, millennial investors want to invest in, companies that have a purpose. And once millennials are the dominant economic generation, they will demand that companies have a purpose—any company that does not take on forward-looking responsibilities will be left behind.

Fink's letter left little room for creative interpretation. To impress BlackRock, a board is encouraged to answer Fink's call—which, in turn, is to convince BlackRock you are answering society's call by focusing on board diversity, corporate strategy and allocation, compensation that promotes long-termism, environment risks and opportunities and human capital management. In particular, Fink called upon companies to come up with innovative solutions to solve the growing retirement problem: For years, according to Fink, both governments and companies alike have attempted to shift their burden of funding employees' retirement to the other. Embracing a responsibility for retirement will create a more secure economic population, but also a stable and engaged workforce. But more pointedly, BlackRock has mentioned, in multiple annual letters, the need for a stable and engaged workforce through retirement education and empowerment, and it is becoming clear that issues related to human capital management and its role in attracting and retaining talent is critical.

And while the tone of the BlackRock letter certainly has a near social-justice undertone, the link of purpose to profit should not be underestimated—at the end of the day, through its engagement efforts, BlackRock is looking for companies to demonstrate how "the company's purpose informs its strategy and culture to underpin sustainable financial performance." All of BlackRock's focus is an attempt at molding how companies should best view their ability to make and maintain profits.

Show State Street the Company Has a Corporate Culture—and a Way to Measure it

State Street made clear, via its 2019 letter to boards of directors,[2] that it wants companies to facilitate productive, top-down corporate cultures. Simply stating a corporate culture exists is

[1] BlackRock, *Larry Fink's 2019 Letter to CEOs: Purpose &* Profit, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

[2] State Street, *Aligning Corporate Culture with Long-Term Strategy* (Jan. 15, 2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/01/2019%20Proxy%20Letter-Aligning%20Corporate%20Culture%20with%20Long-Term%20Strategy.pdf.

necessary, but not sufficient. In State Street's view, the test of culture is measured against its relationship to long-term corporate strategy. State Street encourages companies to analyze whether its culture and strategy are indeed aligned and to implement processes by which relevant stakeholders can report candidly to the board regarding strategy and culture, and, in turn, permit the board to monitor a company's strategy and purpose actively. However, State Street made the important distinction between *managing* and *monitoring* culture and strategy—management should be tasked with managing, and the board should be tasked with identifying, and, if necessary, plotting a path towards rectifying, any deficiencies in or gaps between a company's corporate purpose and corporate strategy.

Like BlackRock, State Street plainly laid out what it wants to see from public boards: tangible progress towards identifying, facilitating, and improving one's corporate culture and strategy. Boards are therefore encouraged to describe clearly their views on the corporate culture and long-term corporate strategy, and to delineate specific (and measurable) steps to achieve related goals. Companies can have effective meetings with State Street by describing the oversight mechanisms in place to identify and monitor corporate strategy and purpose and how the board thinks about improving and aligning the relationship between corporate strategy and culture.

Show T. Rowe Price the Company is Proactive—not Reactive

T. Rowe Price, via Donna Anderson's interview with Gladstone Place Partners,[3] delivered a tried and true message: tell us why you did what you did and why you are doing what you are doing. A board's answer to those questions should be centered upon their own company's goals and corporate position—not exogenous factors. Specifically, T. Rowe Price chastised companies for their short-term focus on defending against activism and making resulting impracticable decisions, despite what T. Rowe believes is a low-risk to being a target. In particular, Ms. Anderson criticized the stock buyback trend as an overused tool that should be used tactically, not to solely demonstrate a defined short-term use for capital.

Successful engagements with T. Rowe Price will likely feature discussions that underpin that sound financial planning and long-term considerations undergird corporate decision-making. T. Rowe Price indicated their willingness, in some situations, to be a patient investor so long as the decisions are thoughtful and investors are apprised of long-term plans. It is less clear how patient investors will be with poor performance, even only for the short-term, but understanding that T. Rowe, and perhaps other investors, want to hear a company "show its work" when presenting corporate decisions is a helpful tool for successful engagement. In particular, Ms. Anderson notes that she prefers engagement to be short, sweet, and not tied to a presentation.

[3] *Talking Governance with Donna Anderson* (Jan. 10, 2019), https://corpgov.law.harvard.edu/2019/01/10/talking-governance-with-donna-anderson/.

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Purpose, Culture and Long-Term Value—Not Just a Headline

Posted by David Feirstein, Sarkis Jebejian, and Shaun J. Mathew, Kirkland & Ellis LLP, on Tuesday, February 26, 2019

Editor's note: David B. Feirstein, Sarkis Jebejian, and Shaun J. Mathew are partners at Kirkland & Ellis LLP who specialize in mergers and acquisitions. The following post is based on their Kirkland memorandum. Related research from the Program on Corporate Governance includes Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy by Lucian Bebchuk and Scott Hirst (discussed on the forum here).

Key Takeaways

- Recent letters from two of the world's largest long-term "passive" investors provide a powerful counterpoint to the seemingly never-ending short-term oriented agitation from activist hedge funds.
- These long-term investors believe that purpose and profit are "inextricably linked" and seek to elevate "value" (not "values") in support of long-termism over short-termism.
- Index fund managers can either be powerful allies in promoting and protecting long-term shareholder value or at-risk "swing votes" in a proxy contest.
- Effective "off-season" engagement should be a strategic priority.

Public company CEOs and directors have a new pen pal. Adding to Larry Fink's annual letter to CEOs, this year Cyrus Taraporevala, State Street's new CEO, sent his own letter encouraging boards to focus on aligning corporate culture and strategy as a driver of long-term, sustainable shareholder value.

These letters from two of the world's largest long-term "passive" investors offer a powerful counterpoint to the seemingly never-ending short-term oriented agitation from activist hedge funds. As capital continues to flow from actively managed strategies into passive index funds, BlackRock, State Street and Vanguard—the three largest "passive" managers—now control approximately 20 percent of the value of the S&P 500 and collectively constitute the single largest shareholder in almost 90 percent of S&P 500 firms. And because they generally may not sell their shares when a company underperforms (or buy more when it outperforms), they view themselves as permanent capital focused on the long term.

From this position of strength, these asset managers are pushing companies to take actions that benefit the interests of long-term shareholders through emphasis on purpose, culture and other intangibles—concepts that have not traditionally been measured or discussed with investors.

Both BlackRock and State Street make it abundantly clear that their goal is not philanthropy but rather to promote principles and practices that support a long-term outlook rather than a narrow focus on short-term financial results. They believe that purpose and profit are “inextricably linked” and seek to elevate “value” (not “values”) in support of long-termism over short-termism.

Directors and senior management should be prepared to engage with and actively address the priorities of this increasingly vocal and powerful asset class, and to that end, should consider the following:

- **Ignore Passives at your Peril.** Index fund managers can either be powerful allies in promoting and protecting long-term shareholder value or at-risk “swing votes” in a proxy contest, where the big three index funds support activists on average more than 25 percent of the time. Activists are already spending significant time with index funds and other large institutions, including during the “off-season,” engaging on environmental, social and governance (“ESG”) matters, making it all the more important for companies to be doing the same.
- **Align Strategy and ESG.** Developing and articulating your strategic, long-term vision and identifying the intangible value creators that actually matter to your company, its stakeholders and its industry will be important tools for shareholder engagement. Long-term investors expect management and directors alike to be familiar with, and be prepared to discuss, how the company’s approach on both strategy and ESG topics are aligned, including with respect to corporate governance, human capital, compensation and the long-term risk of regulation or industry change. For example, State Street expects that directors ensure that corporate culture aligns with strategy, and through engagement they expect directors to articulate their company’s culture and demonstrate how they assess, monitor and influence change to culture when needed.
- **Refresh Disclosure.** Investor communications materials and SEC disclosure should be evaluated with a fresh eye to ensure that the company’s strategic direction and business case, as well as risk factors and challenges, are clear to investors and match current strategic priorities, culture and purpose. Long-term investors also expect these materials to address ESG factors that are material to the company’s ability to generate positive returns for investors over the long run rather than merely highlighting notoriously unreliable ESG rankings. The emphasis should be on substance, not decoration.

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An Investor Consensus on U.S. Corporate Governance & Stewardship Practices

Posted by Michael McCauley, Florida State Board of Administration, on Wednesday, May 9, 2018

Editor's note: Michael McCauley is Senior Officer, Investment Programs & Governance, of the Florida State Board of Administration (SBA). This post is based on a publication from the Florida SBA by Mr. McCauley; Lindsey Apple, Senior Proxy Analyst at MFS Investment Management; Jacob Williams, Florida SBA Corporate Governance Manager; and Tracy Stewart, Florida SBA Senior Corporate Governance Analyst.

The ISG, as a private initiative wholly independent of any regulatory body, was formed to bring together all types of investors to establish a framework of fundamental standards of investment stewardship *and* corporate governance for U.S. institutional investor and boardroom conduct. The Investor Stewardship Group (ISG) is a collective of some of the largest institutional investors and global asset managers with the goal of establishing the first ever, broad-based U.S. Stewardship and Governance Code for companies and investors. Founding members include U.S. and international institutional investors with large investments in the U.S. equity market. Since its inception in late January 2017, membership in the ISG has grown significantly, with assets under management increasing to over $22 trillion.

The ISG published its 'Framework for U.S. Stewardship and Governance' which comprises both a set of six stewardship principles for institutional investors as well as 6 corporate governance principles for U.S. listed companies. (see graphic below) The principles capture fundamental corporate governance and stewardship elements that its members believe are essential to preserving and increasing long-term shareholder value. The corporate governance principles are not intended to be overly prescriptive or all-encompassing in their scope—allowing flexibility in their application. The Framework borrows from other governance codes outside the U.S., which are typically structured on a "comply-or-explain" basis, thereby avoiding concerns over strict compliance and "one-size-fits-all" criticism. The Framework also serves to improve alignment of U.S. corporate governance practices with those in other global markets. Although members of the ISG are supportive of the corporate governance principles, individual ISG members may (and often do) differ on specific standards regarding corporate governance practices that are expected of companies, as outlined in their own proxy voting policies and guidelines. The ISG members will evaluate companies' alignment with these principles, as well as any disclosure of alternative approaches that boards view as being in the company's best interests.

In September 2017, the ISG announced that it had partnered with the John L. Weinberg Center for Corporate Governance at the University of Delaware to serve as the home of the ISG and the ISG Framework. The Weinberg Center works with ISG on ISG's ongoing governance, administration, communications, and other related matters.

ISG Corporate Governance Principles espouse the adoption of annual director elections, boards comprised of a majority of independent directors, majority voting standards used for uncontested board elections, equal voting capitalization with a one-share, one-vote structure, and clear explanations why the board has chosen to adopt or maintain a variety of anti-takeover devices. The ISG Framework also takes the view that directors need to make the substantial time commitment required to fulfill their responsibilities and duties to the company and its shareowners. When considering the nomination of both new and incumbent directors, nominating committees should assess a candidate's ability to dedicate sufficient time to the company in the context of their relevant outside commitments.

In addition to the governance principles, the Stewardship Framework seeks to articulate a set of fundamental stewardship responsibilities for institutional investors. The framework serves to affirm investment managers' responsibility for engagement and proxy voting policies and decisions, regardless of how they may use services offered by third parties. As guidance, the rationales and expectations that underpin each principle have been articulated. For example, Stewardship Principle B-1 states, "Good corporate governance is essential to long-term value creation and risk mitigation by companies. Therefore, institutional investors should adopt and disclose guidelines and practices that help them oversee the corporate governance practices of their investment portfolio companies. These should include a description of their philosophy on including corporate governance factors in the investment process, as well as their proxy voting and engagement guidelines."

The ISG encourages institutional investors to be transparent in their proxy voting and engagement guidelines and to align them with the stewardship principles. These principles should not restrict investors from choosing to adopt more explicit and/or stronger stewardship practices. Notably, the Framework for U.S. Stewardship and Governance is *not* intended to replace or supersede any existing federal or state law and regulation, or any listing rules that apply to a company or an institutional investor. The Framework is also *not* intended to be static. The Framework is designed to be enduring, yet evolving. While the ISG does not anticipate frequent amendments to the Framework, it believes it should be evaluated periodically and amended to reflect commonly accepted governance and stewardship standards over time.

Goals of the ISG

The ISG Framework is likely to have a major impact on how U.S. companies govern themselves, and also improve how asset managers and owners conduct their fiduciary activities on behalf of clients. The Framework advocates constructive dialogue and engagement, practices which have been a work in progress for both investors and issuers. The members believe that the ISG Framework is likely to foster a collaborative reconciliation between a company's strategy and its governance protocol. While announced in 2017, the Framework went into effect January 1, 2018, which was timed to allow U.S. firms to review and adjust to ISG standards in advance of the 2018 proxy season. The ISG encourages companies to evaluate their alignment with the corporate governance principles and where and why they differ in approach. ISG members believe companies can best decide on how and where to disclose their alignment with the Principles, for example, investor relations, boards of directors or corporate governance websites, or in other investor outreach/engagement materials.

While the ISG is the first investor-led governance and stewardship framework developed for the U.S. market, it also aligns with other global stewardship guidelines, such as those espoused by the International Corporate Governance Network (ICGN).

In late March, the ISG announced the establishment of Steering, Governance, and Marketing and Communications committees to provide ongoing guidance and governance of the ISG. The ISG, under the leadership of the Steering and Governance Committees, has adopted an Amendment Process for the Framework that permits all members a means to participate.

The ISG's Framework for U.S. Stewardship and Governance

Stewardship Principles for Institutional Investors	Stewardship Principles for U.S. Listed Companies[1]
A. Institutional investors are accountable to those whose money they invest.	**1.** Boards are accountable to shareholders.
B. Institutional investors should demonstrate how they evaluate corporate governance factors with respect to the companies in which they invest.	**2.** Shareholders should be entitled to voting rights in proportion to their economic interests.
C. Institutional investors should disclose, in general terms, how they manage potential conflicts of interest that may arise in their proxy voting and engagement activities.	**3.** Boards should be responsive to shareholders and be proactive in order to understand their perspectives.
D. Institutional investors are responsible for proxy voting decisions and should monitor the relevant activities and policies of third parties that advise them on those decisions.	**4.** Boards should have a strong, independent leadership structure.
E. Institutional investors should address and attempt to resolve differences with companies in a constructive and pragmatic manner.	**5.** Boards should adopt structures and practices that enhance their effectiveness.
F. Institutional investors should work together, where appropriate, to encourage the adoption and implementation of these corporate governance and stewardship principles.	**6.** Boards should develop management incentive structures that are aligned with the long-term strategy of the company.

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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.

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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."

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Lazard's 1Q 2019 Activism Review

Posted by Jim Rossman, Lazard, on Monday, April 22, 2019

Editor's note: Jim Rossman is Head of Shareholder Advisory at Lazard. This post is based on their Lazard memorandum. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); Dancing with Activists by Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

1. Slower Pace than Record 2018, but In Line with Historical Levels

Q1 2019's campaign activity (57 new campaigns against 53 companies) was down year-over-year relative to 2018's record pace, but in line with multi-year average levels

- Capital deployed in Q1 2019 ($11.3bn) was in line with recent quarters, and the top 10 activists had a cumulative $75.5bn deployed in public activist positions (new and existing)1 at the end of the quarter
- Starboard overtook Elliott as the most prolific activist in Q1 2019, launching seven new campaigns

2. Activism's Transactional Focus Continued

- Transaction-focused campaigns were by far the most common in Q1 2019, with an M&A-related objective arising in nearly 50% of all new campaigns
    - Pushes to sell the company (e.g., Caesars, Zayo) or engage in break-up or divestiture transactions (e.g, Dollar Tree, eBay) were the most frequent M&A objectives
    - Attempts to scuttle or sweeten existing deals were relatively less frequent than in prior quarters

3. Numerous Board Seats in Play Heading into Proxy Season

- Activists won 39 seats in Q1 2019,2 down from a record-breaking 65 in Q1 2018
    - All Board seats won were secured via settlements, as only three campaigns for Board seats (all international) went to a final vote
    - Settlements included notable examples in the K. (Hammerson) and Japan (Olympus)
- Q1 2019 saw a notable surge in long slate nominations, with 10 long slates nominated, accounting for 77 Board seats sought

- Heading into the 2019 proxy season, 103 Board seats remain in play

4. Continued Robust Activity Outside the U.S.

- Campaigns outside the S. continued to account for ~33% of global activity
    - In Europe, activists primarily focused on catalyzing change at their existing campaigns (e.g., Barclays, EDP, Hammerson, Pernod Ricard)
    - ValueAct's settlement for Board seats at Olympus and the defeat of Elliott's proposals at Hyundai Motor Company and Hyundai Mobis indicate continued mixed results for S. activists in Asia
    - Heightened capital deployment in Canada (e.g., TransAlta, Methanex), accounting for 10% of the global total

5. Active Managers Taking Vocal Approach to New Heights

- Wellington Management switched its 13G filing to a 13D and publicly opposed Bristol-Myers Squibb's $74bn acquisition of Celgene
    - Starboard separately opposed the deal, but withdrew its campaign after the deal garnered proxy advisor support
- Neuberger Berman twice intervened in activist campaigns (Ashland Global, SeaChange International) to broker Board refreshment deals and avoid proxy fights

6. Passive Managers Urge Focus on Culture and Purpose

- State Street and BlackRock released letters refining their ESG principles to include corporate culture and purpose
- Comments from passive managers come amid continued inflows into low-cost investment strategies and increasing shareholder concentration

Source: FactSet, press reports and public filings as of 3/31/2019.
Note: All data is for campaigns conducted globally by activists at companies with market capitalizations greater than $500 million at time of campaign announcement.

1. Based on the market value of activist positions initiated since 2013 in which the activist still holds a stake. Excludes derivatives.
2. Represents Board seats won by activists in the respective year, regardless of the year in which the campaign was initiated.

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2018 Year-End Activism Update

Posted by Richard Birns, Daniel Alterbaum, and William Koch, Gibson, Dunn & Crutcher LLP, on Monday, April 15, 2019

Editor's note: Richard Birns is partner and Daniel Alterbaum and William Koch are associates at Gibson, Dunn & Crutcher LLP. This post is based on their Gibson Dunn memorandum. Related research from the Program on Corporate Governance includes Dancing with Activists by Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch (discussed on the Forum here); The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

This post provides an update on shareholder activism activity involving NYSE- and Nasdaq-listed companies with equity market capitalizations in excess of $1 billion during the second half of 2018. Shareholder activism underwent a modest decline in the second half of 2017, but accelerated again in the first half of 2018. A similar pattern emerged during the second half of 2018, with a modest decline relative to the second half of 2017 in the numbers of public activist actions (40 vs. 46), activist investors taking actions (29 vs. 36) and companies targeted by such actions (34 vs. 39). However, in light of the robustness of shareholder activism activity in the first half of 2018, full-year numbers for 2018 are virtually identical to those of 2017, including with respect to the numbers of public activist actions (98 vs. 98), activist investors taking actions (65 vs. 63) and companies targeted by such actions (82 vs. 82).

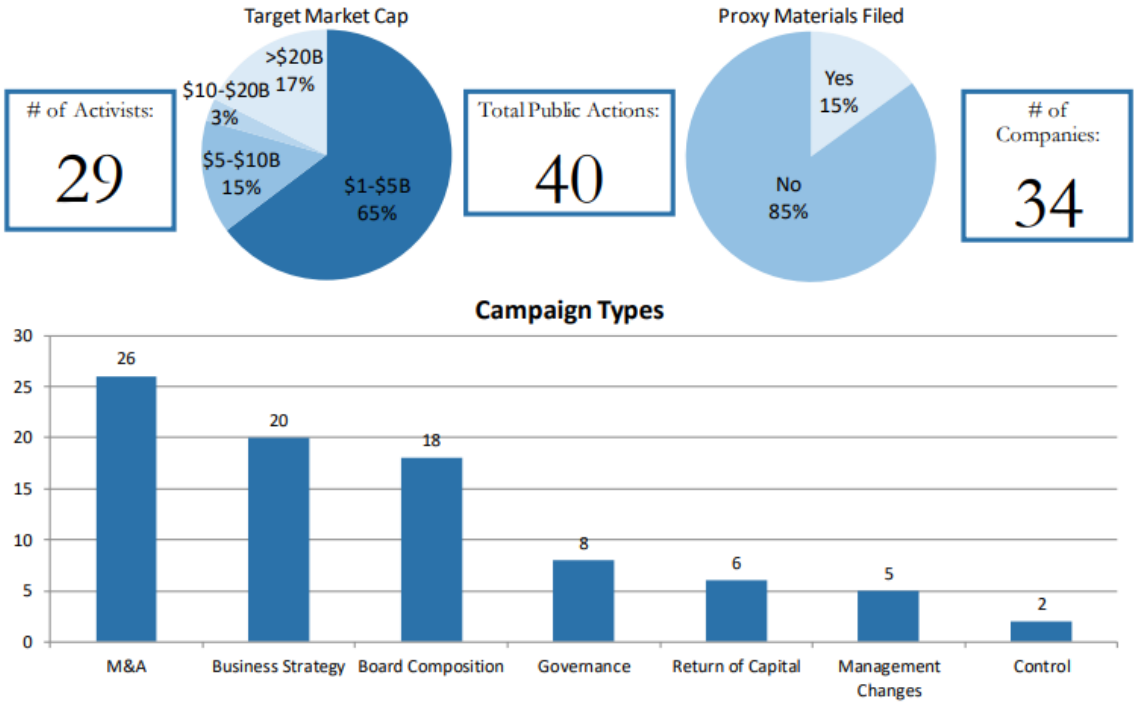
During the period spanning July 1, 2018 to December 31, 2018, four of the 34 companies targeted by activists were the subject of multiple campaigns, led by Dell Technologies Inc., which was the subject of four different activist campaigns. Bunge Limited was also the subject of two simultaneous campaigns by D.E. Shaw Group and a company before settling both campaigns at the same time. As to the activists, seven out of the 29 covered in this post launched multiple campaigns. The market capitalizations of those companies reviewed in this post ranged from just above the $1 billion minimum to just under $100 billion, as of December 31, 2018 (or as of the last date of trading for those companies that were acquired and delisted).

Compared to the first half of 2018, activists focused their campaigns more squarely on M&A as compared to other rationales. In the case of 65% of campaigns, M&A, including advocacy for or against spin-offs, acquisitions and sales, was an activist motivation (as compared to 32% in the first half of 2018), followed by business strategy (50% of campaigns, as compared to 36% in the first half of 2018). Changes to board composition, which had gained prominence in the first half of 2018 as the most common rationale for activist campaigns, represented the goal of activists in 45% of campaigns in the second half of 2018 (as compared to 76% in the first half of 2018). On the other hand, advocacy for changes in governance (20% of campaigns in the second half of

2018), return of capital (15% of campaigns), managerial changes (13% of campaigns) and attempts to take corporate control (5% of campaigns) represented less-frequently cited rationales for activist campaigns. Proxy solicitation transpired in 15% of the campaigns, representing a modest decline relative to the first half of 2018, in which 20% of campaigns featured activists filing proxy materials. (Note that the above-referenced percentages sum to over 100%, as certain activist campaigns had multiple rationales.)

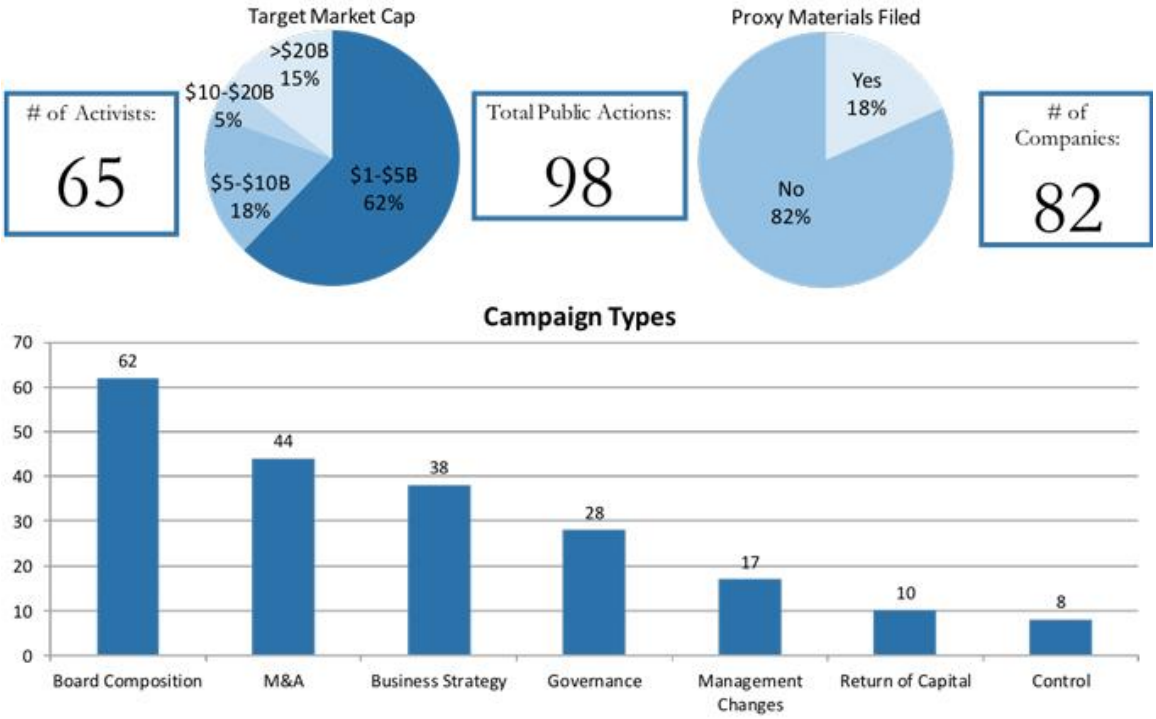
Consistent with the heightened focus on M&A and diminished attention paid by activists in their campaigns to board composition and governance, the number of publicly filed settlement agreements declined to nine (as compared to 21 in the first half of 2018). Consistent with prior trends, certain key terms have become increasingly standard in such settlement agreements. Voting agreements and standstill periods appeared in each of the settlement agreements, and non-disparagement covenants and minimum and/or maximum share ownership covenants appeared in all but one of the settlement agreements. Expense reimbursement appeared in over half of the settlement agreements reviewed (five), continuing a trend that began in the first half of 2018, when 62% of publicly filed settlement agreements contained such a provision (as compared to an historical average of 36% from 2014 through the first of 2017). Strategic initiatives did not figure prominently in settlement agreements entered into during the second half of 2018, being included in only two settlement agreements. We delve further into the data and the details in the latter half of this edition of Gibson Dunn's Activism Update, available here.

By the Numbers—H2 2018 Public Activism Trends



*Study covers selected activist campaigns involving NYSE and Nasdaq-traded companies with equity market capitalizations of greater than $1 billion as of December 31, 2018 (unless company is no longer listed).
**All data is derived from the data compiled from the campaigns studied for the 2018 Year-End Activism Update.

By the Numbers—2018 Full Year Public Activism Trends



By the Numbers—Trends in Settlement Agreements (2014—H2 2018)

H2 2018 Board Representation Analysis

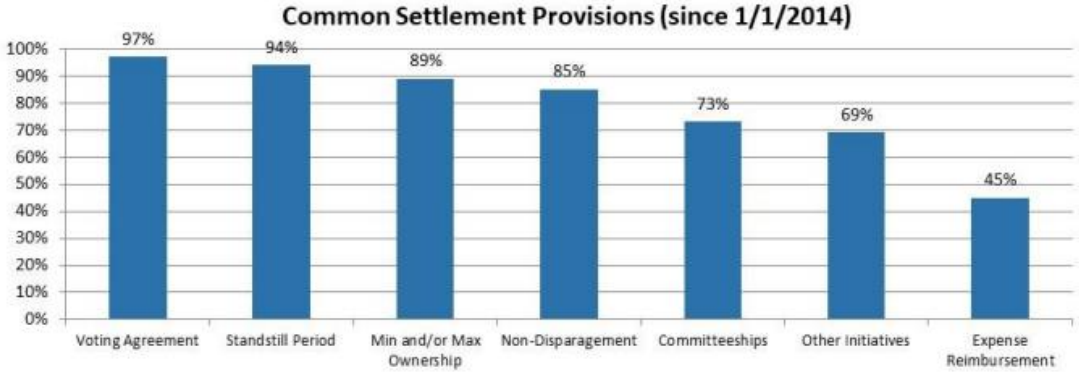
Category	Average
Board Seats Granted	2.1
Total Board Size*	12.3
Percent of Board*	17.1%

*Following settlement agreement

2014-H2 2018 Board Representation Analysis

Category	Average
Board Seats Granted	2.2
Total Board Size*	10.9
Percent of Board*	20.1%

*Following settlement agreement



*All data represented here is derived from the data compiled from the campaigns studied for Activism Update and includes 12 agreements filed in 2014, 22 agreements filed in 2015, 30 agreements filed in 2016, 16 agreements filed in 2017, and 30 agreements filed in 2018.

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Review and Analysis of 2018 U.S. Shareholder Activism

Posted by Melissa Sawyer, Lauren S. Boehmke, and Nathaniel R. Ludewig, Sullivan & Cromwell LLP, on Friday, April 5, 2019

Editor's note: Melissa Sawyer is a partner and Lauren S. Boehmke and Nathaniel R. Ludewig are associates at Sullivan & Cromwell LLP. This post is based on their Sullivan & Cromwell memorandum. Related research from the Program on Corporate Governance includes Dancing with Activists by Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch (discussed on the Forum here); The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

On the surface, the 2018 activism data is largely consistent with 2017, but with an uptick in overall activity. The amount of capital invested in new activist positions in 2018 was up approximately $2.5 billion from 2017, and activists won more board seats in 2018 than in 2017, mostly through settlements. Although several well-known activists (including Third Point, Pershing Square and Greenlight Capital) announced disappointing investment results in 2018, and the industry experienced negative net asset flows overall, activist funds continue to attract substantial new capital.

While Elliott was the most active fund globally in 2018, accounting for 9% of all campaigns, many other established activists were busy: nine of the top ten activist funds (calculated by aggregate market value of their activist positions at year-end 2018) each invested more than $1 billion in new campaigns in 2018. 52% of all board seats won globally since 2013 have been won by a group of 11 activists (in order of board seats won): Starboard, Elliott, Icahn, JANA, Engaged Capital, Sarissa Capital, ValueAct, Corvex, FrontFour, Glenview and Legion Partners. Many of these "name brand" activists have since spun-off new funds, or their key players have moved on to other funds, leading to a dispersion of skills and techniques across a wide playing field and resulting in 2018 producing a record number of first-time activists initiating campaigns.

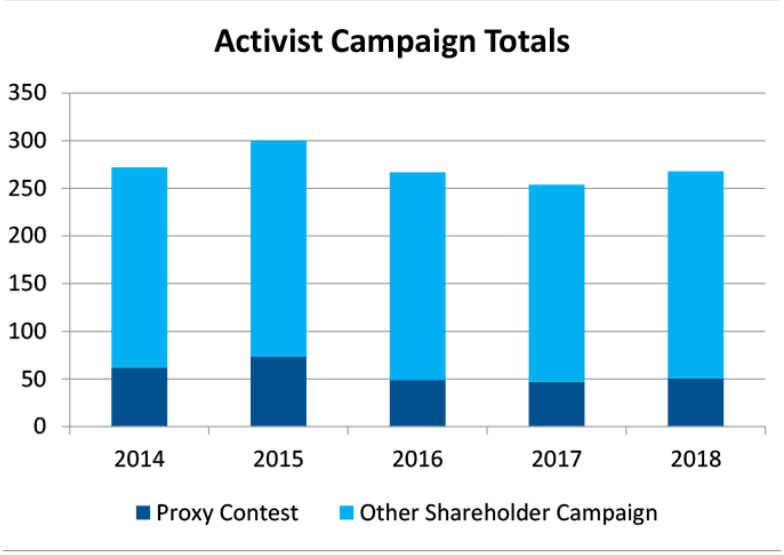
Some activists are also doubling down on their strategies. For example, JANA recently announced it is closing its long/short equity funds to focus on activism and impact investing. Additionally, if there were a market downturn in 2019, the lower entry point for activists would make investments more affordable in companies perceived to be undervalued. In the last four years, when the S&P 500 has decreased year-over-year and the median VIX has increased year-over-year (2014 to 2015 and 2017 to 2018), we have observed increases in the total number of publicly announced activist campaigns. Conversely, during the same four-year period, we have observed decreases in public activist activity in those years in which the S&P 500 has increased year-over-year and the median VIX has decreased year-over-year.

The consistency of 2018's data with 2017's data across multiple metrics suggests that activism practices have begun to stabilize. However, the data alone does not tell the full story, as there have been a few notable trends emerging in the past year. These include: (1) the rise of "purpose" investing; (2) rising prospects for increased civility in activist contests; (3) the changing regulatory landscape; (4) developing technologies that are altering the ways activists and issuers alike can reach shareholders; (5) increased focus on M&A objectives in activism campaigns, including post-deal announcement; and (6) a heightened focus on CEO succession. In addition, more companies are prepared for activists, and activists' strategies are less likely to seem novel or catch large issuers by surprise. Further, more advisors have entered the activism space, resulting in a proliferation of information about how to engage with activists and other shareholders.

Activist Investors

A. Total Activist Campaigns

2018 saw a 5.5% increase in the number of activist campaigns, with 268 campaigns announced. The total number of campaigns has been remarkably consistent over the past five years with an average of approximately 272 campaigns announced per year. However, the total number of public campaigns in a given year does not paint a full picture; based on anecdotal information, a significant number of activist situations also are being resolved without publicity.



Proxy contests made up a slightly smaller percentage of announced activist campaigns in the past three years than had been observed in prior years. During these three years, less than 20% of activist campaigns developed into proxy contests. In comparison, full-scale proxy contests developed, on average, in slightly less than one-quarter of all activist campaigns announced in 2014 and 2015. Importantly, this statistic does not take into account campaigns that were settled prior to developing into a proxy contest but still resulted in board seats for the activists.

H. Most Successful Activists by Board Seats Obtained

Activists have experienced higher success rates in obtaining board seats in recent years, although the volume of campaigns has declined markedly since 2015. In 2018, activists averaged 0.8 board seats per campaign, doubling the 2016 average. As summarized in the table below, activists on average have received more than one board seat for every two campaigns announced in a particular year.

Board Seats Obtained by Activists at U.S. Issuers

	2014	2015	2016	2017	2018
Total Board Seats Obtained	169	173	96	114	116
Number of Total Completed Campaigns	272	300	243	221	143
Average Board Seats Per Campaign	0.62	0.57	0.40	0.52	0.81

The activists that have been the most successful at obtaining board seats are generally those who are the most prolific in terms of number of campaigns. Icahn Associates is a notable exception, in that it has not been in the top-three most frequent activists in any year during the past five years. However, in the campaigns it has announced, Icahn has been remarkably successful, obtaining, on average, 1.48 board seats in each announced campaign over the last five years. Many board seats are also obtained through "quiet" campaigns where an activist engages with the issuer "behind the scenes." As noted in "Notes on the Scope and Sources of Data Used in This Publication," this data is limited to U.S. companies, and so does not reflect the success of activist funds, like Elliott, in Europe over the past five years.

Number of Board Seats Obtained by Most Successful Activists at U.S. Issuers

	2014	2015	2016	2017	2018
Starboard Value LP	24	13	5	7	12
Icahn Associates Corporation	5	9	3	0	14
Elliott Management Corporation	7	6	9	6	5

Types and Objectives of Activist Campaigns

Initiating or threatening to initiate a proxy contest for board representation is a common strategy used by activists to achieve their campaign objectives. A proxy contest occurs when an activist nominates one or more directors for election in opposition to a public company's slate of director nominees. Activists also conduct campaigns through other avenues and tactics, all of which we have included in the general category of "other stockholder campaigns"; this can include publicly disclosing letters to target companies, issuing press releases, proposing precatory or binding shareholder proposals, running "vote no" campaigns against incumbent directors, calling special meetings or taking actions by written consent.

A. Frequency of Different Campaign Types

2018 saw a 5.5% increase in the number of activist campaigns, including both proxy contests and other stockholder campaigns, following a slight reduction in 2017. The number of activist campaigns in 2018 was generally in line with five-year averages.

Number of Campaigns Announced Per Year

	Proxy Contests	Other Stockholder Campaigns	Total
2018	51	217	268
2017	47	207	254
2016	49	218	267
2015	73	227	300
2014	62	210	272
Five-year average	56	216	272

On average, approximately 21% of activist campaigns have taken the form of actual proxy contests in the past five years. The actual percentage of proxy contests compared to total announced campaigns in 2018 was slightly below average at 19%, but this number can be explained in part by the fact that some of the campaigns currently categorized as “Other Stockholder Campaigns” may yet evolve into actual proxy contests in 2019.

B. Underlying Objectives of Activist Campaigns

Although board representation remains the most common objective in activist campaigns, it is almost always sought in conjunction with other underlying objectives. In past years, the most common underlying objectives of proxy contests related to business strategies, balance-sheet actions (such as returning cash to shareholders through dividends or share repurchases, which are often related to capital allocation strategies) and divestitures or other M&A actions (such as encouraging a sale of the company or opposing a merger). In 2018, proxy contests focused mostly on balance-sheet issues (such as concerns about the capital structure of the company) and M&A actions. The number of proxy contests focusing on board-related governance fell dramatically in 2018 after seeing a jump in 2017, and fell far below the five-year average.

Objectives of Proxy Contests

Issue	2014	2015	2016	2017	2018	Five-year average
Business Strategies	44%	34%	21%	15%	12%	25%
Balance Sheet	35%	53%	21%	60%	25%	39%
M&A	27%	40%	21%	13%	27%	26%
Board-Related Governance	26%	26%	23%	51%	14%	28%
Compensation	5%	11%	10%	23%	10%	12%
Other Governance	19%	8%	2%	15%	6%	10%

Underlying Objectives of Other Stockholder Campaigns

Issue	2014	2015	2016	2017	2018	Five-year average
Business Strategies	23%	24%	24%	47%	29%	30%
Balance Sheet	26%	21%	17%	37%	44%	29%
M&A	31%	37%	34%	29%	39%	34%
Board-Related Governance	7%	11%	13%	26%	12%	14%
Compensation	4%	7%	5%	5%	7%	6%
Other Governance	0%	2%	1%	3%	5%	2%

C. Tactics Used by Activists

The most common tactics in the activist's playbook (other than nominating a director slate) are publicity campaigns (including publicly disclosing presentations about the company or letters to the company, issuing press releases, establishing websites and using Twitter and social media). In 2018, publicity campaigns largely returned to their pre-2017 levels; activist investors made public disclosures in 40% of 2018 campaigns. Other tactics that are used from time to time, including initiation of litigation and the calling of a special meeting, happen relatively rarely—in less than five percent of campaigns over this period.

E. Company Responses to Activism

Targeted companies utilize a variety of structural and behavioral actions to respond to activist campaigns. Actions taken by target companies in response to campaigns include:

- hiring advisors and taking substantive business steps (such as evaluating strategic alternatives with or without a public announcement, and returning cash to investors through dividends or buybacks);
- governance changes (including those viewed as governance enhancements by shareholders); and
- tactical actions (such as adoption or revision of poison pills, calling of a special meeting, adjourning or postponing meetings, initiation of litigation or changing board size).

More aggressive tactical steps, such as adoption of poison pills and initiation of litigation, remain relatively uncommon during a campaign. Lastly, target board size changes and share buyback announcements in response to activist campaigns decreased sharply below five-year averages.

Actions Taken by Target Companies in Response to Activism

	2014	2015	2016	2017	2018	Five-year average
Substantive Actions						
Act to Increase Shareholder Value (e.g., buybacks or dividends)	8%	21%	12%	15%	10%	13%
Announce Hiring of Advisors to Evaluate Strategic Alternatives	3%	8%	7%	8%	6%	6%
Governance Changes						
Amend Advance Notice Requirements	2%	4%	3%	2%	2%	3%
Other Charter/Bylaw Changes	5%	10%	3%	9%	5%	6%
Corporate Governance Enhancement	1%	3%	4%	2%	2%	2%
Tactical Actions						
Increase Size of Board	5%	17%	10%	10%	6%	10%
Adopt Poison Pill	7%	1%	2%	3%	2%	3%
Adjourn Meeting	0%	1%	2%	2%	2%	1%
Postpone Meeting Date	1%	3%	2%	2%	2%	2%
Amend Poison Pill	0%	1%	1%	<.5%	1%	1%
Decrease Size of Board	2%	3%	2%	4%	0%	2%
Call Special Meeting	1%	1%	1%	1%	2%	1%
Initiate Litigation	<.5%	1%	0%	2%	1%	1%

Proxy Contests

Initiating a proxy contest for representation on a company's board of directors is one of the primary strategies used by activists to achieve their campaign objectives. Defending against a proxy contest requires a public company to expend considerable time and resources as it undertakes to demonstrate to its shareholders that its director candidates are better positioned to lead the company and the company and the board and management are likely to be subject to repeated attacks throughout the course of the proxy contest. It also requires the company and its management and board to absorb and respond to a steady stream of public criticism. As a result, many companies rationally choose to settle with an activist for limited board representation and a standstill agreement, and accept the risk of prolonged controversy and disruption in the boardroom, rather than taking the risks associated with a public proxy contest (see below under the heading "Settlement Agreements" for a more detailed discussion on settlements). This section analyzes key statistics and trends regarding proxy contests, which may help inform strategies for approaching a potential proxy contest.

However, these overall statistics tell only part of the story, as the decision whether or not to settle in individual cases depends upon the particular facts and circumstances. Moreover, as other statistics provided below demonstrate, the consequences of accepting dissident directors can be profound.

A. How Often Are Proxy Contests Settled?

Proxy Contests: Frequency of Votes, Settlements and Withdrawals

	Total Number	Went to Vote	Percentage	Settled/ Concessions Made	Percentage	Withdrawn	Percentage
2018	51	17	33%	22	43%	5	10%
2017	47	17	36%	19	40%	11	23%
2016	49	15	31%	22	41%	12	25%
2015	73	26	36%	35	48%	12	16%
2014	62	14	23%	32	52%	16	26%

The total number of proxy contests has been stable over the past three years, following a significant drop-off in the number of reported proxy contests in 2016. The recent stabilization in terms of the number of proxy contests in a given year likely reflects a trend toward engaging in private discussions with activist investors to resolve their concerns before a potential proxy contest is made public.

Proxy Contests Settled After the Date of the Definitive Proxy Statement

	Proxy Contests That Went Definitive	As a Percentage of Total Proxy Contests	Proxy Contests Settled After Definitive Date	As a Percentage of Proxy Contests That Went Definitive
2018	24	47%	6	25%
2017	24	51%	5	21%
2016	25	51%	7	28%
2015	36	49%	5	14%
2014	23	37%	5	22%

Each year since 2015, roughly half of the proxy contests extended beyond the date that the proxy statements for both sides went “definitive”—in other words, closer in time to the date of the shareholders’ meeting at which directors are elected. Of these, issuers and activists generally settled, on average, one in four contests.

B. Results of Recent Proxy Contests

Proxy Contests – Short vs. Control Slate

	Number of Proxy Contests With Short Slate	Percentage of Proxy Contests With Short Slate	Activist Wins at Least One Board Seat (Short Slate)	Number of Proxy Contests With Control Slate	Percentage of Proxy Contests With Control Slate	Activist Wins at Least One Board Seat (Control Slate)	Activist Wins Majority of Board Seats (Control Slate)
2018	16	31%	50%	35	69%	46%	9%
2017	23	49%	52%	24	51%	38%	8%
2016	13	27%	39%	36	74%	36%	8%
2015	24	33%	42%	49	67%	39%	8%
2014	18	29%	67%	44	71%	52%	14%

The percentage of proxy contests involving a control slate, or a slate for a majority of the board seats, has ranged from 51% to 74% from 2014 to 2018. This suggests that, once activists invest in formally commencing a proxy contest, many are not content to merely gain a seat at the table to influence the direction of the company but rather are seeking the ability to control the direction of the company, or at a minimum are willing to threaten a control attempt in order to gain negotiating leverage. Control slates returned to more typical levels after a sharp decline in the number of control slate contests (as a percentage of total contests) in 2017 as compared to prior years.

Over the last five years, approximately 45% of all proxy contests, control slates or short slates (a slate for a minority of the board seats) resulted in the activist investor obtaining one or more seats on the board. However, for each year in our study, short slate contests are somewhat more successful than control slate contests by this measure.

Short Slate Contests – Number of Board Seats Sought

	Number of Short Slate Contests	Dissident Nominates 1 Candidate	Dissident Nominates 2 Candidates	Dissident Nominates > 2 Candidates
2018	16	5	3	8
2017	23	2	10	11
2016	13	5	5	3
2015	24	2	13	9
2014	18	2	6	10

When an activist investor puts forward a short slate of directors, they typically nominate two or more director candidates. Over the past five years, activists have sought multiple board seats in approximately 80% of short slate contests each year on average. In 2018, a greater percentage of short slate contests involved activists seeking only one board seat, but activists still sought multiple board seats in the majority of short slate contests.

Proxy Contest Settlement Frequency – Short vs. Control Slate

	Number of Short Slate Contests	Percentage of Short Slate Contests Settled/ Concessions Made	Number of Control Slate Contests	Percentage of Control Slate Contests Settled/ Concessions Made
2018	16	50%	35	40%
2017	16	48%	24	33%
2016	13	31%	36	58%
2015	24	25%	49	60%
2014	18	44%	44	54%

For the three years before 2017, when an activist investor put forward a short slate of directors, the issuer and activist investor ended up agreeing to settle the contest before a vote approximately 32% of the time on average. In the past two years the settlement percentage has been significantly higher. In 2017, the settlement percentage jumped to 48%; in 2018, the percentage increased to 50%, the highest percentage in our study. In the context of control slates, for the three years before 2017, the issuer and activist investor agreed to settle the contest before a vote approximately 57% of the time on average. In 2017, however, that percentage dropped to 33% and increased slightly to 40% in 2018. This data does not appear to present a clear trend, either relatively or absolutely.

The inconsistency in the frequency of the pre-vote resolution of proxy contests in the short versus control slate contexts may have a number of explanations. One explanation is that management may be predisposed to settling in the context of a short slate contest because it may be more difficult to justify the monetary and reputational cost of publicly fighting an activist that is seeking only one or two board seats. In contrast, in the control slate context, an issuer may be less likely to be able to settle with the activist on acceptable terms and may be increasingly willing to defend the company's incumbent directors and strategic direction in a public forum. Issuers' decisions in these cases have been bolstered by data showing that an issuer is more likely to prevail in a control slate contest than the activist.

Outcome of Proxy Contests That Went to a Vote

	Won by Issuer		Won by Activist		Vote Split	
2018	7	41%	8	47%	2	12%
2017	12	71%	4	24%	1	6%
2016	12	80%	3	20%	0	0%
2015	17	65%	7	27%	2	8%
2014	6	43%	8	57%	0	0%

Of the proxy contests that go all the way to a vote, until recently incumbent board candidates had been increasingly successful in defeating activist investors' slates of directors. The margin of success for companies began to decline and fell to a five-year low in 2018. The reasons for the companies' declining success rate vary from campaign to campaign and may result, in part, from an increase in the savviness of activists, improvements in the quality of their director nominees and their increasing appeal to institutional shareholders.

Outcome of Proxy Contests That Went to a Vote – Short vs. Control Slate

	Short Slate Contests			Control Slate Contests		
	Won by Issuer	Won by Activist	Vote Split	Won by Issuer	Won by Activist	Vote Split
2018	33%	67%	0%	43%	43%	14%
2017	80%	10%	10%	57%	43%	0%
2016	60%	40%	0%	89%	11%	0%
2015	67%	27%	7%	64%	27%	9%
2014	33%	67%	0%	50%	50%	0%

From 2015 to 2017, issuers won short slate contests that went to a vote between 60% and 80% of the time. That success rate for short slate contests dropped to 33% in 2018. One possible explanation for the drop is that activist investors have become more selective when pursuing short slate contests. In addition, the limited success of short slate campaigns in the preceding three years, activists may have become increasingly committed to their short slate campaigns and dedicated the necessary resources to see those campaigns through to the finish line.

Similarly, between 2015 and 2017 incumbent slates of directors experienced a fairly rapid year-over-year increase in their success rate with respect to winning control slate votes. In 2018, however, issuer success in control slate contests hit the lowest rate in five years. Although the activist success rate for control contests stayed the same in 2017 and 2018, a vote split in 2018 occurred in 14% of control contests.

C. What Occurs in the Aftermath of a Proxy Contest?

Company Changes in the Aftermath of a Proxy Contest

	CEO Change	Merger or Spin-off	Additional Proxy Contests
2018	6%	6%	0%
2017	9%	9%	28%
2016	7%	14%	21%
2015	11%	14%	11%
2014	44%	31%	0%

The conclusion of a proxy contest, regardless of the outcome, is often a precursor to change for the company. In the year or so after a proxy contest, it is not uncommon to see changes to senior management or the board of directors, strategic initiatives such as mergers or spin- offs or the continuation of activist efforts through additional future proxy contests (whether waged by the same or another activist). The table above presents how often certain changes or events occur in the aftermath of all proxy contests that go to a vote. Note that because these changes can take time, the 2017 and 2018 data should be considered in light of the fact that enough time may not have elapsed since each proxy contest concluded for some of these changes to take place.

Anecdotally, many practitioners believe the incidence of CEO turnover resulting from activism is actually much higher.

There have been fewer CEO changes and mergers or spin-offs from 2015 to 2018, and the likelihood of additional proxy contests declined. However, changes to the board have increased notably since 2014 and have consistently impacted a majority of the target companies after a proxy contest that went to a vote. Activist funds are now holding investments longer, often up to five years, and focusing initially on operational turnarounds. It is possible that activists have had no choice but to adapt to a longer time frame as companies susceptible to quick fixes have largely disappeared due to preemptive actions by boards and prior activist campaigns. We expect that, if operational and share price targets are not achieved, the push for another solution will become more urgent and be reflected in CEO change or merger/ spin-off activity at the same rates as appeared in our data for 2014 and 2015.

Interestingly, the frequency of these types of changes does not seem to depend heavily on the outcome of the contest—that is, whether management or the activist won or the vote was split. This may reflect the fact that activists do not typically withdraw following a contest. They often continue campaigns after a lost vote, many times successfully. It may also indicate that the issues raised during the course of the contest, including those raised by the activist and those arising in shareholder outreach discussions, can in some cases lead the board and management to conclude that responsive steps should be taken even if the management slate wins.

Lastly, no discussion of the aftermath of activist contests would be complete without pointing out that activists are not always successful in delivering the results promised by their campaigns. A good example (but by no means the only example) of this phenomenon is Trian's investment at GE.

The complete publication, including footnotes, is available here.

Harvard Law School Forum on
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Trends in Shareholder Activism

Posted by Josh Black, Activist Insight, on Wednesday, February 27, 2019

Editor's note: Josh Black is Editor-in-chief of Activist Insight. This post is based on an excerpt from the Activist Insight Monthly Half-Year Review 2018, published in association with Schulte Roth & Zabel and authored by Mr. Black, Elana Duré, Iuri Struta, Eleanor O'Donnell, Husein Bektic and Dan Davis. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); Dancing with Activists by Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

The Big Picture

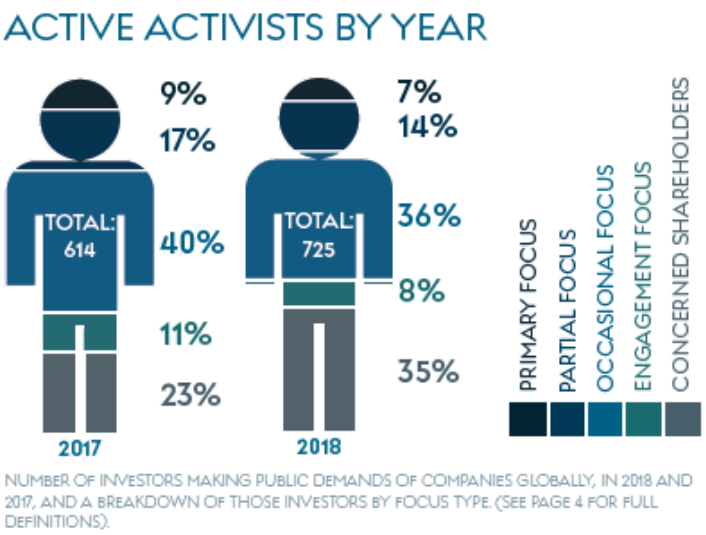
A brief glance at activism in 2018 shows that, after a brief dip in 2017, things are back on track. The number of companies publicly targeted hit record highs in the U.S., Canada, Japan, Australia, and the U.K. Non-U.S. targets made up a record haul of 47%, passing 400 for the first time. Prior to the end-of-year volatility, high valuations in U.S. markets and disruptive forces elsewhere clearly had an impact—as well as swelling activity in Australian and Canadian basic materials industries, only 53% of companies targeted in the Brexit-hit U.K. were targeted by homegrown activists.

M&A activism flourished in a deal-friendly environment: bumpitrage and Elliott Management's take-privates captured the most attention even as the lines between financial and environmental, social, and governance (ESG) activism continued to blur. Activists piling on top of each other at companies like Newell Brands, ThyssenKrupp, Whitbread, and United Technologies highlighted both a limited pool of ideas for well-capitalized funds, and the benefits of incremental pressure as each moved slowly but inexorably in the directions demanded of them.

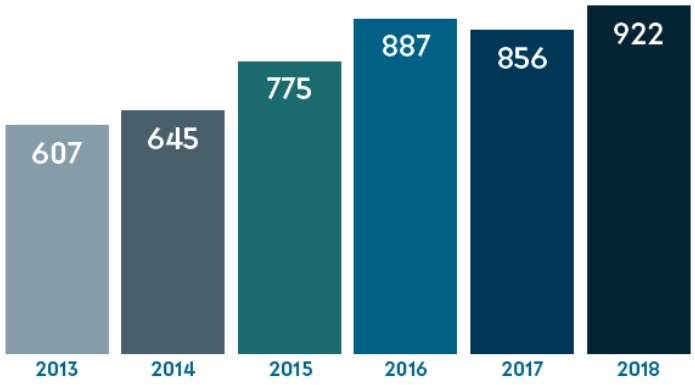
Those tactics meant activists could be effective with smaller pools of capital: according to *Activist Insight Online*, only $42 billion was invested in new positions in the U.S. and Europe during 2018, compared to $72 billion the previous year, even as the proportion of targeted companies valued at more than $10 billion increased.

Activists did not lack for ambition. As we point out in the pages overleaf, they targeted companies with high insider ownership or with no obvious buyer—or both, in the case of Campbell Soup. Trian Partners began a campaign at PPG by calling for the ousting of its CEO, perhaps for the first time.

Yet a year without many big proxy contests meant fewer tests of how institutional investors view activists. Still, activists will have to address the concerns of major shareholders if they are to get a hearing from management teams. As Proxy Insight shows in an article for this report, fears of robo-voting are wide of the mark. Although there has been some talk of engagement-fatigue over the past year, both index funds and active managers are looking deeper into companies for potential risks, with human capital management rising almost to the top of the agenda alongside board diversity.

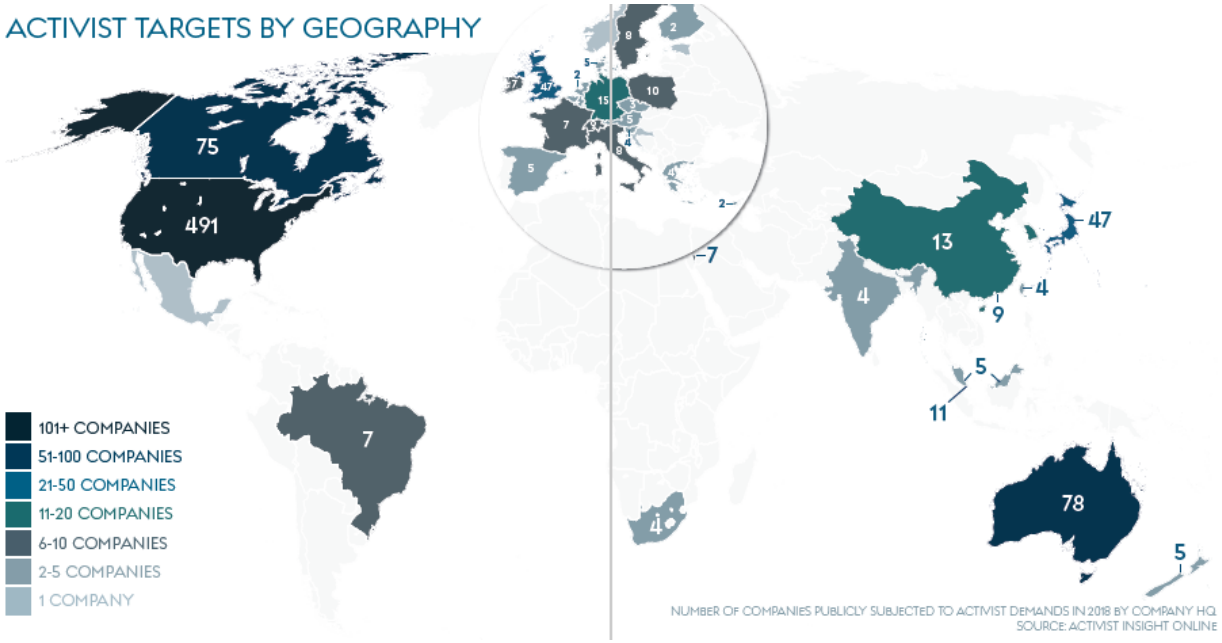


NUMBER OF INVESTORS MAKING PUBLIC DEMANDS OF COMPANIES GLOBALLY, IN 2018 AND 2017, AND A BREAKDOWN OF THOSE INVESTORS BY FOCUS TYPE. (SEE PAGE 4 FOR FULL DEFINITIONS).



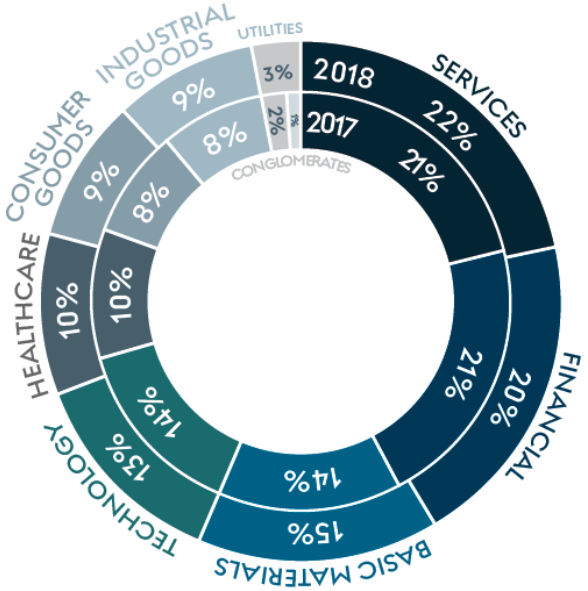
NUMBER OF COMPANIES PUBLICLY SUBJECTED TO ACTIVIST DEMANDS GLOBALLY, BY YEAR.
SOURCE: ACTIVIST INSIGHT ONLINE

ACTIVIST TARGETS BY GEOGRAPHY

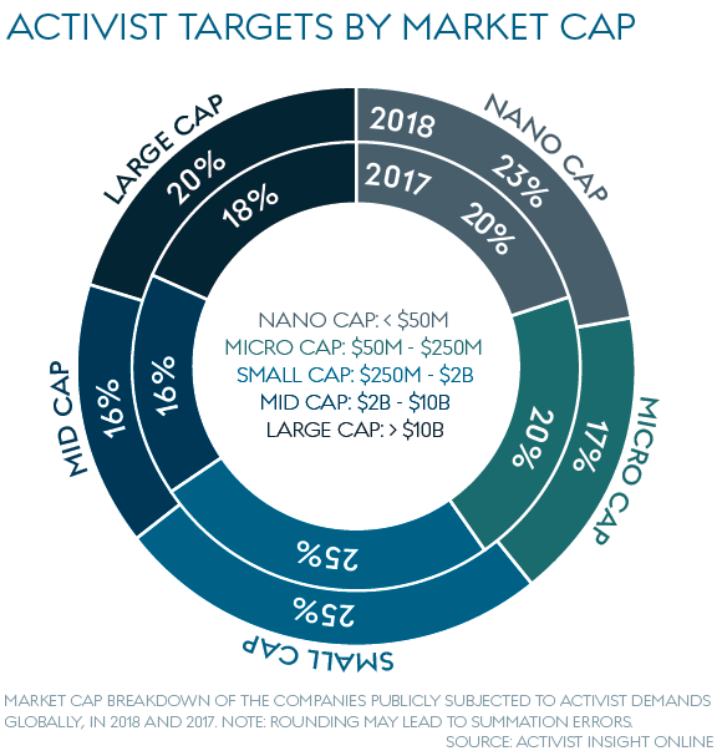


NUMBER OF COMPANIES PUBLICLY SUBJECTED TO ACTIVIST DEMANDS IN 2018 BY COMPANY HQ.
SOURCE: ACTIVIST INSIGHT ONLINE

ACTIVIST TARGETS BY SECTOR



SECTOR BREAKDOWN OF THE COMPANIES PUBLICLY SUBJECTED TO ACTIVIST DEMANDS GLOBALLY, IN 2018 AND 2017. NOTE: ROUNDING MAY LEAD TO SUMMATION ERRORS.
SOURCE: ACTIVIST INSIGHT ONLINE



MARKET CAP BREAKDOWN OF THE COMPANIES PUBLICLY SUBJECTED TO ACTIVIST DEMANDS GLOBALLY, IN 2018 AND 2017. NOTE: ROUNDING MAY LEAD TO SUMMATION ERRORS.
SOURCE: ACTIVIST INSIGHT ONLINE

Activist Insight predicts household name activists will again struggle to find cause to fight proxy contests, although some campaigns that get stuck on a CEO change or other fundamental disagreement may go the distance.

Although we were wrong about the need for a correction to drive activist activity to record highs, the markets will have an impact on whether the action in 2019 is in the U.S., or overseas. American activists have been studying markets like the U.K., Germany, and Japan for some time and an uptick in activity suggests they are now ready to deploy capital if valuations in the U.S. return to their previous highs. If American markets suffer another rout, however, activists will likely stay home.

ESG did prove to be a consistent theme in 2018, if at a low rumble rather than a continuous roar. That will be the case again in 2019 with some funds racing ahead and others trying to keep up. Expect specialists to be in demand at both activist funds and advisory shops.

Activists may push for transactions at an even more furious pace as credit markets tighten and the outlook begins to darken. Some advisers expect activity to mirror 2008, when overall deal volume fell but hostile takeover attempts boomed. Companies that already have activists on their boards may be especially vulnerable.

Greater urgency may also be injected into operational campaigns as the sugar fix of the December 2017 U.S. tax reform wears off. Expect that to mean CEO tenures and multiyear earnings targets come under scrutiny, with more pressure for transformational changes along the lines seen in 2017.

Private equity's relationship with activism has been an uneasy one for a long time. Some private equity firms, such as Waterton Global Resources, are testing out activist strategies and others are partnering with Elliott Management to acquire companies. Yet others are queasy about being seen as unfriendly to management. "White squire" deals at Avon Products and Hudson's Bay Company are alternative models, though they may not be successful. Whether private equity firms stay on the fence or start deploying dry powder in 2019 may influence strategies across the industry.

Withhold campaigns played an outsized role in 2018, especially for newbie activists that had less experience of advance notice bylaws. Those bylaws may come under greater scrutiny following a 2018 lawsuit at Xerox, setting up another litigious proxy season.

The complete publication is available here.

The New York Times

Schumer and Sanders: Limit Corporate Stock Buybacks

Corporate self-indulgence has become an enormous problem for workers and for the long-term strength of the economy.

By Chuck Schumer and Bernie Sanders
Mr. Schumer and Mr. Sanders are U.S. senators.

Feb. 3, 2019

From the mid-20th century until the 1970s, American corporations shared a belief that they had a duty not only to their shareholders but to their workers, their communities and the country that created the economic conditions and legal protections for them to thrive. It created an extremely prosperous America for working people and the broad middle of the country.

But over the past several decades, corporate boardrooms have become obsessed with maximizing only shareholder earnings to the detriment of workers and the long-term strength of their companies, helping to create the worst level of income inequality in decades.

One way in which this pervasive corporate ethos manifests itself is the explosion of stock buybacks.

So focused on shareholder value, companies, rather than investing in ways to make their businesses more resilient or their workers more productive, have been dedicating ever larger shares of their profits to dividends and corporate share repurchases. When a company purchases its own stock back, it reduces the number of publicly traded shares, boosting the value of the stock to the benefit of shareholders and corporate leadership.

Between 2008 and 2017, 466 of the S&P 500 companies spent around $4 trillion on stock buybacks, equal to 53 percent of profits. An additional 40 percent of corporate profits went to dividends. When more than 90 percent of corporate profits go to buybacks and dividends, there is reason to be concerned.

This practice of corporate self-indulgence is not new, but it's grown enormously. Fueled by the Trump tax cut, in 2018, United States corporations repurchased more than $1 trillion of their own stock, a staggering figure and the highest amount ever authorized in a single year.

This has become an enormous problem for workers and for the long-term strength of the economy for two main reasons.

First, stock buybacks don't benefit the vast majority of Americans. That's because large stockholders tend to be wealthier. Nearly 85 percent of all stocks owned by Americans belong to the wealthiest 10 percent of households. Of course, many corporate executives are compensated through stock-based pay. So when a company buys back its stock, boosting its value, the benefits go overwhelmingly to shareholders and executives, not workers.

Second, when corporations direct resources to buy back shares on this scale, they restrain their capacity to reinvest profits more meaningfully in the company in terms of R&D, equipment, higher wages, paid medical leave, retirement benefits and worker retraining.

It's no coincidence that at the same time that corporate stock buybacks and dividends have reached record highs, the median wages of average workers have remained relatively stagnant. Far too many workers have watched corporate executives cash in on corporate stock buybacks while they get handed a pink slip.

Recently, Walmart announced plans to spend $20 billion on a share repurchase program while laying off thousands of workers and closing dozens of Sam's Club stores. Using a fraction of that amount, the company could have raised hourly wages of every single Walmart employee to $15, according to an analysis by the Roosevelt Institute.

Walmart is not alone. Harley Davidson authorized a 15 million share stock-repurchase around the same time it announced it would close a plant in Kansas City, Mo. And Wells Fargo has spent billions on corporate stock buybacks while openly plotting to lay off thousands of workers in the coming years.

At a time of huge income and wealth inequality, Americans should be outraged that these profitable corporations are laying off workers while spending billions of dollars to boost their stock's value to further enrich the wealthy few. If corporations continue to purchase their own stock at this rate, income disparities will continue to grow, productivity will suffer, the long-term strength of companies will diminish — and the American worker will fall further behind.

That is why we are planning to introduce bold legislation to address this crisis. Our bill will prohibit a corporation from buying back its own stock unless it invests in workers and communities first, including things like paying all workers at least $15 an hour, providing seven days of paid sick leave, and offering decent pensions and more reliable health benefits.

In other words, our legislation would set minimum requirements for corporate investment in workers and the long-term strength of the company as a *precondition* for a corporation entering into a share buyback plan. The goal is to curtail the overreliance on buybacks while also incentivizing the productive investment of corporate capital.

Some may argue that if Congress limits stock buybacks, corporations could shift to issuing larger dividends. This is a valid concern — and we should also seriously consider policies to limit the payout of dividends, perhaps through the tax code.

Why wouldn't it be better for our national economy if, instead of buying back stock, corporations paid all of their workers better wages and provided good benefits? Why should a company whose pension program is underfunded be able to buy back stock before shoring up the pension fund?

Whichever way a corporation chooses to invest in its workers, what's clear to the vast majority of Americans is that companies should devote resources to workers and communities *before* buying back stock.

So, in this Congress, the two of us will attempt to get a vote on legislation that demands that corporations commit to addressing the needs of their workers and communities before the interests of their wealthy stockholders.

The past two years have been extremely disappointing for millions of workers. President Trump promised the typical American household a $4,000 pay raise as he pushed for his tax giveaway to the rich. The reality, however, is that from December 2017 to December 2018, real wages for average workers have gone up by just $9.11 a week. Sadly, average workers are making less today than they made in 1973 after adjusting for inflation, while stock buybacks have skyrocketed to record levels.

The time is long overdue for us to create an economy that works for all Americans, not just the people on top. Our legislation will be an important step in that direction.

Chuck Schumer from New York is the Democratic leader in the Senate. Bernie Sanders is a senator for Vermont.

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Correction: *Feb. 4, 2019*
An earlier version of this article misstated the percentage of profits that corporations paid out in dividends from 2008 to 2017. It was around 40 percent, not 30 percent.

A version of this article appears in print on Feb. 4, 2019, on Page A21 of the New York edition with the headline: Workers Before Buybacks

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Are Share Buybacks a Symptom of Managerial Short-Termism?

Posted by Ira Kay and Blaine Martin, Pay Governance LLC, on Saturday, May 18, 2019

Editor's note: Ira Kay is a Managing Partner and Blaine Martin is a Consultant at Pay Governance LLC. This post is based on their Pay Governance memorandum. Related research from the Program on Corporate Governance includes Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay, by Jesse Fried (discussed on the Forum here), and Short-Termism and Capital Flows by Jesse Fried and Charles C. Y. Wang (discussed on the Forum here).

Introduction

Corporate share buybacks (also known as repurchases) have been somewhat controversial for many years, but have taken on even greater significance following the corporate tax cuts passed in 2017 and implemented in 2018. It is estimated that buybacks reached $1 trillion in 2018, likely fueled by extra cash resulting from the tax cuts. Buybacks are also gaining attention across a broader cross-section of the political arena, as three U.S. Senators and an SEC Commissioner have recently criticized share buybacks, with each commentary citing different criticism and potential solutions. [1] [2] [3] However, the common charge is that U.S. public companies are returning money to shareholders instead of investing in productive projects, equipment, workers, and long-term growth. Many buyback critics state the use of earnings per share (EPS) as an incentive metric and stock options inappropriately rewards executives for short-term decisions that reduce long-term value. Specifically, buybacks are criticized for mechanically increasing short-term EPS and "popping" the stock price to generate executive payouts at the expense of long-term performance.

Key Findings

- Many corporate critics believe that excessive share buybacks are an example of harmful executive short-term behavior that creates long-term damage via underinvesting in the core business.
- To evaluate buybacks, we split a sample of the S&P 500 into companies that engaged in small and large buyback activity from 2010 to 2014. We then

[1] Chuck Schumer and Bernie Sanders. "Schumer and Sanders: Limit Corporate Stock Buybacks." The New York Times. February 3, 2019. https://www.nytimes.com/2019/02/03/opinion/chuck-schumer-bernie-sanders.html.

[2] David Morgan et al. "U.S. Republican Senator Rubio Pushes Plan to Tax Stock Buybacks." Reuters. February 13, 2019. https://www.reuters.com/article/us-usa-tax- buybacks/us-republican-senator-rubio-pushes-plan-to-tax-stock-buybacks-idUSKCN1Q22WY.

[3] Commissioner Robert J. Jackson Jr. "Stock Buybacks and Corporate Cashouts." The U.S. Securities and Exchange Commission. June 11, 2018. https://www.sec.gov/news/speech/speech-jackson-061118#_ftn23.

evaluated TSR and other corporate performance metrics after the buyback period (2014-2018).
- Four-year post-buyback performance on TSR and CapEx growth was higher for the companies in the large buyback sample than for the companies with smaller buybacks. This indicates that share buybacks likely did not damage long-term performance or investment.
- Higher short-term (one-year) TSR is associated with higher long-term subsequent (three-year) TSR and CapEx investment. This finding suggests that companies generally do not sacrifice long-term returns or investments for short-term gains.
- The use of stock options and EPS-based incentive plans, rather than encouraging short-term gains at the expense of long-term performance, are correlated with higher long-term TSR.
- Our research shows that buybacks do not appear to be harmful to long term corporate performance. Companies need to continue to align executive incentives with capital decisions to continue their success.

This is an important and charged topic, as many large companies conduct share buybacks that are approved by their boards and typically discussed with large shareholders. Despite solid governance and shareholder support, critics of buybacks include some governance and shareholder groups, politicians, the business media, and academics who are opposed to the alleged short-term implications of a buyback or the "shareholder primacy" model in general.

To bring some important facts to the debate regarding the reality of corporate capital allocation and investment, Pay Governance has updated and expanded our original research on the relationship among share buybacks, long- term growth, and executive compensation for S&P 500 companies. This new study builds on the findings from our prior analysis; importantly, it adds total shareholder return (TSR) and other metrics evaluated not only during, but *after*, the buyback period.

The Relationship Among Share Buybacks, TSR, CapEx Growth, and Revenue Growth

We examined buybacks (2010-2014) and key financial metrics *after* the buyback period (2014-2018). We measure share buyback activity by calculating the change in common shares outstanding (CSO). [4] Using a sample split into groups of companies with above- and below-median change in common shares outstanding, we examined the effect of buybacks on TSR and financial growth data for the subsequent four-year period following the buyback period. Our analysis was based on the same sample as our 2014 research on share buybacks but excluded companies that were acquired or merged. With the benefit of an expanded post-buyback time frame, we were able to compare the long-term performance and prospects for companies with and without share buyback capital allocation strategies.

[4] Companies in our "Small (or Zero) Buyback Companies" subset include companies that conducted no buybacks and companies that were net share issuers.

TABLE 1: SHARE BUYBACKS, TSR, AND CAPEX

Group	Median Change in CSO (2010-2014)	Post Buyback Period Performance (4-Year)				
		Median TSR (12/31/2014-12/31/2018) (Annualized)	Median CapEx Growth (2014-2018) (CAGR)	Median Employee Count Growth (2014-2018) (CAGR)	Median Revenue Growth (2014-2018) (CAGR)	Median EPS Growth (2014-2018) (CAGR)
Small (or Zero) Buyback Companies	5.0%	4.2%	3.5%	1.7%	4.2%	9.15%
Large Buyback Companies	-12.8%	5.4%	4.1%	2.6%	3.8%	9.14%
Total Sample	-4.4%	4.8%	3.7%	2.3%	3.9%	9.14%

n=404
CAGR: compound annual growth rate; CapEx: capital expenditure; CSO: common shares outstanding; TSR: total shareholder return

Contrary to the common assertion that share buybacks damage long-term growth and investment, we found (Table 1) that companies conducting larger share buybacks **(**-12.8**%** change in common shares outstanding over four years**)** showed higher TSR, higher CapEx growth, and higher employee count growth over the subsequent four-year period. Additionally, the companies conducting large buybacks continued to grow revenue in the subsequent period at a pace nearly as fast as the group with smaller buybacks (3.8% annualized revenue growth versus 4.2%). Earnings growth was equal between the two groups (9.15%).

While buybacks are explicitly intended to optimize EPS and potentially increase stock prices, we make no claim that the large buybacks are *causing* the subsequent favorable TSR and CapEx growth. However, the TSR and other data in a “post-buyback” period appear to demonstrate no long-term damage or obvious cannibalization of CapEx investment. This is confirmed in the following sections.

While it is *possible* a company could have grown revenues even further through investing or hiring, it is also not clear that incremental investment would have resulted in higher revenue growth or, more importantly, earnings growth that shareholders would have valued on par with a share buyback. The equal bottom-line EPS growth (9.15% annualized growth) between the two buyback groups suggests that both appear to be optimizing earnings growth.

The Relationship Between Short-Term TSR and Long-Term Performance

The argument of corporate myopia, or short-termism, hinges on the claim that short- and long-term corporate financial success are frequently antithetical and present an excessive trade-off. Examples of such commentary include arguments stating that buybacks damage future results and that companies reduce other investments to attain short-term profits at the expense of long-term growth and profitability.

To examine this, we expanded our investigation into how companies’ strong short-term performance affected long- term performance as measured by TSR and CapEx growth. If the corporate sector is broadly myopic, we would expect companies with higher short-term TSR to have lower subsequent long-term TSR and lower CapEx growth. It seems reasonable to test whether companies that are making short-term cost savings decisions **(**e.g., reducing CapEx growth**)** to increase the short-term stock price are consequently damaging their long- term value.

TABLE 2: SHORT-TERM TSR AND SUBSEQUENT LONG-TERM TSR AND CAPEX GROWTH

Period	Group	Short-Term (1-Year) TSR		Long-Term (3-Year) Subsequent TSR (Annualized) and CapEx (CAGR)				
		Period	TSR	Period	TSR	TSR Change	Capex	CapEx Change
1	High Short-Term TSR	2008	-18.4%	2009-2011	14.7%	Lower	0.0%	Higher
	Low Short-Term TSR		-50.6%		22.1%	Higher	-0.6%	Lower
2	High Short-Term TSR	2009	61.3%	2010-2012	14.8%	Higher	15.7%	Higher
	Low Short-Term TSR		13.1%		11.6%	Lower	8.0%	Lower
3	High Short-Term TSR	2010	39.2%	2011-2013	17.9%	Higher	17.0%	Higher
	Low Short-Term TSR		6.1%		16.7%	Lower	7.1%	Lower
4	High Short-Term TSR	2011	18.3%	2012-2014	21.9%	Equal	9.9%	Higher
	Low Short-Term TSR		-11.4%		22.0%	Equal	4.5%	Lower
5	High Short-Term TSR	2012	29.7%	2013-2015	16.9%	Higher	7.7%	Higher
	Low Short-Term TSR		5.7%		13.8%	Lower	1.5%	Lower
6	High Short-Term TSR	2013	57.0%	2014-2016	9.7%	Higher	5.8%	Higher
	Low Short-Term TSR		19.3%		7.8%	Lower	1.3%	Lower
7	High Short-Term TSR	2014	27.4%	2015-2017	10.3%	Higher	6.3%	Higher
	Low Short-Term TSR		1.6%		9.1%	Lower	-0.9%	Lower
8	High Short-Term TSR	2015	13.6%	2016-2018	8.3%	Higher	7.9%	Higher
	Low Short-Term TSR		-17.1%		6.4%	Lower	0.6%	Lower

CAGR: compound annual growth rate; CapEx: capital expenditure; TSR: total shareholder return

To test this (Table 2), we reviewed and compared S&P 500 companies with low and high short-term TSR (below and above sample median, respectively) to the subsequent long-term TSR and Cap-Ex growth over eight discrete periods. We found that, with the exception of 2008 (probably due to the financial crisis [5]), each period reviewed showed that companies with higher short-term TSR had equal or higher subsequent long-term TSR and CapEx growth relative to companies with lower short-term TSR.

While this test was not definitive, companies appear to be buying stock *without* suffering long-term repercussions or cutting expenses/investments to increase short-term share prices. Rather, the market appears to recognize and reward in the short-term those companies that optimize for the long-term (as illustrated by the correlation between short-and long-term TSR and CapEx growth). While we do not claim that strong short-term performance *causes* strong long-term performance, it appears that companies are optimizing their capital allocation strategies.

The Relationship Between Executive Compensation Design and Share Buybacks

Much of the criticism of share buybacks focuses on the assertion that executive incentive programs encourage short-term focus on increasing their annual compensation and that this myopia has resulted in share buybacks that are otherwise an inefficient allocation of capital. We examined the relationship between executive compensation design and share buybacks by reviewing the use of EPS as a metric in annual bonus plans as well as the use of stock options in long-term incentive (LTI) plans. Table 3 below presents the results of our findings.

[5] 08's -50% TSR appears to have generated a substantial and unique bounce-back. The companies in this group, however, on the average did not get back to their 2007 stock prices even after 3 years of subsequent +22% TSR CAGR.

TABLE 3: EXECUTIVE COMPENSATION DESIGN, SHARE BUYBACKS, AND TSR

Incentive Design Characteristics	Sample Size	Median Change in CSO 2010-2014	Annualized Median TSR 2010-2014	Annualized Median TSR 2015-2018
Grants Stock Options	248	-5.4%	18.2%	5.0%
Does Not Grant Stock Options	149	-1.3%	16.1%	4.8%
Uses EPS as Annual Bonus Metric	123	-4.9%	17.9%	6.4%
Does Not Use EPS as Annual Bonus Metric	274	-3.9%	17.7%	3.6%
Grants Stock Options and Uses EPS Bonus Metric	80	-6.5%	18.2%	7.0%
Does Not Grant Stock Options or Use EPS Bonus Metric	113	-2.2%	17.2%	4.8%
Total Sample	397	-4.4%	17.9%	4.8%

CSO: common shares outstanding; EPS: earnings per share; TSR: total shareholder return

We found that EPS use in annual incentive plans and the use of stock options were indeed associated with increased share buybacks. Contrary to the short-term criticism, companies that granted stock options and used EPS in bonus plans had higher TSR in the period contemporaneous with share buybacks **(**2010-2014**)** a nd the subsequent period (2015-2018**)**.

These findings stress the impact of executive compensation design decisions, including the mix of LTI vehicles and metrics, on company performance. [6] Incentives must appropriately motivate executives to optimize not just a company's operating performance but also its efficient allocation of capital. These findings are not intended to prescribe a particular LTI mix or incentive metric; rather, they demonstrate the importance of selecting the right LTI vehicles and metrics given a company's current and future business outlook.

Conclusion

Following up on Pay Governance's original research into the relationship among executive compensation, share buybacks, and shareholder value creation, we found even stronger evidence that certain executive compensation structures (granting stock options and using EPS bonus metrics) are correlated with share buybacks. We also debunked two common myths: that share buybacks damage long-term corporate investment and that there is an excessive trade-off between short-term and long-term shareholder returns.

Taken together, these findings suggest an alternate narrative about the relationships between executive pay, share buybacks, shareholder value, and company growth. The contemporary fact-driven story of share buybacks is not one of managers shirking investment and long-term stewardship of corporate capital but one of disciplined capital allocation. Companies conducting the largest share buybacks are not just rewarding shareholders with higher long- term returns; they also appear to be investing in the long-term through capital expenditures.

[6] The large amount of executive stock ownership would also serve to balance the pressures in trading off short- and long-term performance.

Executive compensation programs are an important part of the strategic structure ensuring this efficient capital allocation and long-term corporate financial sustainability. The use of short- and long-term financial metrics and share-based incentives remains a proven approach for focusing executive teams on long-term value drivers and aligning executive pay with shareholder interests.

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Share Buybacks Under Fire

Posted by Lizanne Thomas, Robert A. Profusek, and Lyle G. Ganske, Jones Day, on Tuesday, May 21, 2019

Editor's note: Lizanne Thomas, Robert A. Profusek, and Lyle G. Ganske are partners at Jones Day. This post is based on their Jones Day memorandum. Related research from the Program on Corporate Governance includes Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay, by Jesse Fried (discussed on the Forum here), and Short-Termism and Capital Flows by Jesse Fried and Charles C. Y. Wang (discussed on the Forum here).

Stock buybacks reached record levels in recent years, fueled in part by the 2017 tax cuts, shareholder activism, and record low borrowing costs. S&P 500 companies repurchased a record $770 billion in shares in 2018, and forecasts for 2019 are even higher, with companies expected to repurchase $940 billion—using almost a third of the aggregate $3 trillion in cash reflected on the balance sheets of the S&P 500.

Stock buybacks have, however, been sharply criticized of late and have been ensnared in the bitter partisanship in Washington. For example, Senators Schumer and Sanders penned an op-ed in *The New York Times* outlining a plan to limit buybacks to companies that pay workers at least $15 an hour and provide paid sick time. Others have advocated for restrictions on executives' abilities to sell their shares following a buyback announcement or to require additional disclosure about the board's reasons for choosing a share repurchase. Are these criticisms justified, or have buybacks been targeted unfairly?

One of the chief arguments against buybacks is that companies that repurchase shares are using capital for a short-term purpose—returning cash to shareholders—at the expense of long-term goals.

One of the chief arguments against buybacks is that companies that repurchase shares are using capital for a short-term purpose—returning cash to shareholders—at the expense of long-term goals, such as R&D, capital improvement, and worker training. In fact, some companies have used this "short-termism" argument to resist demands by shareholder activists to implement substantial returns of capital.

Capital allocation decisions are, however, far more complicated than many buyback critics admit. In certain circumstances, particularly when interest rates are low and/or the company has a cash surplus, a company's investment in its own shares may be the most efficient near-term use of capital for the company and its shareholders. Cash returned to shareholders can be reinvested in companies with different growth profiles or capital needs, efficiently allocating capital across the economy. Moreover, there is no compelling evidence that share repurchases ultimately result in decreased cap ex spending or negatively impact long-term growth, as for most companies

dividends and other returns of capital are but one component of a company's overall capital allocation strategy.

Another criticism of buybacks is that they unfairly enhance executive pay. Of course, share repurchases boost earnings per share, and may increase share prices, at least in the short-term. When incentive compensation packages are based in part on those metrics, critics may claim that buybacks are unfairly enriching executives. It is our sense, however, that these criticisms based on the purported impact of buybacks on employee pay are misguided.

While they sometimes are opportunistic, buybacks are part of a company's overall capital allocation policy in most cases, and compensation targets are set with this in mind. Moreover, buybacks generally have a positive impact on share prices which, of course, benefits all shareholders, not just executives or employees. Finally, some of the legislative efforts to regulate and improve transparency about buybacks identify a problem that has already been solved—the SEC's current disclosure requirements already cover all that is needed.

A related point, however, is how the buyback boom should affect executive compensation decisions on a more basic level. The overall trend to align shareholder and management interests has resulted in very substantial increases in the percentage of top management (and even directors) being made in the form of equity rather than cash.

However, in an era in which stock buybacks are substantial and consistent, it at least raises the question whether it makes sense for companies to pay employees in equity when they are buying back stock—and have been for years. Companies with large-scale repurchase programs may consider whether general changes to compensation practices are warranted—such as more sharply targeting the people in the equity pool, putting hold requirements on stock awards, adopting (or readopting) vesting restrictions and using phantom equity, which on the whole, are practices that are otherwise becoming less prevalent.

As with most governance issues, there is no one-size-fits-all approach here. Moreover, the decision of how to best allocate capital is, of course, squarely within the purview of the board. Although buybacks may have a short-term impact, that is precisely the kind of investment decision the board is expected to make—how to allocate the company's capital among short- and long-term uses and opportunistic or strategic goals.

In our view, severely restricting repurchases—or limiting them to companies that have adopted specific employment practices—may be an inapt, or even pernicious, way to address concerns relating to share buybacks and may have an unintended impact on the economy as a whole, and Congress has more important topics on which to focus than this.

Two Key Takeaways

- Corporate share buybacks remain at record high levels, although they have been sharply criticized and have spurred possible federal legislation curbing their use.
- Capital allocation decisions—including the return of capital to shareholders through dividends or repurchase programs—are squarely within the purview of the board of directors. Directors should, however, be sensitive to the

criticisms lodged against share buybacks when designing and implementing a repurchase program.

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Democratic Senators and the Buyback Boogeyman

Posted by Jesse Fried (Harvard Law School) and Charles C.Y. Wang (Harvard Business School), on Wednesday, March 13, 2019

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

Last month, Senator Chuck Schumer, along with Senator and presidential candidate Bernie Sanders, declared they would introduce "bold" legislation to prohibit a public firm from repurchasing its own stock, unless the firm first invests in employees and communities, including paying workers at least $15 per hour and offering "decent" pension and health benefits. Welcome to Washington's newest political ritual: Senators seeking to demonstrate their concern for workers by proposing bills that severely restrict—or even outlaw—buybacks. Unfortunately, these proposals appear motivated by misleading measures of corporate capital flows, as well as on a profound misunderstanding of how the U.S. economy works. If enacted, such bills could threaten not only the capital markets but the employees and communities the Senators claim to care about.

Leading Senate Democrats appear to believe that repurchases, when added to existing levels of dividends, harm workers and impair long-term investment by starving firms of needed capital. The Schumer-Sanders bill would join legislation introduced by Schumer and Senator Tammy Baldwin to give the Securities and Exchange Commission authority to reject buybacks that, in its judgment, hurt workers. It also would require boards to "certify" that a repurchase is in the "best long-term financial interest of the company." Senator Baldwin has introduced another bill, co-sponsored by Senator (and presidential candidate) Elizabeth Warren that goes even further: It bans all open-market repurchases.

The accepted wisdom among the Democratic leadership is flat out wrong; there is simply no evidence that the overall volume of corporate payouts to shareholders, through repurchases and dividends, is excessive. Buyback critics, including Schumer and Sanders, say that S&P 500 firms don't have enough investment capital because dividends and repurchases routinely exceed 90% of their net income. Between 2007 and 2016, for example, these companies distributed $7 trillion to shareholders, mostly via repurchases. That was 96% of total net income. But our research shows that public firms recover from shareholders—directly or indirectly—about 80% of the capital distributed via repurchases. Shareholders return this capital by buying newly issued shares, mostly from employees paid with stock, but also directly from firms. Taking into account all types of equity issuances, *net* shareholder payouts in S&P 500 firms during the decade 2007-2016 were only about $3.7 trillion, or 50% of total net income. We analyzed the latest data

available and found this pattern persisted through the third quarter of 2018, after the Trump tax cut had gone into effect.

Consider Microsoft. Between 2007-2016, it distributed $188 billion through buybacks and dividends—more than almost any other public firm—but also simultaneously issued $49 billion of equity to shareholders, making its *net* shareholder payouts only $139 billion.

At this level, net shareholder payouts don't appear to impair investment capacity or firms' ability to pay workers. Indeed, our research shows that total capital expenditures as well as R&D expenditures by public firms are both at the highest level ever. Moreover the *intensity* of investment intensity at public firms, measured by the ratio of capital expenditures and R&D to revenue, has been rising over the past 10 years and is near peak levels not seen since the late 1990s. In fact, R&D intensity at public firms recently reached an all-time high.

One might argue that firms would invest or pay workers *even more* if they had more cash at their disposal. But there is no shortage of cash. During 2007-16, cash balances at S&P 500 firms also rose by 50%, reaching around $4 trillion, providing ample dry powder for additional expenditures. By the end of Q3 2018, these stockpiles had reached $4.5 trillion, even *after* the increase in corporate buybacks following the tax cut.

Again, consider Microsoft. Despite $139 billion in *net* shareholder payouts between 2007 and 2016, Microsoft doubled its annual R&D and capital expenditures—from $10 billion to $20 billion—and boosted its workforce by over 40%. Meanwhile, Microsoft's cash balances grew $90 billion to a whopping $113 billion. By the end of 2017, these balances had reached $143 billion. Given capital needs elsewhere in the economy, the remarkable level of idle cash at Microsoft and other firms suggests that net shareholder payouts are not too high, but may actually be too *low*.

The various proposals to restrict or ban repurchases would make it harder for public firms to return this surplus capital to investors. Indeed, that is the whole point. But the problem with damming up these funds in public companies is that young and growing private firms, which collectively require enormous amounts of equity capital, will find it harder to obtain financing. Private firms are vital to the U.S. economy. They account for more than 50% of nonresidential fixed investment, employ almost 70% of U.S. workers, and generate nearly half of business profits. And historically, private firms funded by VC and PE funds, including Silicon Valley start-ups, have generated tremendous innovation and job growth in the United States, including many high-paying jobs. Forcing large public firms to retain funds they cannot profitably deploy will make it harder for these potentially fast-growing firms to firms hire more employees, pay higher wages, and invest in their communities.

To be sure, firms could respond to restrictions or a ban on buybacks by issuing larger dividends. If firms can easily substitute dividends for repurchases, there will in fact be little harm. But once Congress has begun making decisions about capital allocation, why would it want to limit itself to repurchases? Indeed, even before their anti-buyback legislation has been introduced, Schumer and Sanders have indicated that policymakers should also "seriously consider" proposals to limit the payout of dividends. If Congress goes down this road, large public companies will mis-invest and mis-spend their excess cash, and private firms will be deprived of much needed growth capital. Stock prices will decline, 401(k) savers will be hurt, and IPOs will dry up: who would invest in a public firm if future profits will not be returned to investors?

Moreover, once federal legislators give themselves the authority to decide how much public firms can distribute to investors, they will be tempted to add more mandates and restrictions, ostensibly to address other “problems” in corporate America, but actually to benefit key electoral constituencies and contributors. Crony capitalism will replace real capitalism. Let’s hope Schumer and his Senate colleagues don’t lead us down this path.

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Letter on Stock Buybacks and Insiders' Cashouts

Posted by Robert J. Jackson, Jr., U.S. Securities and Exchange Commission, on Friday, March 8, 2019

Editor's note: Robert J. Jackson, Jr. is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on a letter by Commissioner Jackson to Senator Chris Van Hollen. The views expressed in the post are those of Commissioner Jackson and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

Thank you for your December 18, 2018 letter regarding my research on the relationship between stock buybacks and corporate insiders' stock cashouts—and for your leadership in urging the SEC to ensure that our rules protect investors when public companies buy back stock. I very much appreciate the opportunity to share further details on this work.

I first raised these concerns in a speech last June, when my Office released original research showing that corporate insiders cash out much more of their personal stock immediately after announcing a buyback than on an ordinary day. If executives believe a buyback is the right thing to do, they should hold their stock over the long term. Instead, we found that many executives use buybacks to cash out. That creates the risk that insiders' own interests-rather than the long-term needs of investors, employees, and communities-are driving buybacks.

The issue is more pressing than ever. Since January 2018, when the Tax Cuts and Jobs Act took effect, American public companies have announced a record $1 trillion in buybacks. That's all the more reason why the SEC should, as I proposed last year, hold an open comment period to revisit our rules governing buybacks-rules we haven't examined since 2003.

In your letter, you asked me to address the possibility that my findings "could be coincidental because [a buyback] might coincide with periods when executives are permitted to sell their stocks." The concern is that insiders, aware of a pending buyback, may be prohibited from trading until the event is public, so the selling we observe is driven by the lifting of that restriction. In response to your letter, my Office conducted additional analysis of buybacks and insider cashouts. Our findings show why this area deserves further attention:

- ***First,*** insiders sell more stock when they announce buybacks than on an ordinary day. Some firms likely restrict trading in advance of buybacks; in our sample, 38% of firms with insider sales after buyback announcements have no pre-announcement trading. However, as explained in more detail below, our findings are robust to controls for different levels of pre-announcement trading.
- ***Second,*** insider selling on buybacks is associated with worse long-term performance. It's well known that some buybacks produce long-term stock-price increases while others lead only to a short-term price pop. We show that, when executives unload significant

amounts of stock upon announcing a buyback, they often benefit from short-term price pops at the expense of long-term investors. SEC rules do not address insiders' incentives to pursue buybacks at the expense of buy-and-hold American investors.

It has been over a decade since the Commission last examined our rules governing buybacks. Since then, the growth of stock-based pal has given insiders reason to look for chances to liquidate their shares in public companies. The evidence shows that buybacks give executives that chance-even when it doesn't make long-run sense.

Our securities laws should encourage executives to pursue the kind of sustainable value that creates the stable jobs American families count on. But SEC rules governing buybacks do not distinguish between those that allow executives to cash out on short-term stock-price pops and those that reflect the company's long-term needs. That's why today I am renewing my call for the SEC to open a comment period to reexamine whether, and how, those rules allow corporate insiders to benefit from buybacks at the expense of ordinary investors.

I. Stock Buybacks and Corporate Cashouts: Further Evidence

An important and insightful question about my research has been raised by those who wonder whether buybacks lead to more insider cashouts because executives are often prohibited, or "blacked out," from trading before a buyback. It might be the lifting of the prohibition on insiders' freedom to sell, rather than the buyback, that is driving the selling we see, because there is "pent-up" insider interest in selling that can be addressed only after the buyback is announced.

To examine this possibility, my Office extracted data on all buybacks between January 2017 and the end of 2018. We then estimated the length of any pre-announcement trading prohibition by observing insider transactions in the period prior to the announcement. Consistent with the possibility that such prohibitions apply during this period, 38% of the firms in our sample have no trading in the thirty days prior to the date the buyback is announced. However, and consistent with prior studies, we see that a majority of firms conducting buybacks have insider transactions during the eight days before the buyback is announced.

Because different firms take different approaches to this issue, we empirically measure pre-announcement trading and control for those differences. Controlling for pre-announcement trading, we think, makes sense because a lack of pre-announcement trading may influence the level of post-announcement trading. However, we find that controlling for pre-announcement trading activity has little effect on the level of insider selling on the day a buyback is announced. In other words: even after we account for differences in policies regarding pre-announcement trading, we still observe higher levels of insider selling on buybacks.

Because our estimates of trading restrictions are necessarily imprecise, we performed a second test. Since earnings releases usually involve this kind of restriction, we simply removed from our sample any buyback announced within twelve days of an earnings release. About 41% of the buybacks in our sample fall into this category. Even after removing these cases, we see statistically significantly higher levels of insider selling on the day a buyback is announced.

Even after accounting for important differences in firms' approaches to insider trading before buybacks are announced, the evidence shows that, on average, executives sell far more stock

when they announce a buyback than on an ordinary day. The implications of this evidence for the SEC's work is debatable; the fact that many executives sell significant amounts of stock immediately after they announce a buyback is not.

II. Stock Buybacks and Executives' Incentives

Another important question often raised about this research is the relationship between insider cashouts and post-buyback performance. The evidence you requested in your letter points to a troubling trend. When insiders sell upon announcing a buyback, long-term performance is worse. This raises the concern that insiders' stock-based pay gives them incentives to pursue buybacks that maximize their pay-but do not make sense for long-term investors.

To examine this issue, we begin with data on all buybacks announced in 2017 and 2018. We then divide the level of insider selling into three groups based on the volume of insider sales and observe the abnormal returns for the buybacks with the highest, lowest, and no insider sales for the ten-day period after the buyback announcement. Figure 1 describes the results:

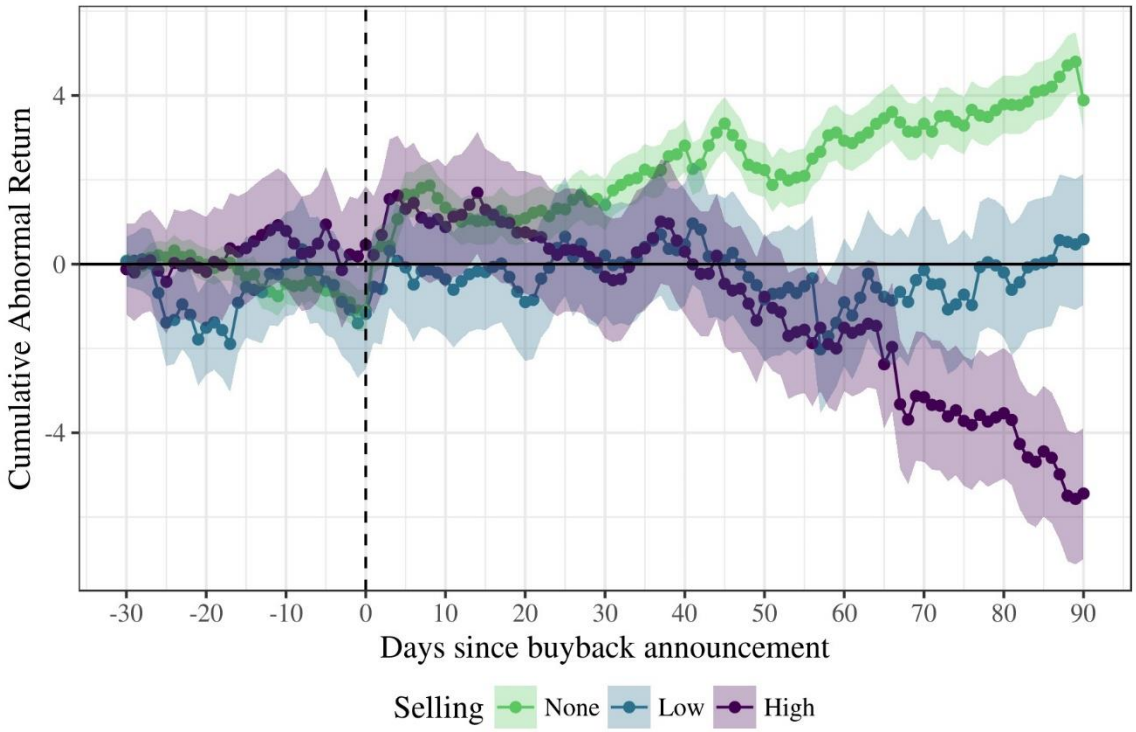

Figure 1 shows that, when executives sell into a buyback, the buyback is more likely to produce a short-term stock-price pop rather than a long-term, sustainable value increase. The difference in performance between buybacks with executive cashouts and those without is meaningful: ninety days after the buyback announcements, firms with insider cashouts underperform the other firms we study by more than 8%.

To be sure, this analysis does not show whether insiders' sales *cause* lower long-run returns or whether insiders correctly anticipate that returns will be lower so sell opportunistically. But from

the perspective of ordinary American investors saving for retirement, I cannot see why that distinction should matter. Whether insider sales cause the stock to fall or simply reflect insiders' view that the buyback won't add value in the long run, the opportunity to cash out stock-based pay gives executives reason to pursue buybacks that do not produce long-term value. Those incentives deserve attention from the SEC.

* * * *

The evidence your letter requested shows that insiders can use buybacks as a chance to cash out at high stock prices-at the expense of long-term investors. Yet SEC rules give a safe harbor to firms whose insiders sell when a buyback is announced. In a world where stock-based pay gives executives powerful incentives to seek opportunities to sell their shares, SEC rules on buybacks should do more to protect ordinary investors who save for the long run.

Although debate over these rules may seem technical or abstract, in my view, your letter reflects a fundamental principle underlying our markets. Our laws should encourage corporations to create the kind of long-term value that American families count on to build their futures. But outdated SEC rules give safe-harbor treatment to buybacks that do little more than give executives a chance to cash out. That's why I am today renewing my call for an open comment period to revisit our rules to make sure they protect American companies, investors, and employees in light of today's unprecedented volume of buybacks.

Thank you again for your letter—and for your work to ensure that SEC rules on buybacks protect the long-term interests of American investors and communities. Should you have any questions, or if you or your Staff would find further information helpful, please do not hesitate to contact me.

Very truly yours,

Robert J. Jackson, Jr.

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A Capitalist's Solution to the Problem of Excessive Buybacks

Posted by Nell Minow, ValueEdge Advisors, on Friday, February 22, 2019

Editor's note: Nell Minow is Vice Chair of ValueEdge Advisors. Related research from the Program on Corporate Governance includes Short-Termism and Capital Flows by Jesse Fried and Charles C. Y. Wang (discussed on the Forum here).

We may not need a government solution to the issue of excessive corporate stock buybacks. We most certainly do not need the solution proposed by Senators Chuck Schumer and Bernie Sanders, requiring companies to adopt minimum wage requirements for hourly workers before buying back stock. What we need is a capitalist solution, removing misaligned incentives, moral hazards, and diversion of assets to make sure the market's buyback decision is the right one.

The conventional thinking about stock buybacks is that when corporate managers and directors believe the stock is undervalued and do not have a better use for excess capital they should return it to shareholders. No one can argue with that; it is vastly preferable to the usual alternative, overpaying for acquisitions that are not core to the company's business. That's a whole different discussion of misaligned incentives.

But as we have often seen, most recently with mortgage-backed derivatives, good ideas can be abused and become destructive. In this case, the excess cash was not the result of operating efficiencies but a windfall from President Trump's tax bill. The corporate tax cuts were sold as a way to increase compensation for workers and support strategic initiatives like research and development. Instead, 2018 saw record buybacks, over $1 trillion worth, much of it at the top of the market, so it was difficult to justify an argument that the stock was undervalued or that there was no better strategic use for the money.

A study by Tim Swift in the Academy of Management Proceedings found that stock buybacks suppress innovation. A real-world example is Sears, where $6 billion buying back stock that was collapsing into bankruptcy could have been deployed to improve operations. And a 2017 studyreached a troubling conclusion that companies are not clear with their boards or their investors about the basis for the decision to buy back stock. "Few companies publicly disclose details about buyback decision-making and very few state the reasons for a specific buyback program."

Why would directors and executives approve buybacks when the stock is not undervalued and there are worthwhile opportunities to invest the cash in support of long-term strategies? One reason is revealed in another study of buybacks, this one conducted by SEC Commissioner Robert Jackson, who found that "right after the company tells the market that the stock is cheap,

executives overwhelmingly decide to sell." And it is almost unheard of for companies to adjust their EPS targets for incentive compensation to reflect the reduction in shares from a buyback. There are two ways to reach earnings per share goals, by increasing earnings or reducing outstanding shares. But only one of those has real long-term benefits to shareholders. Executives do better from buybacks than retail investors, the exact opposite of what incentive compensation is supposed to accomplish. This is not just bad for the long-term viability of the corporations; the agency costs involved undermine the credibility of our system of capitalism.

Therefore, the solution is to re-align the incentives. And that is the job of the corporate boards, especially their compensation committees.

First, compensation committees should not allow a stock buyback unless the incentive compensation EPS goals are adjusted accordingly. Indeed, this is yet another reason that all stock and option awards should be indexed to the peer group or the market as a whole to prevent just this kind of manipulation.

Second, compensation committees should require all insiders—executive or director—to hold all of their shares, including exercised options, until three years after the most recent buyback.

And if they do not, then it is up to the investors, meaning the large institutional investors, to vote against compensation committee members who fail to insist on these provisions, and, if necessary, run their own candidates to replace them.

Shareholders may need to remind boards of directors that their decisions should be based on what will benefit shareholders over the long term. The key metric is not whether corporate insiders think their stock is a good investment; the key is whether the outside shareholders do.

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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.

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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.

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Is it Time for Corporate Political Spending Disclosure?

Posted by Cydney Posner, Cooley LLP, on Sunday, March 17, 2019

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 Shining Light on Corporate Political Spending by Lucian Bebchuk and Robert J. Jackson Jr., (discussed on the Forum here); The Untenable Case for Keeping Investors in the Dark by Lucian Bebchuk, Robert J. Jackson Jr., James David Nelson, and Roberto Tallarita (discussed on the Forum here); Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending by Leo E. Strine, Jr. (discussed on the Forum here); and Conservative Collision Course?: The Tension between Conservative Corporate Law Theory and *Citizens United* by Leo E. Strine Jr. and Nicholas Walter (discussed on the Forum here).

A new bill that has been introduced in the House, H.R. 1053, would direct the SEC to issue regs to require public companies to disclose political expenditures in their annual reports and on their websites. While the bill's chances for passage in the House are reasonably good, that is not the case in the Senate. In the absence of legislation, some proponents of political spending disclosure have turned instead to private ordering, often through shareholder proposals. So far, those proposals have rarely won the day, perhaps in large part because of the absence of support from large institutional investors. But that notable absence has recently come in for criticism from an influential jurist, Delaware Chief Justice Leo Strine. Will it make a difference?

The history of efforts to mandate political spending disclosure through rulemaking is one of profound frustration for the proponents. Rulemaking petitions were filed with SEC in 2011 and 2014 to no avail, notwithstanding over a million signatures in support in one case. Some in Congress were so concerned that the SEC would take action on the petitions that specific prohibitions were included as part of Omnibus Spending Bills. But as discussed in this PubCo post, former SEC Chair Mary Jo White was firmly against any such undertaking, contending that the SEC should not get involved in politics, and her successor has not really addressed the issue.

According to this report from Equilar, there were at least twice as many social and environmental proposals as any other shareholder proposal type for four of the last five fiscal years, with over half being social proposals. Equilar reports that the largest percentage of social proposals concerned the

> "dispensation of discretionary funds used in lobbying activities, political contributions and charitable donations. These propositions often include an element of disclosure as to how those funds are allocated, along with disclosure of associations with trade organizations. A majority of these political and lobbying-based shareholder proposals have to do with

> political donation transparency. In 2010, the Supreme Court of the United States held many of the restrictions unconstitutional in *Citizens United v FEC*. As a result, previous regulations, requiring full disclosure and strict discretionary spending limits, have been largely overturned and have resulted in less transparency in this instance. Prior restrictions required that corporations establish Political Action Committees—PACs—with segregated funds. Such funds were limited to donations by employees or shareholders, and required details about donors and the amounts donated to be fully disclosed to shareholders and the FEC. Under the current regulatory framework, corporations still cannot donate directly to politicians, but there remain many financial avenues to pursue their interests. Since the framework has changed, it is a logical progression that shareholders have concerns regarding how such funds are allocated and seek disclosure thereof."

While some of the environmental proposals have recently gained purchase with majority votes in favor (see this PubCo post), the same cannot be said for political spending proposals.

Why is that? While those environmental proposals were approved thanks in large part to favorable votes from some of the largest institutional shareholders, institutional investors have, for the most part, shied away from political spending proposals. In some ways, that seems to be a bit paradoxical in light of the Big 4's expressed concern with sustainability, given that corporate political spending could well be devoted to purposes inconsistent with that goal. For example, in its 2019 voting guidelines, asset manager BlackRock made clear that the bar for support of political spending proposals was relatively high, taking the position that, when

> "presented with shareholder proposals requesting increased disclosure on corporate political activities, we may consider the political activities of that company and its peers, the existing level of disclosure, and our view regarding the associated risks. We generally believe that it is the duty of boards and management to determine the appropriate level of disclosure of all types of corporate activity, and we are generally not supportive of proposals that are overly prescriptive in nature. We may decide to support a shareholder proposal requesting additional reporting of corporate political activities where there seems to be either a significant potential threat or actual harm to shareholders' interests, and where we believe the company has not already provided shareholders with sufficient information to assess the company's management of the risk."

This reluctance of institutional shareholders to step up with regard to political spending proposals has come under fire from none other than Delaware Chief Justice Leo Strine. The title of this 2018 paper, "Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending," (discussed on the Forum here) communicates the bottom line pretty clearly. While Strine congratulates the "Big 4" institutional investors, BlackRock, Vanguard, State Street and Fidelity, for recognizing "that unless public companies act in a manner that is environmentally, ethically, and legally responsible, they are unlikely to be successful in the long run," he chastises them for continuing "to have a fiduciary blind spot: they let corporate management spend the Worker Investors' entrusted capital for political purposes without constraint." (In the paper, "Worker Investors" are American workers that, through 401(k) and 529 plans, must invest largely in mutual funds to save for retirement and college and whose capital is effectively "trapped" until their retirement.)

According to Strine, corporate political spending has a “double legitimacy” problem. That’s because the Big 4 don’t have legitimacy to speak for workers politically, and “public company management has no legitimacy to use corporate funds for political expression either.” So the Big 4 have essentially “abdicated” by refusing “to support even proposals to require the very disclosure they would need if they were to monitor corporate political spending.” As Strine sees it, the Big 4 have a lot of clout and usually win the day when they “flex their muscles.” In support of that point, Strine cites a “recent study of 25 political spending disclosure proposals [that] found that only one passed. But if the largest stockholders had voted for these proposals, 15 more would have passed—over half the proposals would have gained majority support if just the largest investors—including the Big 4—supported them. By deferring to management, the Big 4 have handcuffed their own ability to oversee political spending by denying themselves the very data they need to do so.”

Why is it so important to monitor corporate political spending? To Strine, “unconstrained corporate political spending is contrary to the interests of Worker Investors. Precisely because Worker Investors hold investments for the long term and have diversified portfolios that track the whole economy, political spending by corporate managers to tilt the regulatory playing field is harmful to them, as humans who suffer as workers, consumers, and citizens when companies tilt the regulatory process in a way that allows for more pollution, more dangerous workplaces, less leverage for workers to get decent pay and benefits, and more unsafe products and deceptive services.” As a result, Strine contends, the Big 4 need to “open their fiduciary eyes … and vote to require that any political spending from corporate treasury funds be subject to approval of a supermajority of stockholders…. Because of their substantial voting power, the support of the Big 4 would ensure that this check on illegitimate corporate political spending would be put in place and thus make an important contribution to restoring some basic fairness to our political process.”

The need to monitor and rein in corporate political spending is not an entirely new position for Strine. In a 2014 paper, Strine (with his co-author) observed that *Citizens United* is premised on the idea that shareholders are able to “constrain corporate political spending and that corporations can legitimately engage in political spending.” But, given the “separation of ownership from ownership” that currently prevails, that idea is not necessarily valid: currently, most shareholders invest through “mutual funds under 401(k) plans, cannot exit these investments as a practical matter, and lack any rational ability to influence how corporations spend in the political process.” What’s more, the impact of *Citizens United* is so profound that it calls into question the prevailing theory in Delaware that the purpose of corporations is just profit maximization for shareholders, and accordingly, boards need not consider the interests of other stakeholders. That theory is premised on the idea that shareholders invest for “financial gain, and not to express political or moral values”; therefore, boards “should focus solely on stockholder wealth maximization and non-stockholder constituencies and society should rely upon government regulation to protect against corporate overreaching….Because *Citizens United* unleashes corporate wealth to influence who gets elected to regulate corporate conduct,” Strine argued, “and because conservative corporate theory holds that such spending may only be motivated by a desire to increase corporate profits, the result is that corporations are likely to engage in political spending solely to elect or defeat candidates who favor industry-friendly regulatory policies, even though human investors have far broader concerns, including a desire to be protected from externalities generated by corporate profit seeking.” As a result, ironically, *Citizens United* “strengthens the argument… that corporate managers must consider the best interests of employees, consumers, communities, the environment, and society—and not just stockholders—when making business decisions.” If not, Strine concludes, “one form of

nonhuman citizen that as a matter of reality controls much of the wealth of actual humans will have the ability to imbalance public policy, in a manner that is inconsistent with social welfare. Put plainly, if corporations are regarded as having equal rights with human beings, without regard to the real-world differences between for-profit corporations and human beings recognized by and built into the design of conservative corporate theory, their managers must have the legal right to act with conscience and a regard for the full range of concerns that animate flesh-and-blood citizens of the United States."

SideBar

The cause of Worker Investors seems to be a consistent refrain for Strine. As reported in the *Daily Journal*, in a recent speech at the 46th Annual Securities Regulation Institute in Coronado, California, Strine posited the theory that the "social and political climate under which corporations see increased public scrutiny and pressure is a product of workers not feeling they have a say equal to their skin in the game….'More and more of the gains have gone to the folks at the top, but the irony is more and more of the investment is coming from working people.'" As reported, according to Strine, "a 'systemic decline in the voice and leverage of working people' drives economic anxiety, causing heavy regulation" in various locations. The influx of corporate money into the political process exacerbates the problem by allowing "business to stymie broadly popular legislation." Here too he reportedly advocated a supermajority vote to approve spending investor funds on political issues.

According to the article, he also made reference to the Accountable Capitalism Act, introduced by Senator Elizabeth Warren, as an example of "legislative backlash." That bill would require certain large corporations to obtain a federal charter, which would, in effect, put an end to the notion that the purpose of the corporation is solely to maximize shareholder value. Under the bill, the applicable standard of conduct—which Warren wrote was patterned after the state "benefit corporation" model—would require directors to manage the business and affairs of the corporation in a manner that seeks to create a general public benefit and balances the pecuniary interests of the shareholders with the best interests of persons that are materially affected by the conduct of the corporation, including employees, customers, communities, the environment, and the short- and long-term interests of the corporation (including the possibility that those interests may be best served by the continued independence of the corporation). One provision of the bill would require that 40% of the board be elected by the corporation's employees. (See this PubCo post.) According to the article, Strine thought the bill would "essentially turn large American corporations into Delaware Benefit Corporations by default" (see this PubCo post) and viewed some aspects of the bill as "underdeveloped," but thought it was "a candid attempt to put forth a solution."

SoapBox

Warren's proposal to federalize corporations to allow the boards of a significant proportion of public companies to consider other constituencies might be largely superfluous if Delaware made some changes, since most companies are incorporated in Delaware. As discussed in this PubCo post, Strine is a big fan of the Delaware Public Benefit Corporation. Unfortunately, there has not exactly been a mad dash by public companies toward adoption of that form and few public benefit corporations have taken the IPO plunge. (See this PubCo post.)

Yet Strine has made clear his view (for example, here, here and here) that the concept that corporate directors are entitled to take into consideration the interests of constituencies other than shareholders is misguided and ineffective (largely because, he believes, the concept does little to change the accountability structure or the incentives of directors to take the interests of these other constituencies into consideration). Ok, maybe it needs more time to gestate, but perhaps the Delaware courts should consider the possibility of sidling up to some version of stakeholder theory? If the public benefit corporation concept does not ultimately gain acceptance by public companies—or catches on only for certain niche companies, such as those in education, currently the business of one (and only?) publicly traded PBC—maybe the Delaware courts might consider broadening their perspective and revisiting the concept of "maximizing shareholder value" as the only purpose of corporations under Delaware law? After all, how likely is it that *Citizens United* will be overturned any time soon?


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2019 Lobbying Disclosure Resolutions

Posted by Timothy Smith, Walden Asset Management and John Keenan, AFSCME, on Thursday, March 14, 2019

Editor's note: Timothy Smith is Director of ESG Shareowner Engagement at Walden Asset Management and John Keenan is a Corporate Governance Analyst at the American Federation of State, County and Municipal Employees (AFSCME). This post is based on a joint Walden Asset Management and AFSCME memorandum by Mr. Smith and Mr. Keenan. Related research from the Program on Corporate Governance includes The Untenable Case for Keeping Investors in the Dark by Lucian Bebchuk, Robert J. Jackson Jr., James David Nelson, and Roberto Tallarita (discussed on the Forum here) and Shining Light on Corporate Political Spending by Lucian Bebchuk and Robert J. Jackson Jr., (discussed on the Forum here).

Corporate lobbying disclosure remains a pressing shareholder proposal topic for 2019. A coalition of at least 70 investors have filed proposals at 33 companies asking for disclosure reports that include federal and state lobbying payments, payments to trade associations and social welfare groups used for lobbying and payments to any tax-exempt organization that writes and endorses model legislation. This year's campaign highlights the theme of corporate political responsibility, with a focus on climate change lobbying.

Corporate lobbying affects all aspects of the economy, including issues ranging from climate change and drug prices to financial regulation, immigration and workers' rights. Lobbying can provide decision-makers with valuable insights and data, but it can also lead to undue influence, unfair competition and regulatory capture. In addition, lobbying may channel companies' funds and influence into highly controversial topics with the potential to cause reputational harm.

More than $3.4 billion in total was spent on federal lobbying in 2018. Companies also spend more than $1 billion yearly on lobbying at the state level, where disclosure is far less transparent than federal lobbying. Additionally, trade associations spend over $100 million annually, lobbying indirectly on behalf of companies. For example, the U.S. Chamber of Commerce spent $95 million on federal lobbying in 2018 and has spent over $1.5 billion on lobbying since 1998.

To address potential reputational and financial risk associated with lobbying, investors are encouraging companies to disclose all their lobbying payments as well as board oversight processes. We believe that this risk is particularly acute when a company's lobbying, done directly or through a third party, contradicts its publicly stated positions and core values. Disclosure allows shareholders to verify whether a company's lobbying aligns with its expressed values and corporate goals.

A major focus for the investor coalition continues to be undisclosed trade association lobbying payments because they are not required to disclose the sources of their funding. In some cases,

a trade association may actively lobby for issues that are contrary to a company's public statements and values or take a controversial public stand. If this is the case, investors urge the company to publicly clarify any differences between its position and that of the trade association.

Whether a company's lobbying aligns with its values and goals captures the emerging concept of corporate political responsibility. Many corporations positively portray their climate policies and sustainability goals while their lobbying through trade associations can tell another story. For example, General Motors declares its commitment to reduce greenhouse gas emissions yet its trade association, the Alliance of Automobile Manufacturers, has lobbied to weaken fuel standards. Corporate political responsibility requires companies that embrace sustainability to be transparent about their political activity.

Regarding climate policy, there are many cases of lobbying misalignment. Companies with programs addressing climate change are also funding the Chamber of Commerce, which has lobbied consistently against effective climate change regulations. Drug pricing, net neutrality, sick leave, shareholder rights and tobacco are other areas where lobbying misalignment takes place. A drug company may support access to affordable medicines while belonging to and funding the Pharmaceutical Research and Manufacturers of America, which spends millions lobbying against affordable drug price initiatives. A telecom company that claims support for an open internet may belong to US Telecom, which is actively fighting net neutrality. Many companies belong to the Business Roundtable and National Association of Manufacturers, which lobby against the right to file shareholder proposals.

The proposals for 2019 focus on companies that lobby significantly at the federal and state levels, do not disclose their trade association lobbying payments, or are members of the American Legislative Exchange Council (ALEC), which has a record of opposing climate change policies and regulation.

Since 2011, this coalition that is comprised of religious investors, members of the Interfaith Center for Corporate Responsibility, foundations, public and labor pension funds, asset managers and individual investors has filed nearly 400 shareholder proposals. The campaign has led to more than 75 agreements to provide greater lobbying disclosure. Additionally, coalition members have engaged more than 80 companies that have left ALEC, including notable 2018 departing companies AT&T, ExxonMobil, Honeywell and Verizon. Investors have also written and held conversations with numerous companies on lobbying issues without filing resolutions.

Companies Receiving Lobbying Disclosure Resolutions for 2019 are:

AbbVie (ABBV)
Altria Group (MO)
American Water Works (AWK)
AT&T (T)
Bank of America (BAC)
BlackRock (BLK)
Boeing (BA)
CenturyLink (CTL)
Chevron (CVX)
Comcast (CMCSA)
Duke Energy (DUK)
Emerson Electric (EMR)
Equifax (EFX)
Exxon Mobil (XOM)
FedEx (FDX)
Ford Motor (F)
General Motors (GM)
Honeywell (HON)
IBM (IBM)
JPMorgan Chase (JPM)
Mallinckrodt (MNK)

MasterCard (MA)
McKesson (MCK)
Morgan Stanley (MS)
Motorola Solutions (MSI)
Nucor Corporation (NUE)
Pfizer (PFE)
Tyson Foods (TSN)
United Continental Holdings (UAL)
United Parcel Service (UPS)
Verizon (VZ)
Vertex Pharmaceuticals (VRTX)
Walt Disney Company (DIS)

Filers of lobbying disclosure resolutions for 2019 include:

Public Pension Funds
State of Connecticut Treasurer's Office
City of New York Office of the Comptroller
City of Philadelphia Public Employees Retirement System
The Employees' Retirement System of Rhode Island
Seattle City Employees' Retirement Systems
Vermont Pension & Investment Committee

International Asset Managers and Pensions
AP7 Seventh Swedish National Pension Fund

Labor Pension Plans and Organizations
AFL-CIO
International Brotherhood of Teamsters
United Steelworkers

Asset Management Companies
Azzad Asset Management
Boston Common Asset Management
Dana Investment Advisers
Domini Social Investments
First Affirmative Financial Network
Harrington Investments
Pax World Management Corp.
Sustainability Group, Loring, Wolcott & Coolidge
Walden Asset Management
Walden Equity Fund
Zevin Asset Management

Foundations
444S Foundation
Brainerd Foundation
Catherine Donnelly Foundation
Educational Foundation of America
Haymarket People's Fund
Lemmon Foundation
Max and Anna Levinson Foundation
Needmor Fund
Swift Foundation
Tides Foundation

Non-Profit Institutional Investors
Center for Community Change
Dwight Hall Socially Responsible Investment Fund at Yale
Oxfam

Religious Filers
Benedictine Sisters of Baltimore – Emmanuel Monastery
Benedictine Sisters of Mount St. Scholastica
Benedictine Sisters of Virginia
Benedictine Sisters, Sacred Heart Monastery
Community Church of New York
Congregation of Benedictine Sisters, Boerne, TX
Congregation of Divine Providence – San Antonio, Texas
Congregation of Sisters of St. Agnes
Congregation of St. Joseph
Congregation of the Sisters of St. Joseph of Brighton, MA
Daughters of Charity, Province of St. Louise
Dominican Sisters of Springfield Illinois
First Parish in Cambridge – Unitarian Universalist
Friends Fiduciary Corporation
Glenmary Home Missioners
Grand Rapids Dominicans
Maryknoll Sisters
Mercy Investment Services
Monasterio De San Benito
Monasterio Pan de Vida
Oblate International Pastoral Investment Trust

Portico Benefit Services (ELCA)
Providence Trust
Province of St. Joseph of the Capuchin Order
School Sisters of Notre Dame Cooperative Investment Fund
Sinsinawa Dominicans
Sisters of Charity of the Blessed Virgin Mary, Dubuque
Sisters of Notre Dame de Namur-Boston
Sisters of St. Francis Charitable Trust
Sisters of St. Francis of Philadelphia
Sisters of the Holy Family, CA
Trinity Health
United Church Funds
Ursuline Sisters of Tildonk, US Province
Unitarian Universalist Association

Individuals
Gwendolen Noyes

2019 Lobbying Disclosure Resolution Filed at Exxon Mobil

Whereas, we believe in full disclosure of ExxonMobil's direct and indirect lobbying activities and expenditures to assess whether ExxonMobil's lobbying is consistent with its expressed goals and in the best interests of shareholders.

Resolved, the shareholders of ExxonMobil request the preparation of a report, updated annually, disclosing:

1. Company policy and procedures governing lobbying, both direct and indirect, and grassroots lobbying communications.

1. Payments by ExxonMobil used for (a) direct or indirect lobbying or (b) grassroots lobbying communications, in each case including the amount of the payment and the recipient.
2. Description of management's and the Board's decision-making process and oversight for making payments described above.

For purposes of this proposal, a "grassroots lobbying communication" is a communication directed to the general public that (a) refers to specific legislation or regulation, (b) reflects a view on the legislation or regulation and (c) encourages the recipient of the communication to take action with respect to the legislation or regulation. "Indirect lobbying" is lobbying engaged in by a trade association or other organization of which ExxonMobil is a member.

Both "direct and indirect lobbying" and "grassroots lobbying communications" include efforts at the local, state and federal levels.

The report shall be presented to the Audit Committee or other relevant oversight committees and posted on ExxonMobil's website.

Supporting Statement

We encourage transparency in ExxonMobil's use of funds to lobby. ExxonMobil spent $99.43 million from 2010–2017 on federal lobbying. These figures do not include state lobbying expenditures, where ExxonMobil also lobbies but disclosure is uneven or absent. For example, ExxonMobil spent $3,860,715 on lobbying in California from 2010–2017. Exxon also lobbies abroad, reportedly spending between €3.75m and €4m on lobbying in Brussels for 2017

("Revealed: ExxonMobil's Private Dinner with Cyprus' Top EU Brass," *EU Observer*, August 12, 2018).

We commend ExxonMobil for ending its membership in the American Legislative Exchange Council ("Exxon Mobil Joins Exodus of Firms from Lobbying Group ALEC," *Reuters*, July 12, 2018). However, serious disclosure concerns remain. ExxonMobil belongs to the American Petroleum Institute, Business Roundtable (BRT), Chamber of Commerce and National Association of Manufacturers (NAM), which altogether spent $260,410,014 on lobbying for 2016 and 2017. Both the BRT and NAM are lobbying against shareholder rights to file resolutions. ExxonMobil does not disclose its memberships in, or payments to, trade associations, or the amounts used for lobbying.

We are concerned that ExxonMobil's lack of lobbying disclosure presents reputational risks when its lobbying contradicts company public positions. For example, ExxonMobil supports the Paris climate agreement, yet was named one of the top three global corporations lobbying against effective climate policy, ("When Corporations Take Credit for Green Deeds Their Lobbying May Tell Another Story," *The Conversation*, July 17, 2018), and the Chamber undermined the Paris climate accord ("Paris Pullout Pits Chamber against Some of Its Biggest Members," *Bloomberg*, June 9, 2017). As shareholders, we believe that companies should ensure there is alignment between their own positions and their lobbying, including through trade associations.

Tab III: Boards

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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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Independent Directors: New Class of 2018

Posted by Steve W. Klemash, Jamie C. Smith, and Kellie C. Huennekens, EY Center for Board Matters, on Saturday, March 30, 2019

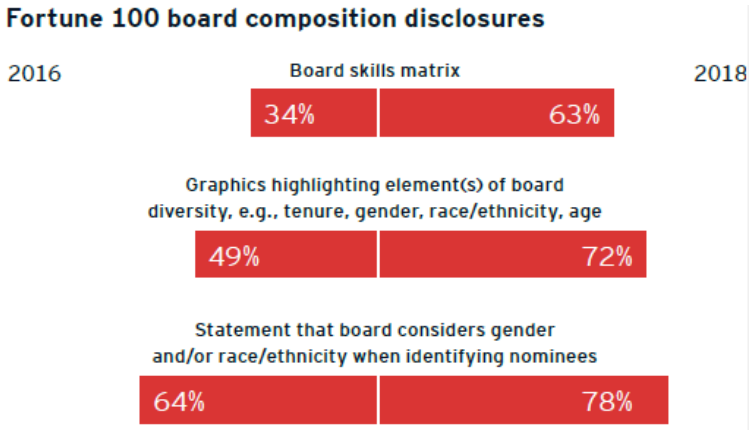
Editor's note: Steve W. Klemash is America's Leader, Jamie C. Smith is Associate Director, and Kellie C. Huennekens is Associate Director, all at EY Center for Board Matters. This post is based on their EY memorandum.

The EY Center for Board Matters took a close look at independent directors newly elected in 2018 by investors to Fortune 100 boards, and we are pleased to present the findings of our analysis of this "new class of 2018."

The report analyzes what these directors bring to the boardroom and how companies are showcasing those strengths, based on a review of corporate disclosures highlighting the skills, expertise and backgrounds associated with these new nominees. In the third year of this series, we also reviewed the same 83 companies' entering class of directors in prior years to enable consistent year-on-year comparisons. What follows is our perspective on the changes and trends we identified.

Our perspective: gradual change is underway

Given the limited number of board seats in the Fortune 100, and that newly added independent directors represent only around 10% of all independent Fortune 100 directors serving each year, boards appear to be making the most of these valuable board refreshment opportunities. We observe a continuing shift of attention from the more traditional director candidates (current and former CEOs) to individuals with a wider range of skills, expertise, backgrounds and personal characteristics—diversity across multiple dimensions. Nearly one-quarter of new directors were recognized for their experience in innovation, transformation and in navigating change, and 10% were highlighted for their ability to bring an investor perspective to the boardroom, including through experiences in asset management or active investment funds. Still, the limited opportunities for adding new directors mean that change continues to be gradual.



Given the limited number of board seats in the Fortune 100, and that newly added independent directors represent only around 10% of all independent Fortune 100 directors serving each year, boards appear to be making the most of these valuable board \refreshment opportunities. We observe a continuing shift of attention from the more traditional director candidates (current and former CEOs) to individuals with a wider range of skills, expertise, backgrounds and personal

Corporate statements that recognize the importance of board diversity appear increasingly common, but we continue to observe an opportunity for greater consistency and comparability in disclosures around board diversity, particularly across gender, race and ethnicity. We find, too, that companies are continuing to expand and refine disclosures to clarify how the disclosed director qualifications align with the company's strategy. The quality and extent of disclosure varies, and we estimate that 14% of the directors' qualifications language and reasons for nominations were clearly linked to company strategy, suggesting that this is an emerging disclosure trend. In one of the stronger examples, we saw a company highlight its nominee's areas of expertise, explain how these experiences contribute to the company's future strategy and link these elements to a brief description of broader industry transformations underway.

Boards are thinking differently about what makes an effective board candidate, and the supply of possible candidates is expanding significantly. This larger pool means boards can be even more selective about their short lists. At the same time, the responsibilities of being a public company director are continuing to increase and become more complex, and boards are setting the expectation that directors must be fully committed to being engaged and active. There is greater concern over the possibility of being "over-boarded" and "over-committed."

Observations on skills and demographics

In 2018, 71% of the reviewed companies added at least one new nominee and 27% added two or more. This represents an increase from prior years when the levels were generally steady at around 56% and 21%, respectively. For companies that added at least one new nominee in 2018, our review yielded the following observations.

71%
of companies added at least one new nominee in 2018.

27%
of companies added two or more new nominees in 2018.

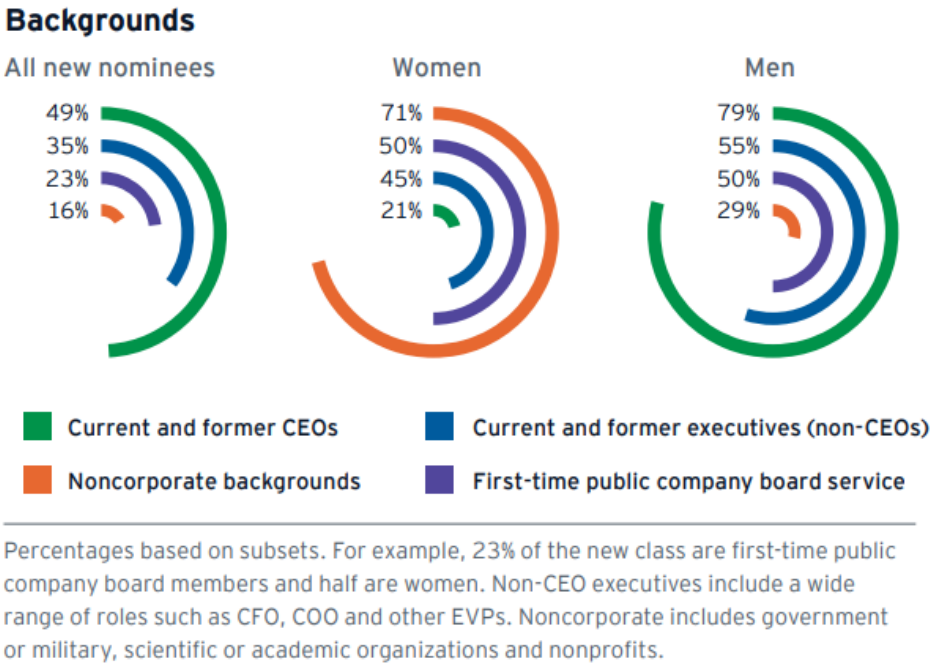
Top 10 most common expertise areas highlighted	
1	International business
2	Corporate finance, accounting
3	Industry
4	Technology
5	Operations, manufacturing
6	Board service, corporate governance
7	Government, public policy, regulatory
8	Risk oversight
9	Strategy
10	Marketing, business development

Top 10 areas of expertise for the new class

For a look at the skills being added to boards, we found that the areas of expertise most frequently cited in new nominations were: international business; corporate finance, accounting; and industry expertise. Around half of the new class was recognized for expertise in at least one of these categories. The next most common areas—technology; operations, manufacturing; and board service, corporate governance—were cited in 40% to 45% of new nominations. On average, 35% was recognized for experience in government, public policy, regulatory; risk oversight; strategy; or marketing, business development.

New class enhances career and gender diversity

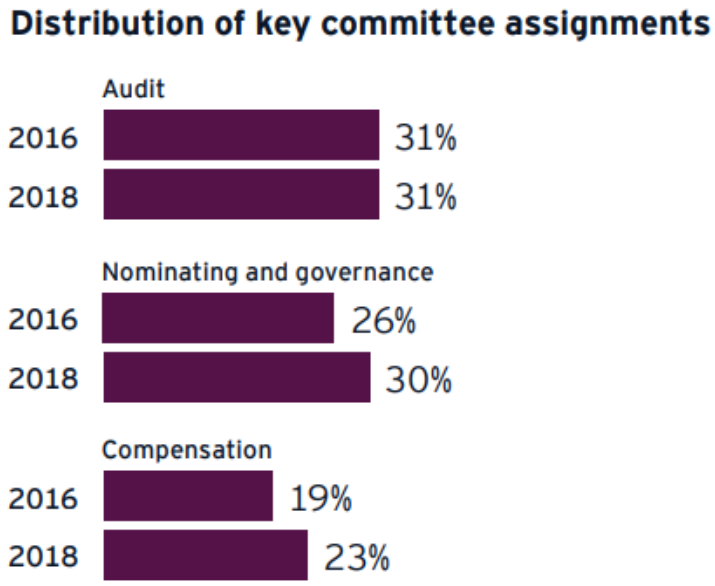
Women continued to represent around 40% of new nominees, contributing to a slight increase in overall board gender diversity; in 2018, 27% of existing independent directors were women, up from 25% in 2016. Slightly less than half of the new class fits the traditional model of independent directors in years past (current and former CEOs) and that group remained predominantly male. The slate of non-CEO new nominees represented a different picture: this group reflected relative gender balance. Further, of those directors with noncorporate backgrounds, most were women.



Percentages based on subsets. For example, 23% of the new class are first-time public company board members and half are women. Non-CEO executives include a wide range of roles such as CFO, COO and other EVPs. Noncorporate includes government or military, scientific or academic organizations and nonprofits.

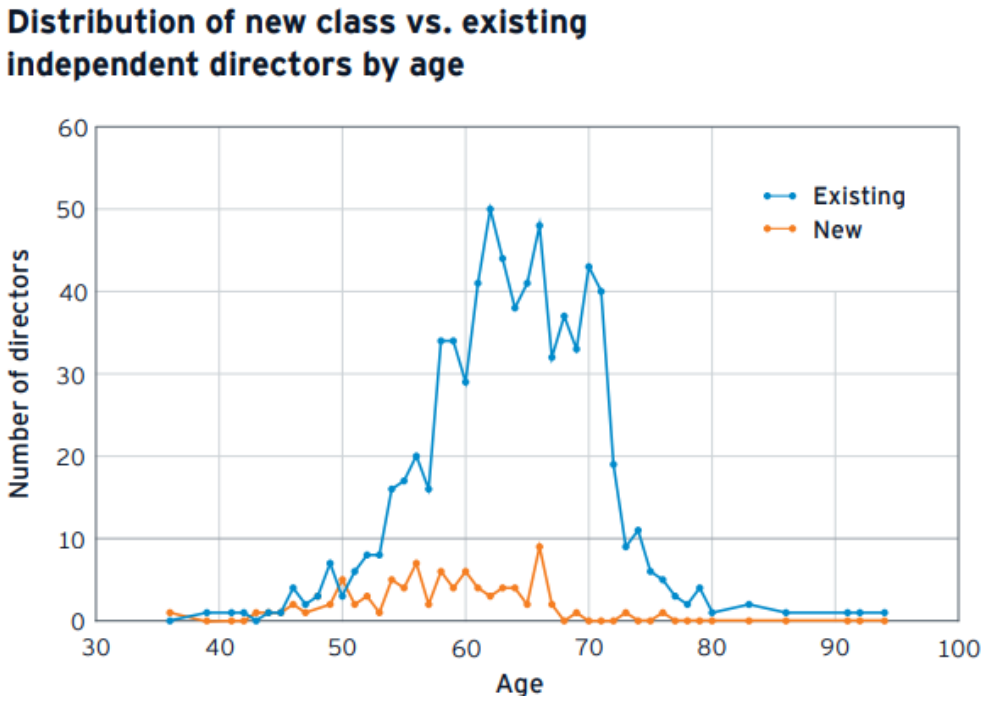
Audit and nominating and governance committee assignments most common

The most common committee assignments continue to be either the audit or nominating and governance committees. However, the 2018 entering class shows a more even distribution of committee assignments with growth apparent in the number of new appointments to nominating and governance committees, and in the number of new directors landing on compensation committees. A look at the portion of new nominees being designated audit committee financial experts found that while these “AC FEs” comprised 23% of the 2016 class, the level was lower in 2018 at 20%.



New class of directors getting younger

The average age of the new class of directors has been getting younger each year. While the changes have been gradual and the numerical differences very slight, a look at the new nominees by age group shows a clear trend. The portion of new nominees under the age of 60 grew from 51% in 2016 to 58% in 2018, while the portion of those under 50 grew from 8% to 14%. Although boards are adding more younger directors, the overall age of the boards remains high due to the portion of existing directors compared to the new class.



Questions for the board to consider

- Is the board proactively aligning director qualifications to the company's strategy and risk oversight priorities, including for the company's future state?
- Is the board considering board diversity across multiple dimensions, including skills and expertise, career background and personal characteristics (age, gender, race/ethnicity, geography, etc.)? In other words, does the board "refresh" or essentially "replace" perspectives? Does the board go beyond seeing diversity as a "check-the-box" concept?
- How effectively is the company communicating that its directors represent the best mix of individuals to guide the company? Would a third party read director qualifications disclosures in the way that the company intends?

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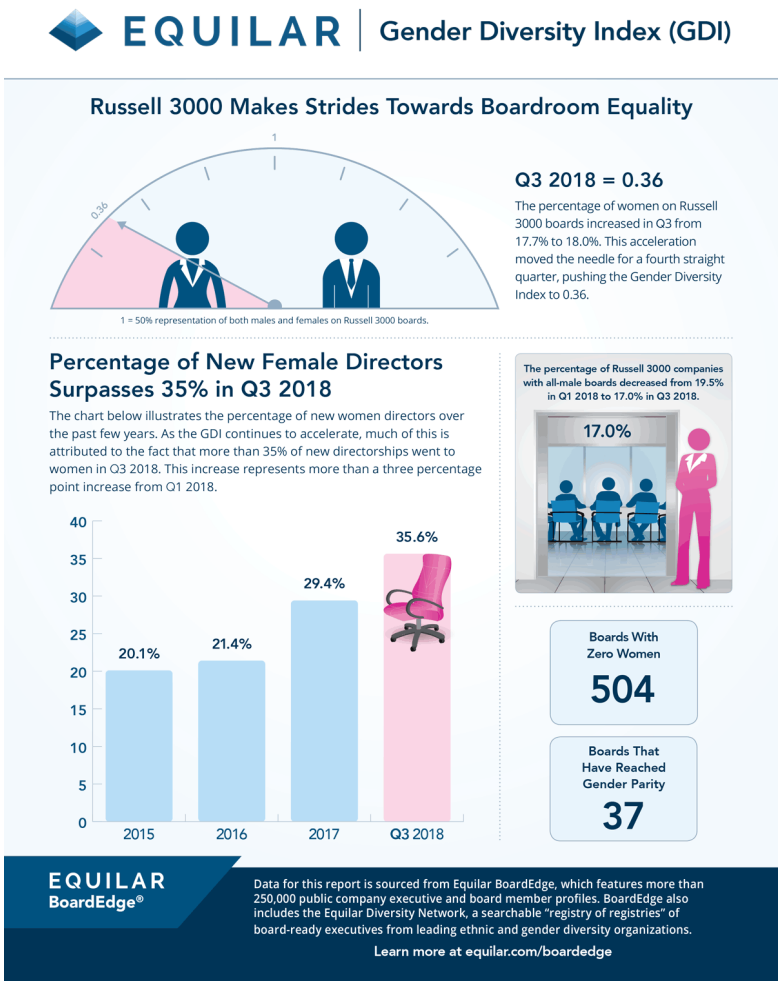
Q3 2018 Gender Diversity Index

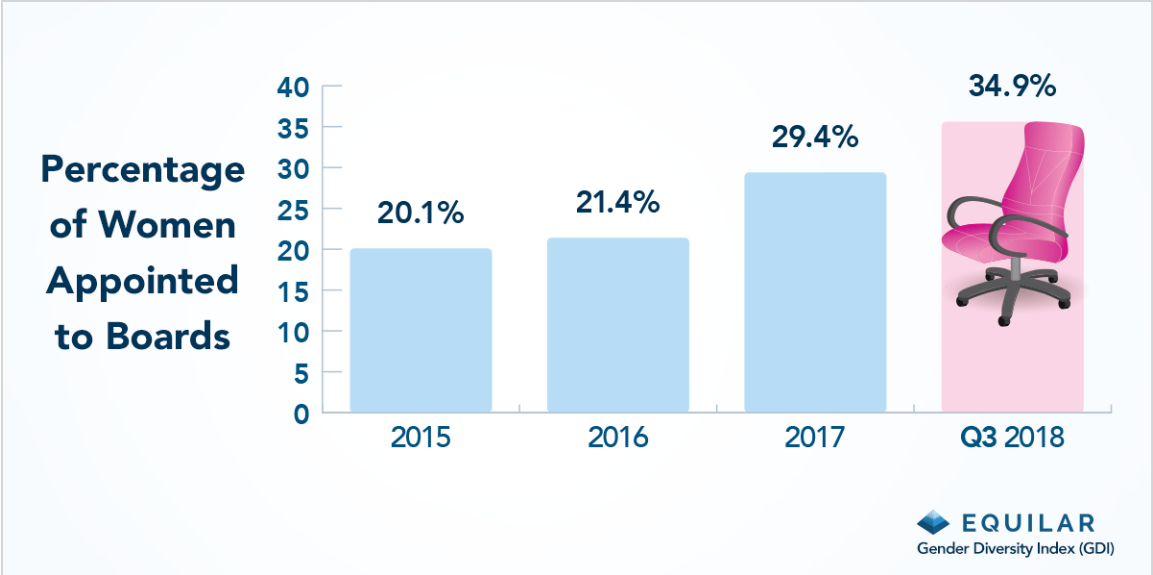
Posted by Amit Batish, Equilar Inc., on Saturday, January 26, 2019

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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Gender Diversity in Silicon Valley

Posted by David Bell and Dawn Belt, Fenwick & West LLP, on Tuesday, April 30, 2019

Editor's note: David A. Bell and Dawn Belt are partners at Fenwick & West LLP. This post is based on a Fenwick memorandum.

Fenwick & West has released its updated study about gender diversity on boards and executive management teams of companies in the technology and life science companies included in the Silicon Valley 150 Index and very large public companies included in the Standard & Poor's 100 Index.[1] The Fenwick Gender Diversity Survey uses 23 years of data to provide a better picture of women's participation at the most senior levels of public companies in Silicon Valley.

The complete publication (available here) reviews public filings from 1996 through 2018 to analyze the gender makeup of boards, board leadership, board committees and executive management teams in the two groups, with special comparisons showing how the Top 15 largest companies in the SV 150 fare, as they are the peers of the large public companies included in the S&P 100.

Executive Summary

Gender diversity in corporate leadership—and diversity in the business world more broadly—continues to drive vigorous discussion across the country, with Silicon Valley and the tech industry often at the center of heightened scrutiny.

The year 2018—dubbed by some as "the year of the woman"—moved the needle in some areas of gender diversity. In the S&P 500, companies appointed a record number of women directors to

[1] The S&P 100 is a cross-section of companies across industries, but is not a cross-section of companies across all size ranges (it represents the largest companies in the United States). While the SV 150 is made up of the largest public companies in Silicon Valley by one measure—revenue, it is actually a fairly broad cross-section of companies by size, but is limited to the technology and life science companies based in Silicon Valley. Compared to the S&P 100, SV 150 companies are generally much smaller and younger, have lower revenue, and are concentrated in the technology and life sciences industries. The 2018 constituent companies of the SV 150 range from Apple and Alphabet with revenue of approximately $239B and $111B, respectively, to Intevac and Aquantia, with revenue of approximately $113M and $103M, in each case for the four quarters ended on or about December 31, 2017. Apple went public in 1980, Alphabet (as Google) in 2004, and Intevac in 1990 and Aquantia in 2004, with the Top 15 companies averaging 18 more years as a public company than the bottom 15 companies in the SV 150. Apple and Alphabet's peers clearly include companies in the S&P 100, of which they are also constituent members (eight companies were constituents of both indices for the survey in the 2018 proxy season), where market capitalization averages approximately $308B. Intevac and Aquantia's peers are smaller technology companies that went public more recently and have market capitalizations well under $1B, many of which went public relatively recently. In terms of number of employees, the SV 150 averages 8,900 employees (with a median of 1,837 employees), ranging from Oracle Corp. with 138,000 employees across dozens of countries to companies such as Aemetis with 140 employees in the United States and India, as of the end of their respective fiscal years 2017 (Innoviva, ranked 128 in the SV 150, has the fewest full-time employees—12). The S&P 100 averages approximately 136,000 employees and includes Walmart with 2.3 million employees in more than two dozen countries at its most recent fiscal year-end. The S&P 100 companies are not necessarily representative of companies in the United States generally, just as the SV 150 companies are not necessarily representative of Silicon Valley generally.

their boards. In politics, the 2018 midterm elections ushered in a record number of women to serve in Congress. California became the first state in the United States to mandate that public companies include women directors on their corporate boards. Progress to meaningfully diversify corporate leadership, however, has continued to be scant across the country even as public pressure to move from the status quo has continued to grow, most notably through the global #MeToo movement against sexual harassment and assault, and from institutional investors, regulators and lawmakers.

Findings from the Fenwick & West Gender Diversity Survey, which looks at women's positions in leadership based on public data from the last 23 years, point to some promising trends and areas where Silicon Valley leads, mixed with some areas with room for continued improvement.

Fenwick's gender diversity survey provides unique insight into women's participation at the most senior levels of technology and life sciences public companies in the Silicon Valley 150 Index(SV 150) and the large public companies of the Standard & Poor's 100 Index (S&P 100). The report reviews public filings beginning in 1996 (the first year for which electronic filings with the SEC were broadly made in the EDGAR system) through the 2018 proxy season to analyze the gender makeup of boards, board leadership, board committees and executive management teams, in the two groups, with special comparisons showing how the Top 15 largest companies in the SV 150 fare (as they are the peers of the large public companies included in the S&P 100).

Our latest survey indicates that company size continues to matter; the bigger the company, the more diverse its leadership. Diversity numbers for the Top 15 largest companies in the SV 150 are generally closer to—and in some cases exceed—those of the S&P 100.

Companies, board members and C-level executives can use this survey as a statistical benchmark for Silicon Valley leaders, as well as for comparison to the landscape of the largest public companies across the United States.

For a long time, much of the discussion about gender diversity in Silicon Valley was based on personal observation and limited data. We believe that our survey, covering more than two decades of statistics, adds perspective and depth to the discussion.

Key observations include:

Growth rates remain low.

- The representation of women on boards continued to increase between the 2016 proxy season (the last time Fenwick published the gender diversity survey) and the 2018 proxy season in the United States, but at lower rates than in some countries. The average percentage of women directors increased 3.0 percentage points in the SV 150 to 17.7% in 2018 and in the S&P 100 rose 1.6 percentage points to 24.7% (with the Top 15 companies in the SV 150 increasing 3.6 percentage points to 25.8%) (page 15).
- However, over the last few years in both the S&P 100 and the Top 15 of the SV 150, 100% of companies have had at least one woman director. In the SV 150 overall, the percentage of companies with at least one woman director increased 7.6 percentage points to 81.6% (page 16).

Fenwick Gender Diversity Score™

Fenwick created the Gender Diversity Score in 2014 as a metric for assessing gender diversity overall. This composite score is based on data at the board and executive management level in the SV 150, Top 15 of the SV 150, and S&P 100 each year over the last two-plus decades surveyed and in a set of categories selected as representative of the overall gender diversity picture (pages 9 and 72).

A review of the annual score over the last 23 years shows that:

- Gender diversity generally has improved over time—albeit slowly—with some years showing no progress.
- In the S&P 100, gender diversity has grown slowly but steadily at a cumulative rate of 70%, or a compound annual growth rate (CAGR) of 2.44%.
- The SV 150 has lower scores overall, but a greater cumulative growth rate of 198%, and more than double the CAGR, 5.09%.
- Among the Top 15 largest companies in the SV 150, where the diversity score is now similar to the S&P 100, the cumulative growth rate has been 140%, or a CAGR of 4.06%, well above the S&P 100 but below the aggregate growth rate of the SV 150 over the period—although, after exceeding the S&P 100 in 2016, the diversity score for the Top 15 companies has declined over the last two years.

New California law requires women in corporate leadership.

Most companies in the SV 150 would meet the new standard affecting California-based public companies set out by a new law mandating inclusion of women on boards of directors in 2019 (page 14).

- Our data show that most SV 150 companies will need to add women to meet the law's 2021 standard.
- Most companies in the S&P 100—all of which have boards with six or more directors—would meet the 2021 standard, with only 24% of this cohort having fewer than three women on their boards (the requirement for boards of six or more directors; page 16).

Size continues to matter; Board Leadership.

- Larger companies by revenue and market capitalization tend to have larger boards and executive management teams, which tend to be more diverse.
- In recent years, the Top 15 largest companies in the SV 150 have surpassed the S&P 100 in percentage of women in board leadership positions, including board chairs, lead directors and committee chairs (page 33).
- Women board chairs are rare across the U.S., but the Top 15 largest SV 150 companies have in recent years more frequently had women board chairs than the similarly sized S&P 100 companies, although they had a similar percentage in 2018 (page 33).
- The Top 15 of the SV 150 appointed women as lead directors—now often considered the most significant board leadership role—at roughly twice the rate of their S&P 100 peers (page 34).

- In 2018, women were more likely than men to serve on primary board committees (audit, compensation, nominating) for S&P 100, SV 150 and the Top 15 of the SV 150, showing that the women who serve on these boards, though fewer in number than men, are viewed as equal partners with their male peers. That has been the case now for half of the last 14 years.

Chief Executive Officers (page 52)

Women CEOs continue to be a rarity in the United States, and companies in the SV 150 mirror the percentage of women CEOs in the general corporate population (approximately 4.8%). However, the S&P 100, with 8% women CEOs, meaningfully exceeds that rate, and the Top 15 companies of the SV 150, though a small sample set, continued to come in at 13.3% with women CEOs.

Executive Officers (page 38)

While the SV 150 initially slightly exceeded the S&P 100 in terms of average percentage of women executive officers, the growth rate of women executive officers, in terms of either the average number of women executive officers per company or the average percentage of executive officers that are women, has been faster in the S&P 100 over the survey period.

Named Executive Officers (NEOs) (page 46)

Named executive officers are the executives that are generally the most highly compensated and in some sense those that a company considers among the most important. As a group, the SV 150 has shown a faster rate of increase in numbers in this cohort.

Notably, the average percentage growth rate of women NEOs has been faster in the Top 15 of the SV 150 (approximately 871% cumulative growth, or 10.79% CAGR) and the SV 150 generally (approximately 560% cumulative growth, or 8.95% CAGR) than in the S&P 100 (approximately 471% cumulative growth, or 8.28% CAGR).

What's more, when measured in terms of likelihood of being a NEO among women that serve as executive officers, the SV 150 as a whole and the Top 15 companies of the SV 150 have been significantly more likely to include women as NEOs than the S&P 100.

S&P 100 companies had more women NEOs under a woman CEO (pages 46-53).

Generally, women CEOs were not more likely to include women in significant roles than men serving as CEOs.

Percentage of Women NEOs

	S&P 100	SV 150	Top 15 (SV 150)
Women NEOs under Male CEO	13%	11%	16%
Women NEOs under Female CEO	33%	8%	0%

Care should be taken when comparing statistics for women and men serving as CEO, as the number of women CEOs is very low.

As discussed previously, the gender diversity survey evolved out of a study of corporate governance more broadly, for which the norms of the S&P 100 companies are often held out as best practices. However, as noted above, size is a significant factor in the diversity statistics studied. Consequently, the broad range of companies in the SV 150 (whether measured in terms of size, age or revenue) is associated with a similarly broad range of gender diversity. Comparison of gender diversity statistics and trends for the Top 15, top 50, middle 50 and bottom 50 companies of the SV 150 (in terms of revenue)[2] bears this out. As a result, throughout the survey we compare the Top 15 of the SV 150 to the S&P 100 because the Top 15 are more similar in size to the S&P 100 and therefore a more apt comparison group than the full SV 150. The survey also includes data broken down by the top 50, middle 50 and bottom 50 of the SV 150 (by revenue) in a variety of categories.

Full Coverage:

For each of the S&P 100, Top 15 of the SV 150 and the full SV 150, the survey includes review of overall gender diversity in these groups (through the Fenwick Gender Diversity Score™) the gender diversity specifically of:

- board of directors, including analysis in comparison to the recently adopted California gender quota
- board committees
- board and committee leadership
- executive officers
- NEOs
- chief executive officer (CEO)
- president/top operations executive
- chief financial officer (CFO)
- top legal officer/general counsel (GC)
- top technology/engineering/r&d executive
- top sales executive
- top marketing executive

[2] The Top 15, top 50, middle 50 and bottom 50 companies of the SV 150, include companies with revenue in the following respective ranges: $11B or more, $1.6B or more, $400M but less than $1.6B, and $103M but less than $399M. The respective average market capitalizations of these groups are $220B, $81B, $3.4B and $1.3B.

- top corporate/business development executive

The survey also includes data broken down by the top 50, middle 50 and bottom 50 of the SV 150 in a variety of categories.

The complete publication is available here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Driving Diversity and Inclusion—the Role for Chairs and CEOs

Posted by David Mills, Rachel Middleton, and Harsonal Sachar, Russell Reynolds, on Wednesday, April 3, 2019

Editor's note: David Mills leads Commercial Strategy and Sector Operations, Rachel Middleton is a member of the Diversity and Inclusion Practice and the CEO & Board Practice knowledge team, and Harsonal Sachar leads Knowledge for the Diversity and Inclusion Practice, all at Russell Reynolds Associates. This post is based on their Russell Reynolds memorandum.

The case for diversity in corporate leadership has never been stronger. To learn more, Russell Reynolds Associates spoke to nearly 60 directors and senior executives at large global companies across 10 countries who have helped foster change in their organizations. They consistently emphasized the critical role that the chair and CEO play in driving diversity and inclusion (D&I) in the workplace, specifically in terms of creating inclusive environments where everyone can thrive. From their insights, we have distilled three sets of takeaways, detailing how chairs and CEOs can drive progress on the agenda.

1. Change Starts with the Chair

As board leaders, chairs can model an ideal culture within the boardroom by:

- **Ensuring that the board itself is diverse**, including women, minorities and diverse points of view; engaging in creative efforts to build the board candidate pipeline; and eliminating bias from the ideal director profile.
- **Creating an inclusive boardroom environment** that fully harnesses the benefits of a diverse board and encouraging all board members to contribute and constructively challenge assumptions and perspectives.
- **Setting the tone that D&I is important to the organization** by keeping it on the board agenda, asking the right questions and monitoring the relevant data. Chairs and boards can and do have a direct impact on the success of D&I within the organizations they serve.

2. A Partnership Between the Chair and CEO is Essential

Within organizations that lead the way on D&I, the chair and CEO are aligned on the importance of the topic. Together they:

- **Embed D&I into the organization's strategy and empower the business to prioritize the topic** alongside other business KPIs and objectives.
- **Make a shared commitment** to role-model purposeful, authentic and inclusive leadership for the rest of the organization.

3. The CEO Delivers Results

While the chair and CEO can partner on tone-setting and making D&I a strategic priority, it is ultimately the CEO's role to deliver results. The best CEOs:

- **Gather data and set targets** to ensure diversity across the business. This means going deep into the data around hiring and promotion decisions at all levels across the firm, analyzing roadblocks and being transparent about success and failure in meeting targets.
- **Put structures and policies into place** that encourage inclusive working environments and that provide diverse talent with the support systems they need to be successful within the organization.
- **Coach and mentor leaders** with the recognition that diverse teams require different management skills than homogenous ones do.

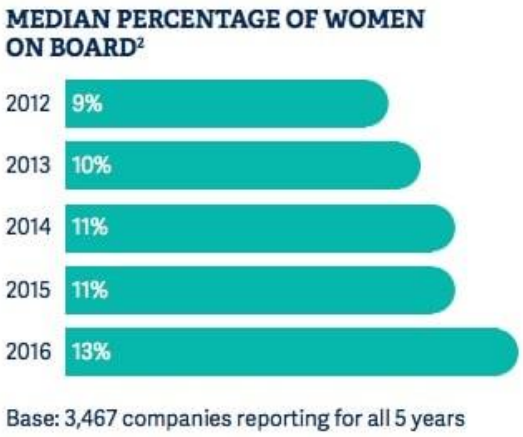
Introduction

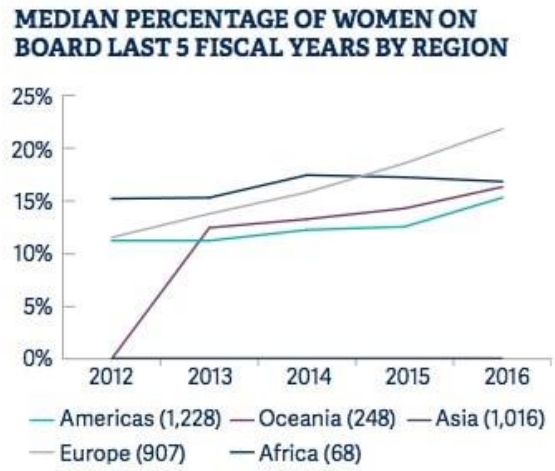
> *"In a world that is changing at a faster rate than ever before, a variety of sensors are essential to enable businesses to effectively interpret different signals, both mitigating risk and seizing opportunity."*
>
> Vittorio Colao, CEO, Vodafone Group plc

A growing body of research shows significant correlations between diverse leadership teams and better business outcomes. McKinsey notes that "diverse companies are better able to attract top talent; to improve their customer orientation, employee satisfaction and decision-making; and to secure their license to operate"[1] and, in the majority of cases, improve their financial performance. Many business leaders believe that having a diverse set of viewpoints is the best way to maximize defenses against relentless disruption. Yet while diverse representation has been steadily increasing, the pace of change remains too slow relative to the challenges that businesses and society face—a clear indicator that there is still much to be done.

> *"We live in a world of exponential change, so it is absolutely critical that organizations have diverse points of view in the boardroom, on the executive team and throughout the organization. And yet, despite the speed at which the world is moving, progress toward gender parity is incredibly slow."*
>
> Hanneke Faber, president of Europe, Unilever plc

In most countries, women occupy fewer than 20 percent of executive roles, and ethnic minorities, even fewer. Boards are faring slightly better, but only slightly.





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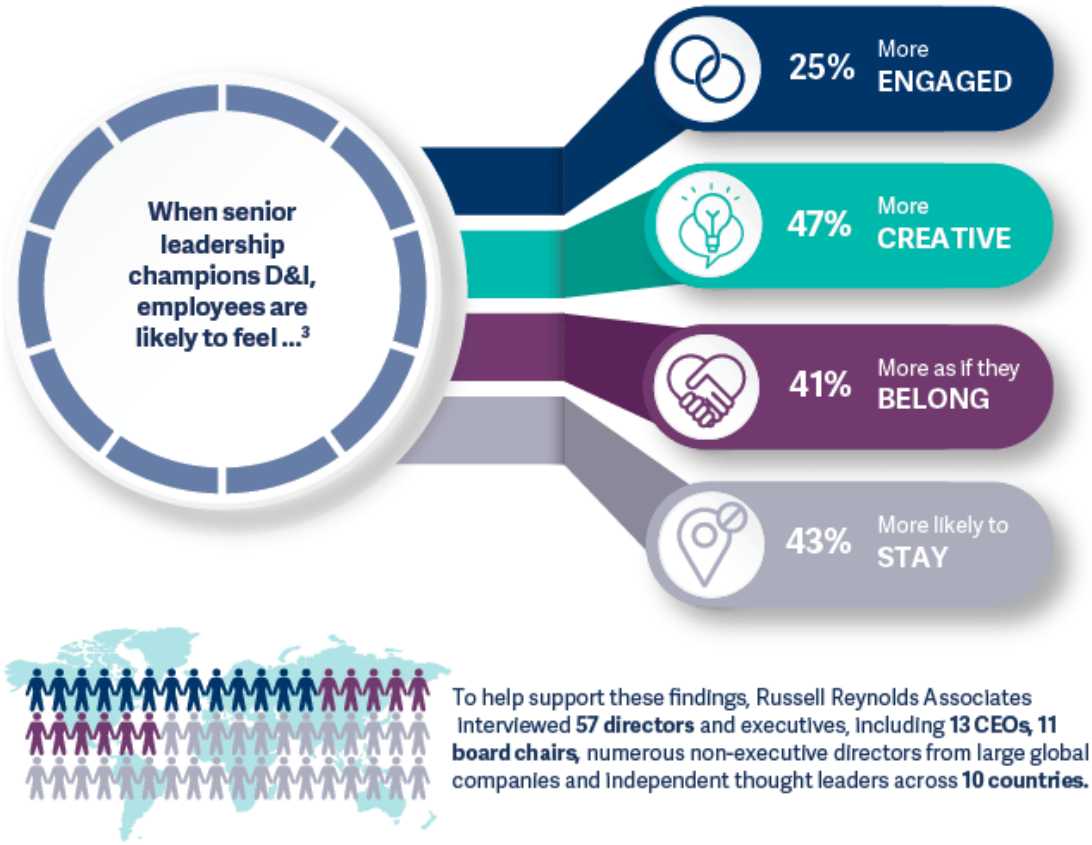
Yet it is increasingly clear that simply hiring diverse employees is not enough to create business value. “If you have diversity, but a culture where people are unable or unwilling to speak up, then diversity doesn’t matter that much,” said Elizabeth Robinson, director of Russell Reynolds Associates and The Bank of New York Mellon Corporation. To fully capitalize on the opportunities that diversity presents, leaders must also work to create an inclusive culture that allows all employees at every level to contribute their unique perspectives and maximize their potential.

Our research at Russell Reynolds Associates reveals that an organization’s senior-most leaders—CEOs, chairs and board members—play pivotal roles in creating inclusive cultures, regardless of their own diversity. In our inaugural D&I Pulse survey, we polled more than 2,100 executives about their employer’s diversity and inclusion efforts and their perceptions of and experiences in the workplace. One of the most striking findings was that when senior leadership (namely, the board and executive committee) champions D&I, key human capital outcomes improve.



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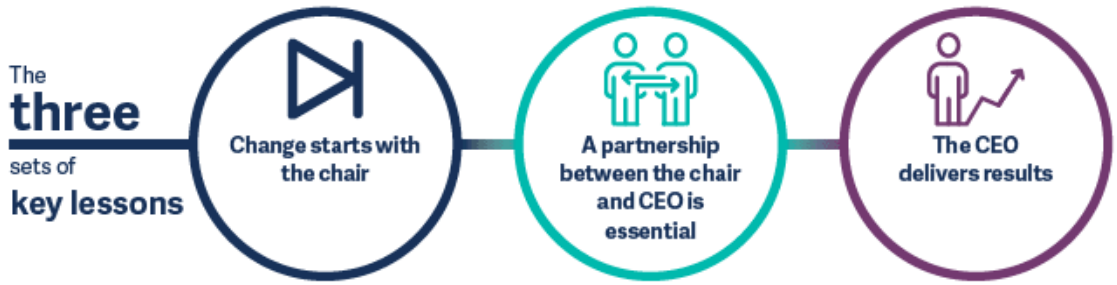
A common thread throughout all of our conversations was the critical role that the chair and CEO can play in driving D&I. Yet how chairs and CEOs deliver tangible results is often less clear. From these firsthand interviews, we draw three sets of key lessons about how board chairs and CEOs can help foster profound change in creating inclusive cultures and driving diversity.



Change starts with the chair

Every member of a board can affect D&I efforts. In general, however, board chairs have the most direct opportunities, as they are responsible for managing the composition of the board, running meetings and setting the board agenda. When the chair uses these functions to create an

inclusive environment for the board, it becomes a model for the CEO and the rest of the organization to follow.

“Most of the time, we talk about boards and executive committees as setting the tone; I think it’s more important when they set the example,” said Ana Paula Assis, general manager of Latin America for IBM Corp.

The obvious—and often uncomfortable—starting point is to take stock of how visibly diverse a board is.

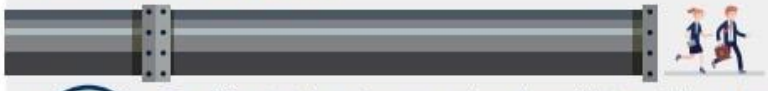
One of the themes we consistently heard from board members was how difficult it is to credibly defend a commitment to diversity when the board itself is homogeneous. For better or worse, the composition of the board sends a strong signal about what the company values.

To be effective, the group has to attain a critical mass of diverse viewpoints rather than simply including a symbolic woman or other minority representative. “My own experience is that when you are a lone female on a board, you are seen as a female voice. Once you reach a critical mass of three or more female directors, you are just seen as a voice; gender is no longer a factor,” said Nancy McKinstry, CEO and executive board chairman, Wolters Kluwer NV.

“Only is lonely. Lone diverse directors instinctively self-censor, resulting in the loss of potentially valuable and distinctive contributions to the discussion. The remedy to this is to have enough diversity to create a feeling of safety in numbers—when everyone is different, no one is different.”

Melissa Bethell, senior advisor, Bain Capital

BUILDING DIVERSE BOARDS



Be willing to take a chance on board candidates with non-traditional backgrounds, including those with no previous board experience. Make a commitment to mentoring and developing new non-executive directors when they join the board.

Create alliances with outside groups such as the 30% Club that draw a diverse membership as well as special-interest networks within familiar groups such as alumni clubs.

Consider innovative measures such as a shadow board internship to offer high-potential talent within the organization early exposure to the boardroom.

“This allows diverse executives to gain exposure to a boardroom environment, which helps their own personal development, as well as builds the pipeline of future non-executive talent,” said Paulette Rowe, managing director, Barclaycard Payment Solutions. This approach can also help boost aspiration among minority groups in the organization by creating and empowering role models.

Just hitting certain numbers isn't enough. To maximize the value of a diverse boardroom, a board chair must also create an environment that encourages participation from all members.

Chairs "who are able to truly get the best out of all the voices in the room tend to be genuinely curious about different points of view and experiences," said Philip Hampton, chair of GlaxoSmithKline plc and head of a UK commission to encourage gender parity among the FTSE 350. They "identify which voices are not being heard and actively create an environment in which everyone can meaningfully participate in the conversation."

"Every board needs diverse non-executives who think differently and are prepared to challenge. The important thing is creating a culture where that works constructively."

Sir Peter Gershon, chairman, National Grid plc

The chair and board can have a direct impact on the success of D&I within the organization by setting the tone that this is a topic prioritized by the board.

Tone is hard to see or measure, yet it is a powerful tool with which chairs and board members can play a crucial role in advancing diversity and inclusion practices in the organization. Through the behaviors and priorities the board chooses, directors can and do have a significant ability to create change.

"If the diversity and inclusion topic is not on the chair's agenda, then it is not a surprise when the organization fails to deliver."

Charles Gurassa, deputy chairman, easyJet plc

The nature of a non-executive director's role is to raise important questions with management. When board members make it a habit to regularly probe for details about efforts to improve diversity, they will encourage the CEO to pay more attention to it. That means "asking direct and meaningful questions about the development paths of diverse talent and ensuring that they have the skills and exposure within the organization to reach the top," said Bridget van Kralingen, a senior vice president at IBM Corp.

A partnership between the chair and CEO is essential

In organizations that maximize the benefits of diversity, the chair and CEO are typically aligned on its importance. “This partnership can make a real difference in terms of progress, as it shows the rest of the organization that diversity is something both the chair and CEO prioritize,” said Margherita Della Valle, group CFO of Vodafone plc.

The chair and CEO should embed D&I into the organization’s strategy. this will empower the business to prioritize the topic in day-to-day operations.

Promoting an inclusive environment thereby becomes part of the company’s core strategic and operational priorities rather than a “nice to have” that receives sporadic attention. The chair and CEO play a critical role in giving the business this license.

> *“The chair and CEO need to drive these initiatives actively, not passively. This means diversity and inclusion must be written into the organization’s strategy. If diversity and inclusion are not in your mission statement, it already shows that the chair and CEO do not truly understand the importance.”*
>
> Hanneke Faber, president of Europe, Unilever plc

Articulating the “why” for diversity needs to be multifaceted, clearly expressed and tailored to the business. While the business case for D&I is powerful, it is the combination of the economic case and committed leadership that changes behavior. The chair and CEO need to articulate this message authentically and personally, explaining not only the importance of the general D&I agenda but also its unique importance to their business.

“I see diversity and inclusion not as an initiative on the side but actually part of the underlying culture of the business,” said one FTSE 100 CEO. Accordingly, it is an integral part of his discussions about the business, based on the idea that “in order to execute our strategy, we need to be open to different views and perspectives.”

The chair and the CEO must make a shared commitment to role-model the behaviors they want the organization to adopt—namely, purposeful, authentic and inclusive leadership.

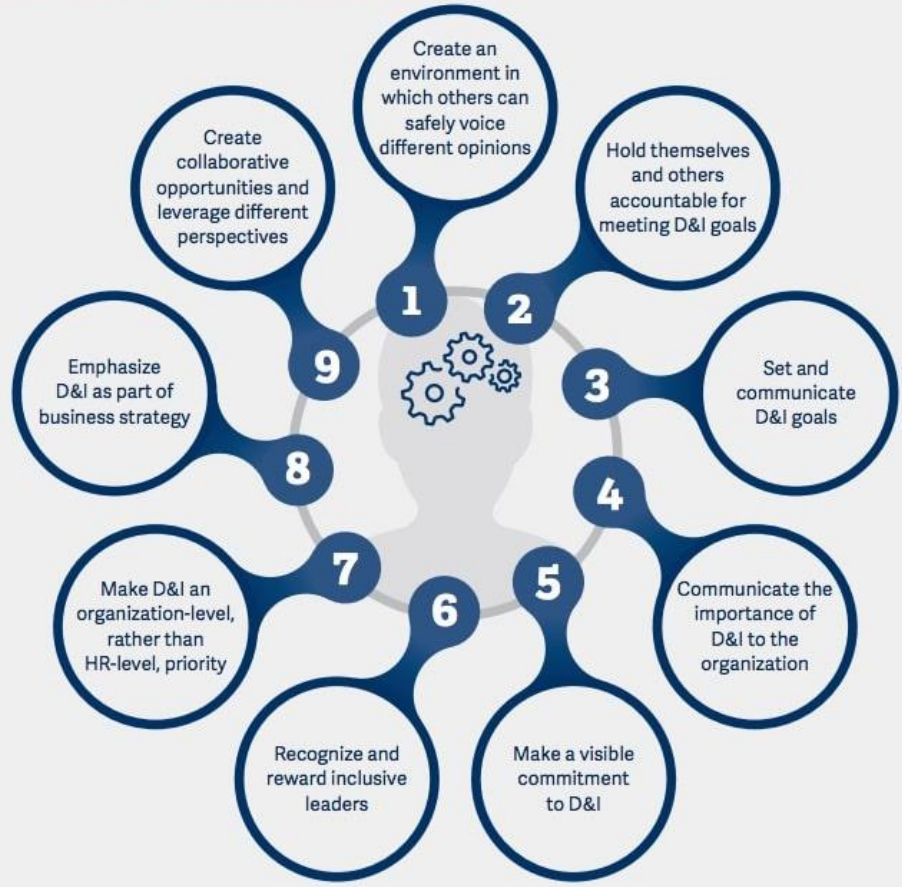
If the company's top leaders are simply checking boxes to comply with external pressures, the company is unlikely to achieve inclusivity and harness the benefits that diversity presents.

> *"You can tell the difference between chairs and the CEOs who are pushing this agenda because of pressure from investors and the market and those who truly believe in it."*
>
> Baroness Rona Fairhead, minister for trade, UK government.

The board members and executives we spoke with described chairs and CEOs who successfully create inclusive environments as being particularly dedicated to eliciting well-rounded dialogue. They are careful about how they divide airtime in meetings and go the extra mile to hear from quieter group members. While undoubtedly strong leaders, they are willing to be vulnerable. They have an "ability to be challenged and also the ability to accept and process different points of view," said Rima Qureshi, EVP and chief strategy officer for Verizon Communications Inc.

"Leaders of global businesses will be required to effectively manage cross-cultural diversity and unlock the potential that it presents. They will need a heightened ability to deal with ambiguity and complexity, which in turn will require exposure to many different operating environments. Those who have experienced only a unidimensional context are likely to be less equipped to lead in a rapidly changing environment."

Su-Yen Wong, former CEO, Human Capital Leadership Institute



Russell Reynolds Associates Diversity and Inclusion Pulse 2018.

The CEO delivers results

While the chair and CEO can partner on tone-setting and making D&I a strategic priority, it is ultimately the CEO's role to deliver tangible results by building a diverse organization, creating an inclusive culture across all levels of the business in which all voices can be heard and consistently reinforcing the strategic imperative of the topic. To achieve these goals, many CEOs are faced with architecting a much broader transformation that includes culture change.

What gets measured gets done.

While some organizations have shied away from counting employees according to their demographic category, most of the executives and board members we spoke with said that gathering data on the positions held by diverse talent is an essential baseline when it comes to diversifying teams. From there, many choose to analyze the root causes behind the numbers and often set targets to improve them. Such targets “can be helpful to focus the mind” and create the necessary impetus to change, noted Vodafone’s group CFO Margherita Della Valle. “When there is more pressure, people need to act on it, and that does tend to work in driving diversity.”

“You get what you measure,” said Hanneke Faber, president of Europe for Unilever. “If this is important in your strategy, you need to know how many minority employees you have and at what levels in your company; you need to set a goal to improve it, and you need to talk about it every quarter.”

Other leaders we spoke with suggested that simply collecting existing data on diversity statistics is not enough. Instead, they indicated that organizations should also seek feedback from people who are leaving them. “The data from these people as to why they are leaving may unlock the issues in a way that the data from those who stay cannot,” said Terrence Duddy, senior independent director for both Hammerson plc and Debenhams plc.

Inclusive policies and structures.

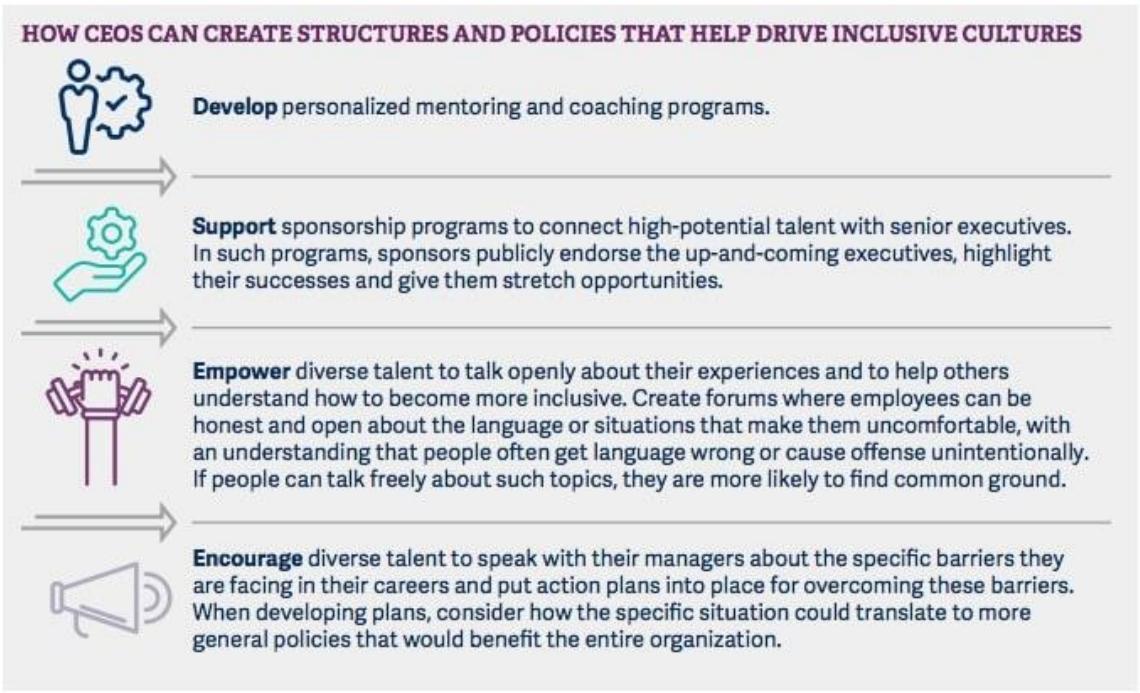
Policies and structures that help to create inclusive working environments, such as mentoring and sponsorship, are critical to success. “The barriers for diverse talent are a lot higher; mentoring

and sponsorship are crucial to overcoming those barriers," said Karen Witts, CFO at Kingfisher plc.

Naturally, it's essential to understand what programs will be most meaningful and effective within a particular organization. Without this understanding, policies designed to enhance inclusion can further segregate certain groups. For example, when flexible working arrangements are aimed solely at women, they tend to be counterproductive. Barry Hoffman, CHRO at Computacenter plc, notes that organizations must be careful not to make gender-based assumptions such as rewarding female employees with a spa day and male employees with tickets to a sporting event.

"We must make sure that in the drive for greater inclusion in the workplace, we don't disengage other groups."

Sanjeev Chatrath, region head of Asia for Thomson Reuters Corp.



Coach and mentor inclusive leaders, with the recognition that diverse teams require different management skills/leadership styles than homogeneous ones do.

Increasingly, leaders are recognizing that a bumpy transition period is an inherent part of moving toward diversity—and that many leaders need coaching and mentoring to manage through it. "Diverse teams are not easy to lead because you have a lot of different kinds of voices and a lot of different kinds of viewpoints and so it takes time," said Sari Baldauf, former chairwoman of Fortum Oyj. As the ultimate role model for inclusive leadership within the organization, a CEO must not only learn how to do it, well but also be proactive in helping other leaders learn similar skills. "There is a need to share best practices on how to manage diverse individuals and perspectives to get the best out of everyone," noted Chris Grigg, CEO of British Land Co. plc. Accordingly, CEOs and executives should expect some challenges as they embark on new D&I initiatives and look for new leadership strategies to work through them.

A continuous commitment for long-term success

Creating an inclusive work environment and realizing the potential of a diverse workforce is not an easy task. “You can’t take your eye off the ball, or people continue to accommodate past behaviors and prevent progress,” said Paula Bellizia, president of Brazil for Microsoft Corp.

While some organizations have made significant progress, now is not the time to take one’s foot off the pedal. If anything we need to accelerate. “Achieving diversity and inclusion is not something that you do just once; you achieve; it is a continuous journey. Diversity numbers move backward the minute you stop focusing on them, faster than you can imagine,” said Judy Hsu, CEO for Singapore and ASEAN Markets at Standard Chartered plc.

For all the challenges associated with corporate D&I efforts, the benefits that accrue to companies that meaningfully cultivate diversity and inclusion are too great to ignore. Diversity is vital to future-proof businesses and create organizational resilience, enabling organizations to more effectively preempt or mitigate risk and capitalize on a wider range of opportunities. As we look forward, it is the ability of leadership to create a culture and environment where the power of all forms of diversity can be fully realized that is the critical differentiator, and it will be one of the defining leadership attributes for the next generation.

Endnotes

[1]“Delivering through Diversity,” McKinsey & Company, Jan. 2018.

[2]“Analysis of Board Diversity and Performance,” Thomson Reuters, Sept. 2016.

[3]Diversity and Inclusion Pulse 2017, Russell Reynolds Associates, N = 2,167.

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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.

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As California Goes, So Goes the Nation? The Impact of Board Gender Quotas on Firm Performance and the Director Labor Market

Posted by Steven Davidoff Solomon (University of California, Berkeley), on Friday, March 8, 2019

Editor's note: Steven Davidoff Solomon is Professor of Law at UC Berkeley School of Law. This post is based on a recent paper authored by Professor Davidoff Solomon; Felix von Meyerinck, Assistant Professor at the University of St. Gallen; Alexandra Niessen-Ruenzi, Chair of Corporate Governance at the University of Mannheim; and Markus M. Schmid, Professor of Corporate Finance at the University of St. Gallen.

Women are still heavily underrepresented in leadership positions in the U.S. corporate sector. According to the Corporate Women Directors International 2018 report, women hold 21.4% of director positions on the boards of the Fortune Global 200 companies. In As California Goes, So Goes the Nation? The Impact of Board Gender Quotas on Firm Performance and the Director Labor Market we examine the consequences of California's adoption of SB 826, a law attempting to cure this disparity. SB 826 mandates that a minimum number of female directors serve on public companies headquartered in California.

The first question we explore is how the introduction of a mandatory gender quota affects Californian firms' valuations. We compute abnormal stock returns for firms headquartered in California and a matched group of control firms for different event windows surrounding the days of the gender quota's adoption and announcement in California. We observe a robust and significantly negative valuation effect of firms affected by the quota. Specifically, firms headquartered in California have a 0.45% lower announcement return on the first day after the quota announcement than a group of control firms headquartered in other U.S. states or the D.C. matched on size and industry. These results translate into a value loss of around 57.2 million USD on average (median: 3.7 million USD) per California-headquartered firm relative to non-California-headquartered firms. The large gap between the mean and median wealth effects is indicative of a skewed distribution, with some firs showing very large effects.

We also find that the market reaction to the quota is more positive (or less negative) the higher the firm's sustainability score. This positive relationship between sustainability and abnormal returns to the quota's announcement applies to both California-headquartered and non-California-headquartered firms, but is stronger for the latter. One conclusion that could be drawn from these results is that part of the market reaction around the quota announcement is caused by investors' disapproval of California's willingness to legislate non-economic values on California firms.

We further examine whether there are negative spillover effects to firms that are headquartered in states that are likely to follow California's lead. First, we examine firms headquartered in democratic states, which are arguably more likely to follow Californian legislation than republican states. Indeed, we find negative spillover effects to firms headquartered in Democratic states. This finding can be interpreted as investors assessing a higher likelihood of mandatory gender quotas being enacted in democratic states. Similarly, we find that firms headquartered in states that followed California in legalizing cannabis to react more negatively to the quota's introduction, a result that is also consistent with the perception of these firms being more likely to face such a quota themselves. Moreover, we find more negative spillover effects of firms headquartered in states that followed California in adopting a minimum wage that exceeds the U.S. federal minimum wage. Hence, we find evidence that firms headquartered in states that are more likely to follow California, and even more so in states that have signaled willingness to legislate non-economic values on firms, show stronger spillover effects. Finally, we document negative spillover effects for firms that operate in industries in which Californian firms need to appoint a large number of female directors to comply with the quota. This finding supports the view that the gender quota is value-reducing because it increases the competition for scarce, experienced female directors.

Finally, we examine whether the board composition of Californian firms has changed in response to the new gender quota. We observe that, relative to control firms, California-headquartered firms significantly increased female board representation by 0.45 percentage points three months after the introduction of the quota law (i.e., as of month-end December 2018). Californian firms that are under more pressure to fulfill the quota, i.e., those that require one (two) female director(s) to comply with the quota, have reacted more quickly to appoint female directors than a sample of control firms headquartered in other states. On average, these firms increased female board representation by 0.58 (0.69) percentage points three months after the introduction of the quota. Some preliminary evidence on the skill set and experience of the newly appointed female directors indicates that they are younger, significantly less likely to possess industry experience or experience as (an outside) director of another listed firm, and less likely to be independent than incumbent female and male directors.

Our results are subject to varying interpretations. One is directly related to the gender quota itself. The value reductions we find may be attributable to investor assessment that the law will lead to the appointment of less-qualified directors and subsequent firm underperformance. In our tests, we find evidence that this may indeed be the case: We document negative spillover effects for firms in industries where competition for female directors is likely to be more intense. We also find that Californian firms appoint younger and less experienced female directors to corporate boards in response to the mandatory quota.

On the other hand, the strong negative valuation results we find are remarkable in that the law only requires the appointment of additional directors, not the removal of male directors. Thus, it is surprising that the simple addition of one to three directors would change firm value so substantially. A second interpretation of the results more in line with this skepticism is that the investor reaction is related to an assessment of the willingness of California (and other similarly politically aligned states) to impose non-economic legislation on firms headquartered in that state. Our results on the effect of this law on smaller firms, those with low corporate governance standards, and those with low sustainability scores imply that firms which might be most affected by future legislation react more strongly, which gives credence to this hypothesis. However, our

findings on spillover effects highlight that the gender quota itself has had some effect and that perhaps both effects are at work here.

Under either hypothesis, our findings suggest that non-economic laws concerning the corporation have economic effects. In the case of gender equality, studies have found that proactive measures to increase female representation on all management levels within a firm seem to be crucial to achieving a sustainable increase of the fraction of women in leadership. Gender quotas at the board level do not find this evidential support and appear to be beneficial only to those women that are directly promoted to a board seat due to the quota, but not to all other women in business who were not appointed to boards.

The complete paper is available for download here.