Harvard Corporate Governance Roundtable

November 5–6, 2019

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Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Purpose & Profit

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

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

Dear CEO,

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

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

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

Purpose and Profit: An Inextricable Link

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

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

The World Needs Your Leadership

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

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

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

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

A New Generation's Focus on Purpose

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

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

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

BlackRock's Engagement in 2019

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

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

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

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

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

Sincerely,

Larry Fink

BlackRock Investment Stewardship Engagement Priorities for 2019

Posted by Michelle Edkins, BlackRock, Inc., on Thursday, January 31, 2019

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

BlackRock, as a fiduciary investor, undertakes all investment stewardship engagements and proxy voting with the goal of protecting and enhancing the long-term value of our clients' assets. In our experience, sustainable financial performance and value creation are enhanced by sound governance practices, including risk management oversight and board accountability.

2019 Engagement Priorities

We are committed to providing transparency into how we conduct investment stewardship activities in support of long-term sustainable performance for our clients. Each year we prioritize our work around engagement themes that we believe will encourage sound governance practices and deliver the best long-term financial performance for our clients. Our priority themes for 2019 are a continuation and evolution of those identified last year and are set out below. We hope that highlighting our priorities will help company boards and management prepare for engagement with us and provide clients with insight into how we are conducting stewardship activities on their behalf. Some governance issues are perennial, such as board quality and performance, although the areas of focus may change over time. These will always be a core component of the Investment Stewardship team's work. Other priorities are evolving and are informed by regulatory and other market developments.

Governance

Quality leadership is essential to performance. Hence, board composition, effectiveness, diversity, and accountability remain a top priority.

Corporate Strategy and Capital Allocation

A clear articulation of corporate strategy and capital allocation provide a clear sense of the direction a company intends to take.

Compensation that Promotes Long-Termism

Executive pay policies and outcomes should link closely to long-term strategy, goals, and performance.

Environmental Risks and Opportunities

Disclosure provides enhanced understanding of board and management oversight of policies, risk factors and opportunities that drive long-term financial performance.

Human Capital Management

In a talent constrained environment, companies should focus on sound business practices that create an engaged and stable workforce.

Our Engagement Philosophy

BlackRock's Investment Stewardship team engages with portfolio companies to encourage them to adopt corporate governance and business practices aligned with long-term financial performance. The team is comprised of more than 40 professionals across all regions (with team members in New York, San Francisco, London, Tokyo, Singapore, Hong Kong, and Sydney), taking a local approach with companies while benefiting from global insights. It is positioned within the firm as an investment function. The team collaborates closely with the members of BlackRock's 125 investment teams to ensure team members have a long-term value mindset and to share their perspective on governance practices. The team engages with companies in the same long-term frame, irrespective of whether a holding is in alpha-seeking, factor, or indexing strategies. As a growing number of our clients invest through index-based strategies, engagement is an important mechanism to provide feedback or signal concerns about governance factors affecting long-term performance, absent the option to sell.

We initiate many of our engagements because companies have not provided sufficient information in their disclosures to fully inform our assessment of the quality of governance. We ask companies to review their reporting in light of their investors' informational needs. In our view, companies that embrace corporate governance as a strategic objective—as opposed to a compliance function—are more likely to generate sustained financial returns over time.

BlackRock takes an engagement-first approach, emphasizing direct dialogue with companies on governance issues that have a material impact on financial performance. We seek to engage in a constructive manner and ask probing questions, but we do not to tell companies what to do. Where we believe a company's governance or business practices fall short, we explain our concerns and expectations, and then allow time for a considered response. As a long-term investor, we are willing to be patient with companies when our engagement affirms they are working to address our concerns. However, when we do not see progress despite ongoing engagement, or companies are insufficiently responsive to our efforts to protect the long-term economic interests of our clients, we may signal our concern by voting against management.

In practice, we assess whether to initiate an engagement or accept an invitation to engage with individual companies based on a range of material factors including our prior history of engagement with the company, our thematic priorities, level of concern on specific governance issues, observation of market events, and assessment that engagement will contribute to outcomes that protect and enhance the economic value of our clients' investments. We strongly encourage companies to provide a detailed agenda when sending us a request for engagement.

Governance

Board composition, effectiveness, and accountability remain a top priority. In our experience, most governance issues, including how relevant environmental and social factors are managed, require board leadership and oversight. We encourage engagement protocols that foster constructive and meaningful dialogue, including making independent directors available in those situations where a director is best placed to explain and justify a company's approach. As we believe that the board should be a competitive advantage, we will seek to better understand how boards assess their effectiveness and performance, along with the skills and expertise needed to take a company through its future (rather than prior) multi-year strategy. In that context, we want to see disclosure regarding the board's position on director responsibilities and commitments, turnover, succession planning, and diversity. With regard to director responsibilities, we will seek better disclosure relating to a board's involvement in crisis management (e.g. cyber events, sudden departures of senior executives, negative media coverage, preparations to mitigate proxy contests) given the likelihood that such events are often material and can significantly detract from a board's ability to carry out its other responsibilities. In relation to board qualifications and effectiveness, we will continue to engage with companies to better understand their progress on improving diversity in the boardroom. In our view, diverse boards make better decisions. BlackRock recognizes that diversity has multiple dimensions, including personal factors such as gender, ethnicity, and age; as well as professional characteristics, such as a director's industry, area of expertise, and geographic location. If there is no progress on enhancing diversity at the board level within a reasonable time frame, we may hold nominating and / or governance committees accountable for an apparent lack of commitment to board effectiveness. Further, we will encourage governance structures that enhance accountability (e.g. proxy access in the U.S.), limit entrenchment (e.g. regular election of directors and board evaluations), and align voting rights and economic interests (e.g. one share, one vote).

Corporate Strategy and Capital Allocation

For several years we have asked companies to articulate their strategic frameworks for long-term value creation and to affirm that their boards have reviewed those plans. Investors expect the board to be fully engaged with management on the development and implementation of the strategy, particularly when the company needs to enhance its competitiveness and / or pivot in light of unanticipated developments. This demonstrates to investors that boards are engaged and prepared, when necessary, to transition and adapt in a fast moving business environment.

Corporate strategy disclosures should clearly explain a company's purpose, i.e. what it does every day to create value for its stakeholders. In our view, companies that better articulate their purpose and connect it with their long-term strategy are more likely to have engaged employees, loyal customers, and other supportive stakeholders. This gives the company a competitive advantage and a stronger foundation for generating superior financial returns.

Companies should succinctly explain the long-term strategic goals the board and management are working towards, the applicable measures of value-creation and milestones that will demonstrate progress, and steps taken if any obstacles are anticipated or incurred.

This explanation should be refreshed periodically and adapted to reflect the changing business environment and how it might affect how a company prioritizes capital allocation, including capital investments, research and development, technological adaptation, employee development, and capital return to shareholders.

Compensation that Promotes Long-Termism

We are interested in how boards establish and explain performance metrics and hurdles in the context of the aforementioned long-term strategy setting. We expect executive incentives to use performance measures that are closely linked to the company's long-term strategy and goals. This should ensure that executives are rewarded for delivering strong and sustainable returns over the long-term, as opposed to short-term hikes in share prices. To this end, we expect companies to clearly articulate the company's balance and prioritization between "input" metrics that are within management's control relative to "output" metrics such as earnings per share or total shareholder return. Where pay seems out of line with performance, we expect the company to provide detailed justification in its public disclosures. We may seek to engage with independent directors where concerns persist. We may ask the board to explain the extent to which it considers internal pay equity and the broader macroeconomic context when setting pay. We believe that companies should use peer groups to maintain an awareness of peer pay levels and practices so that pay is market competitive, while mitigating potential ratcheting of pay that is disconnected from actual performance. We may vote against the election of compensation committee members in instances, including but not limited to, where a company has not persuasively demonstrated the connection between strategy, long-term shareholder value creation, and incentive plan design.

Environmental Risks and Opportunities

In our Global Corporate Governance & Engagement Principles we explain that sound practices in relation to the environmental factors inherent to the business model can be a signal of operational excellence and management quality. Environmental factors relevant to the long-term economic performance of companies are typically industry-specific, although in today's dynamic business environment some, such as regulation and technological change, can have a broader impact. Previously, this priority was entitled "climate risk disclosure" given our involvement in the below-referenced Task Force on Climate-related Financial Disclosures (TCFD). This year, we expanded on this priority because many of our engagements encompass a broader set of environmental factors, ranging from climate risk, energy consumption and efficiency, water and waste management, emissions, and natural resource management. Corporate reporting should help investors and others understand the company's approach to these factors and how risks are integrated and opportunities realized. For industries facing ongoing challenges which may adversely affect a company's business strategy and operational results, we expect disclosure relating to board and committee oversight and enterprise risk management practices. In this context, we expect disclosure of the company's governance of these factors, if and how they are incorporated into the long-term strategy and risk management processes, and any metrics identified targets, along with the performance against them. This helps shareholders assess how well management is dealing with these material factors relevant to the business. Any global standards used by the company to report on such factors should also be disclosed and discussed.

We recognize that the proliferation of reporting standards creates challenges for companies and for investors. Companies report "survey fatigue" and investors find it difficult to navigate inconsistent and incomplete data. We will continue to encourage standard-setters to work together and to seek input from companies and investors. We are active in the Sustainability Accounting Standards Board (SASB) and the TCFD. We find the SASB's industry-specific guidance in the context of its environmental pillar (as identified in its materiality map) beneficial in helping companies identify and discuss their governance, risks assessments, and performance against these key performance indicators (KPIs).

We will continue our multi-year engagements on climate risk as we believe its impacts have the potential to affect companies' business models and operations. The aims of our climate risk engagements are twofold: (1) to encourage companies to provide disclosure that helps investors and others understand how a company assesses, manages, and adapts to those risks, and (2) to understand how those risks are likely to impact the business in the medium- to long-term.

To that end, BlackRock continues to be a member of the industry-led Financial Stability Board's TCFD. The TCFD published in June 2017 its recommendations around four thematic areas that represent core elements of how organizations operate—governance, strategy, risk management, and metrics and targets. This framework offers companies and investors a starting point to assess, report, and price climate-related risks and opportunities. In our view, the TCFD recommendations, which include sector-specific supplemental guidance, provide a relevant roadmap for companies and help achieve comparability and consistency of reporting.

Human Capital Management

Most companies BlackRock invests in on behalf of clients publicly state that their success is heavily dependent on their employees or talent. Often they also report that they are operating in a talent constrained environment, or put differently, are in a war for talent. It is therefore important to investors that companies establish themselves as the employer of choice for the workers on whom they depend. A company's approach to human capital management (HCM)—employee development (including transitioning their skills to the work of the future), diversity and a commitment to equal employment opportunity, health and safety, labor relations, and supply chain labor standards, amongst other things—will vary across sectors but are a factor in business continuity and success. In light of evolving market trends, like shortages of skilled labor, uneven wage growth, and technology, that are transforming the labor market, many companies and investors consider having a high standard of HCM a potential competitive advantage. Our HCM engagement commentary explains that we seek disclosure around a company's approach to ensuring the adoption of the sound business practices likely to create an engaged and stable workforce. We expect such disclosure to provide us with an understanding of if and how boards oversee and work with management to improve performance in these areas. While reporting is still evolving, we believe in the benefit of companies moving towards a more robust disclosure of HCM metrics. For instance, the SASB provides industry-specific HCM metrics. Useful industry-specific metrics can provide companies and investors insight into the return on investment related to talent and enable companies to understand if they are outliers relative to peers from the perspective of long-term performance. Comprehensive disclosure on the issue provides investors with a sense of the company's culture, long-term operational risk management practices and, more broadly, the quality of the board's oversight. In our engagement with companies on HCM, we discuss their views on the current and prospective disclosure requirements, as well as their policies and approach to ensuring the company attracts, retains and develops the workers / employees on which its business performance depends.

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Proxy Voting Outcomes: By the Numbers

Posted by Barbara Novick, BlackRock, Inc., on Wednesday, July 24, 2019

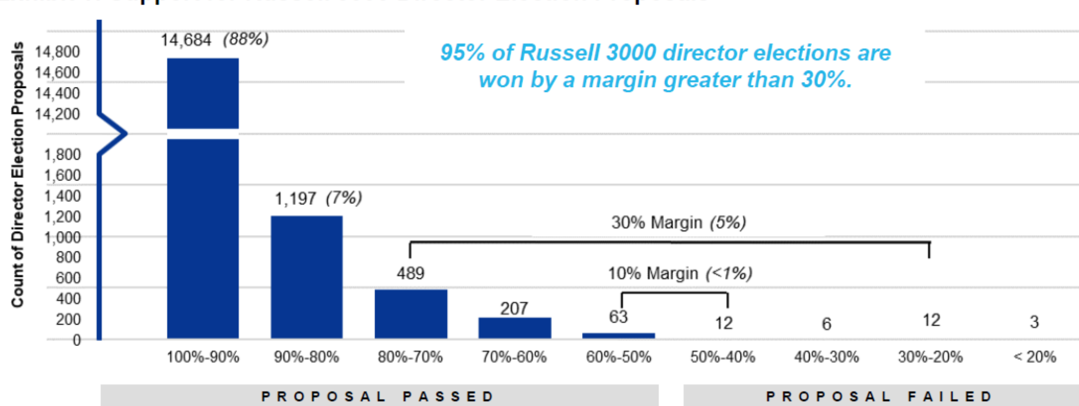
Editor's note: Barbara Novick is Vice Chairman and Co-Founder at BlackRock, Inc. This post is based on a Policy Spotlight issued by Blackrock.

Index funds have democratized access to diversified investment for millions of savers who are investing for long-term goals, like retirement. The popularity of index funds has, however, drawn critics who claim that index fund managers may wield outsized influence over corporations due to the size of their shareholdings in public companies. Some commentators speculate that the largest asset managers are determining the outcome of proxy votes. Central to this hypothesis is an assumption that the shareholdings of the largest asset managers are sufficiently sizeable to determine the outcome of proxy votes. An analysis of the margins by which proxy votes are won or lost demonstrates that this is rarely the case.

Director Elections

The Russell 3000 index is a broad-based index comprised of the 3,000 largest US public companies by market capitalization and thus provides a broad sample of US companies from which to analyze proxy voting activity. Assuming that a single asset manager can vote 10% of a company's shares, Exhibit 1 shows that during the 2017-2018 proxy season, less than 1% of Russell 3000 director elections could have been decided by a 10% shareholder changing their vote. In addition, Exhibit 1 shows that in the 2017-2018 proxy season, 95% of Russell 3000 director elections were won by a margin greater than 30%. This means that even three 10% shareholders changing their votes in the same direction would not have changed the outcome.

Exhibit 1: Support for Russell 3000 Director Election Proposals



Source: FactSet, for the N-PX disclosure period ending June 30, 2018.

By the Numbers
Claims that index fund managers are determining the outcome of most proxy votes is not supported by the data, which show that within the Russell 3000:

- 95% of director elections are won by margins greater than 30%
- 87% of say-on-pay votes are won by margins greater than 30%; and
- 95% of M&A-related votes are won by margins greater than 30%.

In other words, the outcome of the vast majority of votes would not change even if three 10% shareholders changed their vote in the same direction.

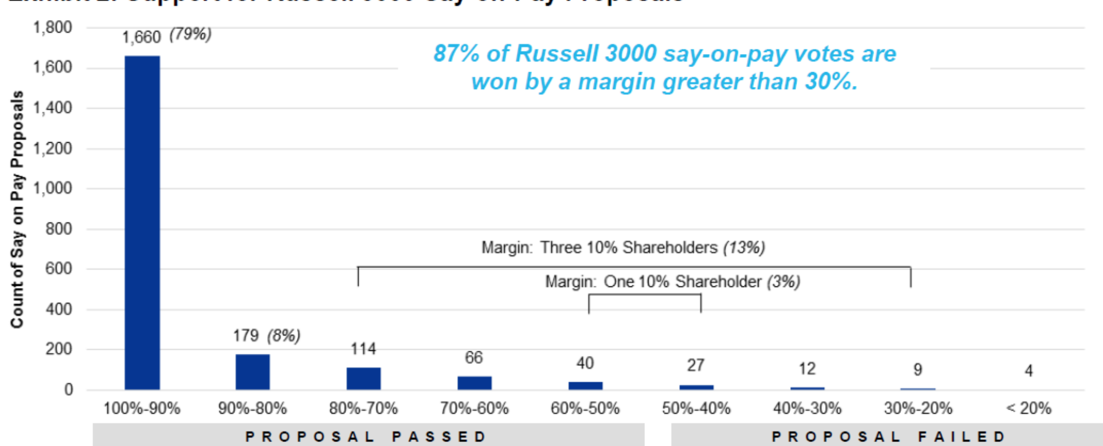
Shareholder proposals are more controversial (about two-thirds are decided within a 30% margin), but the significant variation in asset manager voting records negates the idea of a multi-firm voting bloc.

Say-on-pay and M&A-Related Votes

Another area of focus has been the level of influence shareholders have on executive compensation and mergers and acquisitions (M&A). However, looking at the margins by which 'say-on-pay' and M&A-related votes are approved presents a similar picture to director elections – that it is rarely possible for even the largest shareholders to change the outcome.

According to the Dodd-Frank Act, say-on-pay is a mandatory, non-binding advisory vote (held at least every 3 years). Say-on-pay votes ask shareholders to opine on the compensation of named executives that is disclosed in the proxy statement, rather than on the company's compensation program going forward. Say-on-pay votes are backward looking; they do not dictate current compensation. For more information on executive compensation including regional differences, see the Policy Spotlight, Executive Compensation: The Role of Public Company Shareholders. As shown in Exhibit 2, during the 2017-2018 proxy season, 79% of say-on-pay proposals were approved with greater than 90% support by all shareholders and 87% were won by margins greater than 30%. Only 3% of say-on-pay proposals were won or lost by a margin of 10% or less.

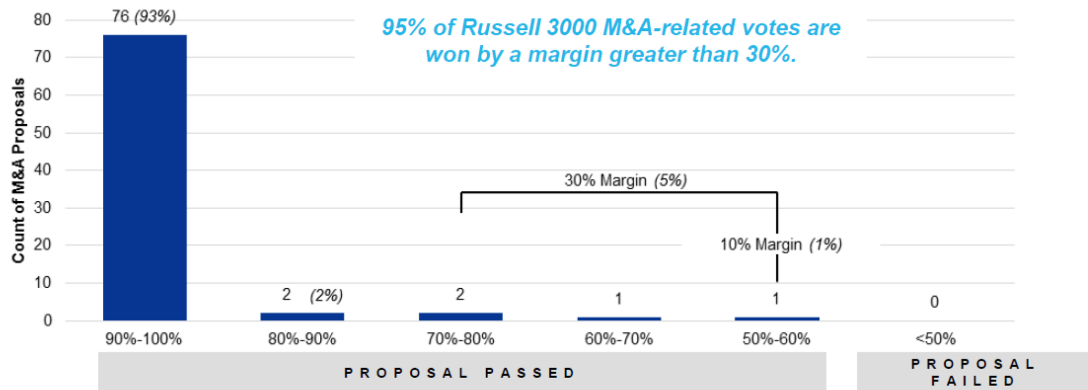
Exhibit 2: Support for Russell 3000 Say-on-Pay Proposals



Source: FactSet, for the N-PX disclosure period ending June 30, 2018.

M&A-related votes, which can entail approving the ability to raise capital to fund a transaction rather than the transaction itself, receive similarly high levels of support. Exhibit 3 shows that 93% of M&A-related votes during the 2017-2018 proxy season received 90% or more support and only one transaction (1%) was passed within a margin of 10% or less. Likewise, less than 5% of transactions passed within a 30% margin. We note that M&A reflects special situations; the company's management and board often spend considerable time presenting the strategic rationale for the transaction directly to shareholders and may, to the extent possible, incorporate feedback in advance of holding a vote. This, in part, explains the high levels of support for M&A-related votes, though the level of support also reflects the fact that most shareholders defer to the board's process and management's business judgement on these types of matters.

Exhibit 3: Support for Russell 3000 M&A-Related Proposals

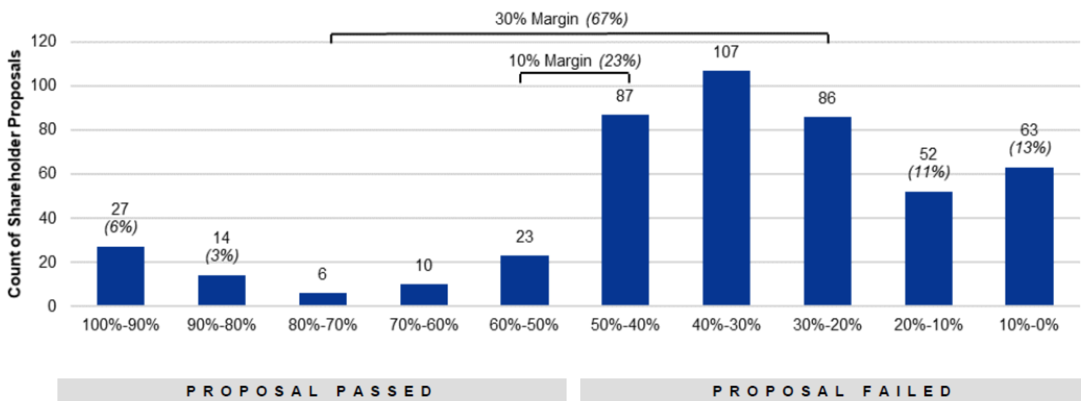


Source: FactSet, for the N-PX disclosure period ending June 30, 2018. Note: Excludes two M&A-related proposals included in the FactSet database that were not ultimately put to a shareholder vote.

Shareholder Proposals

Shareholder proposals comprise about 2% of all Russell 3000 ballot items. As shareholder proposals encompass a wide range of topics, they tend to be more controversial than other ballot items, and the voting outcomes often reflect much smaller margins. As shown in Exhibit 4, nearly one-quarter of shareholder proposals in the 2017-2018 proxy season were won or lost by a margin of 10% or less, and approximately two-thirds were within a 30% margin. As a result, these proposals have become an area of intense focus.

Exhibit 4: Support for Russell 3000 Shareholder Proposals

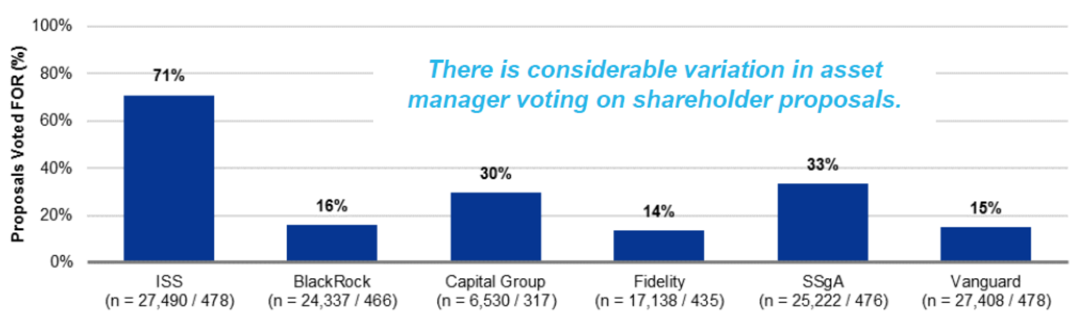


Source: FactSet, for the N-PX disclosure period ending June 30, 2018.

Some commentators have pointed to the influence of proxy advisors, as it has been estimated that due to the mechanical voting of some institutional investors, recommendations by proxy advisors can determine between 15% and 25% of a vote.[1] The largest asset managers do not 'follow' proxy advisor recommendations. BlackRock uses data from proxy advisors as one of several inputs into our decision, evaluating each proposal on its own merits, in conjunction with our region-specific guidelines. (See *ViewPoint*: Investment Stewardship Ecosystem for more information on BlackRock's approach to proxy advisors.)

While shareholder proposals are more controversial and the outcomes reflect closer votes, the idea of a 'multi-firm voting bloc' that has been suggested by some does not exist. Exhibit 5 demonstrates considerable variation in voting for shareholder proposals by the largest asset managers. In essence, large asset managers are informed investors who have views that are often different from one another and from proxy advisor recommendations.

Exhibit 5: Voting Records on Shareholder Proposals



Source: ISS, for the N-PX disclosure period ending June 30, 2017.

[1] Nadya Malenko and Yao Shen, Boston College, The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design (Aug. 2016), available at https://www2.bc.edu/nadya-malenko/Malenko,Shen%20(RFS%202016).pdf.

Bottom line:

The view that asset managers are ‘determining’ the outcome of proxy votes is not supported by the data. The vast majority of ballot items are won or lost by margins greater than 30%, meaning that even the three largest asset managers combined could not change the vote outcome. While the small subset of votes on shareholder proposals tend to be closer, the considerable variation in voting records among asset managers negates the concept of a multi-firm voting bloc as the ‘swing vote”.

Executive Compensation: The Role of Public Company Shareholders

Posted by Barbara Novick, BlackRock, Inc., on Wednesday, July 31, 2019

Editor's note: Barbara Novick is Vice Chairman and Co-Founder at BlackRock, Inc. This post is based on a Policy Spotlight issued by Blackrock.

Index funds have democratized access to diversified investment for millions of savers who are investing for long term goals, like retirement. However, the popularity of index funds has drawn critics, who claim that index fund managers may wield outsized influence over corporations through their proxy voting and engagement. Executive compensation is often cited as an example because public company shareholders can participate in 'say-on-pay' votes. As discussed in the Policy Spotlight, Proxy Voting Outcomes: By the Numbers, index fund managers are rarely the determining factor in say-on-pay votes. That notwithstanding, the focus on say-on-pay is misplaced, since executive compensation is neither structured nor decided by shareholders. Rather, a process is undertaken by the Board of Directors, often under the advisement of the Board's compensation committee and/or compensation consultant, to determine the amount and composition of executive pay packages. This post provides an explanation of the process by which executive compensation is determined, and the role of shareholders in that process. First, we begin by outlining the roles of the various parties that are relevant to executive compensation determinations:

- **Boards of Directors** are ultimately responsible for making executive compensation decisions. The Board relies primarily on input from its Compensation Committee (or similar committee) to make this determination, as well as compensation consultants, who are often hired by the Compensation Committee.
- A **Compensation Committee** is a Board committee that is composed of independent directors (directors who are not company executives). The Compensation Committee is charged with designing the executive compensation program and determining executive compensation. In the US, the role of the Compensation Committee is disclosed in annual proxy statements that each company files with the SEC.
- **Compensation Consultants** are independent advisors who are often retained by the Compensation Committee to provide advice on executive compensation. Compensation Committees are not required to engage a compensation consultant; however, nearly 90% of large companies use compensation consultants and 90% of retention agreements are made directly with the Compensation Committee or Board.[1] In addition to traditional

[1] Ryan Chacon, Rachel Gordon, Adam S. Yore, Compensation Consultants: Whom do they serve? Evidence from Consultant Changes (January 2019).

compensation consultants, advisors to the Compensation Committee may include tax and accounting experts in particularly complex situations.

Independence from management in both hiring and continuing relationships with compensation consultants is important to assure that the compensation consultant is truly an advisor to the Board, which in turn is charged with a fiduciary duty to all shareholders. In the US, the use of compensation consultants is disclosed in annual proxy statements that each company files with the SEC. While there are a number of compensation consultants, Exhibit 1 shows the ten compensation consultants most often retained by large cap companies based on proxy statement disclosures.

Exhibit 1: Top 10 Compensation Consultants

Rank	Consulting Firm	Rank	Consulting Firm
1	Frederic W. Cook & Co.	**6**	Towers Watson
2	Meridian Compensation	**7**	Mercer
3	Pay Governance	**8**	Exequity
4	Pearl Meyer & Partners	**9**	Compensation Advisory Partners
5	Semler Brossy Consulting Group	**10**	Compensia

Source: Equilar. As of March 2019.

In setting executive compensation, a Board considers the mix of fixed (salary and benefit) and variable (performance-based) compensation, as well as the form of compensation. The Board is informed in this review by individual and company performance, both in the current compensation year and also over the longer-term (usually 3 to 5 years). Variable compensation often vests over a period of time under a plan that sets specific targets for both individual and company performance. The Board considers the quantum and structure of compensation relative to what executives in similar companies (by industry, sector, size and complexity of business) may earn. Oftentimes the compensation consultant performs a peer group analysis for the Compensation Committee to facilitate this comparison. The compensation consultant will develop a relevant ‘company peer group,’ which is determined by reference to companies within the same or similar sectors. Peer groups are often publicly disclosed by companies as a reference point in how the Board reaches its compensation decision. An example of a peer group disclosed in a company’s proxy statement is shown in Exhibit 2.

Exhibit 2: Excerpt of Peer Group from Company Proxy Statement (Pfizer)

2018 PHARMACEUTICAL PEER AND GENEERAL INDUSTRY COMPARATOR GROUPS

Our peer group for 2018 consisted of the companies listed in the charts below

2018 Pharmaceutical Peer Group

AbbVie	Bristol-Myers Squibb	GlaxoSmithKline	Novartis*
Amgen	Eli Lilly	Johnson & Johnson	Roche*
AstraZeneca	Gilead Sciences	Merck	Sanofi*

* The committee recognizes that while data are available on the performance of some of our non-U.S.-based peer companies, the compensation data in some cases are limited in terms of comparable benchmarks and may use different pay models as compared to Pfizer's pay model.

2018 General Industry Comparator Group*

3M	Coca-Cola	IBM	United Parcel Service
AT&T	Comcast	Lockheed Martin	United Technologies
Boeing	ConocoPhillips	Mondelez	UnitedHealth Group
Caterpillar	General Electric	PepsiCo	Verizon
Chevron	Honeywell	Procter & Gamble	

* The Committee removed Express Scripts and Microsoft from the General Indsutry Comparator Group.

Source: United States Securities and Exchange Commission Schedule 14A filing for Pfizer. Based on 2019 filing.

At its heart, peer group analysis presumes that a successful executive in one company would be equally successful in a similar one, and thus compensation should be comparable. Peer group analysis also helps companies ensure that they are compensating their executives in line with industry standards for talent retention purposes. The compensation consultant helps guide the Compensation Committee, and ultimately the Board, throughout the review process, including comparisons to programs in other companies. The consultant also provides analysis on how it believes proxy advisors and institutional shareholders will view a particular compensation package against their guidelines, so the Board can be fully informed as to likely reactions, especially if significant compensation changes are under consideration. A report of how executive compensation was determined is included in companies' annual proxy statements that are filed with the SEC. Exhibit 3 provides excerpts of disclosures made by US public companies on various aspects of the determination of executive compensation packages—the discussions included in proxy statements are quite detailed so these excerpts are meant to be illustrative rather than exhaustive.

Exhibit 3: Excerpts from Company Proxy Statements

Microsoft

Use of compensation consultants

"The Compensation Committee retains Semler Brossy Consulting Group, LLC ('Semler Brossy') to advise the Committee on marketplace trends in executive compensation, management proposals for compensation programs, and executive officer compensation decisions…Semler Brossy is directly accountable to the Committee. To maintain the independence of the firm's advice, Semler Brossy does not provide any services for Microsoft other than those described above."

Johnson & Johnson

Peer group analysis

“The Committee compares our executive compensation levels and practices to those of the Executive Peer Group companies. It consists of companies that generally: are similar to Johnson & Johnson’s size and scope; have executive positions similar to ours; and compete with us for executive talent. The Committee reviews the composition of the Executive Peer Group annually. We compare our salaries, annual performance bonuses, long-term incentives, and total direct compensation to the Executive Peer Group companies. We also compare our benefits, perquisites and other compensation to the Executive Peer Group.”

United Health Group

Compensation Committee role

“The Compensation Committee oversees the Company’s policies and philosophy related to total compensation for executive officers. The Compensation Committee approves the compensation for the named executive officers based on its own evaluation, input from our CEO (for all executive officers except himself), internal pay equity considerations, the tenure, role and performance of each named executive officer, input from its independent consultant and market data.”

Sources: United States Securities and Exchange Commission Schedule 14A filings for Microsoft, Johnson & Johnson, and United Health Group Inc. Based on 2018 filings.

Ultimately, the goal of any executive compensation program should be to incentivize senior executives to enhance company performance relative to prior years and relative to its competitors for the benefit of all shareholders. In general, Compensation Committees will set out metrics against which executive performance will be assessed, which provides some rigor around the determination of executive compensation. Examples of compensation metrics contained in company proxy statements are set out in Exhibit 4.

Exhibit 4: Examples of Compensation Metrics Included in Company Filings

American Airlines Group

Our CEO and other executive officers have demonstrated their commitment to fair pay and pay for performance by initiating the following exceptional actions with respect to their compensation.

- Since 2015, at Mr. Parker’s request, we provide 100% of his direct compensation in the form of equity incentives in lieu of base salary and annual cash incentive compensation. That has helped to advance our commitment to paying for performance and aligning Mr. Parker’s interests with that of our stockholders. More than half of these equity incentives will be earned not earlier than the third anniversary of the grant date based on our relative pre-tax income margin and total stockholder return (TSR) performance.

- At his request, Mr. Parker’s target direct compensation has been historically set at below the average for his peers at Delta and United.
- Also at his request, in 2016, our Compensation Committee agreed to eliminate Mr. Parker’s employment agreement so that he is no longer contractually entitled to receive a set level of compensation and benefits and is no longer protected by the change in control and severance provisions of that employment agreement.

United Continental Holdings, Inc.

Our 2017 incentive awards are directly tied to Company performance metrics that we believe are appropriate measures of our success and that will lead to value for our stockholders:

- annual pre-tax income;
- long-term pre-tax margin performance improvement (measured on a relative basis versus our industry peers);
- stock price performance;
- operational performance, as measured by key indicators of customer satisfaction (on-time departures, flight completion factor, and mishandled baggage ratio); and
- specified strategic initiatives designed to enhance management focus on key corporate objectives.

We eliminated ROIC performance, which had historically been included as a performance measure under our prior long-term incentive program design, from our 2017 long-term incentive design in order to accommodate greater focus on our pre-tax margin results. The 2017 long-term incentive structure is equally divided between the pre-tax margin Performance-Based RSU awards and time-vested RSU awards, which provides stability and retentive features to the design.

Sources: United States Securities and Exchange Commission Schedule 14A filings for American Airlines Group Inc. and United Continental Holdings, Inc. Based on 2018 filings.

The mix of cash and non-cash compensation and the aggregate amount of compensation, which is subject to deferral or future vesting, has evolved over the years. Further, compensation programs may differ depending on the size of the company and where it is in terms of its lifecycle. For example, emerging growth companies are more likely to use options as part of their compensation program, while established companies generally use restricted share grants. Tax and accounting rules can drive some compensation design issues. Increasingly, certain practices, including the trend toward greater use of performance based compensation (compensation that is only paid or vested if specific performance metrics are achieved), are driven by criteria established by proxy advisors.

US public companies must disclose in their annual proxy statements the amount and type of compensation (including perquisites) paid to its CEO, CFO and the three other most highly compensated executive officers. In addition, US public companies are required to disclose the criteria used in reaching executive compensation decisions and the relationship between the company's executive compensation practices and corporate performance. Likewise, many other countries require executive compensation disclosures, with varying degrees of granularity (see section on Regional Differences).

As discussed in the following sections, compensation consultants consider the guidelines of proxy advisors as well as the views of institutional shareholders as inputs into the design of executive compensation packages.

The Role of Proxy Advisors

Proxy advisors are a critical component of the proxy voting system as they affect both the design of compensation packages and the vote outcomes for 'say-on-pay' votes and director elections related to compensation decisions. This contributes to the considerable influence that proxy advisors can have in executive compensation matters, as it has been estimated that due to the mechanical voting of some institutional investors, recommendations by proxy advisory firms can determine between 15-25% of a say-on-pay vote.[2] For more information on the role of proxy advisory firms, please see our recent *ViewPoint,* The Investment Stewardship Ecosystem.

The major proxy advisors have established compensation guidelines that are focused on 'pay for performance' relative to a peer group determined by the proxy advisor. Importantly, proxy advisor peer groups may differ from the peer groups identified by the Board and its compensation consultant. Failure to clearly link executive compensation to performance, or the use of weak performance standards, can result in a negative vote recommendation from proxy advisors on the say-on-pay ballot item. Other compensation practices, such as the inclusion of tax gross-up rights or single trigger severance arrangements, can also result in a negative recommendation. In some cases, the negative recommendation goes beyond the say-on-pay vote and includes a recommendation to vote against directors on the compensation committee or even directors at large. Some believe that over time, deference to the proxy advisors' models and policies has led to more standardization and fewer compensation programs tailored to the particular circumstance of the company and the executives that the compensation policy is intended to incentivize. This homogeneity can reduce the effectiveness of pay plans and their alignment with corporate performance.

Say-on-Pay

Shareholders' participation in 'say-on-pay' votes is often pointed out as a mechanism by which shareholders express their view on executive compensation. Yet, the nature and content of say-on-pay is not well-understood. Most people assume that a say-on-pay vote is a vote to approve the executives' compensation for the current year. *This is an incorrect assumption*.

[2] Nadya Malenko and Yao Shen, Boston College, The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design (Aug. 2016), available at https://www2.bc.edu/nadya-malenko/Malenko,Shen%20(RFS%202016).pdf.

In the US, say-on-pay votes are non-binding advisory votes by shareholders, most commonly conducted on an annual basis at the annual general meeting.[3] As an advisory vote, even were a say-on-pay proposal to not receive majority support, this would not prevent a company from implementing its pay practices. Say-on-pay votes ask shareholders to opine retrospectively on the compensation of named executives that is disclosed in the proxy statement, rather than on the company's compensation program going forward. The proxy statement disclosure includes the compensation paid to the top five named executive officers over the previous three fiscal years, as well as the Compensation Discussion and Analysis, which provides additional narrative around the objectives of a company's compensation plan and how they are implemented.[4,5] Say-on-pay requirements were put in place in the US in 2011 under provisions of the Dodd-Frank Act.

When there is a large vote against a particular say-on-pay proposal (or vote against directors due to prior compensation decisions), it is often based on views that the compensation is considerably out of alignment with company performance and shareholder returns. Thus, a significant level of shareholder dissent often leads to engagement between a company and its shareholders to understand the concerns regarding the executive compensation program and to gather input for the structuring of future compensation packages. Further, while non-binding, failure to heed majority votes against executive compensation may result in future votes against Board directors. Some institutional investors also expect that the Compensation Committee will engage with them in the event of a sizeable 'against' vote (generally 25%-30%), and will vote against directors if they fail to engage.

Nevertheless, data show that most say-on-pay proposals pass by a large majority. When there is a closer vote, the explanation is often found in the 'against' recommendation of proxy advisory firms. That said, larger institutional investors may take a more nuanced analysis of compensation decisions and, as a result, support the say-on-pay proposal often following engagement. We explore the levels of support received for say-on-pay votes as well as other types of votes in the Policy Spotlight, Proxy Voting Outcomes: By the Numbers.

Regional Differences

Generally speaking, the manner by which executive compensation at public companies is determined is consistent across regions. That said, there are some regional differences worth noting. Firstly, Compensation Committees in Europe are referred to as 'Remuneration Committees' and most national corporate governance codes or domestic laws require companies to have 'remuneration committees'. Under the Shareholder Rights Directive II (SRD II), shareholders will be able to express their view twice. Ex-ante proxy votes related to remuneration

[3] Per section 951 of the Dodd-Frank Act, US companies must also provide shareholders with the ability to vote, also on an advisory basis, on the 'frequency' (one, two or three year) of the 'say-on-pay' vote.

[4] Final Rule 14a-21(a) requires that companies hold a say on pay vote at least every three years to approve the compensation disclosure required by item 402 of Regulation S-K.

[5] By contrast to say-on-pay votes which are retrospective and non-binding, management equity plans that also appear on company ballots are forward looking and are binding in As noted in the BlackRock Investment Stewardship 2018 annual report, equity plans are intended to incentivize and reward participants and provide a way for them to share in the long-term future success of the company. The fact that equity plan proposals are binding makes them as an effective tool to underscore concerns when equity is not being used effectively at the company. Management equity compensation plans are a means to attract and retain talent—in essence, a human capital management tool. These plans are particularly important when they apply to a wide range of employees. They can help create an 'ownership' mentality, and provide a streamlined incentive structure across the employee base.

at European companies focus on approving the remuneration policy that lays down the framework within which remuneration can be awarded to directors. The remuneration policy must be subject to a vote by shareholders at a general meeting at least every four years and after a material change. These remuneration votes will in principle be binding (as opposed to the non-binding say-on-pay votes in the US), though Member States are able to opt for remuneration votes to instead be advisory votes. This means that companies are allowed to apply a remuneration policy that has been rejected by shareholders, but they are required to submit a revised policy at the next general meeting. Further, in Europe under the SRD II, companies must prepare and publish on their website an annual directors' remuneration report. Here shareholders will vote ex-post on the remuneration report describing the remuneration granted in the past financial year: this vote will only be advisory.

Say-on-pay requirements were put into place in 2003 for UK companies. Similar to SRD II, currently shareholders have the right to cast both an ex-ante and an ex-post vote. As per amendments to the Companies Act in 2013, the ex-ante vote is referred to as the 'remuneration policy' vote, and it is binding and occurs every three years. The ex-post vote is known as the 'remuneration report' vote or 'implementation report', and it is advisory and occurs annually.

Bottom line:

'Say-on-Pay' votes permit shareholders to express their views on executive compensation, but they do not dictate how much executives will be paid. Boards of directors, their Compensation Committees, and compensation consultants design, structure, and approve compensation plans. While shareholders do engage with companies to encourage good governance practices and alignment with company performance, compensation consultants and proxy advisors have a greater influence over the structure of executive compensation packages. Ultimately the decision on executive compensation is that of the Board.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Shareholders are Dispersed and Diverse

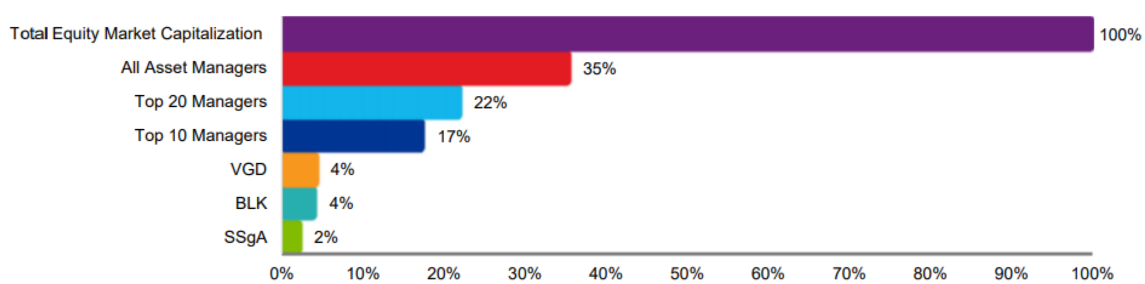
Posted by Barbara Novick, BlackRock, Inc., on Monday, July 15, 2019

Editor's note: Barbara Novick is Vice Chairman and Co-Founder at BlackRock, Inc. This post is based on a Policy Spotlight issued by Blackrock.

Index funds have democratized access to diversified investment for millions of savers, who are investing for long-term goals, like retirement. As index funds are currently growing more quickly than actively managed funds, some critics have expressed concern about increasing concentration of public company ownership in the hands of index fund managers. While it is true that assets under management (or "AUM") in index portfolios have grown, index funds and ETFs represent less than 10% of global equity assets.[1] Further, equity investors, and hence public company shareholders, are dispersed across a diverse range of asset owners and asset managers.

As of year-end 2017, Vanguard, BlackRock, and State Street manage $3.5 trillion, $3.3 trillion, and $1.8 trillion in global equity assets, respectively.[2] These investors represent a minority position in the $83 trillion global equity market. As shown in Exhibit 1, the combined AUM of these three managers represents just over 10% of global equity assets. The largest 20 asset managers only account for 22%. Moreover, about two-thirds of all global equity investment is conducted by asset owners choosing to invest in equities directly rather than by employing an asset manager to make investments on their behalf.

Exhibit 1: Equity Market Investors[3]



[1] BlackRock, *ViewPoint*: Index Investing Supports Vibrant Capital Markets (Oct. 2017). Available at https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-index-investing-supports-vibrant-capital-markets-oct-2017.pdf.

[2] Pensions & Investments (data as of Dec. 31, 2017).

[3] Source: Asset managers' AUM: Pensions & Investments (data as of Dec. 31, 2017); Total Equity Market Capitalization: World Federation of Exchange Database, BIS (data as of Q2 2017), HFR, Cerulli, Simfund (data as of Nov 2017), iShares GBI (data as of Nov 2017), Global Heat Map, McKinsey Cube (data as of December 2016). P&I data is self reported and may not be comprehensive of all managers everywhere. Total equity market capitalization data includes institutional and hedge fund figures sourced from McKinsey Cube data as of the previous year due to data availability

Exhibit 1 alone does not paint a complete picture of the diversity of equity market investors, as there is significant variation amongst asset managers and asset owners. Further, for any individual asset manager, AUM represents a variety of investment strategies, each with different investment objectives, constraints, and time horizons. For example, BlackRock has more than 50 equity portfolio management teams managing nearly 2,000 equity portfolios. These portfolios range from index strategies to actively managed products, across geographies, sectors, and market capitalization. In addition, multi-asset class portfolios, like target date funds, invest in equities as well as other asset classes. Finally, there is often some variation in the way shares are voted across portfolios, even among those managed by a single asset manager. This is due to a variety of reasons including the fact that some clients vote their own shares even though their assets are managed by an asset manager. Approximately one-quarter of equity separate account clients do not delegate voting authority to BlackRock.

The different objectives of each type of investor, which translate into different financial incentives and investment strategies, are often missing from the discussion. These differences are essential to understanding the investment behaviors of shareholders. Following are some examples of types of equity market investors.

Institutional Asset Owners

The majority of equity assets are managed directly by asset owners. Examples of asset owners include pension plans, sovereign wealth funds (SWFs), and insurance companies, the largest of which are shown in Exhibit 2.[4]

- **Pension Plans** include plans sponsored by public entities or by companies. They can be defined benefit (DB) or defined contribution (DC). DB pension plans offer a payout upon retirement based on a pre-determined formula, and thus have long-dated obligations to make future payments to plan participants. DB plans thus seek to match their assets with their liabilities. On the other hand, DC pension plans place the obligation to select investments on the plan participant and do not offer a defined future payout. Due to their long time horizon and the importance of pension assets to individuals' financial security, DC pension plans generally offer a suite of diversified investment options to participants. DC plan participants are increasingly investing in multi-asset portfolios, a trend that reflects the benefit of diversification over long time horizons. While there is variation across pension plans, equities comprise an average of 46% of pension plans' assets.[5]
- **Sovereign Wealth Funds (SWFs)** are pools of assets invested on behalf of sovereign nations generally to benefit a country's citizens by diversifying the country's sources of

[4] For more on the different types of asset owners and their objectives and constraints, see BlackRock, *ViewPoint*, Who Owns the Assets? Developing a Better Understanding of the Flow of Assets and the Implications for Financial Regulation (May 2014), available at https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-who-owns-the-assets-may-2014.pdf.

[5] Global estimates across defined benefit and defined contribution plans as of 2017. See Willis Towers Watson / Thinking Ahead Institute, Pensions & Investments World 300, available at https://www.thinkingaheadinstitute.org/en/Library/Public/Research-and-Ideas/2018/09/P_I_300_2018_research_paper; and PwC, The rising attractiveness of alternative asset classes for Sovereign Wealth Funds (Jan. 2018), available at https://preview.thenewsmarket.com/Previews/PWC/DocumentAssets/498560.pdf.

wealth or pursuing development SWFs have varying charters and thus bespoke investment portfolios. On average, equities make up 44% of SWF's assets.[6]

- **Insurance companies** include property and casualty, health, life, and monoline insurers as well as reinsurers. Insurance companies seek to earn a return on investment that exceeds their liabilities while complying with regulatory, accounting, and tax requirements. Insurers tend to be more heavily weighted towards fixed income, with equities constituting closer to 10% of their assets.[7]

Exhibit 2: Largest Asset Owners by Type—Total Assets

	Pension Funds	AUM ($B)	Sovereign Wealth Funds	AUM ($B)	Insurance Companies	AUM ($B)
1	Japan Government Pension Investment	1,444	China Investment Corporation	941	Allianz	1,047
2	Norway Government Pension Fund	1,064	Abu Dhabi Investment Authority	697	AXA	1,038
3	South Korea National Pension	583	Kuwait Investment Authority	592	Ping An Insurance	926
4	U.S. Federal Retirement Thrift	532	Hong Kong Monetary Authority	523	Prudential Financial	821
5	Netherlands ABP	495	Saudi Arabia Monetary Authority Foreign Holdings	516	Metlife	721
6	China National Social Security	457	China SAFE Investment Company	441	Japan Post Insurance	699
7	California Public Employees	337	Government of Singapore Investment Corporation	390	Berkshire Hathaway	682
8	Canada Pension	284	Temasek Holdings	375	Nippon Life Insurance Company	661
9	Singapore Central Provident Fund	269	Saudi Arabia Public Investment Fund	360	Prudential PLC	645
10	Netherlands PFZW	236	Qatar Investment Authority	320	Legal & General	643

Sources: Pension Funds: Willis Towers Watson / Thinking Ahead Institute, Pensions & Investments World 300; as of year-end 2017. Sovereign Wealth Funds: Sovereign Wealth Fund Institute; as of February 2019. Sovereign wealth fund rankings exclude sovereign pension funds, which are included in pension fund rankings. Insurance Companies: Relbanks, World's Top Insurance Companies; as of September 30, 2017.

Traditional Asset Managers

Traditional asset managers manage assets primarily on behalf of the world's pensioners and savers (including institutions like pension plans and individual investors), who are seeking risk-adjusted returns over long time horizons to meet their investment objectives (e.g., saving for retirement). Many traditional asset managers offer investment strategies that are diversified across markets, asset classes, and/or sectors, as broad diversification reduces portfolio volatility and mitigates exposure to the fortunes or failures of any single investment. The primary focus of traditional asset managers' investment stewardship engagement with companies flows from the fact that asset managers are fiduciaries on behalf of long-term investors. Their engagement is

[6] As of 2016 based on PwC Market Research Centre data. See PwC, The rising attractiveness of alternative asset classes for Sovereign Wealth Funds (Jan. 2018), available at https://preview.thenewsmarket.com/Previews/PWC/DocumentAssets/498560.pdf.

[7] As of 2017 based on OECD data. See PwC, The rising attractiveness of alternative asset classes for Sovereign Wealth Funds (Jan. 2018), available at https://preview.thenewsmarket.com/Previews/PWC/DocumentAssets/498560.pdf.

generally focused on corporate governance matters that promote long-term performance and protect shareholder rights. As a general matter, traditional asset managers engage with companies and vote proxies; however, they do not seek board seats, nor do they initiate proxy fights or shareholder proposals. Further, asset managers' voting records demonstrate variation in voting patterns (see the Policy Spotlight, Proxy Voting Outcomes: By the Numbers).[8]

In recent years, regulation and market developments have encouraged price competition amongst traditional asset managers, leading to lower fees. Since 2009, average annual expenses on equity mutual funds domiciled in the US have dropped by almost one-third, with many equity index strategies being offered for single-digit basis points. [9] While lower fees mean more money in the pockets of retirees and savers, this trend places greater importance on economies of scale. As a result, as shown in Exhibit 3, 24 traditional asset managers now manage equity assets of more than $275 billion.

Exhibit 3: Largest Asset Managers by Equity AUM

	Firm Name	Equity AUM ($B)		Firm Name	Equity AUM ($B)
1	Vanguard Group Inc.	3,508	13	Morgan Stanley	405
2	BlackRock Inc.	3,364	14	UBS Asset Management	382
3	State Street Global Advisors	1,836	15	Prudential Financial	376
4	Fidelity Investments	1,482	16	Legal & General	359
5	The Capital Group Cos. Inc.	1,369	17	Nuveen	353
6	T. Rowe Price Associates Inc.	755	18	Geode Capital Management	352
7	J.P. Morgan Asset Management	561	19	Franklin Templeton Investments	324
8	Northern Trust Asset Management	529	20	The Goldman Sachs Group Inc.	321
9	Invesco	504	21	Asset Management One Co. Ltd	290
10	BNY Mellon Investment Management	473	22	Schroders	281
11	Dimensional Fund Advisors LP	455	23	Amundi	279
12	MFS Investment Management Inc.	419	24	Manulife Financial	276

Source: Pensions & Investments (P&I). All data as of December 31, 2017.Updated May 2018.

Activist Investors

Activist investors are primarily private fund managers whose strategy is to take a position in a company and then vigorously advocate for changes to corporate strategy and often structure, as well as to the board of directors. Their investment strategies are significantly more concentrated in individual companies than broadly diversified strategies. Many activist investors offer funds to third party investors; the value proposition of these funds is their ability to influence the strategic direction of a company to increase value. In contrast to traditional asset managers, activist investors often seek board seats and solicit or agitate for changes in corporate strategy or structure in line with their investment strategy and portfolio concentration. Exhibit 4 lists some of the largest activist investors in the US.

[8] BlackRock, *ViewPoint*, The Investment Stewardship Ecosystem (July 2018). Available at https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf.
[9] Tim McLaughlin, "Investors Save Billions as Funds Cut Fees, Fight for Market Share", available at https://www.reuters.com/article/us-funds-fees-outlook-analysis/investors-save-billions-as-funds-cut-fees-fight-for-market-share-idUSKCN1MD18I. As of October 3,

Exhibit 4: “Activist” Investors & Other Investors Who Take Concentrated Stakes and Board Seats

Firm Name	Equity AUM ($B)
Berkshire Hathaway Inc.	173
Icahn Associates Holding LLC	26
TCI Fund Management Ltd.	24
Elliott Management Corp.	23
Cevian Capital AB	14
GAMCO Asset Management, Inc.	12
ValueAct Capital Management LP	11
Southeastern Asset Management, Inc.	12
Trian Fund Management LP	10
Third Point LLC	7
Pershing Square Capital Management LP	7

Source: Berkshire Hathaway Inc., 2018 Annual Report. Data as of December 31, 2018; Sharkwatch 50 as of March 26, 2019.

Bottom line:

While the equity assets managed by the world’s largest index managers are sizeable, the largest three index fund managers represent less than 5% each, and in aggregate manage just over 10% of total global equity market capitalization. The other 90% of equity assets are dispersed across a diverse range of investors—including in-house asset managers, independent asset managers, activist investors, and individuals. These investors have different investment objectives and strategies.

Diversified Portfolios Do Not Reduce Competition

Posted by Barbara Novick, BlackRock, Inc., on Wednesday, August 7, 2019

Editor's note: Barbara Novick is Vice Chairman and Co-Founder at BlackRock, Inc. This post is based on a Policy Spotlight issued by BlackRock.

In 1990, Professor Harry Markowitz was awarded the Nobel Prize in Economics for his groundbreaking work on the importance of portfolio diversification to achieving better risk-adjusted returns, which serves as the basis of modern portfolio theory.[1] The value of diversified investing is now being challenged by a small group of academics who claim that ownership of diversified portfolios may create anti-competitive effects.

According to their theory, when investors own more than one company in a concentrated industry ("common ownership" or "horizontal shareholding"), these companies are less likely to compete. Investment funds and pension plans—including those using active or index strategies—are equally implicated by this theory, as these investors own broadly diversified investment portfolios, which often entail owning more than one company per sector. The plausibility of the theory (as discussed below) and the methods and data used to measure this purported effect have been vigorously criticized by academics and practitioners. For example, the foundational paper in this area, sometimes called the "airlines paper" is based on incorrect data (see Policy Spotlight, Common Ownership Data is Incorrect).[2] Nonetheless, this theory has received media attention and some focus in competition circles.

Although the papers underlying this theory are controversial, and the theory itself has been challenged by other academics, some anti-trust scholars have accepted the theory and claim that diversified portfolios are creating societal harm. Based on this view, they have proposed drastic policy measures such as: (i) limiting ownership to one company per sector or (ii) eliminating proxy voting rights of mutual funds, pension funds, and other institutional investors.[3]

Common Ownership Theory is Misapplied to Broadly Diversified Portfolios

The "common ownership" theory relies on the assumption that all "common owners" benefit from lessened competition, as it is derived from theories of oligopolies and "cross ownership" (e.g.,

[1] Markowitz jointly received the 1990 Alfred Nobel Memorial Prize in Economic Sciences along with Professors Merton Miller and William Sharp for contributions in the theory of financial See the official press release announcing their award at https://www.nobelprize.org/prizes/economic-sciences/1990/press-release/.

[2] The "airlines paper" refers to José Azar, Martin C. Schmalz, and Isabel Tecu, The Journal of Finance, "Anticompetitive Effects of Common Ownership" (updated May 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2427345.

[3] See Eric A. Posner, Fiona M. Scott Morton and E. Glen Weyl, Antitrust Law Journal, Forthcoming, "A Proposal to Limit the Anti-Competitive Power of Institutional Investors" (March 22, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2872754.

where a company buys a stake in its competitor). While lessened competition might benefit certain concentrated investors, broadly diversified investors, like index funds, own the whole market and do not benefit from lessened competition. This is because broadly diversified investors are subject to *inter*– industry effects—meaning that what happens in one sector affects the performance of the fund's holdings in other sectors. For example, airline carriers represent less than 1% of all major indexes (Exhibit 1), so the benefit of higher ticket prices for the 1% of an index fund's portfolio comprised of airline stocks is likely offset by the negative impact of increased travel expenses (both directly and indirectly on companies whose businesses are sensitive to travel costs) on the other 99% of the portfolio.

Exhibit 1: Representation of airlines in various indexes

Index	American Airlines	Delta	United	Aggregate
S&P 500	0.09%	0.15%	0.07%	0.31%
MSCI US Large Cap 300	0.12%	0.19%	0.09%	0.40%
FTSE RAFI US 1000	0.03%	0.05%	0.04%	0.12%
FTSE USA	0.03%	0.04%	0.02%	0.08%
MSCI USA	0.03%	0.04%	0.02%	0.08%
Russell 1000	0.09%	0.13%	0.07%	0.28%

Source: Index weightings from S&P, MSCI, FTSE, Russell, retrieved from Aladdin, November 2017.

Common Ownership Theory Lacks a Plausible Causal Mechanism

The proponents acknowledge that there is no evidence to suggest that "common owners" are actively discouraging competition. Instead, they argue that since common owners do not encourage competition, their mere presence causes anti – competitive behavior by company management. A range of investors—from active and index fund managers, to pension funds, and even individual investors—make investments in more than one company in concentrated sectors. As discussed in the Policy Spotlight, Shareholders are Dispersed and Diverse, public companies have a diverse range of shareholders that engage with companies in different ways based on their investment strategies and objectives. Aside from activist investors, most other types of investors do not tend to get involved in influencing business strategy of their portfolio companies and focus instead on encouraging good governance. Thus, it seems implausible that the mere presence of hundreds, if not thousands, of investors who are shareholders in public companies is grounds for the far-reaching policy measures that have been suggested. For example, policy measures that call for these investors to own only one company per concentrated sector would likely lead to billions of dollars of divestment from public companies, in addition to a host of other challenges.

Another irony of this debate is that one of the proposed policy measures to mitigate "common ownership" involves curtailing voting rights of diversified institutional investors. If adopted, this policy measure would ensure that diversified investors' could never encourage competition, which is clearly circular if the concern being addressed is that diversified investors are not encouraging competition enough. Further, this policy measure would ultimately empower concentrated investors with shorter- term interests in the performance of a company at the expense of long-term savers.

Common Ownership Theory Contradicts CEO Incentives

Theories about the incentives of company executives due to common owners fail to consider the metrics by which the performance of executives is measured and the composition of pay packages, which is primarily in company stock. For example, according to their 2018 annual proxy filing, American Airlines' CEO has had 100% of his direct compensation paid in the form of equity since 2015. Further, airline executives' performance is measured by metrics such as pre-tax income, margin improvement, and stock price—all measures driven by own-company performance. Exhibit 2 provides actual language from the proxy statements of American Airlines and United Continental Holdings. With compensation tied to company stock performance, CEOs are heavily incentivized to compete. According to the common ownership theory, these CEOs are willing to sacrifice their own personal financial interests to satisfy a theoretical benefit to minority shareholders. This seems implausible.

Exhibit 2: Examples of Compensation Metrics in Company Filings

American Airlines Group

Our CEO and other executive officers have demonstrated their commitment to fair pay and pay for performance by initiating the following exceptional actions with respect to their compensation.

- Since 2015, at Mr. Parker's request, we provide 100% of his direct compensation in the form of equity incentives in lieu of base salary and annual cash incentive compensation. That has helped to advance our commitment to paying for performance and aligning Mr. Parker's interests with that of our stockholders. More than half of these equity incentives will be earned not earlier than the third anniversary of the grant date based on our relative pre-tax income margin and total stockholder return (TSR) performance.
- At his request, Mr. Parker's target direct compensation has been historically set at below the average for his peers at Delta and United.
- Also at his request, in 2016, our Compensation Committee agreed to eliminate Mr. Parker's employment agreement so that he is no longer contractually entitled to receive a set level of compensation and benefits and is no longer protected by the change in control and severance provisions of that employment agreement.

United Continental Holdings, Inc.
Our 2017 incentive awards are directly tied to Company performance metrics that we believe are appropriate measures of our success and that will lead to value for our stockholders:

- annual pre-tax income;
- long-term pre-tax margin performance improvement (measured on a relative basis versus our industry peers);
- stock price performance;
- operational performance, as measured by key indicators of customer satisfaction (on-time departures, flight completion factor, and mishandled baggage ratio); and

- specified strategic initiatives designed to enhance management focus on key corporate

We eliminated ROIC performance, which had historically been included as a performance measure under our prior long-term incentive program design, from our 2017 long-term incentive design in order to accommodate greater focus on our pre-tax margin results. The 2017 long-term incentive structure is equally divided between the pre-tax margin Performance-Based RSU awards and time-vested RSU awards, which provides stability and retentive features to the design.

Sources: United States Securities and Exchange Commission Schedule 14A filings for American Airlines Group Inc. and United Continental Holdings, Inc. Based on 2018 filings.

Bottom line:

There are numerous flaws with the common ownership theory, making it extremely premature to consider policy measures. Sweeping policy measures that would undermine the value proposition of diversified investing, eliminate voting rights for long-term diversified investors, and lead to billions of dollars of divestment from public companies would be very harmful to markets and the global economy, especially in light of the lack of evidence that diversified portfolios cause anti-competitive effects.

Endnotes

[4] ProxyPulse (A Broadridge & PWC Initiative), “2018 Proxy Season Review”, October 2018. Available at https://www.broadridge.com/_assets/pdf/broadridge-2018-proxy- season-review.pdf.

STATE STREET GLOBAL ADVISORS

January 15, 2019

Dear Board Member,

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

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

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

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

The Importance of Corporate Culture

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

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

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

Helping Boards Align Culture and Strategy

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

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

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

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

Focused on the Long Term

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

Sincerely,

Cyrus Taraporevala

Cyrus Taraporevala

President and CEO of State Street Global Advisors

Asset Stewardship

January 2019

Aligning Corporate Culture with Long-Term Strategy

Key Takeaways

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

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

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

What is Corporate Culture?

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

Growing Regulatory and Investor Interest in Corporate Culture

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

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

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

The Board's Role in Assessing and Monitoring Corporate Culture

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

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

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

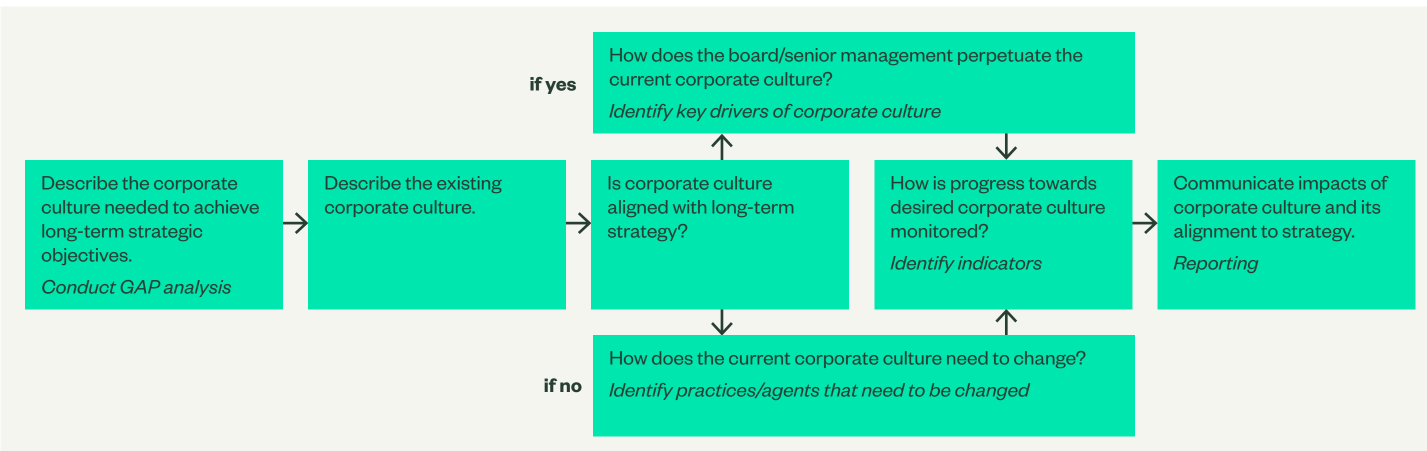
- Can the director(s) articulate the current corporate culture?
- What does the board value about the current culture? What does it see as strengths? How can the corporate culture improve?
- How is senior management influencing or effecting change in the corporate culture?
- How is the board monitoring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

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

A Framework for Assessing and Monitoring Corporate Culture

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

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



Source: State Street Global Advisors.

Phase 1
Comparative Analysis

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

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

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

Phase 2 **Implementation**

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

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

Phase 3 **Reporting**

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

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

Conclusion

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

Contact

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

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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.

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.

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.

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.

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.

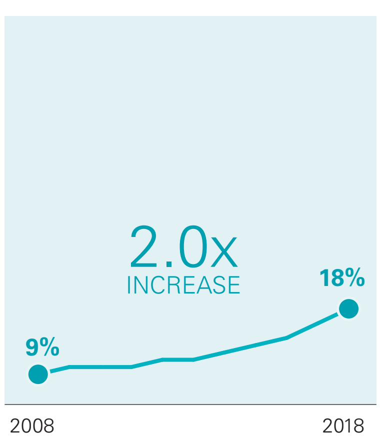
We take a stand for *all* investors. Vanguard's investment stewardship efforts are an important part of our mission, which is *to take a stand for all investors, to treat them fairly, and to give them the best chance for investment success*. Ultimately, we want governance practices to improve in investable 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

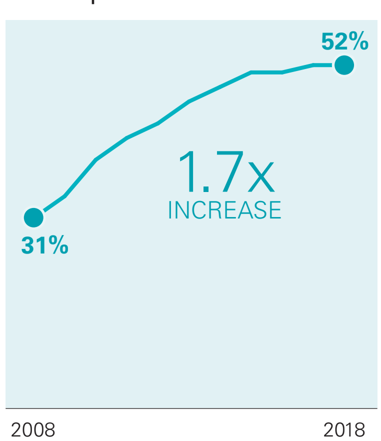
Measurable improvements

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.

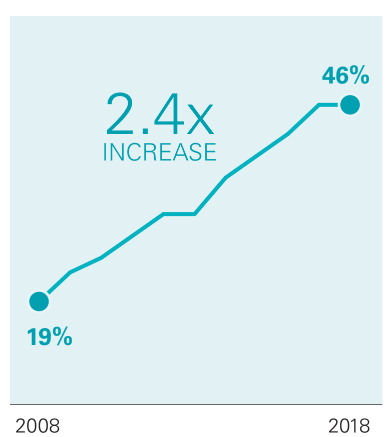
Percentage of women on boards



Percentage of CEO pay that is performance-based



Majority vote standard (director elections)



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.

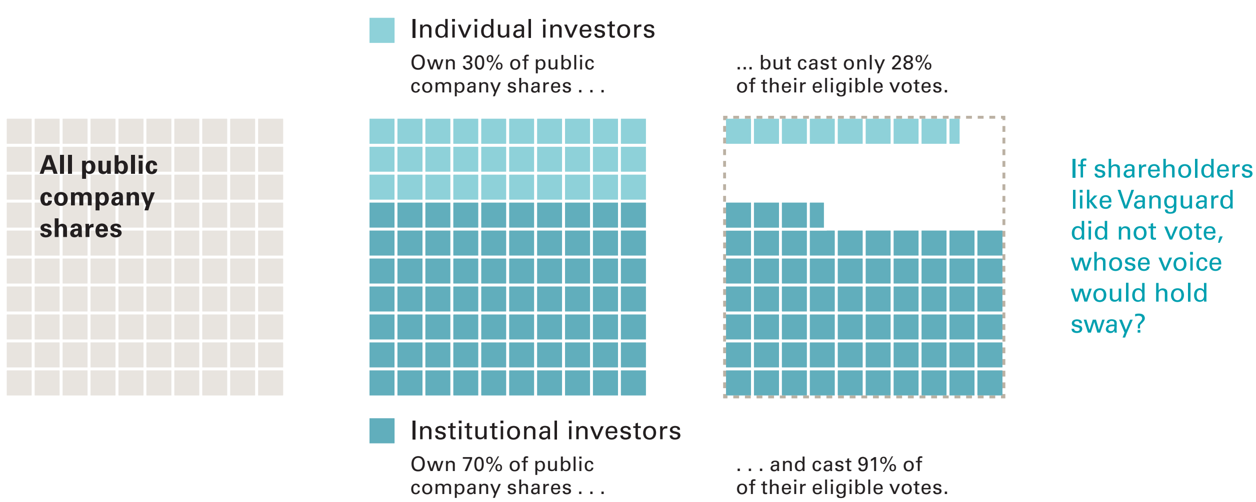
Unique ownership structure, unique perspective. Vanguard is the world's only mutually owned mutual fund company. Rather than being publicly traded or owned by a small group of individuals, Vanguard is owned by its U.S. funds, which in turn are owned by their investors. This unique structure aligns our 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.

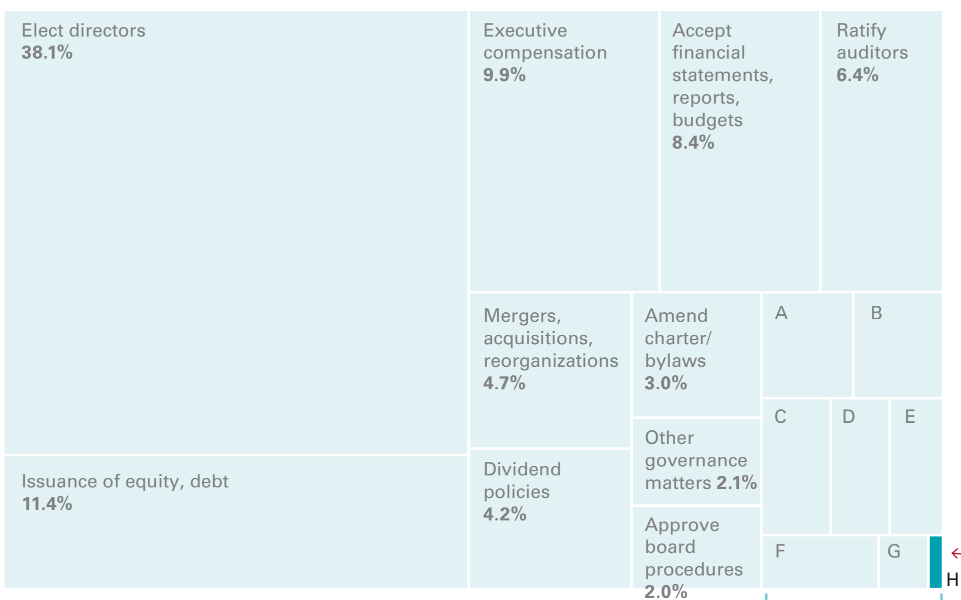
Our Investment Stewardship team consists of an experienced group of analysts that evaluates proposals in the proxies of the Vanguard funds' portfolio companies and casts votes on behalf of each fund in accordance with the voting guidelines the fund has adopted. Each fund's guidelines are designed to 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.

Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy

Posted by Lucian Bebchuk (Harvard Law School) and Scott Hirst (Boston University), on Wednesday, November 28, 2018

Editor's note: Lucian Bebchuk is the James Barr Ames Professor of Law, Economics, and Finance, and Director of the Program on Corporate Governance, at Harvard Law School. Scott Hirst is Associate Professor at Boston University School of Law and Director of Institutional Investor Research at the Harvard Law School Program on Corporate Governance. This post is based on their recent study. Related research from the Program on Corporate Governance includes The Agency Problems of Institutional Investors by Lucian Bebchuk, Alma Cohen, and Scott Hirst (discussed on the Forum here).

Index funds own an increasingly large proportion of American public companies, currently more than one fifth and steadily growing. Understanding the stewardship decisions of index fund managers—how they monitor, vote, and engage with their portfolio companies—is critical for corporate law scholarship. In a study that we recently placed on SSRN—Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy—we seek to contribute to such understanding by providing a comprehensive theoretical, empirical, and policy analysis of index fund stewardship.

We begin by putting forward an agency-costs theory of index fund incentives. Stewardship decisions by index funds depend not just on the interests of index fund investors but also the incentives of index fund managers. Our agency-costs analysis shows that index funds have strong incentives to (i) under-invest in stewardship, and (ii) defer excessively to the preferences and positions of corporate managers.

We then provide the first comprehensive and detailed evidence of the full range of stewardship activities that index funds do and do not undertake. This body of evidence, we show, is inconsistent with a no-agency-costs view but can be explained by our agency-cost analysis.

We next put forward a set of policy reforms that should be considered in order to encourage index funds to invest in stewardship, to reduce their incentives to be deferential to corporate managers, and to address the concentration of power in the hands of the largest index fund managers. Finally, we discuss how our analysis should reorient important ongoing debates regarding common ownership and hedge fund activism.

The policy measures we put forward, and the beneficial role of hedge fund activism, can partly but not fully address the incentive problems that we analyze and document. These problems are expected to remain a significant aspect of the corporate governance landscape, and should be the subject of close attention by policymakers, market participants, and scholars.

Below is a more detailed account of our study:

Index funds—investment funds that mechanically track the performance of an index—hold an increasingly large proportion of the equity of U.S. public companies. The sector is dominated by three index fund managers—BlackRock, State Street Global Advisors (SSGA), and Vanguard, often referred to as the "Big Three". The Big Three manage over $5 trillion of U.S. corporate equities, collectively vote about 20% of the shares in all S&P 500 companies, and each holds a position of 5% or more in a vast number of companies. The proportion of assets in index funds has risen dramatically over the past two decades, reaching more than 20% in 2017, and is expected to continue growing substantially over the next decade.

The large and steadily growing share of corporate equities held by index funds, and especially the Big Three, has transformed ownership patterns in the U.S. public market. It has also been attracting increasing attention to index fund stewardship.

Leaders of the Big Three have repeatedly stressed the importance of responsible stewardship, and their strong commitment to it. For example, Vanguard's then-CEO William McNabb stated that "We care deeply about governance", and that "Vanguard's vote and our voice on governance are the most important levers we have to protect our clients' investments." Similarly, BlackRock's CEO Larry Fink stated that "our responsibility to engage and vote is more important than ever" and that "the growth of indexing demands that we now take this function to a new level." The Chief Investment Officer (CIO) of SSGA stated that "SSGA's asset stewardship program continues to be foundational to our mission."

The Big Three leaders have also stated both their willingness to devote the necessary resources to stewardship, and their belief in the governance benefits that their investments produce. For example, Vanguard's McNabb has said, of governance, that "We're good at it. Vanguard's Investment Stewardship program is vibrant and growing." Similarly, BlackRock's Fink has stated that BlackRock "intends to double the size of [its] investment stewardship team over the next three years. The growth of [BlackRock's] team will help foster even more effective engagement."

The stewardship promise of index funds arises from their large stakes and their long-term commitment to the companies in which they invest. Their large stakes provide these funds with significant potential influence, and imply that by improving the value of their portfolio companies they can help bring about significant gains for their portfolios. Furthermore, because index funds have no "exit" from their positions in portfolio companies as long as the companies remain in the index, they have a long-term perspective, and are not tempted by short-term gains at the expense of long-term value. This long-term perspective has been stressed by Big Three leaders, and applauded by commentators. Vanguard's founder, the current elder statesman of index investing, has said that "index funds are the … best hope for corporate governance."

Will index funds deliver on this promise? Do any significant impediments stand in the way? How do the legal rules and policies affect index fund stewardship? Given the dominant and growing role that index funds play in the capital markets, these questions are of first-order importance, and are the focus of our Article.

In particular, we seek to make three contributions. First, we provide an analytical framework for understanding the incentives of index fund managers. Our analysis demonstrates that index funds managers have strong incentives to (i) under-invest in stewardship and (ii) defer excessively to the preferences and positions of corporate managers.

Our second contribution is to provide the first comprehensive evidence of the full range of stewardship choices made by index fund managers, especially the Big Three. We find that this evidence is, on the whole, consistent with the incentive problems that our analytical framework identifies. The evidence thus reinforces the concerns suggested by this framework.

Our third contribution is to explore the policy implications of the incentive problems of index fund managers that we identify and document. We put forward a number of policy measures to address these incentive problems. These measures should be considered to improve index fund stewardship—and thereby, the governance and performance of public companies. We also explain how these incentive problems shed light on important ongoing debates about common ownership and hedge funds.

Our analysis is organized as follows. Part I discusses the features of index funds that have given rise to high hopes for index fund stewardship. The views of Big Three leaders and supporters of index fund stewardship, we explain, are premised on a belief that index fund decisions can be largely understood as being focused on maximizing the long-term value of their investment portfolios, and that agency problems are not a key driver of those decisions.

By contrast to this “no-agency-costs” view, Part II puts forward an alternative “agency-costs” view. Stewardship decisions for an index fund are not made by the index fund’s own beneficial investors, which we refer to as the “index fund investors,” but rather by its investment adviser, which we label the “index fund manager.” As a result, the incentives of index fund managers are critical. We identify two types of incentive problems that push the stewardship decisions of index fund managers away from those that would best serve the interests of index fund investors.

Incentives to Under-Invest in Stewardship. Stewardship that increases the value of portfolio companies will benefit index fund investors. However, index fund managers are remunerated with a very small percentage of their assets under management (AUM) and thus would capture a correspondingly small fraction of such increases in value. They therefore have much more limited incentives to invest in stewardship than their beneficial investors would prefer. Furthermore, if stewardship by an index fund manager increases the value of a portfolio company, rival index funds that track the same index (and investors in those funds) will receive the benefit of the increase in value without any expenditure of their own. As a result, an interest in improving financial performance relative to rival index fund managers does not provide any incentive to invest in stewardship. Furthermore, we explain that competition with actively managed funds cannot be expected to address the substantial incentives to under-invest in stewardship that we identify.

Incentives to be Excessively Deferential. When index fund managers face qualitative stewardship decisions, we show that they have incentives to be excessively deferential—relative to what would best serve the interests of their own beneficial investors—toward the preferences and positions of the managers of portfolio companies. This is because the choice between deference to managers and nondeference not only affects the value of the index fund's portfolio, but could also affect the private interests of the index fund manager.

We then identify and analyze three significant ways in which index fund managers could well benefit privately from such deference. First, we show that existing or potential business relationships between index fund managers and their portfolio companies give the index fund managers incentives to adopt principles, policies, and practices that defer to corporate managers. Second, we explain that, in the many companies where the Big Three have positions of 5% or more of the company's stock, taking certain nondeferential actions would trigger obligations that would impose substantial additional costs on the index fund manager. Finally, and importantly, the growing power of the Big Three means that a nondeferential approach would likely encounter significant resistance from corporate managers, which would create a significant risk of regulatory backlash.

We focus on understanding the structural incentive problems that motivate index fund managers to under-invest in stewardship and defer to corporate managers, thereby impeding their ability to deliver on their governance promise. We stress that in some cases, fiduciary norms, or a desire to do the right thing, could lead well-meaning index fund managers to take actions that differ from those suggested by a pure incentive analysis. Furthermore, index fund managers also have incentives to be perceived as responsible stewards by their beneficial investors and by the public—and thus, to avoid actions that would make salient their under-investing in stewardship and deferring to corporate managers. These factors could well constrain the force of the problems that we investigate. However, these structural problems should be expected to have significant effects; the evidence we present in Part III demonstrates that this is, in fact, the case.

As with any other economic theory, the test for whether the no-agency-costs view or the agency-costs view are valid is the extent to which they are consistent with and can explain the extant evidence. Part III therefore puts forward evidence on the actual stewardship activities that the Big Three index funds do and do not undertake. We combine hand-collected data and data from various public sources to piece together a broad and detailed picture of index fund stewardship. In particular, we investigate eight dimensions of stewardship:

1. *Actual Stewardship Investments*. Our analysis provides estimates of the stewardship personnel, both in terms of workdays and dollar cost, devoted to particular companies. Whereas supporters of index fund stewardship have focused on recent increases in stewardship staff of the Big Three, our analysis examines personnel resources in the context of the Big Three's assets under management and their number of portfolio companies. We show that the Big Three devote an economically negligible fraction of their fee income to stewardship, and that their stewardship staffing enables only limited and cursory stewardship for the vast majority of their portfolio companies.

2. *Behind-the-Scenes Engagements*. Supporters of index fund stewardship view private engagements by the Big Three as explaining why they refrain from using certain other stewardship tools available to shareholders. However, we show that the Big Three engage with a very small proportion of their portfolio companies, and only a small proportion of these engagements involve more than a single conversation. Furthermore, refraining from using other stewardship tools also has an adverse effect on the small minority of cases in which private

engagements do occur. The Big Three's private engagement thus cannot constitute an adequate substitute for the use of other stewardship tools.

3*. Limited Attention to Performance*. Our analysis of the voting guidelines and stewardship reports of the Big Three indicates that their stewardship focuses on governance structures and processes and pays limited attention to financial underperformance. While portfolio company compliance with governance best practices serves the interests of index funds investors, those investors would also benefit substantially from stewardship aimed at identifying, addressing, and remedying financial underperformance.

4. *Pro-Management Voting*. We examine data on votes cast by the Big Three on matters of central importance to managers, such as executive compensation and proxy contests with activist hedge funds. We show that the Big Three's votes on these matters reveals considerable deference to corporate managers. For example, the Big Three very rarely oppose corporate managers in say-on-pay votes, and are less likely than other investors to oppose managers in proxy fights against activists.

5. *Avoiding Shareholder Proposals.* Shareholder proposals have proven to be an effective stewardship tool for bringing about governance changes at broad groups of public companies. Many of the Big Three's portfolio companies persistently fail to adopt the best governance practices that the Big Three support. Given these failures, and the Big Three's focus on governance processes, it would be natural for the Big Three to submit shareholder proposals to such companies aimed at addressing such failures. However, our examination of shareholder proposals over the last decade indicates that the Big Three have completely refrained from submitting such proposals.

6. Avoiding *Engagement Regarding Companies' Nomination of Directors.* Index fund investors could well benefit if index fund managers communicated with the boards of underperforming companies about replacing or adding certain directors. However, our examination of director nominations and Schedule 13D filings over the past decade indicates that the Big Three have refrained from such engagements.

7. *Limited Involvement in Governance Reforms*. Index fund investors would benefit from involvement by index fund managers in corporate governance reforms—such as supporting desirable changes and opposing undesirable changes—that could materially affect the value of many portfolio companies. We therefore review all of the comments submitted on proposed rulemaking regarding corporate governance issues by the Securities and Exchange Commission (SEC), and the filing of amicus briefs in precedential litigation. We find that the Big Three have contributed very few such comments and no amicus briefs over the past decade, and were much less involved in such reforms than asset owners with much smaller portfolios.

8. *Lead Plaintiff Positions.* Legal rules encourage institutional investors with "skin in the game" to take on lead plaintiff positions in securities class actions; this serves the interests of their investors by monitoring class counsel, settlement agreements and recoveries, and the terms of governance reforms incorporated in such settlements. We therefore examine the lead plaintiffs selected in the large set of significant class actions over the past decade. Although the Big Three's investors often have significant skin in the game, we find that the Big Three refrained from taking on lead plaintiff positions in any of these cases.

Taken together, the body of evidence that we document is difficult to reconcile with a "no-agency-cost" view under which stewardship choices are made to maximize the value of managed portfolios. Rather, the evidence is, on the whole, consistent with, and can be explained by, the agency-costs view and its incentive analysis described in Part II.

In the course of examining the evidence on index fund stewardship, we consider the argument that some types of stewardship activities are outside the "business model" of the Big Three. This argument raises the question of *why* this is the case. The "business models" of the Big Three and the stewardship activities they choose to undertake are not exogenous; rather, they are a product of choices made by index fund managers, and thus they follow from the incentives we analyze.

In Part IV we consider the policy implications of our theory and evidence. We begin by examining several approaches to address the incentives of index fund managers to under-invest in stewardship and defer excessively to corporate managers. In particular, we consider measures to encourage stewardship investments, as well as to address the distortions arising from business ties between index fund managers and public companies. We also examine measures to bring transparency to the private engagements conducted by index fund managers and their portfolio companies—transparency that, we argue, is necessary to provide material information to investors, and can provide beneficial incentives to those engaged in such engagements.

We further discuss placing limits on the fraction of equity of any public company that could be managed by a single index fund manager. The expectation that the proportion of corporate equities held by index funds will keep rising makes it especially important to consider the desirability of continuing the Big Three's dominance. For instance, we explain that if the index fund sector continues to grow and index fund managers control 45% of corporate equity, having a "Giant Three" each holding 15% would be inferior to having a "Big-ish Nine" each holding 5%.

Part IV also discusses the significant implications of our analysis for two important ongoing debates. One such debate concerns influential claims that the rise in common ownership patterns—whereby institutional investors hold shares in many companies in the same sector—can be expected to have anticompetitive effects and should be a focus of antitrust regulators. Our analysis indicates that these claims are not warranted. The second debate concerns activist hedge funds. Our analysis undermines claims by opponents of hedge fund activism that index fund stewardship is superior to—and should replace—hedge fund activism. We show that, to the contrary, the incentive problems of index fund managers that we identify and analyze make the role of activist hedge funds especially important.

Although the policy measures we put forward would improve matters, they should not be expected to eliminate the incentive problems that we identify. Similarly, although activist hedge funds make up for some of the shortcomings of index fund stewardship, we explain that they do not and cannot fully address these shortcomings. The problems that we identify and document can be expected to remain an important element of the corporate governance landscape. Obtaining a clear understanding of these problems—to which this this Article seeks to contribute—is critical for policy makers and market participants.

Our study is available here. Comments would be most welcome.

Passive Investors

Posted by Jill E. Fisch (University of Pennsylvania Law School), Assaf Hamdani (Tel Aviv University), Steven Davidoff Solomon (University of California, Berkeley), on Thursday, July 5, 2018

Editor's note: Jill E. Fisch is Perry Golkin Professor of Law at the University of Pennsylvania Law School; Assaf Hamdani is Professor of Law at Tel Aviv University; and Steven Davidoff Solomon is Professor of Law at UC Berkeley School of Law. This post is based on their recent paper. Related research from the Program on Corporate Governance includes The Agency Problems of Institutional Investors by Lucian Bebchuk, Alma Cohen, and Scott Hirst (discussed on the Forum here)

Passive investors are the new power brokers of modern capital markets. An increasing number of investors are investing through exchange traded funds and indexed mutual funds, and, as a result, passive funds—particularly the so-called big three of Blackrock, Vanguard and State Street—own an increasing percentage of publicly-traded companies. Although the extent to which index funds will continue to grow remains unclear, some estimates predict that by 2024 they will hold over 50% of the market.

In our paper, Passive Investors, we provide the first comprehensive framework of passive investment. We use this framework to explore the role of passive funds in corporate governance and the capital markets and to assess the overall implications of the rise of passive investment.

A number of commentators have expressed concern, even alarm, over the growth of passive investors. The literature to date, however, ignores the institutional structure of passive funds and the market context in which they operate. Prior criticism has focused on two key attributes of passive funds. First, passive funds, by virtue of their investment strategy, are locked into the portfolio companies they hold. In particular, they cannot follow the Wall Street rule and exit from underperforming companies the way traditional shareholders, particularly active funds, can. Second, passive funds compete against other passive funds primarily on cost. As a result, critics argue that passive investors will be unwilling to incur the costs of firm-specific research and monitoring of their portfolio companies.

We challenge this portrayal of the passive investor business model as incomplete and offer a more nuanced approach. Our key insight is that although index funds are locked into their investments, the shareholders who invest in these funds are not. Like all mutual fund shareholders, investors in index funds can exit at any time by selling their shares and, when they do so, they receive the net asset value of their ownership interest. Moreover, because mutual fund inflows are driven by performance, passive investors risk losing assets if their returns lag those of actively-managed funds on a cost-adjusted basis. As a result, passive investors must compete for investors, and, because they cannot exit, they compete through engagement.

Understanding the business model of passive investors leads us to develop a comprehensive theory of their incentives and behavior. We show that active and passive funds compete for investors differently. Active funds compete based on their ability to generate alpha through the use of their investment discretion—choosing particular securities to under- and over-weight relative to their benchmark on the basis of firm-specific information. If active managers can generate substantial alpha on a cost-adjusted basis, fund investors will exit index funds in favor of actively-managed alternatives. Passive investors therefore seek to reduce the comparative advantage of active funds, i.e., their ability to exploit mispricing to generate alpha. Passive investors must do this by relying on voice, rather than exit. Importantly, because passive investors hold the market, their monitoring need not be and, as a practical matter, cannot be, firm-specific. Instead, passive investors can exploit economies of scale to improve governance across their portfolios.

Our theory finds support in practice. We document the emerging engagement by passive funds and their increasing influence with respect to individual and market wide firm governance. We show that passive investors have responded to the incentives to identify governance weaknesses that contribute to underperformance and mis-pricing and to seek to reduce governance risk. We also document how passive investors are coordinating with and mediating the efforts of shareholder activists. We note that recent empirical research shows that passive investor engagement appears to have a positive impact on governance.

Our theory has important implications for corporate law. Although, we show that recent proposals to disenfranchise passive investors due to governance concerns appear to be misguided, we note that the rise of passive investors raises other potential concerns. These concerns, which have thus far been overlooked, include new types of conflicts of interest, access to information and the concentration of economic power in the hands of a small number of fund sponsors and advisers. We delineate those concerns and the potential regulatory issues they raise.

While the role of passive investors continues to develop, and it is too early to determine the impact of passive investors on economic outcomes, our Article provides a theoretical framework for analyzing passive investor behavior and documents how current passive investor engagement is consistent with that framework. Our understanding of the institutional context that drives passive investor incentives will be critical in evaluating future policies to address their growing role in corporate governance.

The complete paper is available here.

Why Isn't Your Mutual Fund Sticking Up for You?

Posted by Leo E. Strine Jr. (Delaware Supreme Court and Harvard Law School) and Antonio Weiss (Harvard Kennedy School), on Friday, August 23, 2019

Editor's note: Leo E. Strine, Jr. is Chief Justice of the Delaware Supreme Court, the Austin Wakeman Scott Lecturer on Law and a Senior Fellow of the Harvard Law School Program on Corporate Governance. Antonio Weiss is a senior fellow at the Harvard Kennedy School's Mossavar-Rahmani Center for Business and Government. This post is based on an op-ed by Chief Justice Strine and Mr. Weiss that was published today in *The New York Times,* which is available here. Related research from the Program on Corporate Governance includes The Agency Problems of Institutional Investors by Lucian Bebchuk, Alma Cohen, and Scott Hirst (discussed on the Forum here) and Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy by Lucian Bebchuk and Scott Hirst (discussed on the forum here).

Growing inequality and stagnant wages are forcing a much-needed debate about our corporate governance system. Are corporations producing returns only for stockholders? Or are they also creating quality jobs in a way that is environmentally responsible, fair to consumers and sustainable? Those same corporations recognize that things are badly out of balance. Businesses are making record profits, but workers are not sharing in those gains.

This discussion is necessary. But an essential player is missing from the debate: large institutional investors. For most Americans, their participation in the stock market is limited to the money they have invested in mutual funds to finance retirement, usually in 401(k) accounts through their employers. These worker-investors do not get to vote the shares that they indirectly hold in American public companies at those companies' annual meetings. Rather, the institutions managing the mutual funds do.

Institutional investors elect corporate boards. Institutional investors vote on whether to sell the company and on nominations for new directors, and whether to support proposed compensation packages for executives. At the average S. & P. 500 company, the 15 largest institutional investors own over half the shares, effectively determining the outcomes of shareholder votes. And the top four stockholders control over 20 percent.

What this all means is that corporate governance reform will be effective only if institutional investors use their voting power properly. Corporate boards will not value the fair treatment of workers or avoid shortcuts that harm the environment and consumers if the institutional investors that elect them do not support them in doing the right thing. And they are unlikely to end the recent surge in stock buybacks as long as there is pressure from institutional investors for immediate returns.

And yet American workers must hand over money each paycheck to these same institutions to invest for their retirement.

If the American corporate governance system is to work better, then the institutional investors, who have a fiduciary responsibility to the workers whose money they invest, must represent the interests of these investors and vote to uphold high standards of social responsibility. The worker-investors are not single-issue voters, solely focused on shareholder returns. The vast majority of their income and ability to build wealth depends on continued access to good jobs. They will suffer unless corporations make money in a manner that works for employees, consumers and the environment.

Some leading institutional investors, including Vanguard and BlackRock, have recently called for corporations to respect all stakeholders and invest to support long-term, sustainable growth. They have begun to push corporations in the right direction and should continue to do so.

But reforms must make sure that mutual funds align their investing and voting behavior with the interests of the individuals whose capital they control. For example, retirement and index funds should have shareholder voting policies tailored to the objectives of long-term investors. And, if we want companies to operate in a socially responsible manner that creates sustainable profits, then institutional investors need to factor environmental, social, and most important of all, employee factors into their investing *and* voting decisions.

We must also reduce the constant mini-referendums at American public companies. Every year, there are over 30,000 votes for mutual funds to cast. With fewer but more meaningful votes, we can create a vibrant accountability system focused on sustainable wealth creation.

We should also provide better incentives for institutional investors to make long-term capital investment in our economy. By enacting a fractional tax on all securities trades and making lower capital gains tax rates available only on investments held for at least five years, we could discourage rapid portfolio turnover and help institutional investors focus more on long-term returns, and the thoughtful deployment of capital to serve the interest of American worker-investors.

The proceeds could be used to make long-term investments in the environmental efficiency of infrastructure, basic scientific research, better training for America’s students and workers, and in helping workers move from carbon-intensive industries to the sustainable-energy industries of the future.

American workers depend on good jobs and long-term economic growth for their economic security. With a more rational corporate governance framework that holds both institutional investors and corporations accountable, our nation can begin again to make our economy work well for the many, and not the few.

Tab II: Stakeholders and Corporate Purpose

Business Roundtable

Statement on the Purpose of a Corporation

Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.

Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to <u>all</u> of our stakeholders. We commit to:

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.

- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.

- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.

- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.

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Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Legal Implications of The Business Roundtable Statement on Corporate Purpose

Posted by Betty M. Huber, Joseph A. Hall, and Louis Goldberg, Davis Polk & Wardwell LLP, on Wednesday, August 21, 2019

Editor's note: Betty M. Huber is counsel, and Joseph A. Hall and Louis Goldberg are partners at Davis Polk & Wardwell LLP. This post is based on a Davis Polk memorandum by Ms. Huber, Mr. Hall, Mr. Goldberg, William H. Aaronson, Neil Barr, and Margaret E. Tahyar.

The Business Roundtable has endorsed stakeholder capitalism in its highly publicized Statement on the Purpose of a Corporation. The Statement of Purpose breaks from what has long been the dominant model in the United States, which conceptualizes a corporation's sole or primary purpose to be that of maximizing shareholder value. A handful of BRT members declined to sign the Statement of Purpose. Under the Statement of Purpose, each signatory commits to (1) delivering value to its **customers**, (2) investing in its **employees**, (3) dealing fairly and ethically with its **suppliers**, (4) supporting the **communities** in which it works, and (5) generating long-term **shareholder** value.

The Statement of Purpose, available here, at just under a page in length, incorporates some of the environmental, social and governance, or ESG, concepts that have taken root, first in Europe and more recently in the United States. It includes the concept of a "social license to operate," or the need for acceptance of a corporation's business practices and operations by customers, employees, suppliers and the general public, in addition to shareholders. The Statement of Purpose is for the moment mainly symbolic since legislatures and courts, not trade associations, define the scope of a director's fiduciary duties.

A great deal of media attention has focused on the political implications of the Statement of Purpose, but less so on the legal implications. We note two below.

Fiduciary Duty Claims. The Statement of Purpose does not change the business judgment rule, which provides directors broad discretion in discharging their duty of care to the corporation and its shareholders. So long as in their decision making directors are acting in good faith, on a fully informed basis, and not grossly negligent, directors should be protected under the business judgment rule.

Directors also owe a duty of loyalty to the corporation and its shareholders which is not shielded by the business judgment rule. It remains to be seen whether, in time, through legislation or otherwise, the concepts in the Statement of Purpose will lead to an evolution of the duty of care or the duty of loyalty, or to a new separate duty, that would encompass a requirement to balance duties to the corporation and its shareholders, as well as the interests of other stakeholders.

ESG Disclosures. The Statement of Purpose delves into several ESG topics with respect to which some investors have been agitating for more disclosure, including through corporate engagement, shareholder proposals and petitions to the SEC. These topics include: (1) human capital and employee attraction, development and retention, diversity and inclusion and gender pay disparity; (2) supply chain management; (3) human rights; (4) political lobbying and spending; and (5) climate change. Many corporations during this past proxy season have secured withdrawals of shareholder proposals on these topics by agreeing to provide additional ESG disclosures. The SEC itself proposed a rule two weeks ago which if adopted would require additional human capital management disclosures. The Statement of Purpose, supported by a large and powerful group of CEOs, is likely to fuel expectations of various shareholder and activist groups for increased ESG disclosures.

Stakeholder Governance—Some Legal Points

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Friday, September 20, 2019

Editor's note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Steven A. Rosenblum, William Savitt, Karessa L. Cain, and Sabastian V. Niles.

Recently, a number of questions have been raised about the legal responsibilities of directors in pursuing long-term sustainable business strategies and taking into account ESG (environmental, social, governance) factors and the interests of all the stakeholders in the corporation. The following are key parts of the answers we have been giving.

1. The purpose of a corporation is long-term business success and long-term increase in the corporation's value.
2. Shareholders elect the directors of a corporation and thereby have the power to determine the composition of the board of directors.
3. The directors of a corporation have a fiduciary duty to the corporation to use their business judgment to promote its long-term business success and increase in value.
4. The means and time horizon for achieving corporate goals is confided to the business judgment of the directors.
5. In their oversight of the management of the corporation, directors must use due care to ensure that the corporation has procedures reasonably designed to identify and mitigate the material risks faced by the corporation. Sustainability and ESG factors may be material risks.
6. The directors have a fiduciary duty to use their business judgment to seek to avoid or mitigate any risk that would reasonably be expected to materially affect the long-term success or value of the corporation.
7. The directors do not have a fiduciary duty to maximize the value of the corporation in the short term. The directors may use their business judgment to reject an offer to acquire the corporation at a premium to the current market price or a demand by a shareholder to take an action for the purpose of increasing the short-term market price of the corporation's stock.
8. In addition to the shareholders, the stakeholders in the corporation include, among others, employees, customers, suppliers, creditors and communities.
9. A director's fiduciary duty to the shareholders or other specific stakeholders does not require her to act other than to promote the corporation's long-term business success and increase in value.

10. Directors may exercise their independent business judgment to allocate value to stakeholders other than shareholders to the extent the directors believe that doing so will contribute to the long-term business success and value of the corporation.
11. It is within the business judgment of the directors to recognize that the purpose of the corporation is long-term business success and increase in the value of the corporation and to manage the corporation and the interests of the corporation's stakeholders to achieve that purpose.
12. As long as the directors fulfill their duties of due care and loyalty in allocating corporate value and resources among stakeholders, the business judgment rule protects them from liability.
13. It is appropriate for the directors to consider such factors as reputation of the corporation, potential for adverse legislation or regulation, the value of well trained and incentivized employees, avoidance of material risks and any other matter that could affect the business success or value of the corporation.

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Putting to Rest the Debate Between CSR and Current Corporate Law

Posted by Peter A. Atkins, Marc S. Gerber, and Edward B. Micheletti, Skadden, Arps, Slate, Meagher & Flom LLP, on Saturday, September 7, 2019

Editor's note: Peter A. Atkins, Marc S. Gerber, and Edward B. Micheletti are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on their Skadden memorandum.

There is an ongoing debate regarding the role of publicly traded for-profit business corporations in addressing the many serious challenges confronting society, including some directly involving nonshareholder corporate stakeholders (such as employees and communities). It has been framed most recently by a statement issued by the Business Roundtable on the purpose of a corporation and a response by the Council of Institutional Investors.[1] As is the nature of many debates, some frame this as an all-or-nothing exercise, with a spotlight on the sharpest point of divergence, and with some calling for federal legislation to address the issue.

Stepping back from an all-or-nothing dichotomy, and regardless of whether one is ideologically for or against publicly traded for-profit business corporations spending corporate funds on societally important objectives, from a legal perspective this debate already has been solved.

Earlier this year, we authored an article titled "Social Responsibility and Enlightened Shareholder Primacy: Views From The Courtroom and Boardroom."[2] The bottom line of the article is that the shareholder primacy rule, which governs Delaware corporations (which constitute approximately 60 percent of the Fortune 500 companies), has sufficient room to accommodate socially responsible corporate expenditures—including those aimed at addressing the interests of nonshareholder stakeholders—determined in the lawful exercise of a board's business judgment. The article highlights the Delaware judicial underpinnings of this "enlightened" shareholder primacy focus, and offers thoughts on how a board of directors can travel the path of social responsibility consistent with serving shareholder interests. In other words, a for-profit Delaware corporation is not precluded from taking social issues into account in the conduct of its business, so long as the corporation's consideration of those social issues has a sufficient nexus to shareholder welfare and value enhancement or protection.[3]

[1] See, *e.g.*, Business Roundtable Statement on the Purpose of a Corporation and the Council of Institutional Investors press release in response.

[2] Harvard Law School Forum on Corporate Governance and Financial Regulation, February 21, 2019. The article originally ran as a Skadden client alert.

[3] A number of other state courts are guided by Delaware corporate law if no statute or case law in the relevant jurisdiction otherwise governs the matter at issue.

We believe that the perspective provided above, based on Delaware's well-established body of corporation law, has merit from a number of standpoints.

First, and most importantly, it provides the existing legal basis and practical guidance for corporations wishing to take socially responsible positions—including those responding to nonshareholder stakeholder interests—to do so immediately, consistent with the lawful exercise of a board's business judgment.

Second, it avoids the need to redesign and implement an entirely new doctrine of corporate governance for "garden variety" for-profit business corporations.[4] And it avoids the time-consuming, heated, public and, for many, unpleasant debate that would almost certainly accompany any such redesign effort.

Third, it acknowledges our current private enterprise system, implemented in very large measure through publicly traded for-profit business corporations, as flexible and capable of allowing boards of directors, in considering the best interests of shareholders, to be responsive to new and evolving issues facing corporations, including those involving nonshareholder stakeholders as well as more general societal issues and sensitivities regarding them.

To be clear, vis-a-vis any particular proposed action, any number of internal matters will need to be addressed, including gathering information and understanding the relative merits and trade-offs of alternative courses of action and how they may ultimately deliver value for shareholders as well as benefit other stakeholders or more general societal interests. And after a board exercises its business judgment and a particular action plan is approved and made public, any number of interested parties may weigh in, including shareholders, other stakeholders, third-party organizations with views on the issue and politicians. Nevertheless, a properly functioning board gathering the information and making a decision that is intended to benefit shareholders as well as advance the interests of nonshareholder corporate stakeholders or more general societal interests will have acted in a manner consistent with today's legal framework (at least in Delaware) and should have the protections afforded to directors' decision-making under current Delaware corporate law, including, importantly, the business judgment rule.

The ongoing debate concerning the role of the for-profit public corporation in society does not appear likely to subside in the near-term. Whether companies take into consideration societal interests, including the interests of nonshareholder stakeholders in the corporation, within the context of serving shareholder interests ultimately is a matter of business judgment for boards of directors. The shareholder primacy model is not a barrier to doing so. However, the question will still remain whether for-profit public corporations sufficiently avail themselves of this flexibility to quell critics of the perceived narrow operational focus of the shareholder primacy model, including forestalling efforts by those who call for systemic change.

[4] Some states—but not Delaware—have "constituency statutes" that generally expressly permit directors to consider the interests of nonshareholder constituencies when making decisions about their companies.

As noted in our article, in 2013, Delaware amended its corporation law, adding provisions permitting the formation of "public benefit corporations." Delaware General Corporation Law §§361-368. These provisions, among other things, specifically modify the shareholder primacy principle by requiring directors to balance the pecuniary interests of shareholders, the interest of those materially affected by the corporation's conduct and the public benefits identified by the corporation in its charter.

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So Long to Shareholder Primacy

Posted by Cydney Posner, Cooley LLP, on Thursday, August 22, 2019

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

In a press release issued [August 19, 2019], the Business Roundtable announced the adoption of a new Statement on the Purpose of a Corporation, signed by 181 well-known, high-powered CEOs. What's newsworthy here is that the Statement "moves away from shareholder primacy" as a guiding principle and outlines in its place a "modern standard for corporate responsibility" that makes a commitment to all stakeholders. Yup, *that* Business Roundtable. According to the press release, the Business Roundtable has had a long-standing practice of issuing Principles of Corporate Governance. Since 1997, those Principles have advocated the theory of "shareholder primacy—that corporations exist principally to serve shareholders"—and relegated the interests of any other stakeholders to positions that were strictly "derivative of the duty to stockholders." The new Statement supersedes previous statements and "more accurately reflects [the Business Roundtable's] commitment to a free market economy that serves all Americans. This statement represents only one element of Business Roundtable's work to ensure more inclusive prosperity, and we are continuing to challenge ourselves to do more." Fasten your seatbelts, disciples of Milton Friedman; it's going to be a bumpy night.

SideBar

Shareholder primacy was not always the prevalent theory, argues Professor William Lazonick in "Profits without Prosperity," published in the September 2014 *Harvard Business Review*:

"From the end of World War II until the late 1970s, a retain-and-reinvest approach to resource allocation prevailed at major U.S. corporations. They retained earnings and reinvested them in increasing their capabilities, first and foremost in the employees who helped make firms more competitive. They provided workers with higher incomes and greater job security, thus contributing to equitable, stable economic growth—what [he calls] 'sustainable prosperity.' This pattern began to break down in the late 1970s, giving way to a downsize-and-distribute regime of reducing costs and then distributing the freed-up cash to financial interests, particularly shareholders. By favoring *value extraction* over *value creation*, this approach has contributed to employment instability and income inequality." [emphasis added]. (See this PubCo post.)

The shift to shareholder primacy has been widely attributed to the development of the "shareholder preeminence theory" by the Chicago school of economists, beginning in the 1970s, with economist Milton Friedman famously arguing that the only "social responsibility of business is to increase its profits." Subsequently,

> two other economists published a paper characterizing shareholders as "'principals' who hired executives and board members as 'agents.' In other words, when you are an executive or corporate director, you work for the shareholders." (See this PubCo post.)

According to Jamie Dimon, Chair of the Business Roundtable and CEO of JPMorgan Chase, "The American dream is alive, but fraying….Major employers are investing in their workers and communities because they know it is the only way to be successful over the long term. These modernized principles reflect the business community's unwavering commitment to continue to push for an economy that serves all Americans." The former CEO of Vanguard, also quoted in the press release, welcomed "this thoughtful statement by Business Roundtable CEOs on the Purpose of a Corporation. By taking a broader, more complete view of corporate purpose, boards can focus on creating long-term value, better serving everyone—investors, employees, communities, suppliers and customers." According to the *WSJ, s*even CEOs declined to sign the Statement, and the Council of Institutional Investors also opposed the Statement, contending that it "gives CEOs cover to dodge shareholder oversight."

Reproduced below is the new Statement from the Business Roundtable:

> **"Statement on the Purpose of a Corporation**
>
> "Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.
>
> "Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.
>
> "While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:
>
> - Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.
> - Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
> - Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
> - Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.

> - Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.
>
> "Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country."

As noted in this article from *Fortune*, the "new statement is 300 words long, and shareholders aren't mentioned until word 250." According to the author, the shift in perspective is "the result of a yearlong reexamination that began with a testy dinner attended by a group of journalistic critics and involving a comprehensive survey of CEOs, academics, NGOs, and political leaders." These discussions raised a fundamental question about "how well capitalism is serving society."

That question may have its origins in the 2008 financial crisis, which "shook the foundations of the sprawling market economy and bared some of its uglier consequences: an enormous and widening gulf between the über-rich and the working poor, between the ample rewards of capital and the stagnating wages of labor, between the protected few and the vulnerable many. Compounding these inequities, moreover, was a sweep of disruptive business technologies that began to come of age in the wake of the crisis—from digitization to robotics to A.I.—and that made vulnerable workers feel ever more so." The crisis triggered a strong reaction against the system of capitalism in some quarters, especially among the younger generation.

> **SideBar**
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> That widening gulf might be reflected in this new report from the Economic Policy Institute, which showed that, from "1978 to 2018, CEO compensation grew by 1,007.5% [valued based on when options granted] (940.3% under the options-realized measure), far outstripping S&P stock market growth (706.7%) and the wage growth of very high earners (339.2%). In contrast, wages for the typical worker grew by just 11.9%.

In December 2016, the article continues,

"*Fortune* assembled roughly 100 big-company CEOs in Rome, at the encouragement of Pope Francis, and spent a day in working-group deliberations on how the private sector could address global social problems. The group…proposed ways that business could help reach the billions of people in the world who lacked basic financial services; support the effort to fight climate change; expand training programs for those whose jobs were threatened by technological change; and provide basic community health services to the half-billion people who had no access to care…. But the backdrop for the conversation…was never far from mind—and remains so today: More and more CEOs worry that public support for the system in which they've operated is in danger of disappearing."

The authors suggests that the Business Roundtable's new perspective has been driven by a shift in public sentiment—"as many Americans (64%) say that a company's 'primary purpose' should include 'making the world better' as say it should include 'making money for shareholders'"—as well as pressure from employees, especially younger workers.

> **SideBar**
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> A broader view of "corporate purpose*"* has been advocated for several years now by Laurence Fink, the Chair and CEO of BlackRock and one of the signatories to the new Business Roundtable Statement. Governments, in Fink's view, have not been up to the task, with the result that "society increasingly is turning to the private sector and asking that companies respond to broader societal challenges…. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. *Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."* [Emphasis added.] What does that mean in practice? According to Fink, among other things, a company should consider its role in the community, its management of its environmental impact, its efforts to create a diverse workforce, its ability to adapt to technological change and take advantage of new opportunities, its retraining programs for employees in an increasingly automated world and its efforts to help prepare workers for retirement. But these goals are not just goals in and of themselves; they have a larger purpose. (See this PubCo post.)

According to a poll conducted by *Fortune* in March, 41% of Fortune 500 CEOs agreed that "solving social problems should be 'part of [their] core business strategy.' (Seven percent, it's worth noting, still stick to the Friedman view that they should 'mainly focus on making profits and not be distracted by social goals.')" CEOs and others were coining new terms such as "compassionate capitalism" and "inclusive capitalism"—as the author phrased it: capitalism "was desperately in need of a modifier."

Needless to say, some are skeptical of the change in corporate attitude and see it as, perhaps, just a kind of virtue-signaling. The article cites, for example, Anand Giridharadas, author of the book *Winners Take All: The Elite Charade of Changing the World*, who told the article's author that he could

> "'absolutely see the change….It has become socially unacceptable as a company or a rich person not to be doing good. CEOs are asking the question: 'What can I do to make the world better?' But what many are failing to do is ask: 'What have I done that may be drowning out any of the do-gooding I'm doing?' He cites the 2017 tax bill, supported by the Business Roundtable, as an example. The lion's share of the benefits, he argues, ended up in the hands of the top 1%, increasing the income inequality underlying many social problems. 'What I see are well-meaning activities that are virtuous side hustles,…while key activities of their business are relatively undisturbed … Many of the companies are focused on doing more good but less attentive to doing less harm.'"

Nevertheless, the article's author maintains, with government in a state of paralysis, "the new social consciousness of business surely should be seen as a step in the right direction," with business leadership "filling the leadership vacuum."

> **SideBar**
>
> One hiccup might be the legal doctrine currently prevalent in the Delaware courts. In this 2015 article, *The Dangers of Denial*, Delaware Chief Justice Leo

Strine wrote:

"In current corporate law scholarship, there is a tendency among those who believe that corporations should be more socially responsible to avoid the more difficult and important task of advocating for externality regulation of corporations in a globalizing economy and encouraging institutional investors to exercise their power as stockholders responsibly. Instead, these advocates for corporate social responsibility pretend that directors do not have to make stockholder welfare the sole end of corporate governance within the limits of their legal discretion, under the law of the most important American jurisdiction—Delaware. I say stockholder welfare for a reason. To the extent that these commentators argue that directors are generally empowered to manage the corporation in a way that is not dictated by what will best maximize the corporation's current stock price, they are correct. But their claim, as I understand it, is a more fundamental one: they contend that directors may subordinate what they believe is best for stockholder welfare to other interests, such as those of the company's workers or society generally. That is, they do not argue simply that directors may choose to forsake a higher short-term profit if they believe that course of action will best advance the interests of stockholders in the long run. Rather, these commentators argue that directors have no legal obligation to make—within the constraints of other positive law—the promotion of stockholder welfare their end. According to these commentators, if only corporate directors recognized that the stockholders are just one of many ends they can legally pursue, the world would be a better place….Despite attempts to muddy the doctrinal waters, a clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare."

But for another view, see, "*The Central Role of Political Myth in Corporate Law*," in which a Yale professor argues that, in light of the strength of the business judgment rule (and in the absence of conflicts of interest), shareholder wealth maximization as a legal tenet is really just a myth: "the law does not *require* that managers maximize shareholder wealth"; rather, "market forces, as distinct from legal duties, appear to be forcing managers of public companies to single-mindedly pursue the goal of wealth maximization." In the author's view, the

"reality is that directors essentially can do whatever they want (subject to the subterfuge condition and the qualification that directors refrain from actively damaging shareholders' interests)….As many others have observed, understanding the nature and function of the business judgment rule is the key to understanding why the notion of shareholder wealth maximization is a norm and not an enforceable legal principle. Unless directors are actually stealing from the corporation, in order to be actionable, conduct that ostensibly constitutes a failure to maximize profits for shareholders must be shown to violate the fiduciary duty of care. The business judgment rule is a strong evidentiary presumption that whenever a decision of directors is challenged as being inconsistent with the requirement of shareholder wealth maximization, the defendants are entitled to a strong presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company….Judges go to such great lengths to defer to directors decisions that the shareholder wealth maximization norm is for all intents and purposes a complete nullity."

As a myth, he suggests, it's function is more a normative one.

And now the norm is changing. So the question that is teed up by the Statement is this: what will all of these companies actually do to fulfill the commitments set forth in the Statement?

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Stakeholder Governance and the Fiduciary Duties of Directors

Posted by Martin Lipton, Karessa L. Cain, and Kathleen C. Iannone, Wachtell, Lipton, Rosen & Katz, on Saturday, August 24, 2019

Editor's note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy; Karessa L. Cain is a partner; and Kathleen C. Iannone is an associate. This post is based on their Wachtell Lipton publication.

There has recently been much debate and some confusion about a bedrock principle of corporate law—namely, the essence of the board's fiduciary duty, and particularly the extent to which the board can or should or **must** consider the interests of other stakeholders besides shareholders.

For several decades, there has been a prevailing assumption among many CEOs, directors, scholars, investors, asset managers and others that the sole purpose of corporations is to maximize value for shareholders and, accordingly, that corporate decision-makers should be very closely tethered to the views and preferences of shareholders. This has created an opportunity for corporate raiders, activist hedge funds and others with short-termist agendas, who do not hesitate to assert their preferences and are often the most vocal of shareholder constituents. And, even outside the context of shareholder activism, the relentless pressure to produce shareholder value has all too often tipped the scales in favor of near-term stock price gains at the expense of long-term sustainability.

In recent years, however, there has been a growing sense of urgency around issues such as economic inequality, climate change and socioeconomic upheaval as human capital has been displaced by technological disruption. As long-term investors and the asset managers who represent them have sought to embrace ESG principles and their role as stewards of corporations in pursuit of long-term value, notions of shareholder primacy are being challenged. Thus, earlier this week, the Business Roundtable announced its commitment to stakeholder corporate governance, and outside the U.S., legislative reforms in the U.K. and Europe have expressly incorporated consideration of other stakeholder interests in the fiduciary duty framework. The Council of Institutional Investors and others, however, have challenged the wisdom and legality of stakeholder corporate governance.

To be clear, Delaware law does not enshrine a principle of shareholder primacy or preclude a board of directors from considering the interests of other stakeholders. Nor does the law of any other state. Although much attention has been given to the *Revlon* doctrine, which suggests that the board must attempt to achieve the highest value reasonably available to shareholders, that doctrine is narrowly limited to situations where the board has determined to sell control of the company and either all or a preponderant percentage of the consideration being paid is cash or the transaction will result in a controlling shareholder. Indeed, the *Revlon* doctrine has played an outsized role in fiduciary duty jurisprudence not because it articulates the ultimate nature and objective of the board's fiduciary duty, but rather because most fiduciary duty litigation arises in the context of mergers or other extraordinary transactions where heightened standards of judicial review are applicable. In addition, *Revlon*'s emphasis on maximizing short-term shareholder value has served as a convenient touchstone for advocates of shareholder primacy and has accordingly been used as a talking point to shape assumptions about fiduciary duties even outside the sale-of-control context, a result that was not intended. Around the same time that *Revlon* was decided, the Delaware Supreme Court also decided the *Unocal* and *Household* cases, which affirmed the board's ability to consider all stakeholders in using a poison pill to defend against a takeover—clearly confining *Revlon* to sale-of-control situations.

The fiduciary duty of the board is to promote the value of the corporation. In fulfilling that duty, directors must exercise their business judgment in considering and reconciling the interests of various stakeholders—including shareholders, employees, customers, suppliers, the environment and communities—and the attendant risks and opportunities for the corporation.

Indeed, the board's ability to consider other stakeholder interests is not only uncontroversial—it is a matter of basic common sense and a fundamental component of both risk management and strategic planning. Corporations today must navigate a host of challenges to compete and succeed in a rapidly changing environment—for example, as climate change increases weather-related risks to production facilities or real property investments, or as employee training becomes critical to navigate rapidly evolving technology platforms. A board and management team that is myopically focused on stock price and other discernible benchmarks of shareholder value, without also taking a broader, more holistic view of the corporation and its longer-term strategy, sustainability and risk profile, is doing a disservice not only to employees, customers and other impacted stakeholders but also to shareholders and the corporation as a whole.

The board's role in performing this balancing function is a central premise of the corporate structure. The board is empowered to serve as the arbiter of competing considerations, whereas shareholders have relatively limited voting rights and, in many instances, it is up to the board to decide whether a matter should be submitted for shareholder approval (for example, charter amendments and merger agreements). Moreover, in performing this balancing function, the board is protected by the business judgment rule and will not be second-guessed for embracing ESG principles or other stakeholder interests in order to enhance the long-term value of the corporation. Nor is there any debate about whether the board has the legal authority to reject an activist's demand for short-term financial engineering on the grounds that the board, in its business judgment, has determined to pursue a strategy to create sustainable long-term value.

And yet even if, as a doctrinal matter, shareholder primacy does not define the contours of the board's fiduciary duties so as to preclude consideration of other stakeholders, the practical reality is that the board's ability to embrace ESG principles and sustainable investment strategies depends on the support of long-term investors and asset managers. Shareholders are the only corporate stakeholders who have the right to elect directors, and in contrast to courts, they do not decline to second-guess the business judgment of boards. Furthermore, a number of changes over the last several decades—including the remarkable consolidation of economic and voting power among a relatively small number of asset managers, as well as legal and “best practice” reforms—have strengthened the ability of shareholders to influence corporate decision-making.

To this end, we have proposed *The New Paradigm*, which conceives of corporate governance as a partnership among corporations, shareholders and other stakeholders to resist short-termism and embrace ESG principles in order to create sustainable, long-term value. See our paper, *It’s Time to Adopt The New Paradigm*.

Six Reasons We Don't Trust the New "Stakeholder" Promise from the Business Roundtable

Posted by Nell Minow, ValueEdge Advisors, on Monday, September 2, 2019

Editor's note: Nell Minow is Vice Chair of ValueEdge Advisors.

A new statement from the Business Roundtable commits to stakeholder interests instead of making the primary purpose of the company shareholder value. Long-term shareholders are increasingly committed to explicitly ESG investing, which values stakeholder interests as a way to minimize investment risk. But I am skeptical about what the CEO signatories to this statement have in mind for six reasons.

1. We've seen this before. The last time the BRT deployed stakeholder rhetoric it was during the 1980's era of hostile takeovers, when a feint to the interests of anyone other than shareholders was the best way to entrench management. The CEOs who signed this statement know that accountability to everyone is accountability to no one. It's like a shell game where the pea of any kind of obligation is always under the shell you didn't pick. It's shoot an arrow at the wall and then draw a bull's-eye around it goal-setting.

2. It does not really mean anything. As the law and basic economics already make clear, stakeholder interests are already included within the obligation to shareholders; sustainable shareholder value requires commitment to employees, customers, suppliers, and the community. There is also a serious credibility problem here. Barry Ritholtz notes dryly, "Scan the list of 181 signatories to the recent memo and it's a Who's Who of corporate behavior that has burdened and disadvantaged the very stakeholders they will now champion." His exhaustive lists include many specific examples of opposition to unions, health, environmental, consumer protection and safety rules, and efforts to reduce shareholder oversight. Jordan Weissmann makes a similar point on Slate, pointing out that Senator and Presidential candidate Elizabeth Warren has proposed stakeholder legislation, and if the signatories to this statement want to be believed, they should support it.

3. It is not consistent with the principles of capitalism. Capitalism is not named after the managers; it is named after the providers of capital, the shareholders. Its foundation is the strict and scrupulous fiduciary obligation ("the punctilio of an honor the most sensitive," as Justice Benjamin Cardozo said in *Meinhard v. Salmon*), that gives credibility to capitalism by addressing the agency cost risk of entrusting money to others. Why should investors entrust their money to people who want to turn the fiduciary duty of strict loyalty into some version of "just trust me?" The Council of Institutional Investors has responded to the new statement by noting pointedly that they and their members have discussed the importance of stakeholders with corporate CEOs many times in the past. They said, "The BRT statement suggests corporate obligations to a variety of stakeholders, placing shareholders last, and referencing shareholders simply as providers of capital rather than as owners…[CII] believes boards and managers need to sustain a focus on long-term shareholder value. To achieve long-term shareholder value, it is critical to respect stakeholders, but also to have clear accountability to company owners."

4. We are waiting to see CEOs put their money where their mouths are. Everything will depend on how specifically and quantifiably each CEO describes his or her stakeholder goals and especially how their compensation is tied to those goals. If pay continues to be exclusively or primarily based on stock price, this statement is just an attempt at distraction. Indeed, its greatest significance may be as an indicator that CEOs do not think stock-based metrics will support current levels of compensation in a likely recession and they want to tie it to something less quantifiable. Furthermore, following a record-setting amount of stock buybacks last year, the options for short-term manipulation through timing of repurchases are narrowing, CEOs have to find other ways to justify their astronomical—and non-performance-related—pay packages.

5. There is a bait and switch element. When companies go public, they almost always promise in their offering documents to deliver shareholder returns. Their presentations to security analysts have chart after chart showing all of the prospects for creating shareholder value. Companies with other priorities can make that clear and allow the market to decide whether to discount the stock price to reflect investment risk. They can incorporate as Public Benefit Corporations, which let investors know from the beginning that their primary purpose is not shareholder returns and let shareholders value their investment potential accordingly.

6. Corporations are not designed for making public policy. The key issue in any discussion of stakeholders is what happens when there is a trade-off between stakeholder and shareholder interests. Allocating more capital to R&D, becoming carbon-neutral, developing more environmentally friendly products, better pay and training for employees, or a brand-enhancing charitable contribution, can all be justified in terms of long-term, sustainable creation of value for shareholders. We need to know whether the signatories to this statement are talking about something different: trading off shareholder value in support of some kind of policy goals. Given the amply corporate funded attacks on shareholder proposals and the independent research and analysis of proxy advisory firms at the SEC over the past 18 months, all making completely unsupported claims that "political" initiatives on proxies are contrary to shareholder value, it is fair to assume that this is what corporate managers have in mind. But corporations thrive when they are accountable through robust market forces. As The Economist puts it in their cover story responding to the BRT statement, "Competition, not corporatism, is the answer to capitalism's problems." Trade-offs on social/political issues, including allocating capital to determine environmental/health/safety/consumer protection standards, can only be made by those accountable through a very different kind of market test—the political process. Who do we want to trust to set auto safety and emission standards, the auto industry or legislators and regulators? Here's a hint: do we let students grade their own papers? These decisions must be made by those with the most robust accountability, and that means the fewest conflicts of interest and the least likely to externalize costs or divert assets to higher pay levels for managers.

Shareholders will be doing what the market and, in the case of intermediaries like pension funds and mutual funds, their own fiduciary obligation requires in response to this statement. We will look for specifics and incentive compensation tied to quantifiable, transparent goals. We will look for corporate support for legislative and shareholder initiatives on climate change and better pay and working conditions for the human capital companies always claim—at least once a year in their annual reports—are their most important asset. And then, as market forces and fiduciary duty require, we will adjust our own capital allocations accordingly, because that's what keeps companies and markets—and economies—strong.

Toward Fair and Sustainable Capitalism

Posted by Leo E. Strine Jr. (Delaware Supreme Court and Harvard Law School), on Tuesday, October 1, 2019

Editor's note: Leo E. Strine, Jr. is Chief Justice of the Delaware Supreme Court, the Austin Wakeman Scott Lecturer on Law and a Senior Fellow of the Harvard Law School Program on Corporate Governance. This post is based on Chief Justice Strine's recent paper.

I recently placed on SSRN a new paper, *Toward Fair and Sustainable Capitalism: A Comprehensive Proposal to Help American Workers, Restore Fair Gainsharing Between Employees and Shareholders, and Increase American Competitiveness by Reorienting Our Corporate Governance System Toward Sustainable Long-Term Growth and Encouraging Investments in America's Future*. The *Financial Times* published earlier this week an op-ed in which I provide an overview of the proposal put forward in this new paper, which was prepared in connection with this week's *A New Deal For This New Century: Making Our Economy Work For All* conference in Washington, D.C.

To promote fair and sustainable capitalism and help business and labor work together to build an American economy that works for all, this paper presents a comprehensive proposal to reform the American corporate governance system by aligning the incentives of those who control large U.S. corporations with the interests of working Americans who must put their hard-earned savings in mutual funds in their 401(k) and 529 plans. The proposal would achieve this through a series of measured, coherent changes to current laws and regulations, including:

- requiring not just operating companies, but institutional investors, to give appropriate consideration to and make fair disclosure of their policies regarding EESG issues, emphasizing "Employees" and not just "Environmental, Social, and Governance" factors;
- giving workers more leverage by requiring all societally-important companies to have board level committees charged with ensuring fair treatment of employees, authorizing companies to use European-style works' councils to increase employee voice, and reforming labor laws to make it easier for workers to join a union and bargain for fair wages and working conditions;
- reforming the corporate election system so that voting occurs on a more rational, periodic, and thoughtful basis supportive of sustainable business practices and long-term investment;
- improving the tax system to encourage sustainable, long-term investment and discourage speculation, with the resulting proceeds being used to revitalize and green America's infrastructure, tackle climate change, invest in American workers' skills, transition workers from carbon-intensive industries to jobs in the clean energy sector; and
- taking other measures, such as reform of corporate political spending and forced arbitration, to level the playing field for workers, consumers, and ordinary investors.

Tab III: Engagement Between Issuers and Investors

2019 Proxy Season Review: Part 1—Rule 14a-8 Shareholder Proposals

Posted by Marc Treviño, Sullivan & Cromwell LLP, on Friday, July 26, 2019

Editor's note: Marc Treviño is a partner at Sullivan & Cromwell LLP. This post is based on a Sullivan & Cromwell memorandum by Mr. Treviño, Melissa Sawyer, H. Rodgin Cohen, and June Hu.

A. Overview of Shareholder Proposals

The following table and pie charts summarize, by general category, the Rule 14a-8 shareholder proposals submitted in 2018 full-year and 2019 year-to-date, the number voted on and the rate at which they passed. Overall, the total number of shareholder proposals significantly declined, continuing a downward trend from 2015. A total of 678 shareholder proposals have been submitted to-date in 2019, relative to 751 at this time last year, 788 for 2018 as a whole and 836 for 2017. The decline relative to this time last year is led by a 12.5% drop in environmental, social, and political ("ESP") proposals, closely followed by compensation-related proposals (11.9% drop), with governance-related proposals declining by a smaller proportion (6.2% drop). The overall decline would have been steeper but for the increase in proposals against investing or managing on the basis of ESP factors (so-called anti-ESP proposals).

Summary of 2018-2019 Shareholder Proposals

SUMMARY OF 2018-2019 SHAREHOLDER PROPOSALS

	Shareholder Proposals Submitted		*Shareholder Proposals Voted On*		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
Type of Proposal	*2019 YTD*	*2018*	*2019 YTD*	*2018*	*2019 YTD*	*2018*	*2019 YTD*	*2018*
ESP	**323**	387	**146**	139	**28%**	26%	**9**	8
Governance-related	**303**	335	**195**	234	**37%**	37%	**41**	31
Compensation-related	**52**	66	**30**	42	**24%**	23%	**2**	0
Total	*678*	*788*	*371*	*415*				

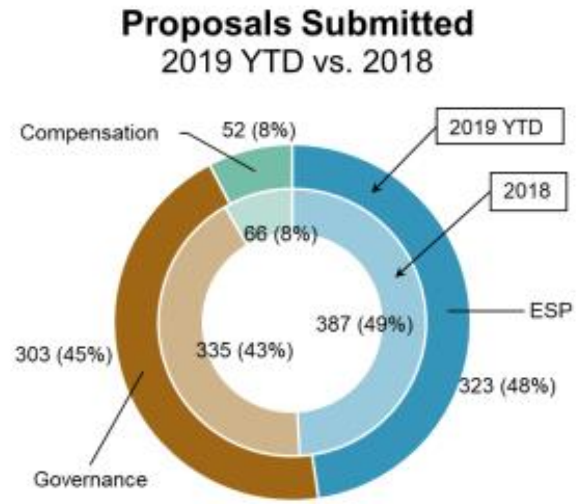
Despite the drop year-over-year, more ESP proposals were submitted than any other type of shareholder proposal for the third year in a row. This year nearly half of submitted ESP proposals went to a vote, while in 2018 only about a third reached the shareholder vote stage.

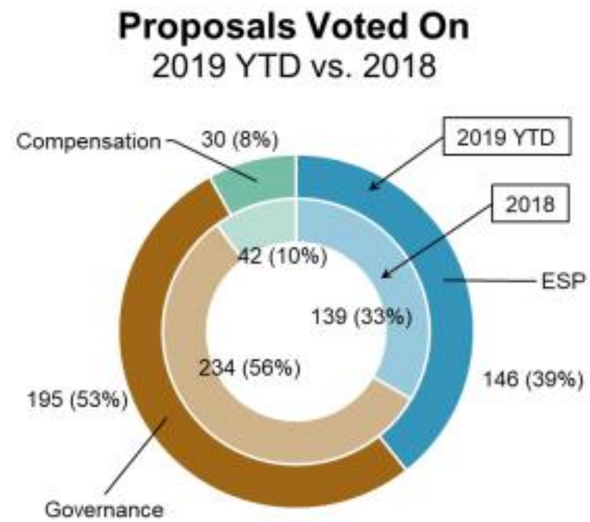
Very few ESP proposals actually passed, as was the case in 2017 and 2018, although shareholder support for ESP proposals has increased steadily over both the long- and short-term. Average shareholder support for ESP proposals reached 28% this year, continuing the upward trend from less than 10% ten years ago to 26% in 2018. The gap in the average support rate between ESP and governance-related proposals also continued to narrow, down to nine percentage points from 11 percentage points in 2018 and 17 percentage points in 2017. ESP proposals are discussed in more detail in Section D.

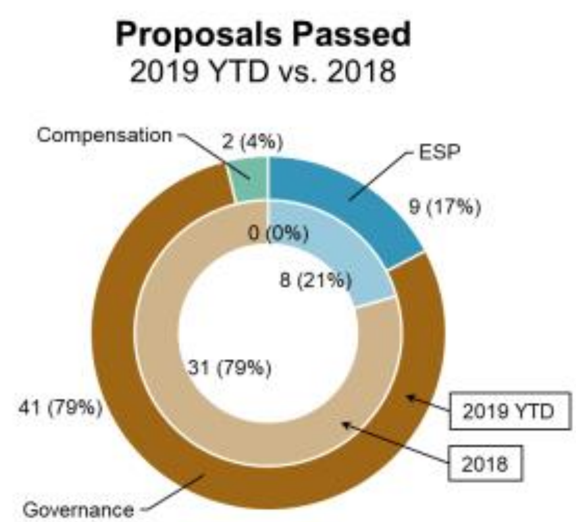
The number of governance-related proposals fell 6.2% compared to the same time last year, as companies continued proactive adoption of practices that have become market standard (*e.g.*, proxy access), and proponents continued to explore those areas where market practice has not settled (*e.g.*, independent board chair).

As was the case in 2018, governance-related proposals were the most likely to reach a vote (64.4% in 2019; 69.9% in 2018) and continued to represent the vast majority of proposals that actually passed. The percentage of proposals that passed in 2019 (21% of voted proposals) increased from 2018 (13% of voted), primarily due to an increase in the number of elimination of supermajority thresholds proposals that came to a vote and that passed (19 and 16 in 2019, respectively, compared to 11 and 9 in 2018). Governance-related proposals are discussed in more detail in Section E.

The number of compensation-related proposals remained at a negligible level, continuing a trend that began when mandatory say-on-pay votes came into effect. As was the case in 2018, the most common proposal topic is tying ESP performance to compensation targets (34.6% of all compensation-







related proposals submitted, compared to 36.4% in 2018). Whereas no compensation-related proposals passed in 2018, two proposals (both related to clawbacks) passed in 2019. Compensation-related proposals are discussed in more detail in Section F.

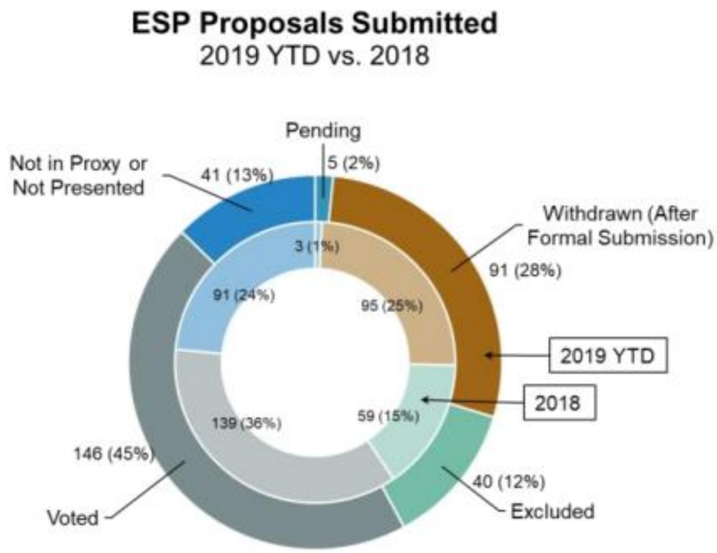
* * *

D. Shareholder Proposals on Environmental / Social / Political Matters

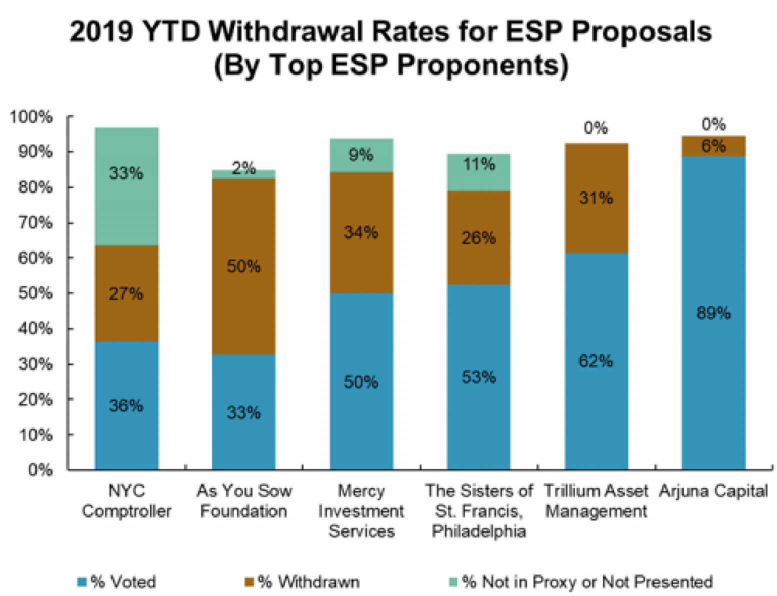
ESP proposals continued to gain momentum, with the ESP proposals that went to a vote receiving record average support of 28% and a record nine proposals passing. Unlike governance proposals, which have high support concentrated in a limited number of topics, support across a variety of ESP topics was relatively consistent. The proposals that did register substantially lower voter support related to requests that were in direct contradiction with the company's business (*e.g.*, proposing The Coca-Cola Company report on the deleterious health impact of processed sugar, or requesting Altria Group, Inc. reduce nicotine levels in tobacco products) or were so-called anti-ESP proposals (*e.g.*, proposing that Duke Energy report on the costs of voluntary environment-related activities).

	ESP PROPOSALS							
	Shareholder Proposals Submitted		Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2019 YTD	2018	2019 YTD	2018	2019 YTD	2018	2019 YTD	2018
Political	**93**	93	**59**	55	**34%**	29%	**4**	0
Environmental	**64**	110	**20**	34	**24%**	31%	**0**	5
Human capital	**54**	59	**30**	13	**24%**	28%	**2**	0
Human rights	**40**	35	**14**	11	**25%**	8%	**1**	0
Sustainability report	**24**	21	**4**	6	**30%**	34%	**0**	1
Health and safety	**11**	10	**4**	4	**6%**	23%	**0**	0
Animal rights	**8**	8	**1**	1	**7%**	3%	**0**	0
ESP – other	**29**	51	**14**	15	**30%**	18%	**2**	2

The percent of ESP proposals voted rose sharply to 45.2% from 35.9% in full-year 2018. As a result, the number of ESP proposals voted on is higher than the same period last year, notwithstanding the 12.5% drop in the number of ESP proposals submitted in the first half of 2019 compared to the same period in 2018 (16.5% drop compared to full-year 2018).



The ten shareholder proponents referenced in Section B submitted about two-thirds of all ESP proposals received by U.S. S&P Composite 1500 companies. Among these proponents, As You Sow Foundation submitted the greatest number of ESP proposals (46), most of which related to climate change and reducing the company's carbon footprint, the majority of which was withdrawn. Arjuna Capital (18), Mercy Investment Services (32), Sisters of St. Francis (19) and Trillium Asset Management (13) also submitted a meaningful number of ESP proposals, particularly focusing on environmental issues and political contributions. Companies resolved about half of the proposals brought by these proponents outside of a shareholder vote, but almost all of the proposals brought by Arjuna went to a vote (most of these were proposals to disclose an unadjusted gender pay gap and are further discussed in Section D.3.a). Although social investment entities and religious groups submitted the bulk of ESP proposals, as was the case in 2018, ESP proposals also represented a larger portion of the submissions this year from other types of proponents, such as public pension funds. For example, over half of all proposals submitted by the NYC Comptroller this year have been ESP proposals.



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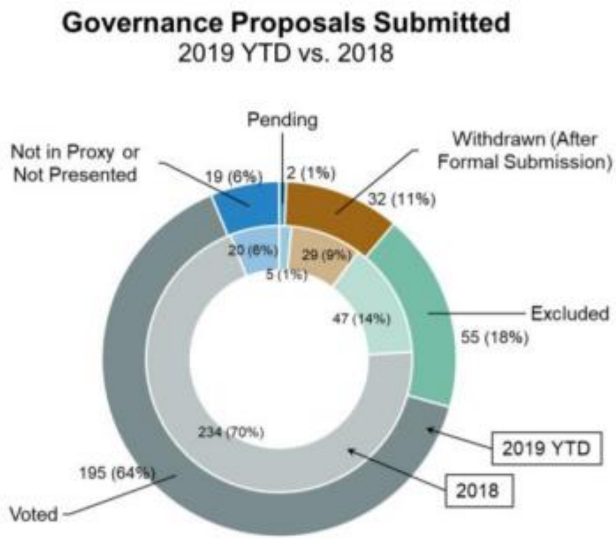
E. Shareholder Proposals on Governance Matters

The number of proposals on governance matters (board-related and anti-takeover concerns) that came to a vote in 2019 was down significantly from 2018, continuing a trajectory from 2015. Proposals on independent chair, board composition, supermajority vote requirements, and majority voting in uncontested elections increased year-over-year. These increases did not offset the significant drop in special meeting-related proposals, the most common governance-related topic in 2018. Average support for governance-related proposals in 2019 was 37% overall, level with 2018 but representing a decrease from prior years.

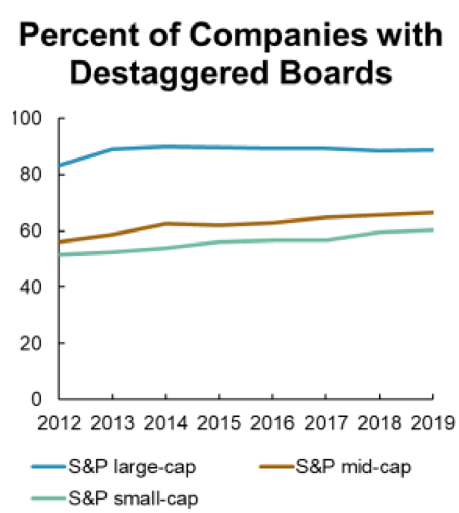
	Governance Proposals							
	Shareholder Proposals Submitted		Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2019 YTD	2018	2019 YTD	2018	2019 YTD	2018	2019 YTD	2018
Independent Chair	62	54	54	47	29%	32%	0	0
Board Composition	39	30	9	6	8%	16%	0	0
Board Diversity	32	27	9	3	8%	17%	0	0
Director Qualifications	7	3	0	3	-	14%	0	0
Act by Written Consent	38	41	33	36	39%	42%	6	6
Eliminate Supermajority Thresholds	37	26	19	11	68%	65%	16	9
Proxy Access	33	47	27	35	33%	32%	3	3
Adopt new right	11	18	5	10	53%	43%	3	3
Amend existing right	22	29	22	25	29%	28%	0	0
Special Meeting	26	77	21	61	44%	40%	4	5
Adopt New Right	1	18	1	8	42%	39%	0	1
Lower % on Existing Rights	25	59	20	53	44%	40%	4	4
Majority Voting in Uncontested Elections	12	7	7	3	58%	67%	4	2
Dual Class Voting	7	11	6	10	27%	32%	0	0
Declassify Board	7	8	4	5	76%	85%	4	5

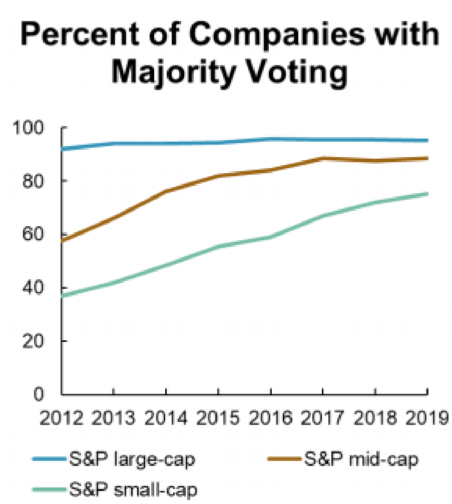
Unlike ESP proposals, when governance proposals failed to reach the shareholder vote stage, it was most often due to exclusion through the SEC no-action process, as the following chart illustrates:



As so-called shareholder-friendly governance features have become standard at S&P 500 companies, a number of governance proposals that previously have dominated proxy seasons and garnered high support from investors (*e.g.*, destaggered boards, majority election of directors, special meeting rights, simple majority vote thresholds and, more recently, proxy access) have become much less prevalent. There are simply fewer large-cap companies that have not already adopted these features, and those companies are often unappealing targets for governance proponents because many have structural hurdles, such as dual class voting, that limit the efficacy of shareholder proposals.

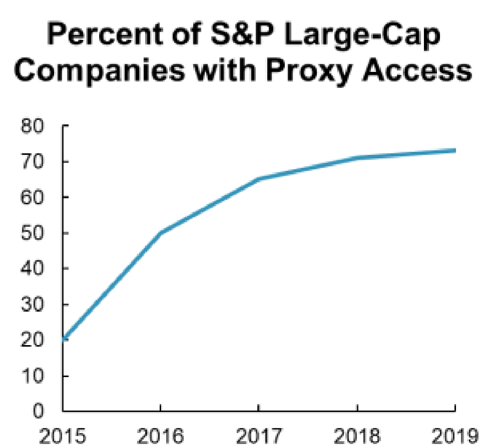
Notwithstanding the continuing decline of governance proposals voted on since 2016 at small- and mid-cap companies, these companies may be experiencing heightened pressure as a consequence of developments in governance proposals and practices. Therefore, over time, the most popular governance practices have become somewhat more common (*e.g.*, destaggered boards) or much more common (*e.g.*, majority voting) at smaller companies, as demonstrated in the following charts:





In recent years, special meeting rights and proxy access also have become more widely adopted, especially among the S&P 500, although they are still comparatively less common. As the following chart illustrates, the number of S&P 500 companies that have adopted special meeting rights has plateaued at around 65%, without much change over the past four years. There is also a significant level of adoption of special meeting rights among large-cap and small-cap companies (around 50% among each of the S&P 400 and S&P 600). This is partially attributable to the fact that many of the smaller companies are incorporated in states that have adopted the Model Business Corporation Act, which mandates the shareholder right to call special meetings (about 30% of S&P 400 companies and 25% of S&P 600 companies are incorporated in states that mandate the right, as compared to about 15% of S&P 500 companies).

Approximately 600 U.S. companies have adopted proxy access provisions at this point, including roughly 73% of the S&P 500. Proxy access was a rarity among public U.S. companies before 2015 but became a favorite topic among shareholder proponents between 2015 and 2017 (the New York City Comptroller was the primary sponsor of these proposals from 2015 to 2017, primarily at large-cap companies). As further discussed in Section E.5 and illustrated in the following chart, in recent years, many large-cap companies have elected to adopt proactively a market standard proxy access provision rather than face a shareholder vote.



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F. Compensation-Related Shareholder Proposals

F. COMPENSATION-RELATED SHAREHOLDER PROPOSALS

	COMPENSATION-RELATED PROPOSALS							
	Shareholder Proposals Submitted		Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2019 YTD	2018	2019 YTD	2018	2019 YTD	2018	2019 YTD	2018
Social compensation issues	***18***	24	***9***	14	***24%***	19%	***0***	0
Limit golden parachutes	***1***	7	***0***	7	**–**	29%	***0***	0
Clawbacks	***8***	11	***5***	7	***45%***	40%	***2***	0
Stock retention	***2***	2	***1***	1	***25%***	28%	***0***	0
Compensation – other	***23***	22	***15***	13	***18%***	13%	***0***	0

From 2012 to 2017, there was a steep decline in the number of compensation-related proposals, in large part a result of mandatory say-on-pay votes becoming the primary mechanism by which shareholders express concerns over executive compensation. In 2018, the number of compensation-related proposals leveled out, and this trend has continued in 2019. Compensation-related proposals still tended to receive relatively low support, although two passed this year.

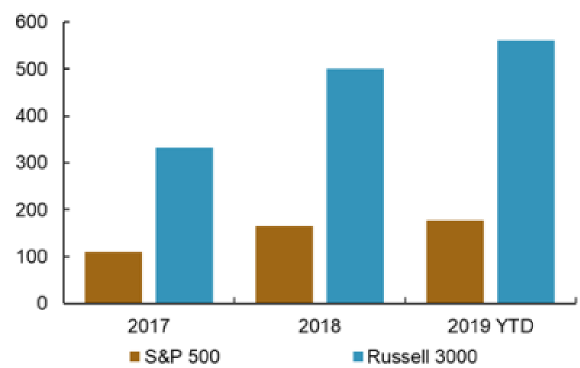
The most common type of compensation-related proposal in 2019 sought to link executive compensation to social issues, such as sustainability or social or environmental impact. Though there have been fewer ESP compensation-related proposals so far in 2019, the number was still higher than 2017 (12 submitted). Shareholder proposals linking compensation to ESP issues may increase going forward; for example, Trillium Asset Management has hinted that it is contemplating submitting proposals linking diversity performance metrics to senior executive compensation, as discussed in Section D.3.b. Similar to 2018, half of these proposals reached a vote in 2019 (nine total, including five proposals relating to the integration of drug pricing risks into compensation plans at pharmaceutical companies). Five of the compensation proposals relating to social issues that did not go to a vote were withdrawn (covering drug pricing risks, greenhouse gas reduction and human rights risks), while the other three (two covering sustainability as a performance measure) were excluded.

ISS supported 70% of the compensation-related proposals voted on so far in 2019, and shareholder support averaged 31% for proposals where ISS recommended in favor, as compared to 9% for proposals where ISS recommended against. ISS recommended in favor of all clawback-related proposals, continuing the trend from 2018, which likely is also responsible for the continued increase in average support for this proposal in 2019. One of the two clawback-related proposals that passed this year was at drug maker Mallinckrodt, who also had a lobbying proposal pass this year, as discussed in Section D. The other was at FleetCor Technologies.

Proposals to limit golden parachutes (*i.e.*, acceleration of performance awards upon a change in control) and to enhance executive stock retention requirements saw temporary increases in frequency and support levels in 2014 and 2015, but have since slowed to a trickle.

This year, two proposals on data privacy and cybersecurity as performance metrics for senior executive compensation went to a vote. ISS supported the proposal submitted to Walt Disney, although it received only 26.8% shareholder support. Recent regulatory changes, such as recent SEC cybersecurity guidance and new data privacy laws (*e.g.*, the General Data Protection Regulation in the E.U.), may spur shareholders to submit more proposals of this type going forward, in particular if they consider a company's disclosures on issues relating to cybersecurity and/or data privacy to be outdated, overly generalized or otherwise lacking. The SEC issued guidance on cybersecurity disclosures in February 201835 and issued an Investigative Report in October 2018 urging public companies to consider cyber threats when implementing internal accounting controls, based on its investigations of nine public companies that were victim to cyber fraud.36 In connection with these regulatory developments, it has become increasingly common for both large- and small-cap companies to address the topic of cybersecurity in their proxy statements. The number of proxy statements that included the term "cyber," which presents a partial picture of trends in proxy disclosures with respect to cybersecurity risk oversight, has risen steadily:

Proxy Statements Including Term "Cyber"



Notwithstanding the trend of proactive disclosure on cybersecurity, given the recent attention on this subject, shareholder proposals on cybersecurity issues may increase going forward. One future source of shareholder movement may relate to companies and their handling of facial recognition technology. This year, Amazon received two proposals related to facial recognition—one to prohibit the sale of facial recognition technology to government agencies unless it is found to not harm civil and human rights, the other to report on the impact of government use of its facial recognition technology. As facial recognition becomes more prevalent in fraud prevention and security, companies may expect increased disclosure regarding their use of this technology and data.

2019 Proxy Season Recap and 2020 Trends to Watch

Posted by Lyndon Park, ICR Inc., on Tuesday, September 17, 2019

Editor's note: Lyndon Park is Managing Director at ICR Inc. This post is based on his ICR memorandum.

Overview

At first glance, the patterns and trends of the 2019 proxy season don't seem to indicate shifts that are beyond marginal in terms of proxy voting impact. But in closer analysis, in conjunction with recent investor behavior and industry trends (e.g., Business Roundtable Statement on the Purpose of a Corporation signed by 181 CEOs disavowing shareholder-centrism in favor of greater commitment to stakeholders and society), the results of the 2019 proxy season evince an already-shifting pattern of voter behavior, and contain important clues as to what companies must do to prepare for the 2020 proxy season.

Throughout this post, we will note some of the specific issues to watch out for 2020 proxy season.

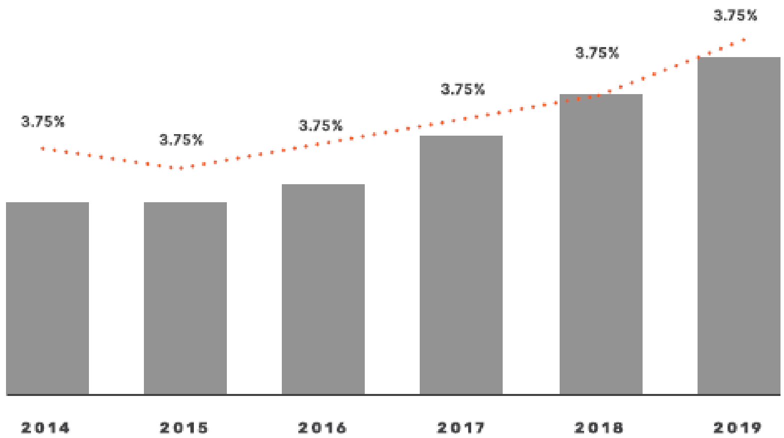
* * *

Director Elections

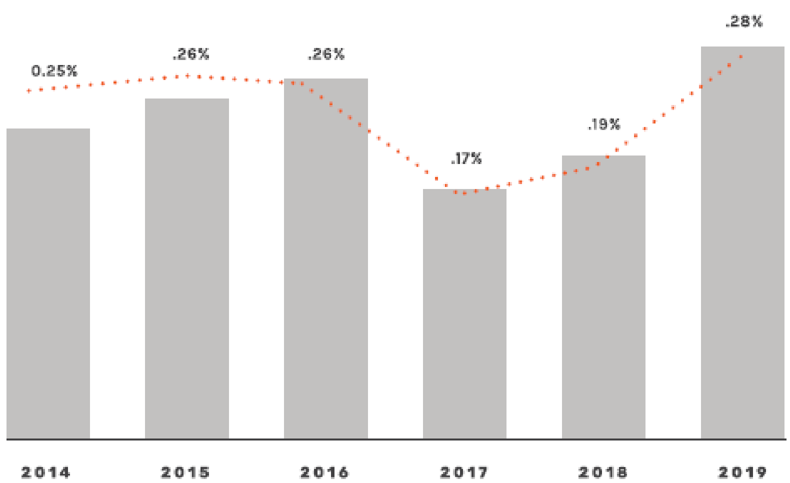
Through Russell 3000 shareholder meetings held in the first half of 2019, 45 directors failed to receive majority support from shareholders in uncontested elections (vs. 36 such directors in the entire year of 2018). According to the data provided by Council of Institutional Investors (CII), an influential governance coalition whose members include almost all the significant asset owners and asset managers, 89% of the directors who received less than majority support in 2018 still remain on the boards. CII is calling these directors zombie directors, and is now tracking the list of these directors on their website, which is viewable by all their members.

In addition to the directors who have failed to receive majority shareholder support, the percentage of directors receiving withhold votes from investors has sharply risen in 2019. Per ISS data:

DIRECTORS RECEIVING < 80% SUPPORT



DIRECTORS RECEIVING < 50% SUPPORT

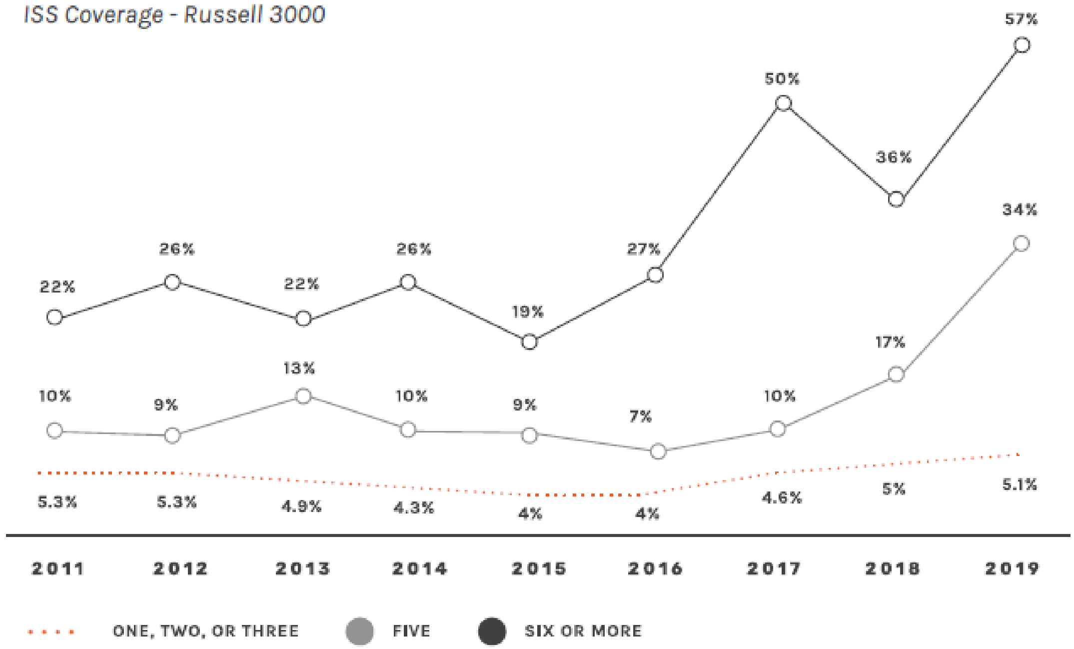


There is a strong correlation between the rising level of SOP opposition in recent years and the increased levels of director election opposition: around 16% of the Russell 3000 directors receiving negative recommendation from ISS was for compensation-related reasons, primarily due to their non-responsiveness to poor SOP in 2018.

Further contributing to poor director election results is the more stringent director over-boarding policies by large asset managers which went into effect in 2019. BlackRock, for example, allows maximum of 2 boards that a sitting CEO can serve on, and 4 boards for non-CEO directors (Vanguard: 2 maximum for CEOs, 5 for non-CEO directors).

A MAXIMUM OF FOUR BOARDS EMERGES AS THE NEW STANDARD

Percentage of non-CEO directors who received support by less than 80% of votes cast by total numbers of boards served and by year
ISS Coverage - Russell 3000

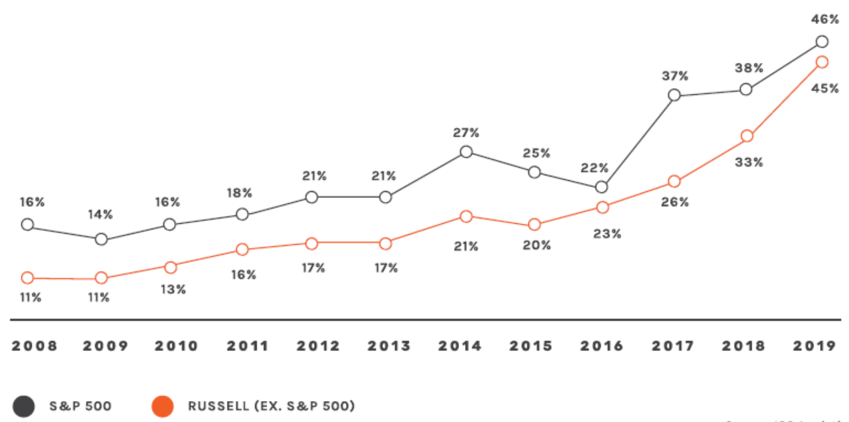


Source: ISS Analytics

Also impacting director election results are gender diversity policies adopted by some investors. In 2019, 45% of new Russell 3000 board seats were filled by women (compared to only 12% in 2008), and now 19% of all Russell 3000 seats are held by women directors:

UNPRECEDENTED PROPORTION OF THE NEW DIRECTORS ARE WOMEN

Percentage of new directorship filled by women



Source: ISS Analytics

Especially given this rising trend of refreshing boards with women directors, institutional investors have been more willing to adopt a more strident policy concerning gender diversity, voting against Nominating and Governance Committee members of boards who do not have sufficient minimum number of women directors. BlackRock, for example, has sent out letters this year warning companies whose boards have less than 2 women directors. From 2020 proxy season, it is expected that BlackRock will take more of a bright line approach and start voting against board members whose boards have less than 2 women.

A critical issue to watch for director elections in 2020 will be on the ISS policy against directors who set and approve excessive director compensation. If you recall, ISS revised its policies in 2018 to start flagging companies with high director pay levels relative to those at peer company boards, and stated that if there is excessive director pay for 2 or more consecutive years without mitigating factors stated in disclosure, it will start recommending withhold votes for the relevant directors responsible for determining director pay. ISS began noting issues with director pay levels at companies in 2019, which means they will issue negative recommendations starting 2020.

Shareholder Proposals & ESG

Continuing the trend in 2018, shareholder proposals related to corporate governance comprised most of the proposals that actually reached a vote (64.4% in 2019) and represented the majority of proposals that passed at companies.

MOST COMMON PROPOSALS INCLUDED:

66 Independent Board Chair	62 Political Contribution Disclosure	45 Board Diversity

Among these governance proposals, Adoption of a Majority Voting Standard continued to receive a high level of support, as the proponents of shareholder proposals and investors both realize that the increase in the number of proposals that passed (21% in 2019 vs. 13% in 2019) is correlated with the increase in the number of Elimination of Supermajority Thresholds proposals that passed. In continuation of this trend, 16 of supermajority elimination proposals passed in 2019 vs. 9 in 2018.

In contrast to the governance proposals, though more environmental & social (E&S) proposals were submitted than governance proposals year-over-year (454 vs. 367), these proposals did not reach a vote but instead were withdrawn at record levels. This does not indicate that E&S factors are de-prioritized by the shareholders, but instead signal an important fact that as investors continue to prioritize ESG issues, both companies and investors are proactively engaging on the key ESG issues in the offseason, consequently leading to a high number of withdrawn proposals.

As ICR Governance Solutions had forecast prior to the 2019 proxy season, the investor focus on the “S” factor has been ascendant in 2019 in the E&S spectrum, eclipsing the environmental issues that had been the focal point in 2017. In 2019, around 56% of human capital management proposals actually went to a vote (vs. 22% in 2018). If you consider this year’s letter from Larry Fink, CEO of BlackRock, exhorting public companies to link social purpose and profit to serve all their stakeholders, as well as other large investors’ policy and engagement focus on similar aims, this trend should not be surprising.

On August 19, 2019, Larry Fink’s vision received a huge validation and endorsement with the Business Roundtable Statement on the Purpose of a Corporation signed by 181 CEOs, disavowing the Milton Friedman-esque shareholder-centrism and value maximization in favor of greater commitment by the companies to their stakeholders and society. This said, companies need to mindfully engage with their shareholders to let them know that their stakeholder-inclusive governance approach (to the extent adopted) is not exclusive but complementary to being accountable to their shareholders.

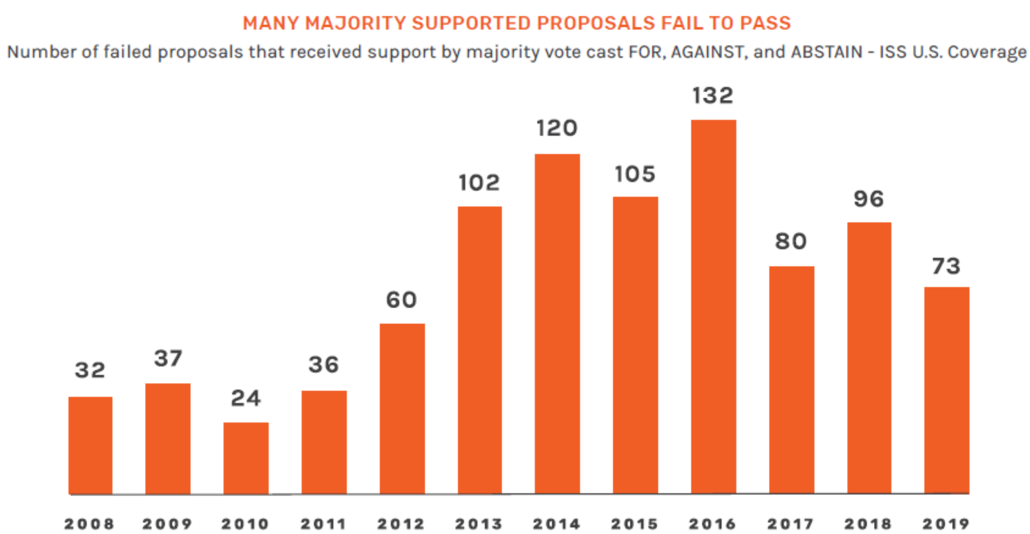
We believe this momentum will carry forward into 2020 and beyond, and encourage all companies to level-set their expectations on this and other ESG issues this offseason with their important shareholders who have become more vocal in this arena through their engagement and voting. Many of these important investors are now incorporating ESG screens not just for stewardship and engagement/voting activities, but for their investment decision-making.

As many of these investors have developed proprietary methodologies to rate their portfolio companies' ESG scores (e.g., State Street's R-Factor platform), it would be wise for companies to be as thoroughly prepared as possible on these investors' "house approach", as well as on commonly adopted ESG frameworks such as those established by SASB, TCFD, et al., prior to engaging with their shareholders on sustainability issues.

Intensifying Scrutiny on Recent IPO Companies

In 2019, the most prevalent reason for negative ISS recommendation against Russell 3000 directors related to adverse corporate governance provisions and shareholder rights. These provisions include classified boards, non-independent board leadership, plurality vote standards, and supermajority voting requirements to amend bylaws.

Both proxy advisors and investors have especially focused on the supermajority voting provisions in recent years, as even when companies on their own volition submit a management proposal to improve certain of these IPO-related governance structures, they fail to pass due to the supermajority requirement.

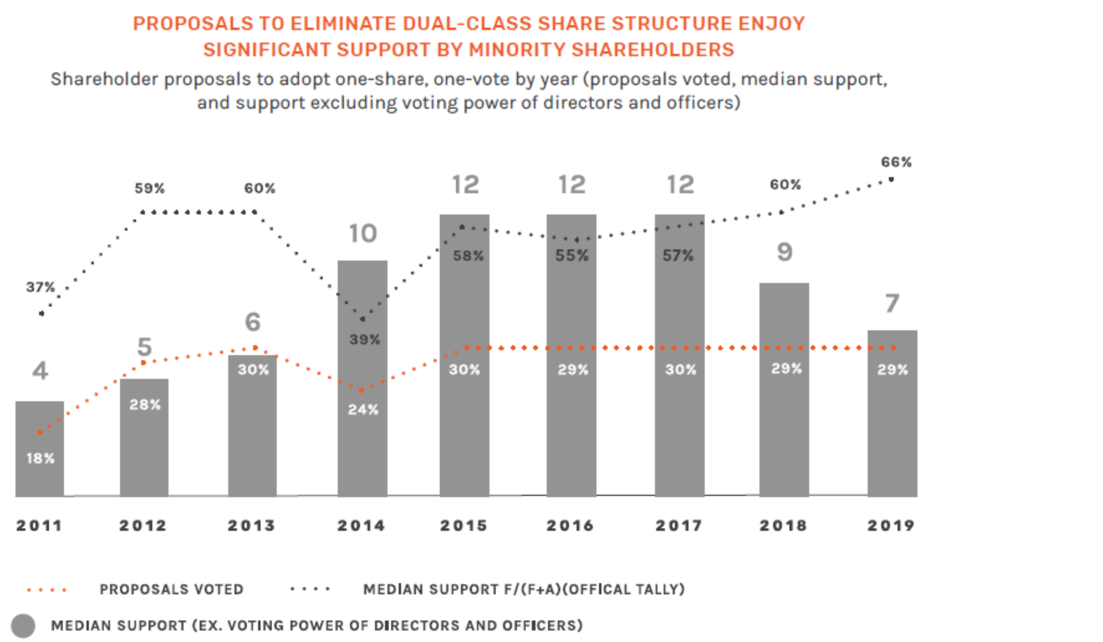


Source: ISS Analytics

ISS by policy will recommend voting against relevant directors, board committees or entire boards, if prior to or in connection with the IPO a company adopted bylaw or charter provisions that impair shareholder rights or implement multi-class structures (currently, around 7% of Russell 3000 companies maintain a dual-class structure).

Although ISS is rather dogmatic in their voting policies against these such IPO-related governance provisions, institutional investors have so far shown a more pragmatic approach to these issues by preferring to engage rather than apply punitive votes against directors proactively. This said, the current investor sentiment on these starter kit IPO governance provisions is rapidly turning more negative, as more IPO companies continue to adopt such shareholder-unfriendly governance structures.

In addition, shareholder proposals to adopt one-share, one-vote continue to enjoy a healthy support from the investors, as most investors view one-share, one-vote mechanism as one of the foundational pillars of shareholder rights, to be able to hold boards and management teams accountable through the proxy vote, as well as have a voice in important corporate events and transactions:



Source: ISS Analytics

In August 2019, CII launched a new tool aimed at holding board members accountable for enabling dual-class stock at IPOs. CII is tracking, and disclosing, the names of these “dual-class enabling” directors as well as all the boards they sit on.

Given that large institutional investors like BlackRock, Vanguard, State Street and Dimensional are members of CII, companies will need to reach out to their investors this offseason to gauge whether this list could indeed be used by them to single out these directors.

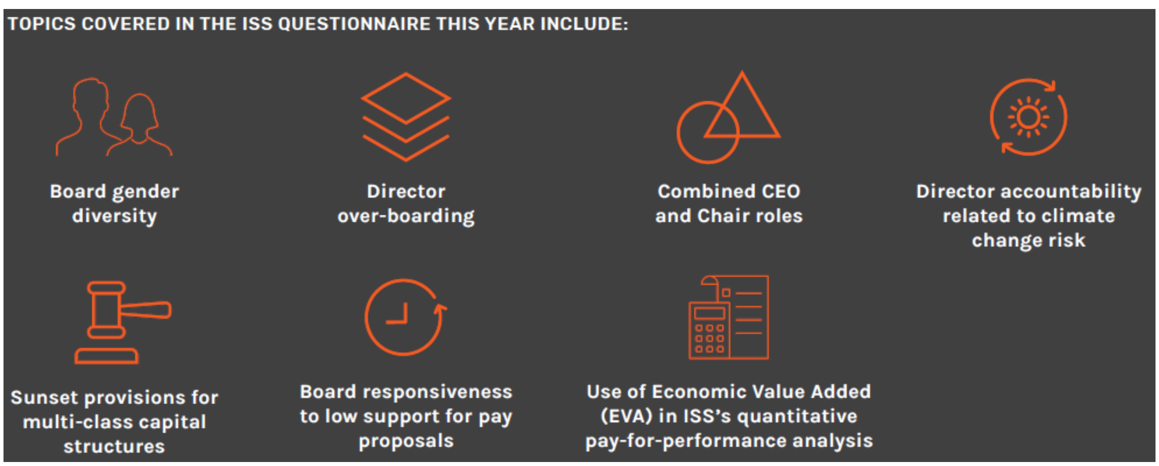
But more importantly, all recent IPO companies must engage with their shareholders this offseason, when there is no proxy vote on these matters, to communicate their views on maintaining such governance provisions, and also learn from the investors their expectations on these IPO-contiguous governance regime to proactively address potential proxy issues in 2020 and beyond.

> "Some investors may choose to vote against directors at single-class companies who participated in pre-IPO board decisions to adopt dual-class equity structures without sunsets elsewhere."
>
> —Ken Bertsch, Director of CII

2020 Proxy Season: Sneak Preview

There is no better way for companies to prepare for the 2020 proxy season other than by crafting a compelling engagement strategy and reaching out to their shareholders to solicit feedback and communicate their positions on corporate governance, sustainability, and board-related concerns; in so doing, they must tie these factors to their corporate strategy and how their boards and management are protecting and enhancing the long-term interests of their shareholders.

There are several industry trends to keep in mind as you consider your company's offseason engagement program.



ISS released its Annual Policy Survey, which is used by ISS to make decisions on potential policy changes for the next proxy season and beyond. Their clients—institutional investors as well as other market participants—respond to the survey.

On the regulatory front, the SEC on August 20, 2019 voted 3-2 in favor of proposing new rules on proxy advisory firms to address complaints that the issuers have had, such as correcting mistakes in the proxy advisory reports, as well as conflicts of interest in these proxy advisory firms' business models.

But perhaps more significantly, in addition to requiring ISS and Glass Lewis to take more steps to disclose how they make their proxy voting recommendations, the SEC voted to issue guidance to asset managers that will likely prescribe steps they should consider if they become aware of errors or weakness in ISS or Glass Lewis reports.

In addition to the cost burden that will likely be borne by ISS and Glass Lewis on hiring more personnel to interact with issuers and address product quality (the cost which likely will be passed down to their investor clients), there could likely be an increased pressure on investors to engage in a more thorough due diligence upon finding errors in proxy advisors' reports, especially when companies reach out, thereby putting an even greater emphasis on the importance of engagements.

2020 Proxy and Annual Report Season: Time to Get Ready—Already

Posted by Laura D. Richman and Michael L. Hermsen, Mayer Brown LLP, on Tuesday, October 1, 2019

Editor's note: Laura D. Richman is counsel and Michael L. Hermsen is partner at Mayer Brown LLP. This post is based on a Mayer Brown memorandum by Ms. Richman, Mr. Hermsen, Jennifer J. Carlson, Robert F. Gray, Jr., and David A. Schuette.

As summer closes and autumn begins, it is time for public companies to begin planning for the 2020 proxy and annual report season. Advance preparations are key to producing proxy statements and annual reports that not only comply with disclosure requirements but also serve as tools for shareholder engagement. This post highlights the following issues of importance to the upcoming 2020 proxy and annual report season:

Proxy Statement Matters

- Hedging Disclosure
- Pay Ratio Disclosure
- Board Diversity
- Trending Shareholder Proposals
- Shareholder Proposal Guidance
- Environmental and Social Disclosure
- Say-on-Pay
- Overboarded Directors
- Proxy Voting Advice Guidance and Investment Adviser Guidance
- Compensation Litigation and Compensation Disclosure
- Director and Officer Questionnaires

Annual Report Matters

- Amendments to Form 10-K Disclosure Requirements
- Critical Audit Matters
- Trending Annual Report Topics
- Risk Factors
- Inline XBRL
- Proxy Statement Matters

Hedging Disclosure

On December 18, 2018, the US Securities and Exchange Commission (SEC) adopted a rule requiring companies to disclose their hedging policies and practices for employees, officers and directors. This rulemaking was mandated by Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The text of the hedging disclosure requirement is contained in paragraph (i) of Item 407 of Regulation S-K.

The 2020 proxy season will be the first proxy season in which most public companies will need to include the new hedging disclosure in their proxy statements. Smaller reporting companies and emerging growth companies will not need to comply until they file proxy or information statements for the election of directors during fiscal years beginning on or after July 1, 2020.

The hedging disclosure rule requires companies to disclose whether employees (including officers) or directors or their designees are permitted to purchase financial instruments or otherwise engage in transactions that hedge or offset, or that are designed to hedge or offset, any decrease in the market value of a company's equity securities granted to the employee or director as compensation or held directly or indirectly by the employee or director. If companies apply different policies for certain types of transactions, their disclosure would need to make clear what categories of transactions they permit and what categories they prohibit.

The hedging disclosure rule only requires disclosure of practices and policies. It does not require disclosure of any hedging transactions that have occurred, although other existing disclosure requirements may reveal that company equity securities have been hedged. The hedging disclosure requirement extends beyond the pre-existing requirement that the compensation discussion and analysis (CD&A) address hedging policies affecting the executive officers whose compensation is required to be disclosed in an annual meeting proxy statement to the extent material to a discussion of their compensation. The new requirement mandates disclosure of hedging policies with respect to all employees, officers and directors, whether or not material to their compensation. In addition, the hedging disclosure rule applies to all companies that are required to comply with the SEC's proxy rules. Therefore, this new rule impacts companies that are not required to provide CD&A disclosure, such as smaller reporting companies and emerging growth companies.

While the new rule does not require any company to have a hedging policy, a company without a hedging policy should reflect on how its shareholders will react when the company discloses that it does not have a hedging policy and consider whether it would be appropriate to adopt one in light of the upcoming requirement. This may also be an appropriate time for companies that have hedging policies to evaluate whether their existing policies should be amended. For more information about the hedging disclosure rule, see our Legal Update "SEC Adopts Dodd-Frank Hedging Disclosure Rule," dated December 27, 2018.

Pay Ratio Disclosure

The 2020 proxy season will be the third year for mandatory pay ratio disclosure. The pay ratio rule, which requires disclosure of the ratio of the annual total compensation of a company's median employee to that of its chief executive officer, permits a company to identify its median employee only once every three years as long as the company reasonably believes there has not been a change in its employee population or compensation arrangements that would significantly change the pay ratio disclosure. Whether or not a company identified a new median employee for the 2019 proxy season, it should consider if it is appropriate to do so for the upcoming proxy season. The analysis of whether a new determination of the median employee is required is a company-specific matter. For example, in some situations, a significant acquisition or divestiture may affect workforce composition or compensation arrangements.

In any event, each company needs to review its employee composition and compensation practices in order to assess whether it is necessary to identify a new median employee for pay ratio disclosure purposes. Companies should perform this process sufficiently in advance of the date on which they will be filing their proxy statements in order to allow time for the median employee's compensation and the pay ratio for 2019 compensation to be calculated and confirmed. If a company concludes that it is not necessary to identify a new median employee for its 2020 proxy statement, it will need to disclose that it is using the same median employee in its pay ratio calculation and describe briefly the reason for its belief that there have not been any changes requiring a newly determined median employee.

If the rules do not require a new determination of the median employee, but the median employee identified for the 2019 proxy statement pay ratio disclosure has left the company or has had any compensation changes, the company may substitute another employee with substantially similar compensation as the median employee previously identified. In addition, the rules do not preclude a company from identifying a new median employee every year even if it would otherwise be able to rely on a previous year's determination of the median employee. In any event, a company must disclose the date it selected to identify the median employee.

For more information about the pay ratio disclosure rule, see our Legal Update "Understanding the SEC's Pay Ratio Disclosure Rule and Its Implications," dated August 20, 2015, our Legal Update "SEC Provides Pay Ratio Disclosure Guidance," dated October 25, 2016, our Legal Update "Get Ready for Pay Ratio," dated September 6, 2017, and our Legal Update "Pay Ratio Rule: SEC Provides Additional Interpretive Guidance," dated September 28, 2017.

Board Diversity

Board diversity, especially with respect to women and minorities serving as directors, has grown to be a corporate governance issue attracting a great deal of attention. Many large institutional investors have adopted and publicized proxy voting policies under which they will vote against or withhold their votes from directors due to a lack of gender diversity. For example, BlackRock has publicly stated that it expects to see at least two women directors on every board, indicating that it may vote against nominating/governance committee members if it believes that a company has not accounted for diversity in its board composition. State Street Global Advisors announced that it has enhanced its US board gender diversity voting guideline so that starting in 2020 it "will vote against the entire slate of board members on the nominating committee if a company does not have at least one woman on its board, and has not engaged in successful dialogue on State Street Global Advisors' board gender diversity program for three consecutive years."

Proxy advisory firms also consider board diversity when they make voting recommendations to their clients. According to ISS's policy for meetings of companies in the Russell 3000 or S&P 1500 indices being held on or after February 1, 2019, ISS will generally recommend an against or withhold vote for the chair of the nominating committee and possibly other directors at companies when there are no women on the board. ISS will consider mitigating factors such as a commitment contained in the proxy statement to appoint at least one female to the board in the near term or the presence of a female on the board at the preceding annual meeting. Glass Lewis's policy, which became effective in 2019, provides that it will generally recommend voting against the chair of the nominating committee of a board that has no female members and, depending on the circumstances, may extend that negative recommendation to all members of the nominating committee.

In addition to proxy voting policies and recommendations, there have been other ways in which some investors have advocated for board diversity. New York City Comptroller Scott M. Stringer and the New York City Pension Funds have recommended that the skills, race and gender of board members be presented in a standardized board matrix in proxy statements. Other investors have also sought additional disclosure on board diversity, engaging companies on this topic. Disclosure of board diversity characteristics in proxy statements has been increasing, although not necessarily in a standardized matrix. According to EY Center for Board Matters (EY), 45 percent of the Fortune 100 explicitly disclosed the racial and ethnic diversity of the board of directors and 36 percent disclosed the level of overall diversity on the board, up from 23 percent and 13 percent, respectively, since 2016. EY also reports that "[t]hree-quarters of the Fortune 100 now use a skills matrix to highlight the diversity of relevant director qualifications in an easily readable format, up from 30% in 2016."

With the increased focus on board diversity, more information is being gathered regarding directors' diversity characteristics. On February 6, 2019, the staff (Staff) of the SEC's Division of Corporation Finance issued two identical Regulation S-K compliance and disclosure interpretations (C&DIs), C&DI 116.11 and C&DI 133.13, addressing disclosure of a director's self-identified diversity characteristics. According to these C&DIs, if a board or nominating committee has considered the self-identified diversity characteristics such as race, gender, ethnicity, religion, nationality, disability, sexual orientation, or cultural background of an individual in determining whether to recommend a person for board membership, and the individual has consented to the company's disclosure of those characteristics, the Staff expects the company's proxy statement will include, but not necessarily be limited to, identification of those characteristics and how they were considered. Similarly, in such a circumstance, the Staff expects the proxy statement's description of company diversity policies to discuss 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. For more information about these C&DIs, see our Legal Update "Disclosure of Board Self-Identified Diversity Characteristics," dated February 11, 2019.

Some companies are taking additional steps to enhance their director searches to assure that they consider women and minorities as potential nominees. For example, the New York City Pension Funds indicated in its 2018 Shareowner Initiatives Postseason Report, issued in April 2019, that "[a]t least 24 companies publicly committed to include women and people of color in the candidate pool for every board search going forward, also known as the "Rooney Rule" of board governance."

Some states have taken action with respect to board diversity. California law requires publicly-traded companies based in California to have at least one female (defined as an individual who self-identifies her gender as a woman) director by the end of 2019, with boards of five directors required to have at least two female directors and boards of six or more directors required to have at least three female directors by the end of 2021. The law authorizes the California Secretary of State to impose fines and penalties for violations. Illinois has enacted legislation requiring publicly-held corporations with principal executive offices located in Illinois to report information about diversity in the annual reports they file with the Illinois Secretary of State as soon as practical, but no later than January 1, 2021. The Illinois statute does not set specific board diversity requirements but instead requires disclosure of the self-identified gender and minority person status (as defined in the statute) of directors, as well as information about policies and practices for considering and promoting demographic diversity, including with respect to executive officers. A number of other states are in various stages of consideration of board diversity legislation.

The push for gender diversity on boards of directors has been having an effect. This summer The Wall Street Journal reported that there are no longer any S&P 500 companies with all-male boards. The rate of change has been slower in the broader Russell 3000 Index, although the overall percentage of women on Russell 3000 boards has been increasing while the number of all-male Russell 3000 boards has been decreasing. With respect to ethnic diversity, ISS reported that there has been a record number of members of ethnic minorities becoming directors, although that rate of change is considerably slower than the rate by which gender diversity has increased.

Trending Shareholder Proposals

Topics of shareholder proposals received during the 2019 proxy season may foreshadow subject matters for shareholder proposals during the 2020 proxy season. For example, during the last proxy season, multiple companies received shareholder proposals regarding independent board chairs, political spending and lobbying, supermajority voting or shareholder written consent. In addition, there were proposals on topics garnering attention in society in general, such as proposals relating to diversity, human rights, the opioid crisis and climate change. Any of these topics may resurface in shareholder proposals submitted for the 2020 proxy season. Individual companies may also find that issues raised by investors during shareholder engagement sessions may give rise to specific shareholder proposals.

While most shareholder proposals do not receive majority support, there were some shareholder proposals during the 2019 proxy season that received majority support in areas including diversity (board, executive and workplace diversity), opioid risk, human rights, political activities (spending and lobbying disclosure) and clawbacks. And even shareholder proposals falling short of majority approval may also impact companies by pressuring them to take some action in order to be perceived as being responsive to investor concerns.

Companies should also be aware that some proponents of shareholder proposals now file voluntary notices of exempt solicitations pursuant to Rule 14a-6(g) and Rule 14a-103 under the Exchange Act with the SEC to urge shareholders to vote for their shareholder proposals, to vote against a management proposal or to encourage shareholders to vote in situations where a proposal otherwise may be in danger of failing. These notices allow proponents to respond to the company's statement of opposition in the proxy statement and to make additional arguments supporting the proposal, without being subject to any word limitation. Notices of exempt solicitation appear on the EDGAR page of the company, identified by a "PX14A6G" filing type, which means that persons who have set up general alerts for a company's SEC filings will be notified when such a filing is made by a proponent of a shareholder proposal. Companies do not need to respond to notices of exempt solicitation, but they likely will want to at least review them and be prepared to address their views with respect to the matter.

Shareholder Proposal Guidance

During the last two proxy seasons, the Staff issued two legal bulletins providing guidance on the shareholder proposal process. Companies receiving shareholder proposals for the 2020 proxy season should review these recent Staff positions when evaluating whether to seek no-action relief to exclude such proposals.

On November 1, 2017, the Staff issued Staff Legal Bulletin No. 14I (SLB 14I) to provide guidance on shareholder proposals submitted pursuant to Rule 14a-8. SLB 14I addressed four topics:

- the scope and application of ordinary business grounds for exclusion under Rule 14a-8(i)(7);
- the scope and application of economic relevance grounds for exclusion under Rule 14a-8(i)(5) for proposals relating to less than five percent of a company's total assets, net earnings and gross sales;
- proposals submitted on behalf of a shareholder by a representative, sometimes referred to as proposal by proxy; and
- the impact of graphs and images on the 500-word limit in Rule 14a-8(d).

Following the 2018 proxy season, the Staff issued Staff Legal Bulletin No. 14J (SLB 14J) on October 23, 2018, to provide further guidance on shareholder proposals submitted pursuant to Rule 14a-8. SLB 14J addressed three topics:

- board analyses provided in no-action requests that seek to rely on economic relevance pursuant to Rule 14a-8(i)(5) or ordinary business under Rule 14a-8(i)(7) as a basis to exclude shareholder proposals;
- the scope and application of the argument that micromanagement would be necessary to implement a proposal as a basis to exclude a proposal under Rule 14a-8(i)(7); and
- the scope and application of Rule 14a-8(i)(7) for proposals that touch upon senior executive and/or director compensation matters.

Both SLB 14I and SLB 14J discussed the inclusion of board analyses as part of the no-action request process for companies seeking to exclude shareholder proposals on the basis of economic relevance or ordinary business. SLB 14J identified the following six factors as examples of the types of considerations that may be appropriate for inclusion in the board analysis discussion of a no-action request:

- the extent to which the proposal relates to the company's core business activities;
- quantitative data, including financial statement impact, related to the matter that illustrate whether or not a matter is significant to the company;
- whether the company has already addressed the issue in some manner, including the differences between the proposal's specific request and the actions the company has

already taken, and an analysis of whether the differences present a significant policy issue for the company;
- the extent of shareholder engagement on the issue and the level of shareholder interest expressed through that engagement;
- whether anyone other than the proponent has requested the type of action or information sought by the proposal; and
- whether the company's shareholders have previously voted on the matter and the board's views as to the related voting results.

SLB 14J specified that this list was not intended to be exclusive or exhaustive. In addition, it is not necessary for the board to address each one of these factors.

The Staff has not automatically granted noaction relief for exclusion of shareholder proposals where a board analysis was provided, either on economic relevance grounds under Rule 14a-8(i)(5) or on ordinary business grounds under Rule 14a-8(i)(7). And, there have been situations where the Staff has granted no-action relief where no board analysis was provided. SLB 14I and SLB 14J reflect the Staff's view that a board analysis has the potential to be useful, although not required, in the no-action process for shareholder proposals where economic relevance or ordinary business may provide a basis for a company to exclude a proposal from its proxy statement by sharing the insight a board of directors has regarding the details of the company's operations and the nature of its business.

Since the Staff enumerated in SLB 14J six factors that it deems appropriate for a board analysis to consider in support of exclusion of a shareholder proposal under Rule 14a-8(i)(5) or Rule 14a-8(i)(7) grounds, if companies plan to include a board analysis as part of their noaction requests, it makes sense for them to address as many of those factors as their particular circumstances support. However, the specific details discussed in a board analysis, as opposed to the existence of a board analysis, is what has the potential to influence whether the Staff finds an argument for exclusion on the basis of economic relevance or ordinary business persuasive.

While the Staff's guidance regarding board analyses is a significant feature of the recent staff legal bulletins, SLB 14I and SLB 14J also addressed other important topics that companies receiving shareholder proposals should take into account. For example, SLB 14J specified that proposals addressing senior executive and/or director compensation under Rule 14a-8(i)(7) could be excluded if a primary aspect of the targeted compensation is broadly available or applicable to a company's general workforce. SLB 14J expressly conditioned that exclusion on the company's demonstration "that the executives' or directors' eligibility to receive the compensation does not implicate significant compensation matters" and the Staff denied no-action requests during the 2019 proxy season if it was not satisfied that the company sufficiently made this demonstration. Therefore, it would be useful for companies seeking to exclude a senior executive and/or director compensation proposal involving aspects of compensation that also may be provided to the general workforce to explain in their no-action requests why the ability of senior executives and/or directors to receive the targeted compensation does not implicate significant compensation matters, rather than just arguing that these individuals receive compensation pursuant to the same plan, or of the same type, as the general workforce.

On September 6, 2019, the Staff announced a significant change to its process with respect to reviewing no-action requests submitted pursuant to Rule 14a-8. Starting with the upcoming proxy season, the Staff will no longer automatically provide a written response of its views to all no-action requests. The Staff intends to issue a written response "where it believes doing so would provide value, such as more broadly applicable guidance about complying with Rule 14a-8." However, the Staff may respond orally to some of the requests.

When responding to a no-action request to exclude a shareholder proposal, the Staff will continue to inform the proponent and the company of its position, but the response may be that the Staff concurs, disagrees or declines to state a view with respect to the company's asserted basis for exclusion. According to the Staff's announcement, a Staff decision to decline to state a view on a particular request should not be interpreted as indicating that the company must include the proposal in its proxy statement. However, the company will need to decide whether it is comfortable excluding the shareholder proposal from its proxy statement without any direct guidance from the Staff or whether to take other steps, such as going to court, if it would like additional comfort before excluding the proposal from its proxy statement.

For more information on SLB 14I and SLB 14J, see our Legal Update "SEC Staff Issues Legal Bulletin on Shareholder Proposals," dated November 7, 2017, and our Legal Update "SEC Staff Legal Bulletin No. 14J Provides Additional Shareholder Proposal Guidance," dated October 30, 2018. For more information on the recent Staff announcement, see our Legal Update "SEC Announces Significant Changes to Shareholder Proposal Process," dated September 10, 2019.

Environmental and Social Disclosure

There has been growing interest in environmental and social (E&S) disclosure and, as a result, an increasing number of companies have chosen to discuss sustainability initiatives and commitments in distinct sections of their proxy statements, which are separate from responses to any E&S shareholder proposals that may be voted upon at meetings. Some large investors have published proxy voting and engagement guidelines addressing E&S issues. For example, BlackRock has indicated that it may vote against directors if it feels the company may not be dealing with E&S issues. State Street Global Advisors has affirmed its commitment to sustainable investing. In addition, there are a number of organizations separately rating companies based on their initiatives in the environmental, social and governance area, including Bloomberg, ISS, CDP and MSCI. There are also a number of voluntary disclosure frameworks in this area that have been developed by organizations including the Global Reporting Initiative, Principles for Responsible Investment and the Sustainability Accounting Standards Board Foundation.

With increased E&S awareness among investors and other constituencies, as well as companies themselves, the approach of adding voluntary E&S disclosure in the proxy statement may provide an opportunity for companies to control their message and provide a basis to direct shareholder engagement in this area. To the extent that the practice of devoting a section of the proxy statement to a discussion of E&S matters gains traction, investors may see more companies providing E&S disclosure in the proxy statement or otherwise. When preparing E&S disclosure for the proxy statement, companies should be cognizant of the securities law and other legal ramifications of such disclosure. For example, from a liability perspective, it may be prudent to describe corporate E&S initiatives in aspirational terms rather than as commitments to achieve specific results. The team involved in drafting and approving E&S disclosure should develop a process to fact-check the disclosure. Board oversight and review of E&S disclosures may help to confirm alignment with company initiatives. It is important that public companies draft E&S

disclosure in a manner that is not susceptible to a characterization that it is false or misleading. Therefore, it may be useful for companies to include disclaimers in their E&S disclosures.

Say-On-Pay

By now, the say-on-pay vote is well integrated into the annual meeting process and drives a great deal of the proxy statement disclosure. The say-on-pay vote has also contributed to executive compensation as a topic of shareholder engagement. Compensation-related shareholder engagement has become a year-round process, especially since many investors are too busy during the proxy season to spend time talking to companies about their executive compensation programs.

During the 2019 proxy season, the say-on-pay proposal at most companies once again received majority approval. According to the Semler Brossy 2019 Say On Pay & Proxy Results report, through late June 2019, only 2.4 percent of the Russell 3000 had a failed say-on-pay vote. The average vote result was 90.8 percent in favor.

According to the Semler Brossy report, when ISS recommended an "Against" vote on a say-on-pay proposal during the 2019 proxy season, shareholder support for the proposal was 31 percent lower than at companies that receive a "For" recommendation. Although an "Against" recommendation does not always result in a failed say-on-pay vote, the drop in shareholder support may influence the ongoing level and tone of shareholder engagement on compensation matters and director nominees in the coming year, as well as future votes on say-on-pay and director elections.

If a company receives a negative proxy voting recommendation from a proxy advisory firm, it often (but not always) prepares additional material in support of its executive compensation program. In order to use such materials, companies must file them with the SEC as definitive additional soliciting material not later than the date first distributed or used to solicit shareholders.

Overboarded Directors

An issue that some companies faced during the last proxy season and some companies may face during the upcoming proxy season arises when directors serve on the boards of multiple public companies or when a public company's chief executive officer serves on boards of companies other than the one he or she works for. Depending on the total number of public company boards that a director serves on, and whether or not the director is a chief executive officer of a public company, some investors may consider the director to be over-committed, or "overboarded." Some investors have adopted policies to vote against or withhold votes from directors they consider to be overboarded and proxy advisory firms Glass Lewis and ISS each have overboarding policies. According to ISS Analytics, during the 2019 proxy season overboarding criteria seemed to contribute to the highest level of significant director election opposition in the United States since 2011.

The total number of public directorships that investors consider acceptable varies by investor, with some setting a cap of directorships at a total of six public boards, while others have adopted overboarding policies limiting the number of directorships to four or five. Overboarding policies may set a lower threshold for directors who also serve as executive officers. BlackRock reported that in 2019 it voted against 94 chief executive officers running for re-election to corporate boards outside their own. Companies need to be aware that a nominee for director may receive reduced shareholder support if that individual serves on more public company boards than their investors find acceptable.

Proxy Voting Advice Guidance and Investment Adviser Guidance

With the increased concentration of share ownership by institutional investors over the past several decades, the influence of proxy advisory firms has grown dramatically, all while the proxy regulatory process has become more complex. Emphasizing the importance of proxy voting, the SEC issued two separate sets of commission-level guidance on August 21, 2019. One release contains interpretation and guidance regarding the applicability of certain rules promulgated under Section 14 of the Exchange Act to proxy voting advice. The other provides guidance on the proxy voting responsibilities of investment advisers under the Investment Advisers Act of 1940. As guidance and interpretations of existing requirements (as opposed to amendments), both sets of proxy voting guidance apply to the 2020 proxy season.

For more information on the SEC's proxy voting guidance, see our Legal Update "SEC Issues Guidance on the Application of the Proxy Rules to Voting Advice," dated August 27, 2019, and our Legal Update "SEC Publishes Guidance on the Proxy Voting Responsibilities of Investment Advisers," dated September 6, 2019.

Compensation Litigation and Compensation Disclosure

Executive and director compensation decisions by companies should be made with care, especially by companies that anticipate resistance to any aspects of their compensation programs. Director compensation can potentially raise self-dealing issues, requiring the application of a heightened "entire fairness" standard rather than the business judgment rule in litigation, and there has been litigation in this area in recent years. To minimize potential litigation risk arising from director compensation, companies and boards should carefully review existing director compensation arrangements (perhaps on a separate cycle from executive compensation) and consider adding shareholder approved annual limits or annual formula-based awards to current (or new) plans. Alternatively, companies and boards may choose to develop a factual record of these arrangements with a view to withstanding "entire fairness" scrutiny, including by reviewing director compensation paid at comparable companies.

Executive compensation can also give rise to litigation. Compensation committee members should be able to demonstrate that they exercised due care in applying their business judgment to determine executive compensation by reviewing adequate information, asking questions and understanding the pros and cons of various alternatives, any or all of which can involve the assistance of company personnel or outside experts, as appropriate.

Companies should also pay close attention to how they present compensation disclosures in their proxy statements, including by emphasizing the corporate governance processes followed when making director and executive compensation decisions. Companies may also want to include additional narrative detail in their proxy statements describing the objectives and resulting design for determining director and executive compensation. When plans are submitted for shareholder approval, the proxy disclosure should be sufficiently clear to establish that the shareholder vote was obtained on a fully informed basis.

Finally, the SEC recently has focused on the adequacy of perquisite disclosure. Accordingly, it would be worthwhile for companies to confirm that they are properly characterizing and disclosing, if required, perquisites in their proxy statements. Companies should confirm that their disclosure controls and procedures are adequately identifying all perquisites being provided to their executive officers and directors.

Director and Officer Questionnaires

There are no changes to SEC rules or New York Stock Exchange or Nasdaq listing standards in the past year suggesting a need for changing annual director and officer questionnaires at this time. However, to the extent that companies determine to include self-identified diversity characteristics in their proxy statement, they may want to develop questions for their questionnaires to elicit such information. In addition, if companies need to provide diversity data on directors and officers for other purposes, such as a state law requirement, adding one or more questions to the director and officer questionnaire process may be the best vehicle for gathering that information.

For example, the new Illinois diversity law requires that public corporations having their principal executive offices in Illinois report on diversity in the annual reports they submit to the Illinois Secretary of State no later than by the end of calendar year 2020. These Illinois-based public companies will need to disclose the self-identified gender of each director and the race and ethnicity of each director that self-identifies as a minority person (using statutorily defined categories). Additionally, it appears that the California Secretary of State is monitoring compliance with California’s new gender diversity law by reviewing the Corporate Disclosure Statement filed annually by applicable companies, which requires disclosure of female directors. Companies impacted by these laws may find it useful to design a question responsive to such state disclosure requirements for inclusion in their annual director and officer questionnaires, particularly since the director and officer questionnaire being circulated for the 2020 proxy season may be the last questionnaire circulated to directors before state reports requiring diversity information become due.

Proxy Access and Leverage

Posted by Cydney Posner, Cooley LLP, on Monday, October 21, 2019

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

Thanks to thecorporatecounsel.net for catching this announcement from NYC Comptroller Scott Stringer and the NYC Retirement Systems, which reported that, since the inception of the Comptroller's "Boardroom Accountability Project," there has been a 10,000% increase in the number of companies with proxy access. Stringer began the Project in 2014 with proxy access proposals submitted to 75 companies. At the time, Stringer viewed the campaign as having been "enormously successful: two-thirds of the proposals that went to a vote received majority support and 37 of the companies have agreed to enact viable bylaws to date." (See this PubCo post and this PubCo post.) So effective was the proxy access campaign that Stringer leveraged its success and the "powerful tool" it represented to "demand change" through the Boardroom Accountability Project 2.0, focused on corporate board diversity, independence and climate expertise. Now, five years later, the number of companies with "meaningful" proxy access has climbed from just six in 2014 to over 600—including over 71% of the S&P 500—all as a consequence, Stringer contends, of the Boardroom Accountability Project. But, you say, proxy access has hardly ever been used (see this PubCo post), so what difference it make? In Stringer's view, it makes a big difference.

In fact, Stringer views the proxy access campaign as "groundbreaking," having ignited a radical transformation of the corporate landscape. How can that be? In his view, the threat implicit in proxy access bylaws serves to create substantial leverage. According to Stringer, "[c]orporations have been in the business of raising barriers, shutting blinds, and avoiding accountability for far too long. Proxy access gives us the leverage to flip that script, and break open the insular systems which have enabled excessive CEO pay, dismal levels of boardroom diversity, and inaction on climate change. Most importantly, stronger board oversight leads to better long-term performance, and helps protect the retirement security of hundreds of thousands of hardworking New Yorkers."

You might recall that, in 2010, after almost a decade of failed efforts, the SEC adopted "proxy access," changes to the federal proxy rules to allow eligible shareholders to include their nominees in companies' proxy materials. The amendments were designed to address the common complaint that procedures currently available to shareholders for director nominations, such as waging a costly proxy contest, did not afford a practical mechanism for shareholders to participate effectively in the nomination process. The prevalence of plurality voting also limited the effectiveness of "vote no" campaigns. Failing these efforts, it was argued, shareholders dissatisfied with board performance may be left with selling their shares as the only option. However, when challenged in the courts, the SEC's proxy access rules went down in flames, as the court concluded that the SEC had acted “arbitrarily and capriciously” in issuing the rule when it failed to provide an adequate cost/ benefit analysis.

Instead of reproposing new proxy-access rules, the SEC implemented changes to Rule 14a-8 to allow shareholder proposals for proxy access to go forward, in effect permitting each company and its shareholders to make the decision on proxy access—and the applicable standards for proxy access—on an individual basis (so-called “private ordering”). But private ordering for proxy access did not gather much steam; only six companies had adopted proxy access—until Stringer’s initiative that is. Then, in 2014, Stringer, acting on behalf of several New York City pension funds, submitted proxy access proposals to 75 companies, followed by a raft of proxy access proposals in subsequent years. The form of proposal was similar to the SEC’s rules that were vacated in court, requiring an eligibility threshold of 3% ownership held continuously for three years, with shareholders having the right to nominate up to 25% of the Board.

Just in the last year, the Comptroller’s office reports, over 35 targeted companies have adopted proxy access, which, the office believes, boosted corporate accountability, giving the pension funds “a stronger voice in…long-term oversight.” In fact, the Comptroller’s office attributes to proxy access substantial progress on a variety of issues, including “diversity of board members, the company’s approach to climate change, and treatment of employees. The increased board responsiveness provided by proxy access has pushed some 62 companies to nominate 77 new board directors who identify as a woman or person of color—including 59 women, 19 African Americans, five Hispanic Americans, two Asian Americans, and one Middle Eastern American. Moreover, at least 24 companies have publicly committed to include women and people of color in the candidate pool for every board search going forward, also known as the ‘Rooney Rule.’”

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Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities and Investors

Posted by Lenore Palladino (Roosevelt Institute), on Tuesday, October 22, 2019

Editor's note: Lenore Palladino is a Senior Economist and Policy Counsel at the Roosevelt Institute. This post is based on his recent testimony before the United States House of Representatives' Committee on Financial Services. 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) and Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay, by Jesse Fried (discussed on the Forum here).

Thank you, Chairwoman Maloney and Ranking Member Huizenga, for inviting me to speak today [Oct. 17, 2019]. It is an honor to be here. My name is Lenore Palladino, and I am Assistant Professor of Economics & Public Policy at the University of Massachusetts Amherst, a Fellow at the Roosevelt Institute, and Research Associate at the Political Economy Research Institute.

I join you today to discuss the causes and consequences of the rise of stock buybacks. Stock buybacks may sound like a technical matter of corporate finance: Why should it matter whether or not corporations repurchase their own stock? When a company executes a stock buyback, they raise the price of that company's shares for a period of time, but the funds spent on buybacks are then unavailable to be spent on the types of corporate activities that could make the company more productive over the long term: investments in future productivity and in the workforce. Stock buybacks are one of the drivers of our imbalanced economy, in which corporate profits and shareholder payments continue to grow while wages for typical workers stay flat.

Stock buybacks are virtually unregulated, even though Congress has recognized their potential for market manipulation. Importantly, there are currently no meaningful limits to stop executives from using corporate money on stock buybacks to raise share prices for their own short-term gain. Executives are not required to disclose that they have conducted a buyback until the next quarter's filing; meanwhile, there are no substantive limits to stop them from selling their own personal shares in the same quarter as they are conducting buybacks.

Stock buybacks have reached record volume: Corporations spent roughly $900 billion on them in 2018, and projections for 2019 predict an even higher scale. To put this into perspective, that is nearly a third of our national spending on health care. The volume of stock buybacks explains why more money has flowed out of our public capital markets than has flowed back in, for the nonfinancial sector, in almost all of the last 20 years. Their magnitude explains why even many on Wall Street are ringing warning bells, saying that executives are prioritizing stock price highs over the kinds of true investment that will lead to long-term prosperity.

Congress and the Securities Exchange Commission (SEC) recognized decades ago that this kind of practice could manipulate the stock market, and before 1982, open-market stock buybacks were functionally impermissible. Rule 10b-18, the stock buyback “safe harbor,” was a sharp departure from the proposals made by the SEC in the 1970s that clearly recognized that a large volume of stock buybacks would manipulate the market. Rule 10b-18 leaves stock buybacks virtually unregulated, allowing companies to spend billions a year with no oversight or accountability. This is out of step with the spirit of our securities laws, which is to “insure the maintenance of fair and honest markets.”

Some have argued that stock buybacks serve the stock market by moving capital from companies that have no use for it to companies with a higher need for new funds. This begs the question: Could it really be the case that so few American corporations have innovative ideas, could build up their cash reserves or pay down debt, or invest in their workforce? Or could there be another motivation for the high volume of stock buybacks? Additionally, more money has been flowing out of our public capital markets from stock buybacks than has been flowing back in through new equity issuances (for nonfinancial corporations). Rather than argue about how stock buybacks could recirculate funds around the public markets in theory, it is better to look at who stands to gain the most from their use in practice and what tools of public policy we can use to mitigate the focus inside corporate boardrooms on short-term stock returns at the expense of long-term productivity and prosperity.

This committee is well aware of the long-term stagnation of wages for typical workers, widening wealth gaps, and the continual rise of executive compensation. To give some context to who benefits from stock buybacks: According to the Federal Reserve’s Distributional Financial Accounts, in the first quarter of 2019, the richest 10 percent of households owns 86.8 percent of corporate equities; while the bottom 50 percent owns just 0.8—less than 1 percent of the total value of the stock market. Meanwhile, companies spending billions on buybacks claim that they cannot afford to pay family-supporting wages to their employees, who largely create the value that allows businesses to conduct stock buybacks in the first place.

Companies are conducting stock buybacks in the midst of layoffs, calls by their workforce for an end to poverty wages, and clear productive uses for corporate funds. According to economist William Lazonick, Boeing spent $43.1 billion on stock buybacks from 2013 to 2019, raising the company’s stock price to a record high just 10 days before the second crash of its 737 MAX. Boeing CEO Muilenburg collects most of his pay through stock or compensation based on financial metrics. Yet the company reportedly avoided spending the estimated $7 billion it would have needed to engineer a safer plane. Less than 10 years after a public sector bailout, GM has spent $10.6 billion on stock buybacks, while engaging in layoffs and plant closures. That amounts to $221,308 for each of the 47,897 active UAW members currently on strike at GM. Walmart spent $9.2 billion on stock buybacks from August 2018 to July 2019, which, by my calculations, could have been used to give a raise of roughly $5/ hour to each of its 1 million hourly workers instead.

It is the lack of meaningful regulation of stock buybacks that has permitted their rise. SEC Rule 10b-18, the stock buyback safe harbor, gives companies the go-ahead to spend up to 25 percent of their average daily trading volume on buybacks without liability for market manipulation, but it also states that there is no assumption of liability for companies spending above that limit.

Furthermore, the SEC does not collect the kind of information necessary to even determine if companies are staying within the safe harbor limit.

I recommend that Congress ban stock buybacks, or in the alternative, place bright-line limits on their use. At minimum, corporate insiders should not be able to personally benefit from the practice, and buybacks should be disclosed immediately.

Stock Buybacks Are Premised on a Flawed Model of Corporate Governance

Before I discuss the particular challenges of stock buybacks and potential legislative solutions, I would like to pull back to the model of the corporation that has justified their extensive use. The practice of stock buybacks is premised on a theory of the corporation known as "shareholder primacy." This theory holds that shareholders should be the only stakeholder engaged in firm governance, and they are due the profits that the firm does not require for contractual obligations to other stakeholders, such as employees, suppliers, or customers, or for investment purposes. However, this theory—that shareholders should have sole governing authority because they are the primary risk-takers, because they invest capital with no guarantee of return, and thus the residual claimants of its wealth—is flawed. Shareholders do, of course, have some appropriate legal claims—they own their shares, which entitles them to an income flow, the right to sell their shares, and a certain set of limited rights to vote for the board of directors and shareholder resolutions, as well as the right to bring a claim for a breach of fiduciary duty. However, shareholders are not the sole risk-takers, as other stakeholders also take risks: Employees risk the loss of their sole source of income, and the entire society risks suffering from the negative externalities created by the production process. The Business Roundtable has recently redefined the purpose of the corporation away from shareholder primacy and toward a commitment to all stakeholders, including customers, employees, suppliers, and communities, along with generating long-term value for shareholders.

Stock buybacks are justified under this theory of shareholder primacy on the grounds that shareholders should be "returned" available cash when it has not found another productive use. This flawed theory not only fails to recognize that productive uses properly include other types of corporate expenditures, including increased wages, and demands a long-term time horizon. It also gives rise to expectations by shareholders and executives that unused, and frequently borrowed, resources are "owed" to them as sole and exclusive risk-takers within a firm. Finally, it confuses shareholder purchases of new equity from a company with trading transactions that take place on the secondary market.

The remainder of my testimony will outline the specific harms caused by stock buybacks to a productive and equitable economy.

Stock Buybacks Create the Potential for Stock Price Manipulation

First, stock buybacks create the potential for stock price manipulation in violation of Section 9(a)(2) of the Exchange Act. Most simply, share repurchases may be used to manipulate stock prices because the very nature of buying back stock means that the remaining shares rise in value. Stock buybacks have become a favorite corporate practice because they are a straightforward and fast mechanism to raise share prices and boost earnings per share (EPS).

Stock buybacks are regulated by the Securities and Exchange Act under Rule 10b-18, which creates a “safe harbor” in which companies are free from risk of liability for manipulation under the Securities and Exchange Act as long as they follow the conditions as laid out in the rule. The conditions concern the volume, manner, price, and timing of repurchases, and disclosure is required on quarterly reports to the SEC.

In theory, firms that conduct buybacks within these certain conditions (although there is no assumption of liability if buybacks happen outside those conditions), would not have a manipulative effect on the market. But the main effect of repurchases in the short term is to reduce the number of shares available on the open market for trading, meaning that the value of each remaining share goes up in value. Though there is no practical improvement in the sales of a company’s goods, customer satisfaction, or efficiency gains in the production process, share prices go up through the removal of share volume. At the volume of repurchases seen today, conducted intentionally by corporate executives, it is worth considering whether this could be considered manipulation of share prices. One study has shown that the probability of share repurchases is sharply higher for firms that would have just missed EPS forecasts in the absence of repurchases.

Stock Buybacks Create Incentives for Insiders to Sell Their Own Shares for Personal Gain

The current regulatory regime for stock buybacks creates the potential for corporate executives to personally gain during stock buyback programs. These buybacks create incentives for corporate insiders to sell the shares they own, which can create a substantial conflict of interest. Corporate executives hold large amounts of stock, and their compensation is often tied to an increase in the company’s EPS metric. That means that the decision of whether and when to execute a stock buyback can greatly affect his or her compensation. Only corporate insiders know precisely when buybacks are actually conducted, which gives executives a personal incentive to time buybacks so that they can profit off of a rising share price. In other words, insiders have a personal incentive to announce buyback programs that they know will raise share price, because they can then turn around and sell their own personal holdings for profit.

Recent research by SEC Commissioner Robert Jackson Jr., demonstrated that executives are utilizing this loophole, finding that the likelihood of insiders selling shares increased five-fold in the week after the announcement of a repurchase program. This is in stark contrast to the rationale often heard in the corporate finance literature that stock buybacks happen because executives believe that their stock is undervalued. If that were the case, we would expect corporate insiders to be buying stock, rather than selling it, around the time of buyback execution.

In recently published research, I examined the relationship between corporate insider transactions and stock buyback programs and found a strong association between quarters where stock buybacks were occurring (in excess of 1 percent of market value) and high levels of insider transactions (over $100,000). I conducted an empirical analysis of the relationship between insider sales and stock buybacks and found a statistically significant relationship between an increase in the use of corporate funds for stock buybacks and an increase in corporate executives selling their own personal shares in the same quarter.

Despite these facts—that stocks constitute a substantial proportion of executives' pay, and that stock buybacks provide a way for executives to raise their pay by millions of dollars—the rules that govern how a company authorizes stock buyback programs fail to account for this significant conflict of interest. The decision to authorize a new stock buyback program is made by the board of directors. The actual execution of buybacks is left to the executives and financial professionals inside the companies, with no board oversight as to the timing or amount of such buybacks, as long as the buybacks stay within the limit previously authorized. As long as directors are using their best "business judgment" to authorize programs, and there is no other insider trading violations, there is no recourse to hold directors accountable for extremely high repurchase programs. Further, executives are required to disclose the monthly volume of actual open-market repurchases, but only after the fact. This means that longer-term investors who hold a small amount of stock, and who could be disadvantaged by the decision to execute a stock buyback program if it is at the expense of investments that could lead to the company's long-term growth, have no say whatsoever in the company's decision-making process, and no access to real-time disclosure about buybacks that could be used for selling decisions.

It is useful to observe specific examples in which corporations have high joint levels of buybacks and insider sales.

- Exxon Mobil: In Q2 of 2008, Exxon Mobil insiders collectively sold $42 million in personal shares, at the same time the company spent $8.4 billion on stock Insiders purchased zero shares themselves.
- IBM: In Q2 of 2007, IBM insiders collected $21.5 million from selling off their personal shares while the company spent $14.6 billion on stock buybacks. Again, insiders elected not to purchase any shares themselves.
- Microsoft: In Q4 of 2005, Microsoft insiders sold $49.5 million in personal shares and purchased zero shares. At the same time the company spent $7.7 billion on stock buybacks.
- Gilead Sciences: In Q1 of 2016, insiders at Gilead Sciences earned $37.4 million from selling off their personal shares. The same insiders purchased no shares themselves while the firm spent $7.4 billion on stock buybacks.

The results suggest that executives may be taking advantage of the regulatory loophole left in the regulation of stock buybacks, and that policymakers should reform the regulations governing stock buybacks and corporate insider share-selling.

Stock Buybacks Have Wide-Ranging Economic & Social Impacts

Next, we must consider the wider social and economic impacts of stock buybacks. Stock buybacks are conducted at the expense of other potential uses of corporate funds and primarily benefit short-term share-sellers who sell their stock after the price goes up, rather than longer-term shareholders who are Americans holding shares for retirement. Two studies demonstrate the harm of stock buybacks to long-term shareholders: Keasler and Byerly show that buyback announcements lead to short-term gains but long-term declines in wealth, and Ayers and Olenick show a causal relationship between buybacks and lower growth rates. Another study by Almedia, Fos, and Kronlund showed that the probability of a firm conducting buybacks is sharply higher if the firm would have just missed its EPS forecast in the absence of a buyback program.

Corporations have variable needs for funds to ensure long-term growth; stock buybacks constitute an opportunity cost for further investment, employee compensation, or the build-up of reserves. Their rise correlates with a long-term decline in corporate investment. According to Gutierrez and Philippon, “business investment in the US has been weak relative to measures of profitability, funding costs, and market values since the 2000s.” As noted by Senator Marco Rubio, business investment is decreasing—net private domestic investment has fallen from nearly a tenth of US GDP in the mid-1980s to less than half of that in 2018. Stock buybacks are rising at the same time that corporate leverage rose to an all-time high: Nonfinancial corporate credit as a percentage of GDP reached 74.9 percent in the first quarter of 2019.

It is important to keep the scale of spending on stock buybacks in mind: For some of our largest employers, such as Walmart, if corporate funds spent on buybacks were redirected to employee compensation, wage increases could lift low-income workers out of poverty. Joint research between the Roosevelt Institute and the National Employment Law Project examined stock buybacks in industries where low-wage workers are concentrated and found that McDonald’s could pay all of its 1.9 million workers almost $4,000 more a year if the company redirected funds spent on buybacks to workers’ paychecks. Lowe’s, CVS, and Home Depot could all afford to give their workers raises of at least $18,000 per year. In recent research, I find that for large nonfinancial corporations, there is a statistically significant relationship between a rise in shareholder payments and a decline in reported employee compensation. At the aggregate level, I found that while payments to shareholders have doubled as a percentage of corporate assets over the last 45 years, the wage bill fell from 21 percent of total corporate assets in 1972 to 11 percent in 2017.

Stock buybacks have an impact on wealth and income inequality. In terms of wealth inequality, stock buybacks only benefit those who hold stock. Less than half of US households own any stock at all, and less than one third of households own at least $10,000 worth of stock. Stock ownership is concentrated at the top of the wealth distribution: 93 percent of households in the top 1 percent of households by income own more than $10,000 of stock. Stock ownership reflects broader racial stratification as well: While approximately 60 percent of white households own stock either directly or indirectly, only 34 percent and 30 percent of Black and Latinx households, respectively, hold stock. All of this means that increasing stock value driven by stock buybacks disproportionately benefits wealthier, white households.

Responses to Justifications for Stock Buybacks

Defenders of repurchases argue that buybacks serve an important function by reallocating capital to where it would be most useful. Under this theory, when executives determine that they have no investment opportunities where the rate of return is above the cost of capital, they should logically return the cash to shareholders, who will invest the funds in companies that do have investment opportunities that are profitable to pursue. Yet net issuances in the nonfinancial corporate sector have been negative for every year since 1997, sometimes sharply so. This means that more equity is pulled out of the market through buybacks than is created through new issuances.

There is also little evidence that there is a financing constraint for the long-term capital necessary for the development of lower-cost, higher-quality products. Firms have large stocks of cash with which to conduct internal financing. Interest rates for corporate borrowing are historically low. Furthermore, claims that buybacks are useful for the capital-allocation reason do not grapple with the other reasons why firms conduct buybacks: to raise the share prices and thus reward large share-sellers, and potentially executives.

History of Stock Buyback Regulation

The practice of stock buybacks at the scale we see today is a relatively recent phenomenon. For most of history, the SEC itself recognized the hazards of allowing this action and considered multiple proposals to restrict them prior to adopting its current framework.

The Securities and Exchange Act of 1934 (the “Act”) governs secondary trading of equities and lays out anti-fraud and anti-manipulation provisions to govern such activity. Prior to the adoption of Rule 10b-18, stock buybacks were subject to potential liability under several anti-fraud and manipulation statutes of the Act: Sections 9(a)(2)[38] and 10(b)[39] of the Act and its promulgating Rule 10b-5. Because there was no explicit permission nor denial of permission for stock buybacks, they operated in a legally hazy area, inhibiting their use. Congress passed the Williams Act Amendment to the Securities and Exchange Act in 1968, which focused on the tender offer process. It gave the Commission authorization to adopt rules and regulations to prohibit buybacks, by defining them as fraudulent, deceptive or manipulative, based on their role protecting investors and the interest of the public. Section (2)(e)(1) stated specifically that it is unlawful for issuers to repurchase their own securities if the purchase “is in contravention to such rules and regulations as the Commission . . . may adopt (A) to define acts and practices which are fraudulent, deceptive or manipulative and (B) to prescribe means reasonably designed to prevent such acts or practices.”

Throughout the 1970s, the Commission proposed but failed to adopt a series of rules to regulate repurchases. In 1970, Rule 13e-2 was proposed to make stock buybacks “unlawful as acts and practices which are fraudulent, deceptive or manipulative” unless the transactions were conducted according to a certain set of conditions. The conditions included: one broker per transaction; no sales before the opening transaction and a half-hour before the close of daily trading; prices could not exceed the highest current independent bid price or the last sale price, whichever is higher; and the volume was limited to not exceeding 15 percent of the average daily trading volume in the four calendar weeks preceding the week in which the buybacks were conducted. These same conditions, with the volume increased by 10 percentage points, would become the conditions for the safe harbor. The critical difference in proposed Rule 13e-2 was that all other transactions were unlawful. The proposed Rule did not include specific disclosure requirements but did include a provision under which the Commission could approve repurchases on a case-by-case basis that would otherwise be unlawful.

In 1973 and 1980, amendments to proposed Rule 13e-2 were added, including a significant proposal for disclosure. In 1973, the Commission was more forthright about its purpose for the rule, describing it as “prescrib[ing] means . . . to prevent an issuer from effecting repurchases which may have a manipulative or misleading impact on the trading market in the issuer’s securities.” The Commission later described the conditions for repurchases as “designed to ensure that an issuer neither leads nor dominates the trading market in its securities.” This language points to the rationale behind the types of conditions outlined, such as disallowing issuers to set the first or last price for a trading day. The Commission included an initial disclosure regime, including several questions about whether officers or directors should be required to disclose if they are considering buying or selling securities in conjunction with a repurchase that they are in charge of executing. The language points to awareness by the Commission that officers and directors face conflicts of interest, requesting comments on "[w]hether any officers or directors intend to dispose of the issuer's securities they might presently hold." The proposal invited comments on the idea that the source of funds to be used for the repurchases should be disclosed, and how public such disclosures should be made, along with volume and manner disclosure requirements.

A revised proposed Rule 13e-2 also laid out the rationale for a need to limit stock buybacks. The Commission explained that the "regulatory predicate . . . [is a] need for a scheme of regulation that limits the ability of an issuer . . . to control the price of the issuer's securities." Such a need "stems in part from the unique incentives that an issuer . . . [has] to control the price of the issuer's securities." The Commission explained that the guidance was intended to help issuers avoid securities law liability that they could not otherwise predict, since the anti-fraud and anti-manipulative provisions of the Act are general in nature. The Commission once again explained that limits it was proposing were intended to "prevent the issuer from leading or dominating the market through its repurchase program. In fashioning those limitations, the Commission has balanced the need to curb the opportunity to engage in manipulative conduct against the need to avoid excessively burdensome restrictions." Again the Commission left room for a case-by-case exemption of transactions that otherwise would exceed the proposed Rule.

Even though the elaborate description of the need for the proposed rule was new, the substantive conditions put in place were mainly the same as in the 1970 and 1973 proposals, with one significant difference: transactions that took place outside of its conditions would not be automatically suspect. The Commission gave specific reasoning as to why each of the volume, timing, pricing, and manner conditions were critical to designing procedures that would limit the impact of repurchases on the market. The Commission also proposed specific disclosure requirements for large-volume repurchase programs but noted that disclosure was not a substitute for substantive regulation, explaining at some length that disclosure would not be enough to curb activity that could be manipulative to the market. Disclosure would, however, "give the market an opportunity to react to the fact that the issuer may account for a substantial amount of purchasing activity in its securities."

In 1982, rather than proposing another revision to proposed Rule 13e-2, the Commission instead proposed Rule 10b-18, which was adopted later in the year. An analysis published at the time claimed that this was a "regulatory about-face," and that the new safe harbor should be viewed as "constructive deregulatory action . . . [that] contrasts markedly with past Commission views on the regulation of issuer repurchases." Rule 10b-18 stood in contrast to proposed Rule 13e-2, which had the purposes of preventing manipulation by prohibiting the issuer from raising the market price, prohibiting the perception of wide-spread interest by the use of several broker-dealers, and limiting domination of the market with high repurchase volumes. The purpose of Rule 10b-18 instead was to facilitate repurchases and limit intrusive regulation into corporate decision-making.

Regulation of Stock Buybacks in Other Jurisdictions

Internationally, most countries with robust capital markets have some regulation in place for curbing stock buybacks, including both disclosure and substantive limitations. To summarize, the significant differences from the US model of regulation include: requiring shareholder rather than board approval, placing bright-line limits on buybacks rather than adopting a safe-harbor approach, requiring immediate disclosure, and requiring insiders to not trade during buyback programs. Many countries follow the US model with restrictions on timing, price, volume, and manner. Among the 10 countries with the largest capital markets, all others place clear limits on repurchase activity, and most have more specific repurchase requirements. In the United Kingdom, approval is required at a shareholder meeting, not just from the board of directors.

Open-market share repurchases must be reported immediately to the Financial Supervisory Authority, and disclosure of volume and price is required. Requirements put in place by the Tokyo Stock Exchange restrict repurchases in terms of price, quantity, and timing, and disclosure is required on execution at the close of the trading day. There are also restrictions on insiders, including limiting trading of an insider’s own holdings while a buyback program is underway, and mandating the establishment of trading rules to avoid conflicts of interest.

In European Union member states, approval at a shareholder meeting is also required, and the authorization is valid for 18 months. In France, significantly, the regulatory agency (the Commission des Operations de Bourse) must also approve the program. In Italy, shareholders must also approve the maximum number of shares to be acquired and the minimum and maximum purchase price. There is a bright-line limit that a firm cannot buy back more than 10 percent of outstanding shares in France, Germany, Italy, Switzerland, and the Netherlands. EU countries require repurchases to be made out of distributable profits, i.e., not purchased with debt. Canada’s Toronto Stock Exchange (TSE) also requires the board to seek authorization from the TSE, and repurchase activity must be filed with the TSE within 10 days after the end of each month. Repurchasing firms must also disclose whether insiders plan to sell their holdings during the firms’ buyback program. In Switzerland, buybacks are conducted according to a second trading line, and these transactions are fully disclosed on a real-time basis, visible to the public because the firm is the only buyer of this trading line. When a repurchase program is completed, a firm must immediately make a public announcement. Several countries also disallow buybacks within 10 days prior to earnings announcements.

Several other economies—Japan and Canada, for example—have substantive bans on insider transactions during buyback program, or require disclosure of insider plans to sell their personal holdings before such a sale takes place. Other countries require immediate disclosure of buybacks, including the United Kingdom and Canada. In the UK, share repurchase decisions must be reported to the Financial Supervisory Authority immediately; and once the purchase is complete, it must be reported to the UK Listing Authority no later than 7:30 am the next business day. In Canada, disclosure rules require that corporations file a notice of intention before a buyback program is undertaken; firms then have to file repurchase activity no later than 10 days after the end of each month.

Recommendations to Rein in Stock Buybacks

At today’s hearing, the Committee is considering several bills to constrain stock buybacks, and I applaud your efforts to do so.

I recommend that Congress adopt legislation that would either ban or seriously constrain the practice of open-market stock buybacks. At minimum, Congress must remove the potential for insider gain during buyback periods and require their immediate disclosure. Regardless of the direction that Congress takes, Rule 10b-18 should be repealed, as it has failed in its original intent to curb the potential harms of stock buybacks.

Congress can ban open-market share repurchases by passing affirmative legislation that prohibits purchases by an issuer of its own equity on the open market. As Congress recognized in 1968 with the Williams Act, stock buybacks have the potential to allow companies to manipulate their share price. A ban is the clearest mechanism to ensure that corporate executives and share-sellers are not faced with the incentive for short-term share gain, but instead invest available resources in the types of productivity improvements that will ensure sustainable prosperity. A ban would fulfill the spirit contained within our securities laws: to ensure fairness and investor confidence in our capital markets by removing the ability of corporations to manipulate the price of their own stock.

In the alternative, Congress should limit the volume of permissible buybacks to a bright-line percentage of outstanding shares, so as to dampen both the potential for stock price manipulation and encourage the use of corporate funds for truly productive purposes. A clear limit is the best approach for ensuring compliance, accompanied by immediate disclosure of stock buybacks, restrictions on corporate insider transactions, and enforcement. The limit must be well below the 25 percent that is currently in the safe harbor. According to economist William Lazonick, with a 25 percent average daily trading volume limit, Apple could spend $1.4 billion per day, while Exxon Mobil could spend $200 million daily. As noted above, there is a bright-line limit that a firm cannot buy back more than 10 percent of outstanding shares in France, Germany, Italy, Switzerland, and the Netherlands.

Another alternative is for Congress to condition or prohibit the ability of a company to conduct repurchases based on other corporate variables. For example, Congress could amend the Internal Revenue Code to levy a tax of equal amount on a public company if the company does not pay a “workers’ dividend” that is commensurate with company spending on stock buybacks. Congress could prohibit buybacks if companies have unfunded pension liabilities, have engaged in layoffs, have failed to meet a certain level of productive investment, have wage dispersion below a certain threshold, or have executive compensation above a certain limit. In the alternative, Congress could condition the ability of a company to engage in buybacks only if they meet certain affirmative thresholds, based on conditions like a median worker-to-CEO compensation ratio or job creation metrics. There is the potential for different interpretations of the substantive metrics involved, and the potential for firms to take actions to try to avoid compliance requirements.

Another alternative is that Congress could use its tax-and-spend power to directly impose a specific tax on stock buyback transactions by amending the Internal Revenue Code, regardless of other corporate behavior. Taxation would disincentivize firms to conduct stock buybacks.

Though it is extremely difficult to estimate the elasticities of trading volume with respect to financial transaction taxes generally, it is likely that a tax on repurchases would serve to significantly reduce their use, if the tax was set higher than capital gains taxes.

Finally, specific policy reforms must focus on addressing the particular potential for corporate insiders to personally gain during buyback announcement and execution periods. First, corporate insiders—both executives and directors—should be prohibited from selling their personal shares in the aftermath of a buyback announcement and execution. Second, at minimum, buyback execution programs should be immediately disclosed, rather than allowing corporations to wait until their next quarterly filing to announce buyback activity. Activity should be disclosed at the daily level, rather than monthly.

Conclusion

In conclusion, the current use of stock buybacks poses a threat to a productive and equitable economy, and I applaud the committee for taking a hard look at this practice. The SEC's Rule 10b-18 has both substantive and democratic flaws in its implementation, and it is not an effective mechanism to appropriately curb issuer repurchasing behavior. Congress should adopt a new statute to ban repurchases as impermissible, or, in the alternative, place bright-line limits on corporate use of open-market share repurchases. At minimum, Congress should immediately remove the ability of corporate insiders to personally benefit from buybacks and require their immediate disclosure. In order to ensure that capital markets are not manipulated by tremendous repurchase activity or the interests of a small group of executives and share-sellers, new policies to rein in stock buybacks are required.

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The complete publication, including footnotes, is available here.

Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities and Investors

Posted by Jesse Fried (Harvard Law School), on Wednesday, October 23, 2019

Editor's note: Jesse Fried is the Dane Professor of Law at Harvard Law School. This post is based on his recent testimony before the United States House of Representatives' Committee on Financial Services. 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) and Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay, by Jesse Fried (discussed on the Forum here).

Chairwoman Maloney, Ranking Member Huizenga, and members of the Subcommittee: I thank you for inviting me to testify. Stock buybacks are an important and increasingly controversial feature of our capital markets. I am honored to have been asked to participate in this hearing.

I was asked for comment on the role of buybacks in the economy and their regulation, including: (1) whether the cash distributed via buybacks could instead be better used for other purposes, such as investing more in R&D; (2) the appropriate level of transparency surrounding buybacks; and (3) executives' conflicts of interest in buybacks related to their stock-based compensation.

I was also asked for comment on the following pieces of legislation: (1) H.R._____, Stock Buyback Reform and Worker Dividend Act of 2019; (2) H.R._____: Stock Buyback Disclosure Improvement Act of 2019; (3) H.R. 3355, Reward Work Act; and (4) H.R._____, To amend the Securities Exchange Act of 1934 to require issuers to disclose to the Securities and Exchange Commission the details of any repurchase plan for an equity security, and to prohibit such a repurchase unless it is approved by the Commission (hereinafter, "SEC Approval Act").

In this statement, I share my background and credentials and then, in five Parts, offer my views on buybacks and my general reactions on the provisions in these pieces of legislation, some of which currently are in discussion-draft form.

Part I describes the role of stock buybacks in the economy and offers some "investor-benign" explanations for firms' use of repurchases rather than dividends to distribute cash to investors. Part I then explains that the overall level of shareholder payouts (that is, the total amount of dividends and repurchases) does not appear to be too high; in fact, it may well be too low.

Part II describes the current regulation of buybacks, which I believe is too lax and enables their abuse by corporate executives. In particular, I will explain how current regulation can enable executives to use buybacks to enrich themselves at the expense of public investors, through (1) indirect insider trading, (2) the manipulation of the stock price and EPS metrics in compensation arrangements, and (3) “false signaling:” announcing repurchases that executives do not intend to carry out, solely to boost the stock price before executives unload shares.

Part III suggests a disclosure rule that would reduce executives’ ability to engage in the above-mentioned abuses, and therefore, better protect public investors: requiring public firms (like their insiders) to disclose trades in firm stock within two business days. I also describe additional measures that could be taken if this disclosure rule turns out be insufficient.

Part IV offers my initial reactions to key provisions in these four pieces of legislation.

Part V concludes.

Background and Credentials

I am the Dane Professor of Law at Harvard Law School, where I teach courses on corporate law, corporate governance, securities regulation, executive compensation, and venture capital and private equity. Before joining the Harvard faculty in 2009, I was a Professor of Law and Faculty Co-Director of the Berkeley Center for Law, Business and the Economy (BCLBE) at the University of California, Berkeley. I have also been a visiting professor at Columbia University Law School, Hebrew University, IDC Herzliya, and Tel Aviv University. I hold an A.B. and A.M in Economics from Harvard University, and a J.D. *magna cum laude* from Harvard Law School.

I have authored over 40 academic articles on executive compensation, insider trading, corporate payout policy, corporate governance, and venture capital. My work has been published in the Harvard Law Review, Yale Law Journal, Harvard Business Review, Journal of Economic Perspectives, Journal of Financial Economics, and Journal of Corporate Finance. One of my main areas of research is executive compensation and insider trading. My book *Pay without Performance: the Unfulfilled Promise of Executive Compensation*, co-authored with Professor Lucian Bebchuk, has been translated into Arabic, Chinese, Japanese, and Italian.

Another main area of research is share buybacks and capital flows in public companies.

I. Role of Buybacks in US Economy

A. Shareholders Payouts by Public Firms

Publicly traded U.S. firms annually generate hundreds of billions of dollars in earnings. Each year, managers must decide how much of their firms’ retained earnings should be distributed to shareholders through either repurchases or dividends, rather than remain in the firm for investment or other purposes. From shareholders’ perspective, cash should be returned when the funds would generate more value for shareholders outside the firm than inside the firm.

In recent years, U.S. public firms have distributed around $1 trillion annually to their own shareholders through dividends and repurchases. However, dividends and repurchases do not capture actual capital flows between shareholders. Firms issue large amounts of equity each year to shareholders, which moves cash from shareholders back to firms, either directly or indirectly.

Actual capital flows between shareholders and firms are measured by *net* shareholder payouts: dividends plus repurchases, less equity issuances.

In 2018, U.S. public firms distributed about $1.4 trillion in dividends and repurchases to shareholders. But they also issued $750 billion of equity, directly or indirectly, to public shareholders. Net shareholder payouts—the cash shareholders were left with at the end of the year were therefore about $650 billion.

Net shareholder payouts from public firms become available for investment in private firms, which are typically younger and faster growing and absorb hundreds of billions of dollars per year in funding. These private firms are vital to the U.S. economy and just as important as public firms. Such firms account for more than 50% of nonresidential fixed investment, employ almost 70% of U.S. workers, and generate nearly half of business profit. Indeed, much of the critical innovation in our economy—including breakthroughs in pharmaceuticals and information technology—takes place in small, private firms.

In sum, shareholder payouts can benefit shareholders by enabling them to generate more value for themselves than if the cash is left in the firm. And shareholder payouts by public firms can thus benefit the economy as a whole by making capital available to smaller, growing firms that will engage in investment and hire American workers, the vast majority of whom work for private firms.

B. Investor-Benign Reasons for Repurchases

Managers must decide not only how much cash to distribute to shareholders but also the manner in which the cash should be paid out—through dividends, share repurchases, or both. During the 1980s and 1990s, many firms began using open market repurchases to distribute cash, in addition to dividends or in place of dividends. Currently, about 40% of distributions take the form of dividends and 60% take the form of repurchases.

There are a number of reasons why it may be in shareholders' interest for managers to use a repurchase rather than a dividend. The two most important are (1) tax savings and (2) the firm's ability to use a buyback to acquire shares to incentivize employees to generate shareholder value.

Tax Efficiency. For U.S. taxable shareholders, repurchases tend to be a more tax-efficient means of receiving cash than dividends. First, repurchases tend to shift the tax burden to shareholders with lower marginal rates. When a firm issues a dividend, all taxable shareholders are taxed on their pro rata share of the dividend. In contrast, when the firm repurchases shares, only those shareholders who choose to sell their shares are taxed. To the extent higher-bracket shareholders avoid selling their shares, leaving the selling to lower-bracket (or tax-exempt) shareholders, the aggregate tax burden on shareholders is reduced.

Second, repurchases allow tax-free recovery of "basis." A shareholder receiving a dividend is taxed on the entire amount. By contrast, a selling shareholder is not taxed on the full amount of the sale proceeds but only on the capital gains (the difference between the sale proceeds and the shareholder's cost basis in the stock). The tax-free recovery of basis, together with the bracket-shifting effect described earlier, can make repurchases more tax-efficient than dividends, even when the tax rates on dividend income and capital gains are the same.

Employee Equity-Compensation Plans. A repurchase enables a firm to acquire shares for executive and employee equity-based pay programs, an important form of compensation in many firms designed to align executives' and employees' interests with those of shareholders. Market-wide, over 50% of issued shares are given to employees; of these shares, 15% go to top-5 executives and 85% go to lower-ranking employees. Issued shares total about 80% of repurchased shares. Thus, market-wide, about 40% of repurchased shares are used for compensation.

It is important to understand how value moves when a firm repurchases a share and later issues the share to an employee, who then sells the share to public investors. The net effect is the same as a transaction in which the firm pays the employee cash, reducing the assets of the firm and the value of each shareholders' interest in it. For example: the repurchase of a share for (say) $100 and the issuance of that share to an employee who sells the share for (say) $100 has the following effects: it puts $100 in the pocket of the employee and leaves shareholders owning a corporation that has $100 less in assets. In other words, it represents a movement of value from shareholders to employees of $100.

C. Assessing the Overall Volume of Shareholder Payouts

Critics of buybacks often compare the magnitude of shareholder payouts (dividends and repurchases) to net income, and conclude that public firms are depriving themselves of the resources necessary to grow. However, there are two problems in comparing shareholder payouts to net income.

First, as explained above, shareholder payouts are an incorrect measure of shareholder-firm capital flows because they exclude effects of equity issuances. Across the market, equity issuances total about 80% of repurchases and about 50% of shareholder payouts. Market-wide, for every $100 of repurchases, firms issue $80 of equity; public investors thus net $20.

Second, net income is a poor measure of income available for investment: it assumes that the expenses deducted to arrive at net income are entirely unrelated to future-oriented investment. In fact, net income is computed after deducting the substantial expenses associated with R&D, which is by definition future oriented. From 2007 to 2016, for example, total R&D expenditures for S&P 500 companies equaled about 28% of total net income. Therefore, net income at best measures the amount available for capital expenditures (CAPEX) and *additional* R&D.

A better measure of income available for investment is "R&D-adjusted net income," which adds a firm's R&D expenses (net of its effective tax rate) back to its net income. Net shareholder payouts as a percentage of R&D-adjusted net income appear quite low. From 2007 to 2016, net shareholder payouts by all public firms amounted to only 33% of R&D-adjusted net income. Even after net shareholder payouts these firms would have had $6.6 trillion available for CAPEX, R&D, and other investment by the end of 2016, even had they started the period with cash balances of zero. (The results are similar after updating to include 2017 and 2018.)

In fact, during 2007-2016 overall investment climbed, reaching record levels in absolute terms and very high levels relative to revenues (so-called "investment intensity"). While overall investment intensity by public firms is volatile on a year-to-year basis, it increased during the decade 2007-2016, and ended the period near levels not seen since the late 1990s boom. By the end of this period, R&D intensity was at a historical high. (Through 2018, overall investment and R&D have continued to increase, both in absolute terms and relative to revenues.)

Nor did a scarcity of cash constrain investment levels, preventing them from being even higher. Corporate cash stockpiles were huge and grew during the 2007-2016 decade. In 2007, public firms held $3.3 trillion in cash. By 2016, this amount had grown by nearly 50%, to $4.9 trillion. These amounts continued to grow in 2017-2018, although there was a slight decline in 2018 relative to 2017. There is good reason to believe that much of this $5 trillion in idle cash sitting in public firms could be better invested in other firms.

Even if a particular firm's net shareholder payouts were very high relative to R&D-adjusted net income, that firm would not necessarily lack the capacity to invest and innovate, as it can simply issue more stock to public investors. The amount of equity issued by any given public firm in any given year does not represent a cap; the firm could generally have issued even more stock to raise cash, acquire assets, or pay employees. Thus, if that firm has a valuable investment opportunity, but little cash, the firm can use equity financing to take advantage of the opportunity. Indeed, small, more quickly-growing public firms outside the S&P 500 issued more equity each year during the period 2007-2016 than they paid out in dividends and repurchases.

II. Current Regulation and Executives' Abuse of Buybacks

A. Current Regulation

For our purposes, the three most important components of buyback regulation are: (1) disclosure requirements (both upon announcement of a buyback plan and after repurchases have commenced; (2) Rule 10b-5's prohibition against repurchasing shares on material nonpublic information; and (3) anti-manipulation rules.

Disclosure Requirements. Before it can begin buying back shares on the open market, a firm traded on NASDAQ or another stock exchange is required to announce its board's decision to approve an open-market buyback program. But such an announcement need not provide specific details about the program. A firm is not required to indicate the number or dollar amount of shares to be repurchased. Nor must the firm indicate the expiration date of its buyback program. Even if a firm voluntarily indicates a repurchase target, it will typically state that actual repurchases will depend on market conditions. As a result, firms do not commit—and are not obligated—to buy back any stock. In fact, one study found that almost 30% of firms announcing repurchases do not buy back a single share during the fiscal year in which the repurchase announcement occurs, with about 15% not buying back any shares within four fiscal years of the announcement year.

After a firm repurchases shares, it must provide very limited disclosure. Before 2003, a firm did not have to disclose <u>any</u> information regarding repurchases. Since 2003, however, the SEC has required a repurchasing firm to report, in its quarterly Form 10-Q (or Form 10-K) filing with the SEC, the number of shares repurchased in each month of that quarter and the average price paid for each share. Because such filings can be made a month or so after the end of the quarter, investors cannot be expected to learn about share repurchases in the prior quarter until one to four months after they occur. By contrast, insiders of publicly-traded firms trading in their own firms' shares must disclose the details of each trade within two business days under Section 16(a) of the Securities Exchange Act of 1934.

Rule 10b-5. Rule 10b-5 requires persons owing a pre-existing fiduciary duty to the firm's shareholders, including corporate insiders, to disclose any material nonpublic information or abstain from trading in the firm's shares. The SEC takes the position that Rule 10b-5 also applies to a firm buying its own shares, even though a corporation is not considered to owe a fiduciary duty to its own shareholders.

However, there are two limits to 10b-5's ability to prevent the firm from trading on all types of valuable inside information. First, the courts' high materiality threshold permits the firm to trade legally on many types of important but "sub-material" information.26 Second, a prohibition against trading on "material" nonpublic information may not always deter such trading because of detection and enforcement problems. Detecting a violation of Rule 10b-5 by a firm's insiders is difficult even though they must report individual trades under Section 16(a).28 Because current trade-disclosure rules for the firm do not require a firm to report individual trades, but rather only monthly averages, it is even more difficult to detect a violation of Rule 10b-5 by a firm that repurchases its own shares while in possession of material inside information.

Anti-Manipulation Rules and the Rule 10b-18 Safe Harbor. Corporations, like individuals, are subject to the anti-manipulation provisions of Section 9(a)(2) of the Securities Exchange Act of 1934. These provisions make it illegal to conduct a series of transactions creating actual or apparent active trading in a security to induce others to buy or sell the security. Purchases of a firm's own shares could be considered manipulative if the intent of the repurchase is to drive up the stock price by making it appear that there is unusually heavy demand for the stock.

In 1982, the SEC adopted Rule 10b-18, which provides repurchasing firms a "safe harbor" from anti-manipulation liability when they repurchase their shares in accordance with the rule's "manner, timing, price, and volume" conditions. The rule went into effect in 1983 and appears to have made managers more willing to engage in open market repurchases: the volume of repurchases increased sharply shortly after the rule became effective. But not all firms comply with these conditions. This is not surprising. It is not clear how the anti-manipulation provisions can be effectively enforced when regulators cannot easily observe the individual trades made by a firm in its own shares.

B. Executives' Abuse of Buybacks

Executives can use buybacks to transfer value from public investors to themselves, reducing investor returns and, perhaps, distorting corporate decision-making in a way that reduces the size of the overall economic pie. This abuse is facilitated by the lax disclosure rules applicable to buybacks.

Indirect Insider Trading. Executives will have an incentive to conduct a buyback when they believe that the stock price is less than the stock's actual value (a "bargain repurchase"). A bargain repurchase transfers value from selling shareholders to non-selling shareholders pro rata.

Thus, to the extent insiders own shares in the firm and decline to sell their shares at a cheap price (which they can be expected to do), they will benefit from a bargain repurchase.

Insiders of U.S. firms announcing repurchases tend to own a substantial fraction of the firms' shares before the repurchase—an average of 15-20%—which is roughly the same as the average insider ownership across all firms. Thus, when insiders know that stock prices are low, they have a strong incentive to conduct a bargain repurchase to transfer value from selling shareholders to themselves and other non-selling shareholders. There is substantial evidence of bargain repurchases, and I have estimated that insiders divert about $5 billion annually through them, at the expense of public investors.

This indirect insider trading is facilitated by the current disclosure rules, which make it difficult to enforce Rule 10b-5 against the firm and which fail to provide public investors with real-time disclosure about the firm's repurchase activity. For example, if investors knew that the firm was aggressively buying shares, they might infer that the stock is underpriced and reassess their valuations of the firm, causing the price to rise and making it harder for insiders to conduct a bargain repurchase.

EPS and Stock-Price Manipulation. There is evidence consistent with executives engaging in buybacks to boost EPS when they are in danger of falling short of forecasted EPS, although it is unclear whether public investors are harmed. Executives might also conduct repurchases to exert upward price pressure on the stock while selling their shares, which would systematically transfer value from public investors to themselves. Depending on how executives' EPS-based bonuses are structured, executives might have an incentive to buy back shares simply to trigger a bonus, which again enriches them at public investors' expense. The lack of detailed, timely disclosure of repurchases emboldens insiders to engage in these strategies by making the abuse difficult to detect.

False Signaling with Misleading Repurchase Announcements. Managers wishing to sell their own shares at a higher price may have an incentive to announce a share repurchase they do not intend to conduct simply to boost the stock price. A repurchase program announcement is generally greeted favorably by the market, as it can signal the stock is undervalued or that excess cash will finally be distributed (rather than being wasted or left to languish inside the firm). By announcing a repurchase program even when they have no intention of repurchasing stock, managers about to sell their own shares essentially attempt to "mimic" managers of firms that use repurchases to buy stock at a low price (or simply to distribute cash). This mimicking appears to be successful: there is no difference in market reaction between announcements followed by repurchase activity and announcements not followed by actual buybacks. To the extent that managers use misleading repurchase announcements to sell their shares for more than their actual value, they transfer value from the parties buying their shares.

III. Two-Day Disclosure Rule

A. The Proposal

Section 16(a) of the Securities Exchange Act of 1934 currently requires corporate insiders to provide detailed information about any trade in their firm's shares within two business days. Firms trading in their own shares, by contrast, may wait months until they disclose the existence of trading activity in their own shares, and can get away with providing only aggregate data.

These lax trade-reporting rules make it easier for insiders to trade indirectly on inside information, imposing potentially large costs on public shareholders. And the easier it is for insiders to engage in bargain repurchases, the greater will be the stock price reaction to a buyback-plan announcement, which in turn makes false signaling more profitable for insiders. Finally, lax disclosure rules make it harder for regulators to detect the use of repurchases to boost the stock price before executive stock-unloading or to improperly achieve EPS hurdles in compensation arrangements.

These costs would be reduced if a firm were subject to the same trade-disclosure requirements as its insiders. In particular, a corporation should be required to disclose each trade in its own shares within two business days of the transaction. This two-day rule would improve transparency and provide public investors with a timely, accurate, and comprehensive picture of insiders' trading, both direct and indirect via the firm.

The proposed two-day rule would not unduly burden firms, just as Section 16(a) has not unduly burdened insiders. Indeed, the largest stock markets outside the United States already require even more timely disclosure by firms of trades in their own shares. For example, in the United Kingdom and Hong Kong, publicly traded firms must report all share repurchases to the stock exchange before trading begins the next business day. Japan requires same-day disclosure. If firms in Hong Kong, Japan, and the United Kingdom can disclose open-market transactions by the end of the trading day (or by the next morning), U.S. firms should be able to disclose their trades within two days without too much difficulty.

B. A Step in the Right Direction

A two-day disclosure rule would be a substantial improvement over existing disclosure requirements but might not go far enough. The two-day rule would still enable insiders to engage in some indirect insider trading, just as Section 16(a) permits insiders to engage in some direct insider trading. Most importantly, to the extent the market does not immediately adjust to the information communicated by a trade disclosure, but rather does so only over time, a firm can continue to trade profitably on inside information even after the market begins adjusting to the information provided by its trade disclosures.

Because of the limitations of a two-day rule, a one-day or same-day rule for both firms <u>and</u> insiders would be even better. Insiders would have less time to trade secretly, directly or indirectly. And stock prices would have more time to impound the information signaled by trade disclosures, reducing insider-trading profits on subsequent trades.

Indeed, I have elsewhere proposed that both insiders and firms be required to disclose their planned trades in advance. Such a pre-trading disclosure rule, I have shown, would substantially reduce the costs associated with direct and indirect insider trading. Thus, I do not claim that the two-day rule proposed here is ideal. Rather, I see the adoption of such a rule as an easy (but important) step in the right direction—-a measure that would harmonize insider-trading rules, improve transparency in the capital markets, and substantially reduce indirect insider trading and its costs. But should the detailed disclosure provided by the two-day rule indicate that abuses were continuing, more aggressive steps—such as requiring pre-trading disclosure—could be considered.

IV. Comments on Bills

I now turn to comment on the provisions of the four buyback-related bills. I will not focus on the technical details of each bill, as there is considerable overlap among them and some of these bills are in draft form. Instead, I will speak to the general desirability of the various types of regulatory approaches embodied in these bills, explaining why I think some of them do not go far enough while others go too far.

A. Improved Disclosure Around Initiation of Repurchases

The Stock Buyback Reform and Worker Dividend Act of 2019, The Stock Buyback Disclosure Improvement Act of 2019, and the SEC Approval Act all require firms to make certain disclosures before commencing a stock buyback. Depending on the bill, these disclosures can include the rationale for the repurchase, whether any executive is purchasing or is permitted to sell stock during the pendency of the repurchase, and the source of funds for the repurchase.

I am skeptical that such disclosures will, by themselves, materially affect the ability of corporate executives to use repurchases for indirect insider trading, to boost the short-term stock price, or manipulate EPS metrics in compensation arrangements. However, it is possible such disclosure could have a beneficial “naming and shaming” effect or could cause a firm’s board to better focus on certain aspects of their repurchase and compensation programs. The only certainty is that requiring firms to provide additional disclosures imposes transaction and additional legal costs on firms which, everything else equal, will reduce investor returns.

B. Prohibition on Certain Sales by Executives around Repurchase Announcements

The Stock Buyback Reform and Worker Dividend Act of 2019 prohibits executives from selling shares for 7 days after the announcement of the initiation, continuation, or increase in size of a repurchase program, with certain exceptions.

I am skeptical that this requirement will have much effect on executives, because the stock-price increase following a repurchase announcement, whether or not the announcement represents false signaling, is likely to endure beyond 7 days.

C. Improved Post-Repurchase Disclosure

The Stock Buyback Reform and Worker Dividend Act of 2019 requires each firm repurchasing its own stock to disclose, during the last business day of each week, the number of shares purchased in the previous week (if not zero) and the average price per share.

This disclosure requirement is a substantial improvement over the current requirement that firms need only disclose transactions on a monthly basis several months after-the-fact. The requirement would reduce executives’ ability to engage in indirect insider trading by alerting the market more quickly as to information-driven trading so it could respond, as well as by making it easier to detect violations of Rule 10b-5. The requirement would also make it easier to spot repurchases designed to help executives sell their shares at a higher price or trigger EPS-based bonuses.

However, the requirement would not be as effective as the two-day disclosure rule I put forward, because (1) it could take 9 more days for trading to be revealed and (2) the trade information be less granular, making it more difficult for investors and regulators to identify particular days on which problematic trading occurred.

The SEC Approval Act would require a repurchasing firm to disclose to the SEC, after the end of each calendar month, the "full details" of that month's repurchases, including the date, quantity, and price paid. The SEC Approval Act appears to contemplate the same type of granular disclosure as the two-day disclosure rule I put forward, which will make it easier to detect (1) violations of Rule 10b-5 and anti-manipulation rules and (2) attempts by executives to boost their bonus pay or the stock price. But the month lag time will make it more difficult for market participants to adjust valuations of the firm in light of recent repurchase activity, making it easier for insiders to trade indirectly on valuable information.

D. Elimination of the Rule 10b-18 Safe Harbor and Restrictions on Manner of Repurchases

The Stock Buyback Reform and Worker Dividend Act of 2019 eliminates the Rule 10b-18 safe harbor and imposes restrictions on the manner of repurchase. This may well provide a modest benefit in preventing use of repurchases to boost the short-term stock price.

Eliminating the Rule 10b-18 safe harbor, by itself, would likely have little effect unless firms came to believe that they were at greater risk for exposure to manipulation liability. To my knowledge, the SEC has not shown much interest in determining whether firms use repurchases to manipulate the stock price. And should that change, the disclosure requirements imposed by the Stock Buyback Reform and Worker Dividend Act of 2019 might not be sufficient to detect manipulative activity. The two-day disclosure rule I put forward, requiring detailed reporting of individual trades, would be more helpful.

E. SEC Approval Requirement for Repurchases

The SEC Approval Act gives the SEC the power to block a repurchase, after reviewing certain disclosures by the firm about the possible effects of the repurchase. As I indicated above, I don't believe that such disclosures by themselves are likely to make much difference in how repurchases are executed. And I am skeptical that the SEC would block any repurchases. If I am correct, this SEC approval requirement would just drive up transaction costs, at investors' expense (and at the expense of the SEC's attention to other, more pressing, issues). If I am wrong, this requirement will tilt firms to dividends or slightly reduce the volume of repurchases, with the effect on investors unclear.

F. Outright Ban on Open-Market Repurchases

The Reward Work Act would ban open-market repurchases. Such a ban would likely be extremely disruptive to firms and very harmful to shareholders, as it would throw a monkey wrench into firms' equity-compensation arrangements, which have been built on the assumption that firms can continue to repurchase shares to give to executives and lower-level employees.

There is no reason to do something so drastic before first adopting a two-day disclosure rule, which would likely reduce most of the abuses associated with repurchases. The two-day rule would also provide shareholders and regulators more information about how repurchases are executed, and enable a determination as to whether more aggressive regulation is required.

G. Beyond Repurchases

Two bills feature provisions that go beyond the regulation of repurchases. The Reward Work Act requires that at least 1/3 of an issuer's directors be employees (presumably in addition to the CEO and other high-level officers serving on the board). The Stock Buyback Reform and Worker Dividend Act of 2019 forces firms to pay employees a "worker dividend" based on the value of shares repurchased and any increase in the amount of ordinary dividends (or the issuance of special dividends).

In my view, adoption of either type of provision would create substantial dislocations in our capital markets, undermine our economy, and provide a windfall to the finance industry.

The Reward Work Act would reduce public-firm director accountability to investors. When more than a third of a company's board consists of executives or their direct or indirect reports, investors would need to win almost every other seat to wrest control from incumbent management. As a result, boards will have little incentive to properly allocate capital, including distributing it when necessary.

The Stock Buyback Reform and Worker Dividend Act of 2019 would not affect director accountability to investors, but essentially impose a tax on the return of capital, distorting the flow of investment funds in the economy. And because this tax increases with the number of employees, we can expect public firms to hire fewer workers.

In either case, excess capital would flow more slowly out of firms and be mis-invested. Smaller companies would be deprived of funds, making it harder for them to innovate and hire workers.

Of course, firms do not have to remain public. They can go private. And many firms that are currently public will go private to escape this kind of intrusive regulation, which completely over-rides the bargained-for protections offered to investors providing capital to help these businesses grow. IPOs would dry up. Ordinary Americans will find it more difficult to invest in large businesses. There would also be a large payday for law firms, investment banks, corporate insiders, and private-equity firms that would profit substantially from taking these firms private. All of this would tend to increase income inequality.

V. Conclusion

The volume of share repurchases and dividends by public companies does not appear to be compromising these firms' ability to invest, innovate, or pay higher wages. Investment levels (CAPEX and R&D) are at record highs in absolute terms, and (over a 25-year time frame) either at record or near-record highs relative to revenues. Nor is investment constrained by lack of cash, as public firms are sitting on about $5 trillion of cash (even after record shareholder payouts). Individual public firms that are strapped for cash can always issue more equity to public investors, which they routinely do. Profits distributed by large, mature public firms are made available for smaller, faster-growing private firms, which employ more than two-thirds of private-sector workers.

Share repurchases can provide certain benefits to public investors. For example, they enable firms to acquire equity to grant to employees to align their interests with those of shareholders. However, executives can also use repurchases to transfer value from public investors to themselves, including through indirect insider trading. This abuse arises due to lax disclosure requirements around repurchases. Tightening disclosure requirements by requiring repurchases to be individually disclosed within two days would go far in reducing executives' abuse of repurchases, in a manner that does not interfere with the use of repurchases for benign purposes. Such detailed disclosure requirements would also enable Congress or the SEC to determine whether further steps are needed.

In my view, the provisions of the four repurchase-related bills under consideration either go too far, or do not go far enough, relative to the 2-day disclosure rule.

Thank you again for the opportunity to discuss this important subject, and I look forward to your questions.

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The complete testimony, including footnotes, is available here.

Petition for Rulemaking to Revise Rule 10b-18

Posted by Heather Slavkin Corzo, AFL-CIO, on Thursday, July 18, 2019

Editor's note: Heather Slavkin Corzo is Director of Capital Markets Policy for the AFL-CIO. This post is based on a rulemaking petition submitted by AFL-CIO and others to the Securities and Exchange Commission. 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).

Petitioners signed below respectfully submit this petition for rulemaking pursuant to Rule 192(a) of the Commission's Rules of Practice.

In 1982, the Securities and Exchange Commission ("SEC" or "Commission") finalized Rule 10b-18, 17 C.F.R. § 240.10b-18, ("Rule 10b-18" or "the Rule"). Rule 10b-18 provided companies with a "safe harbor" to undertake stock repurchase (or "buyback") programs without being subject to liability for manipulation under the Securities and Exchange Act of 1934. Stock repurchase programs have grown in size and importance since Rule 10b-18 went into effect. In particular, the use of the practice skyrocketed after the enactment of President Trump's Tax Cuts and Jobs Act. The tax bill provided significant tax benefits to large corporations, such as a lower corporate tax rate and an incentive to repatriate offshore cash, and led to a 64 percent increase in stock repurchases while real wages for workers remained flat. Indeed, analysts estimate that in 2018 corporations used nearly 60 percent of their corporate tax cut to repurchase stock. In other words, at a time when wages for average workers have failed to keep up with inflation, corporations have used the corporate tax break to collectively pay $1 trillion to executives, boards of directors, and large share sellers. Instead firms could dedicate this capital to worker wages, training, hiring, and other investments necessary for innovation and growth.

The impact of the Tax Cuts and Jobs Act makes clear that repurchase programs under Rule 10b-18 are subject to significant abuse. The Rule's safe harbor conditions—which firms must meet to benefit from its protection from manipulation charges—have failed to prevent executives from using repurchases to boost a company's stock price or meet other performance goals at the expense of investing in its workers. And the inadequate disclosure requirement in Rule 10b-18 frustrates oversight by investors and the Commission. The SEC now has the opportunity to address these recently heightened concerns. Petitioners therefore respectfully requests the Commission initiate a rulemaking to revise Rule 10b-18 to curb manipulative practices by firms and encourage corporations to fairly compensate American workers.

Petitioners are organizations with a vested interest in promoting investor protection, sound capital formation and a strong, stable, and ethical financial system.

I. Background

Under the Securities and Exchange Act, it is unlawful "[t]o effect, alone or with 1 or more other persons, a series of transactions in any security […] creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others." 15 U.S.C. § 78i(a)(2). On the face of the Act, a stock or share repurchase, where a firm buys its own stock, could open a firm to charges of market manipulation. Such a repurchase generates trading activity, decreases outstanding shares, increases the stock price—and is often announced explicitly for this purpose.

In 1982, the SEC enacted Rule 10b-18, which provides a "safe harbor" from liability for manipulation under the Securities and Exchange Act if a firm performs its stock repurchase consistent with the conditions of the Rule. At the time of its enactment, consistent with the anti-manipulation provisions of the Securities and Exchange Act, the Commission intended what became the Rule to be "a scheme of regulation that limits the ability of an issuer *** to control the price of the issuer's securities."

The conditions of the Rule concern the volume, manner, price, and timing of a repurchase. Failure to conform to the conditions of the safe harbor "remove[s] all of the issuer's repurchases from the safe harbor for that day." *Id.*, Preliminary Note. The safe harbor also "is not available for repurchases that, although made in technical compliance with the section, are part of a plan or scheme to evade the federal securities laws." *Id.*

The adoption of Rule 10b-18 represented a sea change in corporate finance, after which stock repurchases became more common. Prior to its adoption, repurchase programs were relatively rare due to the threat of a manipulation charge; after the Rule took effect, the aggregate value of stock repurchases rose significantly. Now, many firms allocate nearly all their profits (net income) to repurchases and other forms of shareholder compensation rather than reinvesting in the productive capabilities of the firm. For the 449 publicly listed companies in the S&P 500 between 2003 and 2012, 97 percent of profit went to shareholders—with 54 percent of profit used for repurchases. This is fungible capital that could be retained by the corporation to be used elsewhere, including worker wages, training, hiring, and other investments necessary for innovation and growth.

II. Specific Concerns with Current Rule 10b-18

Despite Rule 10b-18's ostensible limits on the scope of the safe harbor, the history of stock repurchases—exacerbated by the recent effects of the Tax Cuts and Jobs Act—shows that the Rule has failed to meet the purpose behind its promulgation: limiting the ability of the firm to manipulate its stock price and volume. Specifically, firms retain the ability to artificially inflate stock prices or meet performance goals through repurchases that benefit executives without corresponding improvements to the real value of the firm. This manipulative redirection of capital comes in part at the expense of American workers.

A. Executives retain a strong financial incentive to use repurchases to artificially inflate stock prices and boost their own compensation without real firm improvement.

Rule 10b-18's safe harbor neither prevents firms from manipulating stock prices and volume through repurchase on the open market, nor guards against the strong personal financial incentive for executives to do so.

Stock repurchase programs artificially increase stock prices without altering the real value of the firm, or achieving improvements in profit, the quality of goods, customer relations, or efficiency. Repurchases decrease the availability of stock supply on the open market, increasing the value of each available share. The SEC has recognized the intent and effect of repurchases, noting that repurchases are often used "[d]uring mergers and acquisitions *** to support or raise the market price of the issuer's securities for the purpose of making exchange ratios appear more favorable to target company security holders," as well as "[a]fter mergers and acquisitions, *** to support or raise the market price of the issuer's securities for the purpose of reducing the number of shares required to be issued pursuant to contingent obligations owed to former shareholders of the target company." The mere announcement of repurchases, even without execution by the firms, has been shown to have a positive effect on a business's stock price.

Rule 10b-18 also does not address the strong financial incentive of executives to use these effects of repurchases to increase their own compensation. The SEC intended Rule 10b-18 to prevent abusive "purchases designed to support the price of the issuer's securities in order to assist inside[r]s in disposing of their holdings at or above the pegged price." But the Rule has not kept up with the times. First, in today's market, the majority of executive compensation is often performance-based, tied to stock price or earnings per share. This presents executives with a direct, personal financial incentive to increase the short-term stock price or decrease the volume of outstanding shares to meet performance goals.

Repurchase programs offer a direct lever to achieve those goals. Indeed, empirical analysis of firm behavior has revealed that the likelihood of repurchases is higher at firms that would have just missed analyst earnings expectations without the effect of the repurchase. This strongly suggests that firm executives rely on repurchases to meet earnings targets and thus increase their own performance-based compensation. Rule 10b-18 does not account for the incentives for executives to use repurchases to increase their own compensation.

Second, research by Commissioner Robert Jackson has revealed that executives often time the sale of their personal equity to take advantage of the price increase created by repurchases and their announcement. In half of the repurchase programs in the study, at least one executive at the repurchasing firm sold shares in the month following the announcement. During each of the eight days following an announcement, executives are twice as likely to sell shares as any other day and sell on average five times the volume of stock. As executives are not required to disclose their trading intentions to shareholders in advance of a repurchase program, shareholders are less able to scrutinize repurchase programs for conflicts of interest.

The lack of effective disclosures also obscures whether repurchase programs conform with the conditions of the Rule 10b-18 safe harbor. Firms disclose quarterly information about repurchase programs, but only after the fact and tabulated by month. The Commission therefore cannot effectively compare firm repurchase activity (reported by month) against the daily conditions, such as the daily limit on repurchase volume, of the safe harbor. As then-Chair of the Commission Mary Jo White recognized, "data analyses for issuer stock repurchases presents significant challenges because detailed trading data regarding repurchases is not currently available." Addressing that challenge is within the power of the SEC.

B. The Tax Cuts and Jobs Act of 2017 exacerbated the harm to worker wages caused by repurchase programs.

When firms use stock repurchase programs to "downsize-and-distribute" capital to executives and shareholders for short-term gain rather than "retain[ing]-and-reinvest[ing]" in the firm for longer term innovation and growth, workers often lose out in the process. The Tax Cuts and Jobs Act handed companies a massive tax windfall that many used in exactly that way with precisely that result.

The Tax Cuts and Jobs Act became law in December 2017 and provided significant tax benefits to large corporations, such as a lower corporate tax rate and an incentive to repatriate offshore cash. As a result, firms enjoyed a windfall worth hundreds of billions of dollars. But instead of raising wages as promised by the Trump Administration during the debate over the tax bill, firms raced to repurchase their own stock. In 2018, the first full year after the tax cut, repurchases surged 64 percent over the previous year and topped $1 trillion overall. Yet real wages for typical workers remained flat. A survey of top firms revealed that only 7 percent of the tax windfall will go to workers, while almost 60 percent will be paid to shareholders.

Several examples illustrate how corporations have used the Tax Cuts and Jobs Act to reward executives and large shareholders at the expense of workers:

- **Walmart authorized $20 billion for stock repurchases in 2018 and 2019, enough money to give 1 million employees a $10,000 raise.** Walmart is America's largest corporate employer, with an $11 per hour, or $19,448 per year, starting wage in many states. Its CEO, Doug McMillon, earned nearly $24 million last year—1,076 times the pay of the median worker at Walmart. Despite this disparity, Walmart authorized $20 billion for stock repurchases in 2018 and 2019. By contrast, Walmart's announcement of a one-time bonus for employees of up to $1,000 per worker is expected to total just 0.02 percent of the money distributed to shareholders through repurchases. According to an analysis by the Roosevelt Institute, had Walmart reallocated those repurchase funds to workers, it could have raised 1 million hourly workers' wages by $5.66/hour for the year. That could bring Walmart's starting wage to over $16.00/hour, an extra $10,000 per year for a full-time worker. Alternatively, the retail giant could have used the funds to retain some of the thousands of workers laid off in 2018.
- **In October 2018, Sears Holding Company, which owns Sears and Kmart, filed for bankruptcy with about $5.6 billion in outstanding debt after having spent $6 billion on stock repurchases since 2005.** Rather than investing in the firms' core retail business, Sears opted for bankruptcy after years of layoffs and store closures by firm management amidst massive stock repurchases. When Sears and Kmart combined in 2005, they had approximately 3,500 stores and over 300,000 employees. Sears shuttered 700 stores between 2016 and 2018 alone. As of last year, only about 1,000 stores and 89,000 employees remained. Store closures and employee layoffs have continued since the bankruptcy announcement.
- **Wells Fargo authorized more than $40 billion in stock repurchases since President Trump's tax bill was passed despite continuing to lay off workers across the**

country. In September 2018, Wells Fargo announced that it intends to lay off between 5 and 10 percent of its workforce, or 13,250 to 26,500 employees, over the next three years. It began the process by laying off 1,636 employees in 2018. Yet Wells Fargo expended over $20 billion on share repurchases in 2018, a 108% increase over the previous year. And between the passage of President Trump's tax bill and November 2018, Wells Fargo authorized $40.6 billion in future stock repurchases. Although Wells Fargo has claimed the layoffs are part of efforts to make the firm "more streamlined and efficient" by eliminating $4 billion in expenses, the then-CEO has explained that the repurchases are driven by an "excess of capital" at the firm. According to an analysis by the Roosevelt Institute, if Wells Fargo invested the same $40.6 billion in its workers, instead of authorizing a stock repurchase, the company could have provided each of its 262,700 employees a raise of $154,000. Or if Wells Fargo had saved only one-tenth of the $40.6 billion that it authorized for spending on stock repurchases, all the positions it plans to eliminate could be saved.

- **AT&T reaped over $20 billion from the tax cuts and has spent billions on buybacks while continuing to outsource jobs.** AT&T vocally supported the tax cuts, which increased its cash profits by $ 3 billion annually and reduced tax liabilities by another $ 20 billion. But despite proclaiming itself a job-creator, during 2018 alone AT&T eliminated 10,700 union jobs and closed call centers, continuing a previous seven-year trend that has resulted in 44 closed call centers and 16,000 laid off call center workers nationwide. These layoffs come amidst record stock repurchases by AT&T. The company, which has spent $16. billion on stock buybacks since 2013, spent more on buybacks in the second quarter of 2018 than it has spent in any quarter since 2004.

The tendency toward repurchase programs at the expense of workers is of a piece with a faulty program of short-term shareholder primacy. The management theory of shareholder primacy relies on the false presumption that firms should maximize immediate shareholder value without regard for other stakeholders, like workers and others with long-term interests. As described by Blackrock CEO Larry Fink, shareholder primacy can emphasize short-term returns over re-investment, "sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth," and fail "employees, customers, and the communities in which they operate." Large repurchase programs further this trend, as firms suppress wages even for educated and experienced workers to shift capital to short-term shareholders. Long-term shareholders, alternatively, may lose out as firms fail to make strategic long-term re-investments to improve their market position in the future. Initiating a rulemaking to reform Rule 10b-18 would provide the SEC an opportunity to address these concerns with respect to repurchase programs.

III. Proposal to Repeal Rule 10b-18 and Develop a New Framework That Bans Manipulative Buybacks and Protects American Workers

Petitioners respectfully request that the Commission initiate a rule change to ban manipulative repurchases and protect American workers.

First, we ask the Commission to repeal Rule 10b-18 and reset the regulatory landscape to the pre-1982 regime. Prior to Rule 10b-18, repurchase programs were relatively uncommon because the potential for a market manipulation charge inhibited their abuse. Repealing the current safe harbor would re-set incentives by keeping firms subject to the deterrent effect of market manipulation charges for abusing repurchase programs, consistent with the anti-manipulation and anti-fraud provisions of the Securities and Exchange Act.

Second, we ask the Commission to undertake a rulemaking to develop a more comprehensive framework for regulating stock repurchase programs that would deter manipulation and protect American workers.

The Commission's own history provides a potential starting point for such a regulatory regime. Proposals by the SEC between 1970 and 1980 set out to "prevent an issuer from effecting repurchases which may have a manipulative or misleading impact on the trading market in the issuer's securities." Recognizing the potential for manipulation through repurchase programs, particularly by incumbent management, the proposals would have placed conditions "designed to ensure that an issuer neither leads nor dominates the trading market in its securities" on repurchase programs. The proposals differed substantially from Rule 10b-18. In particular, the following were proposed:

- Limiting repurchases to 15 percent of the average daily trading volume for that security.
- Creating a narrower safe harbor and allowing repurchases that fall outside this safe harbor to be reviewed and approved on an individualized, case-by-case basis.
- Providing that repurchases inconsistent with the safe harbor are expressly "unlawful as fraudulent, deceptive, or manipulative."
- Requiring various disclosures, including whether any officer or director is purchasing or disposing of the issuer's securities, the source of funds to be used to effect the repurchases, the impact of the repurchases on the value of the remaining outstanding securities, and specific disclosures for large repurchases.

These proposals, none of which are reflected in Rule 10b-18, should now be considered anew by the Commission in light of the demonstrated impacts under the current version of the Rule, particularly given market behavior after the Tax Cuts and Jobs Act of 2017.

Further, the SEC should also draw from the experience of foreign countries. Among the ten countries with the largest capital markets, the U.S. is the only country without clear limitations on repurchase programs. Other countries require immediate disclosure, have bright-line trading limits, require shareholder rather than board approval, and prohibit executive trading during repurchase program periods. For example, Japan and the United Kingdom require daily disclosure of repurchases. Though not a substitute for regulation, immediate disclosure provides the market and regulators an opportunity to supervise repurchase activities. Several countries, including France, Germany, Italy, Switzerland, and the Netherlands, enforce a bright-line limit volume limit of 10 percent of outstanding shares within an eighteen-month period. These and other regimes are an instructive basis for future SEC rulemaking.

In conclusion, Petitioners respectfully request that the Commission promptly initiate a rulemaking to repeal and reform Rule 10b-18 to address manipulative repurchase programs that harm workers.

* * *

The complete publication, including footnotes and the complete list of signatories, is available here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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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.

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

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.[1] 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.[2] 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:

[1] Commissioner Robert J. Jackson, Jr., *Stock Buybacks and Corporate Cashouts* (June II, 2018). Following my Office's standard practice, 1 released my findings, along with a data appendix, on the day I reported these results. Commissioner Robert J. Jackson, Jr., *Data Appendix to* Stock Buybacks and Corporate Cashouts (June 11, 2018), *available at* https://www.sec.gov/files/speech-jackson-061118-data-appendix.pdf.

[2] *See* Bob Pisani, *Stock Buybacks Hit a Record $1.1 Trillion, and the Year's Not Over,* CNBC TRADER TALK (December 2018); *c;(* Jesse M. Fried & Charles C.Y. Wang, *Short-Termism and Capital Flows,* 8 REV. CORP. FIN. STUD. 207 (2018) (contesting the degree to which figures of this kind reflect actual capital outflows relevant to long-term corporate investment).

- ***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.[3] 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.[4] 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.[5] 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

[3] For a thoughtful review of the lengthy literature establishing this proposition, *see* Theo Vermaelen, *Share Repurchases,* 1 FOUNDATIONS & TRENDS IN FIN. 171 (2005).

[4] For insightful analysis describing this trend, see David F. Larcker & Brian Tayan, *CEO Compensation Data Spotlight,* STANFORD BUSINESS SCHOOL CORPORATE GOVERNANCE RESEARCH INITIATIVE 8 (2017) (describing increased CEO equity ownership in a sample of 4,000 public companies).

[5] The finance literature has estimated the length of such periods, *see, e.g.,* J. Carr Bettis, Jeffrey L. Coles & Michael L. Lemmon, *Corporate Policies Restricting Trading By insiders,* 57 J. FIN. ECON. 191 (2000) (documenting that most earnings-related blackout periods last between two and twelve trading days). Nevertheless, because corporate policies of this kind frequently (and properly) change in response to market dynamics, we chose to empirically estimate these windows based on data on insider transactions in 2017 and 2018.

with prior studies,[6] we see that a majority of firms conducting buybacks have insider transactions[7] during the eight days before the buyback is announced.[8]

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.[9] 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.

[6] D. Scott Lee, Wayne H. Mikkelson, & M. Megan Partch, *Managers' Trading Around Stock Repurchases,* 47 J. FIN. 1947 (1992); *see also* Ilona Babenko, Yuri Tserlukevich & Alexander Vedrashko, *The Credibility of Open Market Share Repurchase Signaling,* 47 J. FIN. & Q. ANAL 1059 (2012).

[7] As I noted when I initially raised concerns in this area last year, it remains especially important to "be clear: this trading is not necessarily illegal." Jackson *supra* note 1, at text accompanying notes 24-25. Instead, we observe insider transactions in the company's stock solely to identify corporate policies restricting such trading.

[8] To the degree that transactions we observe are pursuant to prearranged trading plans, such trading may not be dispositive with respect to the existence of a blackout period-although in that case there would be less concern about "pent up" insider interest in selling. Still, to address the possibility that our data include such trades, using standard methods from the finance literature, *see* Lauren Cohen, Christopher Malloy, & Lukasz Pomorski, *Decoding Inside Information,* 67 J. FIN. 1009 (2012), we also identify and remove "routine" insider trades, such as those providing liquidity immediately after the vesting of stock-based pay. For two reasons, we follow the finance literature and identify such trades statistically rather than through disclosures. First, such disclosures are voluntary, raising the selection issues that come with voluntary disclosure, M. Todd Henderson, *Voluntary Disclosures Regarding Insiders' Rule I0b5-1 Trading Plans,* HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (Aug. 26, 2008).

Second, and more importantly, I share the bipartisan concern, reflected in a bill recently introduced by your Office, that insider trading pursuant to plans under Rule 10b5-1 is associated with unusual insider profits. *See* Sen. Chris Van Hollen, *Van Hollen, Fischer Introduce Bipartisan Bill to Increase Transparency in Corporate Trading* (Feb. 27, 2019); Pete Schroeder, REUTERS POLITICS, *U.S House Panel's Top Democrat, Republican Seek Executive Trading Oversight* (Jan. 18, 2019). Academic research identified this concern long ago, but neither Congress nor the SEC has addressed it yet. *See* Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade,* 55 MGMT. SCI. iv (Oct. 2008); M. Todd Henderson, Alan D. Jagolinzer, & Karl A. Muller, *Offensive Disclosure: How Voluntary Disclosure Can Increase Returns from Insider Trading,* 103 GEO. L. J. 1275 (2015).

[9] For example, the average buyback in our sample has total insider net selling upon announcement of approximately $3.824 million. After controlling for the degree of pre-announcement net selling, the residual average on the date of the buyback announcement is about $3.786 million.

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[10] 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:

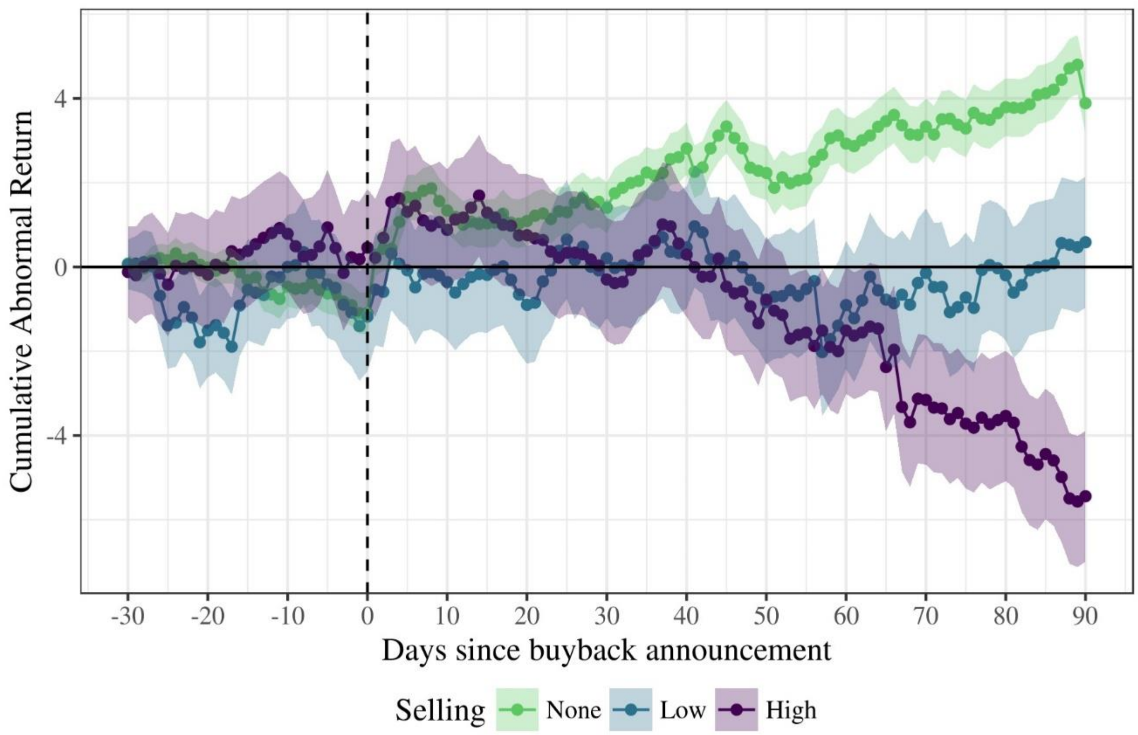

Figure 1 shows that, when executives sell into a buyback, the buyback is more likely to produce a short-term stock-price pop rather than a long-term, sustainable value increase. The difference in performance between buybacks with executive cashouts and those without is meaningful: ninety days after the buyback announcements, firms with insider cashouts underperform the other firms we study by more than 8%.[11]

[10] We calculate abnormal returns by subtracting factor portfolio returns from the individual firm's returns following Eugene F. Fama & Kenneth R. French, *The Cross-Section of Expected Stock Returns,* 47 J. FIN. 427 (1992) and Mark M. Carhart, *On Persistence in Mutual Fund Performance,* 52 J. FIN. 57 (1997). We estimate factor portfolio exposures over a one-year period prior to the buyback announcement, with a 30-day gap between our estimation period and our event period. Contemporaneously with the release of this letter, my Office has publicly released the data we used to conduct this analysis as well as a Data Appendix describing our methodology. To address the important questions raised by those concerned about the effect of trading windows on these findings, the dataset described in Figure 1 excludes any buybacks announced within twelve days of an earnings release. In our Data Appendix, we conduct additional analysis using data going back to 2004, the last time the Commission revisited its rules in this area, and show that the results in Figure 1 are robust in that dataset.

[11] In the Data Appendix, we subject the finding described in Figure 1 to several further tests for robustness. For example, we extend the dataset to buybacks going back to 2004; we use coarsened exact matching, Stefano M. Iacus, Gary King & Giuseppe Porro, *Causal Inference Without Balance Checking: Coarsened Exact Matching,* 20 POL. ANALYSIS I (20I 2), to address potential selection issues; and we extend the post-buyback performance period from the 90 days in Figure I to over 200 days. (In light of important and insightful finance scholarship explaining the problems with

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.

multi-year factor pricing, S.P. Kothari & Jerold B. Warner, *Measuring Long-Horizon Security Price Performance,* 43 J. FIN. ECON. 301 (1997), we do not extend further than one trading year.) Our findings, which are consistent with longstanding literature showing that the market is sensitive to signals insiders send when trading around buybacks, see Lee et al., *supra* note 6; Babenko et al., *supra* note 6, are largely unchanged.

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.

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

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

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

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

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

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

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

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

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

Goals of the ISG

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

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

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

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

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

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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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.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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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."

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Virtual Shareholder Meetings in the U.S

Posted by Marie Clara Buellingen, ISS Custom Research, on Thursday, October 10, 2019

Editor's note: This post is based on an ISS Analytics publication by Marie Clara Buellingen, ISS Custom Research.

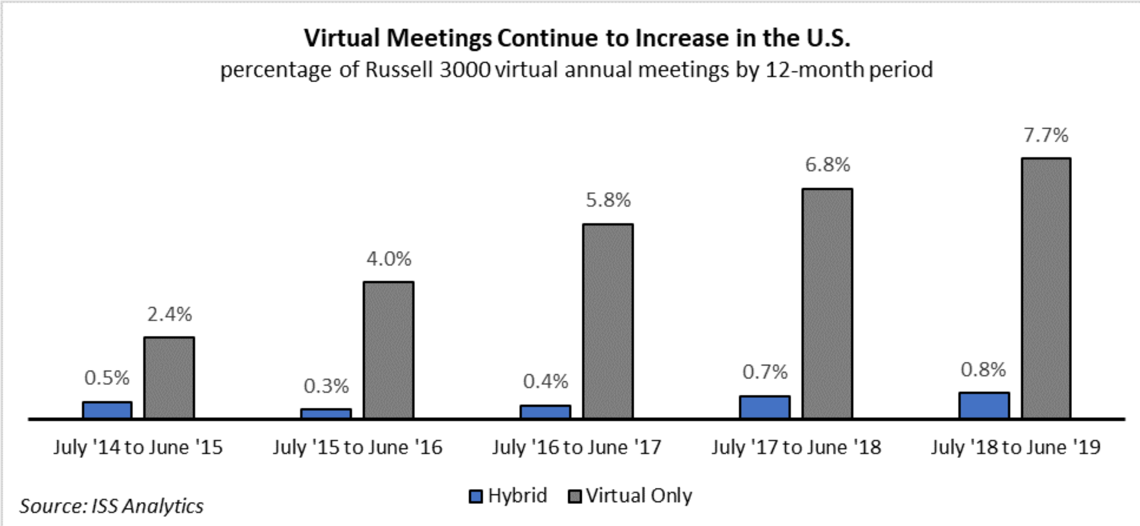
Key Findings

- While overall the share of virtual annual meetings among Russell 3000 firms has increased to 7.7 percent, the number of new adopters has decreased in each of the last two years.
- There does not seem to be a link between governance structure and company meeting format. Companies with virtual meetings appear no more likely to have poor governance provisions.
- Similarly, the dissent levels on key voting items such as say-on-pay and director election appear to not vary materially for both physical and virtual meeting holders.
- When adopting a new meeting format, companies and shareholders should evaluate key considerations to protect shareholder rights and address both concrete and perceived risks associated with a virtual meeting format.

Meeting format proliferation

Supporters of virtual shareholder meetings hail the benefits of giving more shareholders the opportunity to attend and actively participate in annual meetings, while reducing the cost to shareholders. Critics emphasize that the intangible benefits of in-person interaction could be lost, and that virtual meetings could also present problems with standard meeting procedures (such as presenting shareholder proposals). They argue that the virtual meeting format could give boards too much sway over the discussion and allow boards to avoid uncomfortable questions more easily.

While physical shareholder meetings remain, by far, the most common approach for U.S. companies, the number of virtual meeting in the Russell 3000 has tripled since 2014. Given this growth and the ongoing debate on the merits of virtual meetings, understanding the potential benefits and risks of this format as well as the characteristics of companies that adopt the practice appears pivotal to forming a stance on the issue.



In the traditional physical meeting format, the board, management, and shareholders gather in a pre-arranged location. Shareholder meetings for U.S. companies take place all over the country and in certain cases even outside the U.S. Depending on the shareholder base, the location may influence how many shareholders can easily attend. Both the sheer number of annual meetings of portfolio companies as well as the cost of attending are barriers for many shareholders. Virtual meetings, where shareholders can attend meetings all over the world via a webcast, aim to address those barriers.

Shareholder meeting terminology:

Physical meeting: Shareholders and company representatives gather in a physical location. No remote attendance available.

Webcast meeting: Shareholders and company representatives gather in a physical location, and the proceedings are available to shareholders via webcast or teleconference. Certain opportunities may not be provided to remote participants, such as presenting shareholder proposals.

Virtual meeting: Shareholders and company representatives gather virtually only; no in-person attendance is available. All opportunities afforded to shareholders at a physical meeting are offered virtually.

Hybrid meeting: Shareholders have the opportunity to attend either a physical meeting or a virtual meeting. All opportunities afforded to shareholders at the physical meeting are available virtually.

Best practices specific to virtual shareholder meetings continue to develop since virtual shareholder meetings are still a relatively new phenomenon. On a fundamental level, companies adopting a virtual meeting format must comply with relevant state of incorporation regulations and applicable listing requirements as well as their own bylaws. In addition, companies must have the technical and security capabilities to ensure the meeting follows comparable standards to physical meetings (such as participant verification, record keeping etc.). Moreover, the overall shareholder base should have comparable opportunity to participate.

The best meeting format for a given company depends on legal & bylaw requirements as well as best practices that emerge over time. Overall hybrid meetings may best balance meeting approaches by expanding the group of shareholders while also addressing the concerns of not losing the benefits of in person discussions. However, hybrid meetings currently account for less than 1% of annual meetings and their year-over-year growth lags considerably behind virtual meetings.

Virtual meetings considerations

As virtual meetings are still a relatively new phenomenon, best practices are still emerging. At a minimum the meeting format a company chooses must meet the respective exchange requirements. Moreover, the format must ensure that shareholders can exercise all rights granted under the state of incorporation can be fully exercised. Lastly, the format needs to meet a company's bylaw requirements.

Beyond these minimum standards, companies and shareholders need to feel confident that the annual meeting format will afford all stakeholders a fair, complete, effective, and secure forum. Among the things that should be evaluated are:

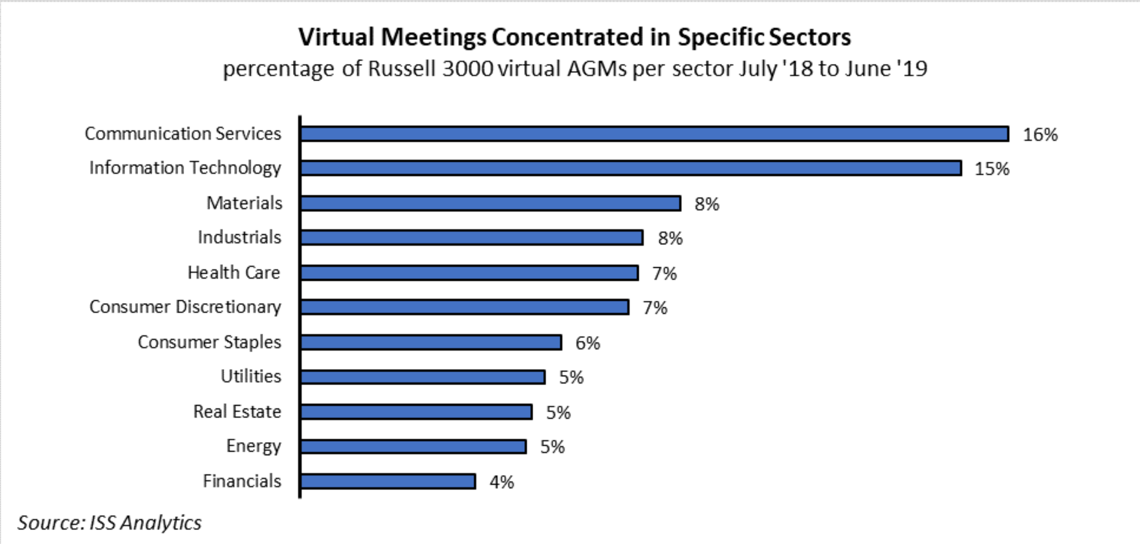
- Will the virtual meeting format result in broader meeting attendance?
- Does the company have the right technical capabilities (in particular, the participant verification process and record keeping) to meet standards comparable to that a of physical meeting?
- Does the virtual meeting platform provide all participants with adequate security?
- Does the virtual meeting format actually save the company money, after ensuring that the right cyber and procedural safeguards are in place?
- How will the company ensure fairness in questions that are allowed and moderated during the meeting? What criteria will be used to evaluate questions to be presented?
- How does the company intend to address issues, including technical and procedural issues, that may arise due to the virtual meeting format?
- Does the company intend to solicit feedback from shareholders regarding the virtual meeting format? How will that feedback be collected?
- Does the company propose to provide an alternative forum for person-to-person interaction among the company, board, and shareholders?

Before switching the meeting format, companies may need to consult with key shareholders to understand if there are any concerns with the switch and how those concerns should be addressed. Designing the meeting structure with the specific needs of the shareholder base in mind will likely make the transition smoother.

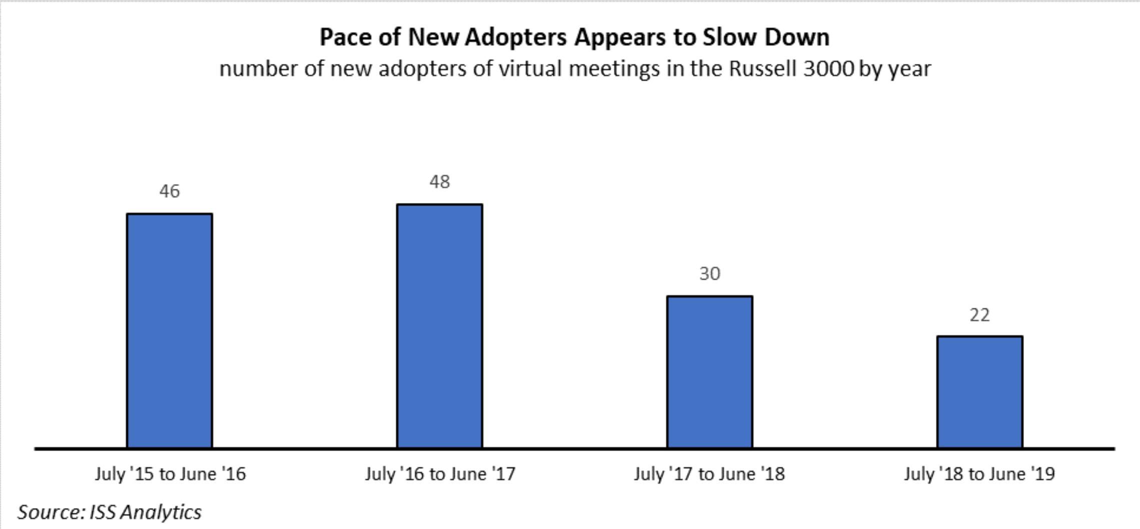
What can happen when best practices are not followed became evident at this year's AGM at General Motors. Shareholders filed a Notice of Exempt Solicitation urged to vote against the Chairman and CEO Mary Barra, Lead Director Tim Solso, and governance committee chair Patricia Russo due to the company's decision to hold a virtual shareholder meeting and avoid uncomfortable discussions ("Who wants to stand in front of a live audience and explain shrinking sales, epic recalls and loss of market share? It is so much easier to explain it to a microphone.").

Communication and IT firms lead the way in virtual meeting adoption

While virtual meetings have increased across sectors, our analysis showed no significant difference between S&P 500 companies and the rest of the Russell 3000. While most sectors have seen year-over-year increases in the adoption of the format, the Information Technology and Communications Services sectors have led the way. As discussed above, a range of factors go into choosing a meeting format. For IT and Communications Services companies, being ahead on technology trends reflects their core business. It's unsurprising to find a higher prevalence of virtual meeting adopters in this group.



While a small group of companies seems to have experimented with different meeting formats over the past five years, a majority of companies stick to a new format once making the switch. In terms of new virtual meeting adopters, our analysis suggests that pace of adoption has slowed over the past couple of years.

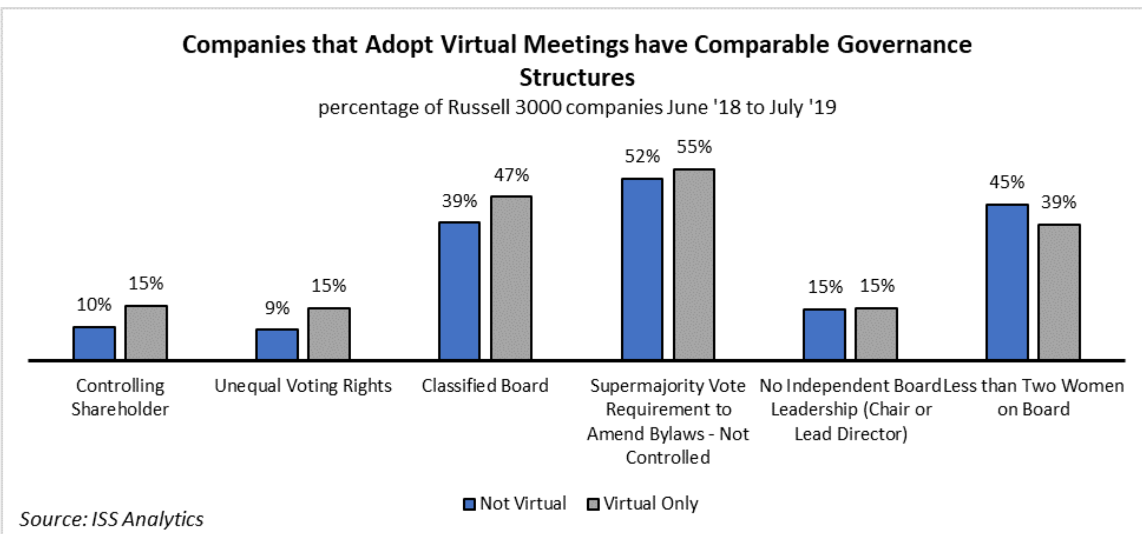


Virtual meeting uptake has also slowed. This may suggest that companies value in-person interaction to communicate their vision for the company and the company's progress. Engagement on a wider range of issues including social and environmental concerns across sectors is growing and many companies already have an ongoing dialog with a wider range of their shareholder base over the course of the year. As such virtual meetings may provide an alternative to physical meetings for a subset of companies. At present, they appear unlikely to become the norm.

Virtual meeting adopters, on average, do not have poor governance structures

Unlike several European markets, there is no requirement in the U.S. to obtain shareholder approval to switch from a physical to a virtual meeting format. Some skeptics believe that companies shifting to virtual meetings may have certain governance features that discourage them from facing shareholders in person. With this concern in mind, we analyzed the data to determine if, in aggregate, patters exist to support this notion. The analysis looks at companies both listed and incorporated in the U.S. from July 2014 to June 2019 in the Russell 3000.[1]

Companies where the most recent meeting was virtual appear to have a slightly higher share of controlling shareholders and unequal voting rights. Looking at the sector distribution of companies in the virtual meeting group, the IT and Communication Services sector rank high. These sectors are known for having a higher concentration of these governance structures. In general, governance structures and practices appear comparable for both virtual and physical meeting groups.



[1] In our analysis we could only identify two bylaw amendment proposals to switch to a virtual meeting format last year—received by a Russell 3000 firm incorporated in the U.K. (Gates Industrial Corporation plc) and a non-Russell 3000 company (Achieve Life Sciences, Inc). There were two shareholder proposals filed since July 2014 asking companies to hold "In-Person Shareholder Meetings" (in 2018 American at Outdoor Brands Corporation and in 2017 at Hewlett Packard Enterprise Company). Both proposals were omitted due to either dealing with the ordinary course of business of the company or not meeting the stock ownership requirements.

Our analysis did not reveal significant differences in shareholder dissent as a measure of alignment of company and shareholder stances on key voting proposals—from say-on-pay to director elections.

Future of Virtual Meetings

Companies that have adopted a virtual meeting format and those who have stuck to the physical meeting format all seem to have comparable governance structures and practices. Looking at shareholder vote dissent as a proxy for alignment between companies and shareholder, our analysis found no significant difference in opposition levels on key voting items.

All meeting formats have potential drawbacks and benefits. Companies adopting virtual meetings should follow best practices that protect shareholder rights and the meeting format overall is conducive to similar interactions as physical shareholder meetings.

While overall the proportion of virtual meetings has increased, the rate of new adoption has slowed. In an age where ongoing shareholder engagement on a wide range of topics is increasingly the norm, companies appear to value the benefits of in-person interaction. Hybrid meetings, which allow both virtual and physical participation, may strike the best balance by expanding the group of shareholders while also maintaining the benefits of in-person discussions.

Harvard Law School Forum on Corporate Governance and Financial Regulation

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2019 Proxy Season Review: Part 1—Rule 14a-8 Shareholder Proposals

Posted by Marc Treviño, Sullivan & Cromwell LLP, on Friday, July 26, 2019

Editor's note: Marc Treviño is a partner at Sullivan & Cromwell LLP. This post is based on a Sullivan & Cromwell memorandum by Mr. Treviño, Melissa Sawyer, H. Rodgin Cohen, and June Hu.

***Virtual-Only Meetings*.**

Over the last three years, an increasing number of companies have moved from in-person meetings to virtual-only meetings. However, based on a 2018 ISS survey, 8% of institutional investors did not support either virtual-only or "hybrid" (both physical and electronic/online) meetings, and 36% considered hybrid shareholder meetings to be acceptable but not virtual-only meetings. In addition, effective in 2019, Glass Lewis's policy is to vote against governance committee members at companies without in-person meetings unless their proxy materials contain disclosures that are sufficiently robust to assure shareholders that they would not lose any participation rights by moving to virtual-only meetings. Earlier this year, Frontier Communications received a shareholder proposal to hold a face-to-face annual meeting with shareholders starting in 2020 (Frontier Communications held a virtual meeting in 2019). The SEC staff granted no-action relief to Frontier Communications, agreeing with the company that this proposal related to ordinary business operations. This was the only shareholder proposal related to virtual meetings this season, and therefore it is too early to predict whether the Staff will continue to permit such proposals to be excluded.

SEC's New Guidance on Proxy Voting Responsibilities

Posted by David A. Bell and Robert A. Freedman, Fenwick & West LLP, on Thursday, September 5, 2019

Editor's note: David A. Bell and Robert A. Freedman are partners at Fenwick & West LLP. This post is based on their Fenwick memorandum.

Possibly signaling the future direction of regulation of proxy advisers, the U.S. Securities and Exchange Commission (SEC) on Aug. 21 issued two sets of interpretive guidance, one regarding proxy advisory firms under the proxy solicitation rules, and one regarding investment advisers and their proxy voting responsibilities. Among other things, the SEC issued an interpretation that proxy voting advice provided by proxy advisory firms generally constitutes a "solicitation" under the federal proxy rules. The SEC did not seek public comment or propose or adopt any new rules—though it pointed to processes that are already underway pursuant to which comment may be provided and noted consideration of specific potential future rulemaking under which public comment would be a part of the normal part of the rulemaking process. The moves may be an indication of what the SEC staff and the commission are considering with regard to requirements on proxy advisers to improve transparency and to give an opportunity to issuers to respond.

Guidance to Proxy Advisory Firms

In the Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice (Release No. 34-86721), the SEC:

- Noted their recent engagements with public input on the role of proxy advisory firms and their use by investment advisers, including the November 2018 proxy process roundtable, as well as a concept release (Release No. 34-62495) in 2010, a prior roundtable in 2013 and a Staff Legal Bulletin (SLB 20) in 2014;
- Promulgated an interpretation that proxy voting advice constitutes a "solicitation" under the federal proxy rules (i.e., within the definition of a "solicitation" under Rule 14a-1), as their recommendations are "communication[s] to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy;"
- Noted that Rule 14a-9, which prohibits false or misleading statements or omissions in connection with solicitations, applies to voting advice from proxy advisory firms, as Rule 14a-2(b) does not provide an exemption from that rule. To this end, the SEC noted that proxy advisory firms should consider whether to include with their voting advice:
    - "[A]n explanation of the methodology used to formulate its voting advice on a particular matter (including any material deviations from the provider's publicly-announced guidelines, policies, or standard methodologies for analyzing such matters);"

- “[D]isclosure about [third-party information sources] and the extent to which the information from these sources differs from the public disclosures provided by the registrant;” and
    - “[D]isclosure about material conflicts of interest that arise in connection with providing the proxy voting advice in reasonably sufficient detail so that the client can assess the relevance of those conflicts;”
- Noted that the SEC staff is also considering recommending that the commission propose rule amendments to address proxy advisory firms’ reliance on the proxy solicitation exemptions in Rule 14a-2(b), which generally allows proxy advisory firms to be exempt from having to file a proxy statement as they are not soliciting the actual power to vote (they merely provide a recommendation).

Guidance to Investment Advisers

In the Guidance Regarding Proxy Voting Responsibilities of Investment Advisers(Release Nos. IA-5325; IC-33605), the SEC noted:

- That investment advisers that control, for example, investment funds, “are fiduciaries that owe each of their clients duties of care and loyalty with respect to services undertaken on the client’s behalf, including voting” and that to “satisfy [their] fiduciary duty in making any voting determination, the investment adviser must make the determination in the best interest of the client and must not place the investment adviser’s own interests ahead of the interests of the client;”
- That where “an investment adviser has assumed the authority to vote on behalf of its client, the investment adviser, among other things, must have a reasonable understanding of the client’s objectives and must make voting determinations that are in the best interest of the client” and “for an investment adviser to form a reasonable belief that its voting determinations are in the best interest of the client, it should conduct an investigation reasonably designed to ensure that the voting determination is not based on materially inaccurate or incomplete information;”
- That where an investment adviser has assumed voting authority, it is not required to vote on every matter presented to stockholders, for example when refraining is in the best interest of the investment fund such as when the cost to the client of voting the proxy exceeds the expected benefit to the investment fund (though the investment adviser should carefully consider its duty of care when making such a determination).
- That when using proxy advisory firms, while “this third-party input into such an investment adviser’s voting decision may mitigate the investment adviser’s potential conflict of interest, it does not relieve that investment adviser of (1) its obligation to make voting determinations in the client’s best interest, or (2) its obligation to provide full and fair disclosure of the conflicts of interest and obtain informed consent from its clients;”
- A variety of arrangements that investment advisers and their clients (investments funds) may have with respect to voting;
- That when investment advisers have voting authority for a variety of funds, they need to consider whether the interests of the various funds differ and whether or not they should be applying uniform voting policies across those funds (“For example, a growth fund that targets companies with high growth prospects may have a different perspective on certain matters submitted to shareholders than an income or dividend fund that seeks to

generate an income stream for shareholders in the form of dividends or interest payments");

- That investment advisers that retain proxy advisory firms a different perspective on certain matters submitted to shareholders than an income or dividend fund that seeks to generate an income stream for shareholders in the form of dividends or interest payments, for example:
    - assessing "pre-populated" votes shown on the proxy advisory firm's electronic voting platform before such votes are cast (such as through periodic sampling of the proxy advisory firm's pre-populated votes);
    - consider policies and procedures that provide for consideration of additional information (other than the recommendation of a proxy advisory firm) that may become available regarding a particular proposal, such as an issuer's or a shareholder proponent's subsequently filed additional definitive proxy materials; and
    - with respect to matters where the investment adviser's voting policies and procedures do not address how it should vote on a particular matter, or where the matter is highly contested or controversial, the investment adviser could consider whether a higher degree of analysis may be necessary or appropriate to assess whether any votes it casts on behalf of its investment fund client are cast in the client's best interest;
- That investment advisers must review and document the adequacy of their procedures with respect to voting in the best interests of their investment fund clients;
- That when determining to work with a proxy advisory firm, the investment adviser should consider:
    - Whether the proxy advisory firm has the capacity and competency to adequately analyze the matters for which the investment adviser is responsible for voting, including the adequacy and quality of the proxy advisory firm's staffing, personnel, and/or technology;
    - Whether the proxy advisory firm has an effective process for seeking timely input from issuers and proxy advisory firm clients with respect to, for example, its proxy voting policies, methodologies, and peer group constructions, including for "say-on-pay" votes (e.g., if peer group comparisons are a component of the substantive evaluation, the investment adviser should consider how the proxy advisory firm (1) incorporates appropriate input in formulating its methodologies and construction of issuer peer groups, and (2) takes into account the unique characteristics regarding the issuer, to the extent available, such as the issuer's size, its governance structure; its industry and any particular practices unique to that industry, its history, and its financial performance);
    - Whether a proxy advisory firm has adequately disclosed to the investment adviser its methodologies in formulating voting recommendations, such that the investment adviser can understand the factors underlying the proxy advisory firm's voting recommendations;
    - The nature of any third-party information sources that the proxy advisory firm uses as a basis for its voting recommendations, and what steps the investment adviser should take to develop a reasonable understanding of when and how the proxy advisory firm would expect to engage with issuers and third parties; and
    - Whether the proxy advisory firm's policies and procedures regarding how it identifies and addresses conflicts of interest are appropriate, such as:

    - Whether they address actual and potential conflicts of interest, including (1) conflicts relating to the provision of proxy voting recommendations and proxy voting services generally (such as the provision of recommendations and services to issuers as well as proponents of shareholder proposals regarding matters that may be the subject of a vote), (2) conflicts relating to activities other than providing proxy voting recommendations and proxy voting services, and (3) conflicts presented by certain affiliations, such as whether a third party with significant influence over the proxy advisory firm [e.g., as a shareholder, lender, or significant source of business] has taken a position on a particular voting issue or voting issues more generally;
    - Whether they disclose details on for example, whether the issuer has received consulting services from the proxy advisory firm, and if so, the amount of compensation paid to the firm (if any), and whether a proponent of a shareholder proposal or an affiliate of the proponent is or has been a client of the proxy advisory firm; and
    - Whether they utilize technology in delivering conflicts disclosures that are readily accessible (for example, usage of online Portals or other tools to make conflicts disclosure transparent and accessible); and
- That an investment adviser should assess the extent to which a proxy advisory firm's advice is subject to potential factual errors, potential incompleteness, or potential methodological weaknesses, including whether they engage with issuers to ensure complete and accurate information, correct any identified material deficiencies in their analysis, disclose the sources of information used in formulating recommendations and consider factors unique to the issuer or proposal when making recommendations.

The guidance and interpretation will be effective upon publication in the Federal Register.

Conclusion

Although the SEC did not directly address its intentions for future rulemaking in its press release or its guidance, the flavor of things to come may be hinted at in the various examples of matters that proxy advisory firms should consider disclosing and the matters that investment advisers should be considering when working with proxy advisory firms. It is possible that this may also be a signal to legislators in Congress who have proposed bills regarding regulation of proxy advisory firms that the SEC is itself addressing the concern.

Harvard Law School Forum on Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

Statement Regarding Proxy Voting and Proxy Voting Advice

Posted by Elad L. Roisman, U.S. Securities and Exchange Commission, on Wednesday, August 21, 2019

Editor's note: Elad L. Roisman is a Commissioner at the U.S. Securities and Exchange Commission. The following post is based on Commissioner Roisman's recent statement at the Open Meeting on Commission Guidance and Interpretation Regarding Proxy Voting and Proxy Voting Advice, available here. The views expressed in the post are those of Mr. Roisman and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

Thank you, Chairman Clayton. I would like to take this opportunity to welcome Commissioner Lee to her first open meeting. I look forward to working with you and am happy that we will all benefit from your insight and passion for this agency and its mission.

As with most of our meetings, there are many "Thank Yous" to go around because so many people worked hard to get us to where we are today. Before discussing the substance of the releases the Commission will vote on this morning, I would like to make sure that I recognize each of you individually.

I would like to begin by thanking Chairman Jay Clayton. Since his earliest days leading the SEC, he has prioritized the interests of Main Street investors and improving our capital markets for all Americans. [1] I am honored that he has entrusted me with leading the Commission's wholesale evaluation [2] of the proxy process, [3] a topic that I have been passionate about for many years.

I would also like to thank Director Dalia Blass of the Division of Investment Management, Deputy Director and Chief Counsel Paul Cellupica, David Bartels, Holly Hunter-Ceci, Tara Varghese, Sarah ten Siethoff, and Jennifer Songer who worked on today's recommendation for Commission-level guidance for investment advisers. Further thanks go to Director Bill Hinman of the Division of Corporation Finance, Michele Anderson, David Fredrickson, Tamara Brightwell, Luna Bloom, Ted Yu, Lisa Kohl, Coy Garrison, Dan Greenspan, David Plattner, and Adam Turk for their work on the recommendation for the Commission to offer an interpretation and guidance regarding the applicability of the federal proxy rules to proxy voting advice. Thank you also to Bob

[1] *See* Chairman Jay Clayton, "Remarks at the Economic Club of New York" (Jul. 12, 2017), https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[2] *See* Chairman Jay Clayton, "Statement Announcing SEC Staff Roundtable on the Proxy Process" (Jul. 30, 2018), https://www.sec.gov/news/public-statement/statement-announcing-sec-staff-roundtable-proxy-process.

[3] *See* Chairman Jay Clayton, "Remarks for Telephone Call with SEC Investor Advisory Committee Members" (Feb. 6, 2019), https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-call-020619; Commissioner Elad L. Roisman, "Brief Statement on Proxy Voting Process: Call with the SEC Investor Advisory Committee" (Feb. 6, 2019), https://www.sec.gov/news/public-statement/statement-roisman-020619.

Stebbins, the Commission's General Counsel, and Meridith Mitchell, Michael Conley, Jeff Berger, Dan Matro, Lori Price, Malou Huth, Cathy Ahn, Mykaila DeLesDernier, Bryant Morris, Dorothy McCuaig, Conner Raso, and Brooks Shirey in his office. I am impressed by how well you all coordinated and informed each other's work. I am particularly impressed by how hard you worked to try and address the feedback of all five members of the Commission.

Finally, I would like to thank all of those who submitted comments to us—not only in response to our 2018 Roundtable on the Proxy Process, [4] but also over at least the last decade. [5] Recognizing that our markets and market participants are dynamic, seeing the evolution of comments, and receiving updated information has been critical to helping us see the many sides of these complex issues as they have changed and exist today. This enables us to identify where Commission action would be most helpful to investors and our markets, and calibrate what that action should be.

With regard to the recommendations before us today, the topic of investment advisers' proxy voting obligations is not new. It has been a subject of SEC rulemaking, staff action, and considerable comment since 2002. Similarly, the Commission over the past several decades has addressed the application of the definition of "solicitation" promulgated under the Exchange Act in a number of ways to ensure that the definition is consistent with the SEC's mission to protect investors and to provide clarity to market participants. In each case, in light of various significant developments, including the absolute and relative increase in assets held in mutual funds and exchange traded products, [6]updating our guidance and providing additional interpretive clarity to address the realities of today's markets is appropriate and many would say overdue.

I. The Importance of Proxy Voting

I have spoken previously about how I view the proxy process as a fundamental aspect of our capital markets. [7] Proxy voting was designed to be one of the primary ways for shareholders to engage with corporate management, including holding them accountable for delivering value from their companies. This shareholder-company dynamic drives productivity in our economy and allows investors to share in the growth and success of a company. Indeed, much of our current public company disclosure regime is designed to inform investors not only so that they can make investment choices, but voting choices as well.

The interpretation and guidance that we vote on today will be the first of several matters that I hope the Commission will consider relating to our proxy voting rules. [8] As our Regulatory

[4] *See* Chairman Jay Clayton, Statement Announcing SEC Staff Roundtable on the Proxy Process (the "2018 Roundtable"), https://www.sec.gov/news/public-statement/statement-announcing-sec-staff-roundtable-proxy-process.

[5] For example, in 2010, the Commission issued a concept release that sought public comment about, among other things, the role and legal status of proxy advisory firms within the U.S. proxy system. (The comment letters received in response to the Concept Release are available at https://www.sec.gov/comments/s7-14-10/s71410.shtml.) Also, in 2013, the staff held a roundtable on the use of proxy advisory firm services by institutional investors and investment advisers. The letters received in response to the announcement are available at https://www.sec.gov/comments/4-670/4-670.shtml.

[6] Between 2010 and 2018, the total net assets held in open-end funds increased by over $9 trillion USD. *See* 2019 Investment Company Fact Book (59th ed. 2019), at Table 1, https://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2019/2019_factbook.pdf; 2016 Investment Company Fact Book (56th ed. 2016), at Table 1 and Table 11, https://www.ici.org/pdf/2016_factbook.pdf.

[7] Commissioner Elad L. Roisman, "Keynote Remarks: ICI Mutual Funds and Investment Management Conference" (Mar. 18, 2019), https://www.sec.gov/news/speech/speech-roisman-031819.

[8] The SEC's short-term and long-term rulemaking agendas, respectively, are available at https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true

Flexibility Agenda notes, in the near future the Commission expects to consider (1) proposed rules to amend the submission and resubmission thresholds for shareholder proposals under Rule 14a-8 under the Exchange Act [9] and (2) proposed rule amendments to address proxy advisory firms' reliance on the proxy solicitation exemptions in Exchange Act Rule 14a-2(b). [10] Additionally, in the longer-term, I hope the Commission will consider actions to modernize the proxy system generally to promote greater efficiency and accuracy in shareholder voting. As I have stated before, I believe the Commission needs to consider not only "quick-fixes" that could marginally improve some aspects of the so-called "proxy plumbing," but also comprehensive solutions based on modern technology. [11]

But today marks an important first step. The Commission will vote on two separate releases, drafted by two different divisions within the agency, that relate to the role of proxy advisory firms in the proxy voting process. I am aware that, for some, this is a controversial topic. I have heard the warnings that any action, regulation, or oversight that directly or indirectly constrains proxy advisory firms will be viewed by some as a gift to the management and directors of public companies, resulting in harm to investors. For example, I have heard that the Commission should not take any action related to proxy voting advice provided by proxy advisory firms because "…the investors themselves…the ones paying for proxy advice…are not asking for protection." [12] To be clear, in this context, I do not consider asset managers to be the "investors" that the SEC is charged to protect. Rather, the investors that I believe today's recommendations aim to protect are the ultimate retail investors, who may have their life savings invested in our stock markets. These Main Street investors who invest their money in funds are the ones who will benefit from (or bear the cost of) these advisers' voting decisions. In essence, I believe it is our job as regulators to help ensure that such advisers vote proxies in a manner consistent with their fiduciary obligations and that the proxy voting advice upon which they rely is complete and based on accurate information.

I encourage everyone to look at the public comments received in connection with the Staff Roundtable on the Proxy Process last year. [13] We have heard not only from hundreds of public companies, [14] but from investor groups and individual investors. [15] These commenters have expressed varying concerns relating to the influence that proxy advisory firms appear to have over proxy voting decisions in our markets. I also want to acknowledge Congress's interest in this

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[9] CFR 240.14a-8.

[10] 7 CFR 240.14a-2(b).

[11] ; *See* Commissioner Elad L. Roisman, "Keynote Remarks: ICI Mutual Funds and Investment Management Conference" (Mar. 18, 2019), https://www.sec.gov/news/speech/speech-roisman-031819.

[12] *See*, *e.g.*, Investor Advocate Rick Fleming, "Important Issues for Investors in 2019" (Apr. 8, 2019), https://www.sec.gov/news/speech/fleming-important-issues-investors-2019.

[13] Public comments related to the 2018 Roundtable are available at https://www.sec.gov/comments/4-725/4-725.htm. *See also* public comments submitted in 2010 and 2013, as noted above in note 5.

[14] *See*, *e.g.*, Letter dated Feb. 4, 2019 from Nasdaq, Inc., et al.; Letter dated Jul. 12, 2019 from Avrohom J. Kess, Vice Chairman and Chief Legal Officer, The Travelers Companies, Inc.; Letter dated Jul. 26, 2019 from Neil A. Hansen, Vice President, Investor Relations and Corporate Secretary, Exxon Mobil Corporation. *See also* Letter dated Nov. 15, 2010 from John F. Coyne, President and Chief Executive Officer, Western Digital Corporation; Letter dated Jul. 19, 2013 from Lynnette C. Fallon, Esq., General Counsel, Axcelis Technologies, Inc.

[15] *See*, *e.g.*, Letter dated Oct. 5, 2018 from James L. Martin, 60 Plus Association; Letter dated Jan. 25, 2019 from Nan Bauroth, Member, Main Street Investors Coalition Advisory Council; Letter dated Mar. 11, 2019 from Rasa Mokhoff; Letter dated Apr. 9, 2019 from Pauline Yee; Letter dated Apr. 16, 2019 from Marie Reed; Letter dated Apr. 29, 2019 from Christopher Burnham, President, Institute for Pension Fund Integrity. *See also* Letter dated Apr. 13, 2019 from J.W. Verret, Professor of Law, Antonin Scalia Law School, George Mason University; Letters dated Oct. 12, 2018 and Nov. 27, 2018 from Bernard S. Sharfman; Letter dated Oct. 20, 2010 from Tom D. Seip.; and Letter dated Sept. 29, 2010 from Mark Latham.

matter over several sessions, including hearings, bipartisan legislation, and requested GAO reports. [16]

The SEC is not in the business of picking winners and losers. We have a three-part mission that informs every action we take: Protect investors. Maintain fair, orderly, and efficient markets. Facilitate capital formation. I appreciate the efforts of our dedicated SEC staff who worked hard to further this mission by addressing the various perspectives and concerns noted in the comment file. They have prepared recommendations that would not change the law or create a new regulatory regime for proxy advisory firms, but reiterate longstanding Commission rules and positions that remain applicable and very relevant in today's marketplace. I believe this approach embodies the long-standing commitment of the SEC staff and the Commission to avoid tipping the scales in favor of any one party in the shareholder-company dynamic.

II. Guidance for Investment Advisers

Our first vote today recognizes the pivotal role that investment advisers play in proxy voting. They vote proxies for an increasing number of retail investors every year. [17] This is a huge responsibility, not only in its importance, but in its magnitude. Investment advisers could be asked to cast a vote on multiple matters of critical importance to many public companies in a matter of days or weeks. [18]

A. Investment Advisers' Proxy Voting Rule of 2003

This is demanding and important work, and advisers should view it as such. The Commission stated as much when adopting the proxy voting rule for advisers in 2003. [19] The rule itself states "it is a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the [Advisers Act] for [an investment adviser] to exercise voting authority with respect to client securities, unless" the adviser follows the specific requirements of that rule. [20]These are strong words, stressing how important the Commission viewed investment advisers' proxy voting obligations to their clients.

With that backdrop, the rest of the Proxy Voting Rule is principles-based and disclosure-based in its requirements. For example, the rule requires investment advisers to adopt and implement policies and procedures that are reasonably designed to ensure that the adviser votes clients'

[16] *See*, e.g., U.S. Government Accountability Office. (2007, June). *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting*. (Publication No. GAO-07-765). Retrieved from https://www.gao.gov/assets/270/263233.pdf; U.S. Government Accountability Office. (2016, November). *Corporate Shareholder Meetings: Proxy Advisory Firms' Role in Voting and Corporate Governance Practices*. (Publication No. GAO-17-47). Retrieved from https://www.gao.gov/assets/690/681050.pdf; Corporate Governance Reform and Transparency Act, H.R. 5311, 114th Cong. (2016); Corporate Governance Reform and Transparency Act of 2017, H.R. 2015, 115th Cong. (2017); Corporate Governance Fairness Act, S. 3614, 115th Congress (2018); Proxy Process and Rules: Examining Current Practices and Potential Changes: Hearing before Committee on Banking, Housing, and Urban Affairs, Senate, 115th Cong. (2018).

[17] For example, over 100 million individuals, representing nearly 45% of U.S. households, own open-end funds, and over one third of the shares of U.S.-issued equities outstanding are held in funds. *See* 2018 Investment Company Fact Book (58th ed. 2018), https://www.ici.org/pdf/2018_factbook.pdf ("ICI Fact Book 2018"), at 39.

[18] For example, in 2017, the average mutual fund voted on over 1,500 matters. ICI Viewpoints, "Funds and Proxy Voting: The Mix of Proposals Matter" (Nov. 5, 2018), at 2.

[19] *See* Rule 206(4)-6 of the Investment Advisers Act of 1940 ("Advisers Act"), 17 C.F.R. 275.206(4)-6 (the "Proxy Voting Rule"); and "Proxy Voting by Investment Advisers," Release No. IA-2106 (Jan. 31, 2003) (the "Proxy Voting Rule Release").

[20] 7 C.F.R. 275.206(4)-6.

proxies in the clients' best interests. [21] That approach was based on the fact that the Advisers Act imposes upon investment advisers a fiduciary duty to serve their clients best interests.

Ten years after the Commission adopted the Proxy Voting Rule, the SEC staff issued Staff Legal Bulletin 20 ("SLB 20") to discuss ways advisers could comply with the rule, including through the use of proxy advisory firms, where the adviser also adopted measures to conduct diligence and supervise those firms, such as with respect to their conflicts of interest. [22] The substance of SLB 20 was tethered closely to the Proxy Voting Rule, staying true to its flexible, principles-based approach and reliance on fiduciary duty.

B. Fiduciary Duty

In the last few years, the Commission has underscored the importance of investment advisers' fiduciary duty outside the context of voting proxies. We recently adopted an interpretation of the Advisers Act fiduciary standard that reaffirmed, and, in some cases, clarified components of advisers' duties of care and loyalty when serving their clients. [23] In this Fiduciary Interpretation, we stated that investment advisers owe each of their clients a fiduciary duty, which "must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client." [24] In other words, while an investment adviser and client can, through contract, shape the services that the adviser performs for the client, the adviser must perform any services it undertakes with care and loyalty—duties that the adviser cannot disclaim, and the client cannot waive.

In that release, we excluded specific discussion about the application of the fiduciary duty in the context of proxy voting, reserving space for ourselves to more specifically discuss advisers' responsibilities in this area, including when they retain proxy advisory firms for help with voting, a topic of considerable Commission and SEC staff engagement over the last decade. [25]

C. Today's Commission Guidance

Today's guidance does just that. It starts from the unassailable premise stated in 2003: "[a]n investment adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting." [26] It then continues on to offer guidance to investment advisers, consistent with the Fiduciary Interpretation, in two main areas: (1) the ability for an adviser and client to shape the adviser's authority to vote proxies on the client's behalf, including whether and when the adviser must vote; and (2) the

[21] *Id.*

[22] *See* SEC Staff Legal Bulletin No. 20, Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms (Jun. 30, 2014).

[23] *See* Fiduciary Interpretation.

[24] *See* Fiduciary Interpretation, at 9-10.

[25] In 2010, the Commission issued a concept release that sought public comment on the role of proxy advisory firms within the proxy system, among a number of other topics relating to the proxy process. *See* Concept Release on the U.S. Proxy System, Release No. 34-62495 (Jul. 14, 2010), 75 FR 42982 (Jul. 22, 2010). In 2013, the staff held a roundtable on the use of proxy advisory firm services by institutional investors and investment advisers. *See* SEC Announces Agenda, Panelists for Roundtable on Proxy Advisory Services, available at https://www.sec.gov/news/press-release/2013-253. In 2015, the SEC's Office of Compliance Inspections and Examinations included in its published priorities examinations of investment advisers' compliance with their fiduciary duty when voting proxies on behalf of investors. *See* OCIE 2015 Examination Priorities, https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf. Most recently, the 2018 Roundtable raised these issues for public comment.

[26] Proxy Voting Rule Release, at 1.

responsibilities of investment advisers when utilizing the services of proxy advisory firms to assist with voting, consistent with their fiduciary duties.

In the first area, this guidance recognizes that the adviser-client relationship is not one-size-fits-all and focuses on the client's objectives when discussing how advisers serve their clients' best interest when making voting determinations. The guidance describes ways investment advisers and clients may scope the adviser's authority to vote proxies on their client's behalf [27] and discusses whether an investment adviser is required to exercise every opportunity to vote a proxy for a client where it has assumed voting authority on behalf of the client. [28]

In the second area, this guidance recognizes the wide scope of services that proxy advisory firms offer investment advisers in today's marketplace, as well as the variety of ways investment advisers can utilize those offerings while maintaining their accountability as fiduciaries for their clients. As when an adviser relies on any third party for services, including assistance with compliance, the adviser remains on the hook for its fiduciary obligations. I cannot think of any context when the Commission has spoken to the contrary. This guidance discusses ways advisers can use the services of proxy advisory firms responsibly, including considerations relevant to: deciding whether or not to retain a proxy advisory firm to assist with proxy voting; [29] addressing potential errors or incompleteness in a proxy advisory firm's analysis; [30] and evaluating the services of a proxy advisory firm on an ongoing basis. [31]

In summary, the staff's recommendation for Commission guidance stays true to the Proxy Voting Rule's flexible, principles-based approach in discussing investment advisers' proxy voting responsibilities, updates and elevates the portions of SLB 20 that may be relevant for investment advisers today, and underscores the importance of the adviser serving its clients' best interest, as discussed in our recent Fiduciary Interpretation.

D. Should we do more?

Some have called for the Commission to impose new obligations on investment advisers with respect to their proxy voting, such as requiring them to conduct pass-through voting or restricting their use of proxy advisory firms. But, after thoroughly considering the reasons behind such requests—namely, the desire to make sure advisers serve clients' best interests and maintain accountability for voting their proxies—I am not convinced such new prescriptive requirements would best achieve these objectives.

I believe that most investment advisers today recognize that they are already subject to a robust regulatory framework, designed to ensure that advisers vote proxies in the best interest of their clients and conduct appropriate due diligence on third-party providers. [32] For any adviser that does not, I am hopeful that today's guidance will serve as a reminder of how seriously the

[27] Guidance, Q/A #1
[28] Guidance, Q/A #6
[29] Guidance, Q/A #3
[30] Guidance, Q/A #4
[31] Guidance, Q/A #5
[32] *See*, *e.g.*, Letter dated Dec. 31, 2018 from Gail C. Bernstein, General Counsel, Investment Adviser Association, at 4.

Commission views proxy voting and will provide a helpful tool for considering how to fulfill the existing obligations under our rules and the Advisers Act.

I have always said to investment advisers: I do not care how you vote. But I care that you fulfill your fiduciary duty when doing so. Today, I am happy to vote on a recommendation from the SEC staff for the Commission itself to deliver this message.

III. Interpretation and Guidance Regarding the Applicability of the Proxy Rules To Proxy Voting Advice

Our second vote today relates to the proxy solicitation rules that the Commission has promulgated under Section 14 of the Exchange Act. Specifically, the release provides an interpretation and related guidance regarding the applicability of Rules 14a-1 and 14a-9 under the Exchange Act to proxy voting advice.

In response to the question of whether proxy voting advice provided by a proxy advisory firm constitutes a solicitation under the federal proxy rules, the release reiterates prior Commission statements that, generally, the furnishing of proxy voting advice does constitute a "solicitation" within the meaning of Exchange Act Rule 14a-1. [33] Although today's interpretation is not new, the release provides a robust explanation of our reasoning, applying the facts and circumstances surrounding the provision of proxy voting advice by proxy advisory firms to our rules, given prior Commission actions as well as relevant court decisions. Our interpretation will not affect proxy advisory firms' ability to rely on the exemptions from the information and filing requirements of the federal proxy rules. [34]

The release also provides helpful guidance with respect to the application of Rule 14a-9 to proxy voting advice. For instance, the release includes examples of information that proxy advisors should consider disclosing that is specific to the types of information we see provided in proxy advisor reports. As the Supreme Court has stated: "The purpose of [Section] 14(a) [of the Exchange Act] is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation." [35] The guidance and interpretation we are voting on today will serve to further that purpose and, I hope, help ensure that those who make voting decisions are doing so based on complete and accurate information.

I am happy to support both of these recommendations. Chairman Clayton, I will now turn it back to you. Thank you.

[33] 7 CFR 240.14a-1(l).
[34] *See, e.g.,* 17 CFR 240.14a-2(b)(1) and 17 CFR 240.14a-2(b)(3).
[35] *J.I. Case v. Borak*, 377 U.S. 426, 431 (1964).

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Institutional Investors' Proxy Voting Responsibilities and Use of Proxy Advisory Firms

Posted by David A. Katz, Sabastian V. Niles, and Elina Tetelbaum, Wachtell, Lipton, Rosen & Katz, on Thursday, August 22, 2019

Editor's note: David A. Katz, Sabastian V. Niles, and Elina Tetelbaum are partners at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton memorandum by Mr. Katz, Mr. Niles, Ms. Tetelbaum, Trevor S. Norwitz, Andrew R. Brownstein, and Adam O. Emmerich.

Yesterday [August 21, 2019], the Securities and Exchange Commission approved new guidance in two releases from the Division of Corporation Finance and the Division of Investment Management concerning the fiduciary responsibilities of investment advisers (like fund managers) with respect to proxy voting, the use of proxy advisory firms (like ISS and Glass Lewis), assessing such advisory firms' "care and competency" with respect to potential factual errors, incompleteness, or methodological weaknesses that may materially affect voting recommendations, and addressing the applicability of proxy solicitation and anti-fraud rules to proxy advisory firms and their vote recommendations.

Consistent with past statements by SEC Chair Jay Clayton and Commissioner Elad Roisman, today's guidance goes beyond the 2014 staff-level interpretations regarding proxy voting and, importantly, reflects Commission-level approval. As noted by the Commission, the guidance and articulated policies (provided in question and answer formats) do not create new obligations or require rulemaking. These pronouncements increase pressure on investment advisers and proxy advisory firms in terms of what is expected of them, and should alter the behavior of those that are not already following this guidance. The SEC is encouraging investment advisers and proxy advisory firms to review their policies and practices in light of the new guidance in advance of next year's proxy season.

Division of Investment Management Guidance. As SEC Chair Clayton emphasized, "investment advisers are fiduciaries that owe each of their clients duties of care and loyalty with respect to services undertaken on their client's behalf, including voting." The guidance from the Division of Investment Management focuses on the proxy voting responsibilities of investment advisers and their fiduciary duties, especially when relying upon proxy advisory firms. One Q&A focuses on how investment advisers can ensure that the scope of their authority to vote proxies on behalf of their client is clearly defined (and offers a number of examples of possible voting arrangements). In this regard, the 2019 guidance clearly states that an adviser is not always required to cast a vote on behalf of its clients on all issues and provides relevant examples of scoping the authority to vote and deciding to refrain from voting.

A second Q&A addresses steps an investment adviser can take to demonstrate that it is making voting determinations in its client's best interests and in accordance with its own (rather than a proxy advisory firm's) proxy voting policies and procedures. In particular, the guidance questions whether an investment advisor's use of "a uniform voting policy would be in the best interest of each of its clients," and states that, as part of its ongoing compliance program, the adviser must "review and document, no less frequently than annually, the adequacy of its voting policies and procedures to ensure that they have been formulated reasonably and implemented effectively."

Another Q&A details considerations an investment adviser should take into account if it retains a proxy advisory firm, including whether the proxy advisor has an effective process for seeking timely input from issuers and others, whether it has adequately disclosed to the investment adviser its methodologies in formulating voting recommendations, and whether it provides adequate "context-specific, non-boilerplate" disclosure of actual and potential conflicts. Reflecting a similar wariness about a "one-size-fits-all" approach to complex issues, the guidance states that investment advisers should consider how proxy advisory firms consider "factors unique to a specific issuer or proposal when evaluating a matter subject to a shareholder vote" and suggests that even as to peer group determinations, proxy advisory firms should take into account "the unique characteristics regarding the issuer, to the extent available, such as: the issuer's size; its governance structure; its industry and any particular practices unique to that industry; its history; and its financial performance."

Addressing a topic that has been particularly sensitive for issuers and shareholders, the SEC provides guidance on how investment advisers should address potential errors, incompleteness or methodological weaknesses in a proxy advisory firm's analysis, including considering whether the proxy adviser has a process for engaging with issuers to ensure that it has complete and accurate information, the proxy adviser's efforts to correct any identified material deficiencies in its analysis and its process, if any, for investment advisers to access an issuer's views about the proxy advisory firm's recommendations in a timely and efficient manner. As highlighted by Commissioner Roisman, this guidance underscores that even when relying on a proxy advisory firm, "the [investment adviser] remains on the hook for its fiduciary obligations."

Fund managers should pay particular attention to their exercise of these duties in the context of M&A votes, contested elections, and other high-profile and non-ordinary-course matters, and to take steps to ensure that they and their proxy advisors have systems in place to ensure that votes are cast in compliance with the fiduciary duties owed by fund managers to their clients.

Division of Corporation Finance. The guidance from the Division of Corporation Finance re-emphasizes that proxy advisory firm recommendations and voting advice, as attempts to influence investors' voting decisions, will generally constitute "solicitations" under the proxy rules, even where the advisory firm is applying custom-tailored guidelines, whether or not the advice was solicited, and whether or not the client follows the advice. In addition, while the exemptions from certain information and proxy statement filing requirements will continue to apply to such firms if the conditions are met, the guidance confirms that Rule 14a-9's anti-fraud rules and prohibition on false and misleading solicitations apply to proxy advisory firms. Several SEC Commissioners underscored this point in their public remarks regarding the guidance.

As such, proxy advisory firm recommendations, including the associated reports, may not include statements which are, at the time and under the circumstances in which they are made, "false or misleading as to any material fact" or "omit to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any earlier communication with respect to the solicitation of a proxy…which has become false or misleading." The guidance recommends that, in order to avoid potential violations of Rule 14a-9, proxy advisors should consider providing appropriate disclosure of material conflicts of interest, third-party or other non-public information underlying their voting advice, and the methodology used to formulate their voting advice (including any material deviations from publicly announced guidelines or policies) and related analyses.

Similarly, the guidance makes clear that proxy advisory firms should disclose where they are getting the information included in their reports and the sources underlying their recommendations and identify material differences between the information they are relying upon and an issuer's public disclosures. This is significant because some companies find that advisory firms issue reports referring to performance data or other company assessments that deviate from the company's publicly-provided information.

Notably, in rejecting the arguments that the Commission should not take action because "…the investors themselves…the ones paying for proxy advice…are not asking for protection" (even though some institutional investors have in fact called for increased transparency and improvements at proxy advisory firms), Commissioner Roisman emphasized that:

> "To be clear, in this context, I do not consider asset managers to be the "investors" that the SEC is charged to protect. Rather, the investors that I believe today's recommendations aim to protect are the ultimate retail investors, who may have their life savings invested in our stock markets. These Main Street investors who invest their money in funds are the ones who will benefit from (or bear the cost of) these advisers' voting decisions. In essence, I believe it is our job as regulators to help ensure that such advisers vote proxies in a manner consistent with their fiduciary obligations and that the proxy voting advice upon which they rely is complete and based on accurate information."

The Commissioners noted that areas of potential future rulemaking include (1) proposed rules to amend the submission and resubmission thresholds for shareholder proposals under Rule 14a-8 under the Exchange Act and (2) proposed rule amendments to address proxy advisory firms' reliance on the proxy solicitation exemptions in Exchange Act Rule 14a-2(b). The SEC will also continue to consider "proxy plumbing" initiatives, and, as previously discussed, Congress remains interested in evaluating the role of proxy advisory firms and considering legislative action.

While broader reform proposals remain under consideration, we believe this new Commission-approved guidance is an important step in promoting accountability in voting, encouraging proxy advisory firms to provide expanded transparency into their methodologies and analyses and reducing rote application of one-size-fits-all policies. The guidance also holds the hope of further empowering institutional investors to reach their own independent, informed judgments on voting matters regardless of the influence of proxy advisory firms, facilitating respectful dialogue between companies and proxy advisory firms and, most importantly, encouraging regular constructive and direct engagement between companies and their investors.

Tab IV: Compensation Issues

2019 Proxy Season Recap and 2020 Trends to Watch

Posted by Lyndon Park, ICR Inc., on Tuesday, September 17, 2019

Editor's note: Lyndon Park is Managing Director at ICR Inc. This post is based on his ICR memorandum.

Overview

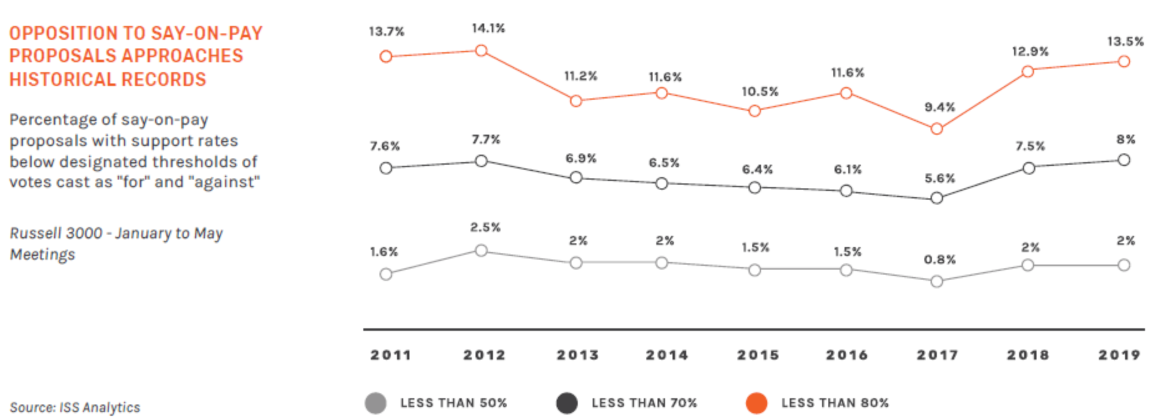
At first glance, the patterns and trends of the 2019 proxy season don't seem to indicate shifts that are beyond marginal in terms of proxy voting impact. But in closer analysis, in conjunction with recent investor behavior and industry trends (e.g., Business Roundtable Statement on the Purpose of a Corporation signed by 181 CEOs disavowing shareholder-centrism in favor of greater commitment to stakeholders and society), the results of the 2019 proxy season evince an already-shifting pattern of voter behavior, and contain important clues as to what companies must do to prepare for the 2020 proxy season.

Throughout this post, we will note some of the specific issues to watch out for 2020 proxy season.

Say-On-Pay (SOP)

The average support for SOP among Russell 3000 companies held steady at around 90% (slightly lower than 2018), as well as the percentage of companies failing SOP (~2%).

However, as evidenced by the chart from ISS Analytics below, there is a marked rise in the percentage of SOP with support rates below 80%—which is the threshold at which both investors and proxy advisory firms begin scrutinizing Compensation Committee members for their oversight of the pay program, as well as their responsiveness to investor concern:



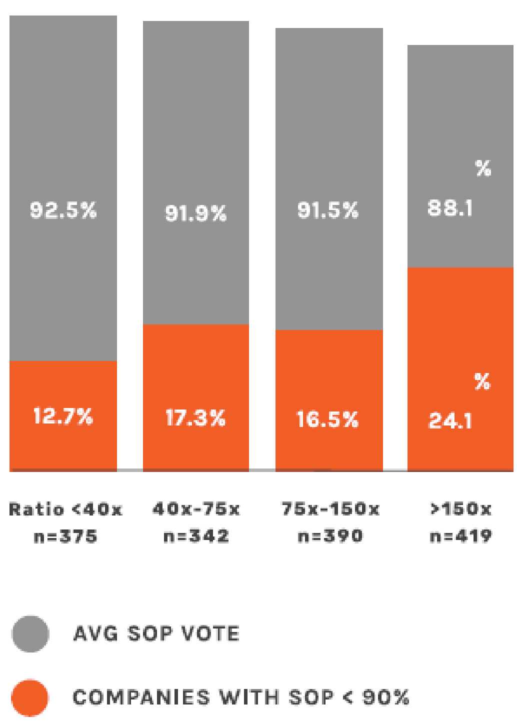
From our perspective, having advised our clients on SOP issues this proxy season, we can note certain trends which may have contributed to this rising opposition to SOP proposals:

1. Big passive investors have been less willing to support one-time retention or discretionary equity awards for executives that do not have performance contingencies. Whereas in prior years, these investors may have been open to supporting such plans if there is a pay-for-performance alignment over the long term, they have been more strident on holding companies accountable this year through their proxy vote.
2. Whereas in previous years, general pay-for-performance alignment relying on relative TSR could suffice as a reason to support SOP, investors have developed more discretionary approaches that employ both quantitative and qualitative factors these firms prioritize (e.g., BNY Mellon utilizes a proprietary quantitative assessment utilizing data provided by Equilar, a compensation data firm).
3. More than ever, investors view problematic pay practices as one of the primary signals that indicates a lack of proper oversight of management by the board, especially Compensation Committee members, which exhibits lack of independence on the board. These investors are more willing to vote against SOP to register their concern to company boards, which will make offseason engagement efforts and company "responsiveness" to investor concerns critically important for the 2020 proxy season.

One more trend to watch for the 2020 proxy season and beyond: although investors have not been using CEO pay ratio as an input by which to assess SOP vote, the strong correlation between CEO pay ratio and SOP results could nudge some of these investors to more closely scrutinize the pay ratio information in the proxy materials.

It would serve the companies well to keep abreast of the just-emerging best practices in pay ratio disclosure, and refrain from the practice of excessively "Non-GAAP"-izing this data which could trigger negative investor reaction, hence leading to votes against board members.

RUSSELL 3000 SAY-ON-PAY RESULTS BY CEO PAY RATIO



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The Test of Time: Adapting to a New Era of Executive Compensation

Posted by Amit Batish, Equilar Inc., on Sunday, July 14, 2019

Editor's note: Amit Batish is Content Manager at Equilar Inc. This post is based on an Equilar memorandum by Mr. Batish. Related research from the Program on Corporate Governance includes the book Pay without Performance: The Unfulfilled Promise of Executive Compensation, by Lucian Bebchuk and Jesse Fried and Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

Since the passage of Dodd-Frank in 2010, there have been a number of regulations around executive compensation and performance that have left a tremendous influence on executive pay plans. The ever-evolving world of executive compensation oftentimes puts companies in a precarious predicament as decisions on pay could have an ample impact across an entire organization. There are several factors that change year-over-year, and there is no question that this leaves compensation committees in limbo on what is considered sound practice. These factors include pressure from investors to align executive pay with performance, sudden executive departures and much more.

This post examines a number of trending topics and issues across the corporate governance world that are affecting the executive compensation landscape. While the changes in the industry are indeed a conundrum to solve at times, the fact remains that corporations must adapt to these changes, regardless of the nuances in the process. Designing effective executive pay plans is not a simple task, yet once achieved, could pay significant dividends for the well-being of a corporation.

Aligning Pay with Performance Takes a Brighter Spotlight

One aspect of executive compensation that is sure not to change anytime soon is the pressure to align pay with performance. Contrary to certain beliefs, this does not necessarily equate to a "one-size-fits-all" model, as numerous factors come into play. In recent years, it has become imperative that corporations tell their pay story clearly and adequately, particularly as investors continue to pay closer attention to performance. Specifically, shareholders are beginning to examine pay for performance through a wider lens, as investors seek perspective on performance over a longer time horizon. Historically, three-year performance periods have reigned supreme for executive long-term incentive plans. In fact, the recent Equilar *Executive Long-Term Incentive Plans* report revealed that in 2017, 86.9% of Equilar 500 companies—a subset of the largest U.S. companies—utilized a three-year period for their CEO LTIPs. This represented a 17.4% increase from 2013.

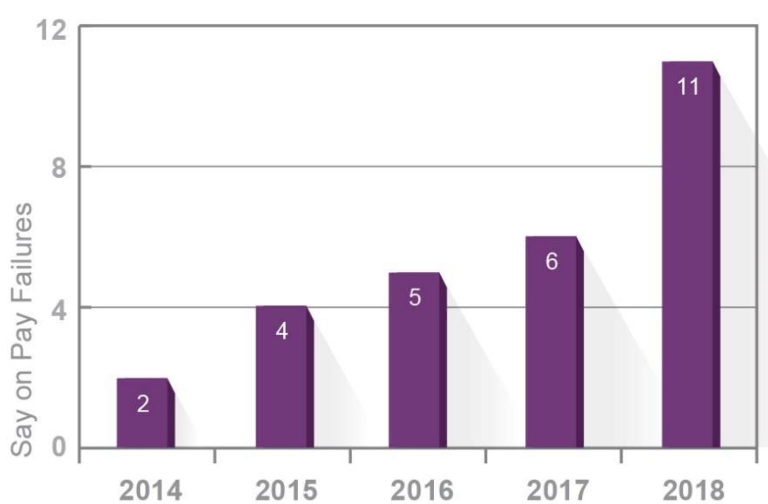
While an overwhelming majority of companies utilized a three-year performance period, there is indication that the trend may be shifting toward a longer performance period in the near future. For one, CalPERS—the largest pension fund in the United States—announced earlier in 2019 that it would begin assessing the executive pay plans of the companies it invests in under a new custom five-year quantitative analysis that compares total CEO realizable pay and total stock performance relative to a company's peers. The new framework, which utilizes a five-year time horizon, provides insight on how investors are evaluating pay for performance with a longer-term view and the potential impact on Say on Pay voting results.

In 2018, CalPERS voted against 45.4% of the S&P 500 on Say on Pay, according to corporate governance nonprofit As You Sow. These results are drastically higher than in previous years, as its five-year average for opposing Say on Pay votes was 16%.

According to Simiso Nzima, Investment Director of Global Equity at CalPERS, among the various compensation goals for CalPERS is to "ensure that the design and practice of compensation at portfolio companies appropriately incentivizes management and employees to generate long-term sustainable returns in alignment with the interests of long-term investors."

This assessment by CalPERS speaks volumes to the fact that Say on Pay continues to have a lasting impact on the executive compensation landscape almost a decade following its inaugural year. While executive compensation packages have been largely accepted by investors, 2018 saw a decrease in the approval percentage that Equilar 500 companies received. In 2018, less than half of companies received more than 95% approval on their executive pay packages, which is 10 percentage points less than the year prior. Furthermore, the number of Say on Pay failures nearly doubled from six to 11 in 2018 (Figure 1).

Figure 1
Say on Pay Failures, 2014–2018



Interestingly, a recent Equilar study revealed that median CEO compensation in the Equilar 500 after the initiation of Say on Pay was $9.5 million, while the median pay before Say on Pay was signed into law was $6.6 million. Of course, Say on Pay is an advisory vote and does not have a direct influence on executive compensation, but this is nonetheless an interesting finding. Diving a bit deeper into this analysis, the study revealed that companies tend to shift the components of pay awarded to CEOs following a failed Say on Pay vote.

For instance, in 2017, options made up an average of 11.8% of the CEO pay mix of companies across the Equilar 500. However, of the companies that failed Say on Pay in 2017, options made up 23.2% of pay mix, a sharp increase from the average. Trends indicate that when a company fails Say on Pay multiple times, it shifts its pay packages in an effort to decrease options significantly—a sure sign that companies are at least somewhat reactive to a failed Say on Pay vote.

As the compensation landscape continues to evolve, trends suggest that investors will pay closer attention to the performance of executives, even more than ever before.

CEO Transitions and Potential Implications of Pay

There is no doubt that the prevalence of CEO departures has increased over the last year or two, and this has captured the headlines across corporate America in the process. There have been a host of factors contributing to this steady climb in departures, including retirement, poor performance, a change in company direction and scandals. While these CEO departures have placed a number of organizations in a difficult position when it comes to a successor, an often overlooked area of concern is addressing the pay packages of these departed CEOs and the pay of a future successor, whether interim or permanent.

Equilar data indicates that in 2018, there were 80 announced CEO departures across the Equilar 500—the first quarter of 2019 alone saw 26. The average lifetime pay for all 26 departing CEOs in Q1 2018 was $129.4 million—a hefty investment for companies to commit to for a top officer who may or may not be the most appropriate fit for the job.

Companies will often appoint an interim CEO while the board searches for a permanent successor following a departure. However, constructing pay packages for these individuals requires meticulous planning. According to experts at the Equilar and Nasdaq Compensation Committee Forum in 2018, corporations should consider setting up interim CEO plans as a three-to-six month agreement and award monthly salary or equity grants. If this arrangement proves to be successful, then the company can extend the plan when applicable. Experts argue that setting up these plans as a one-year engagement risks the interim CEO leaving with a full year package.

During these times of uncertainty, concern from investors also arises. While several CEO departures may be planned and with a successor in place, oftentimes sudden departures put great pressure on corporations to address investors on why they should continue investing during this tumultuous period, particularly if the departed CEO’s pay package was above average. Therefore, it is essential that companies send a strong and articulate message to investors indicating a commitment to financial well-being, and a specific plan to keep operations running smoothly.

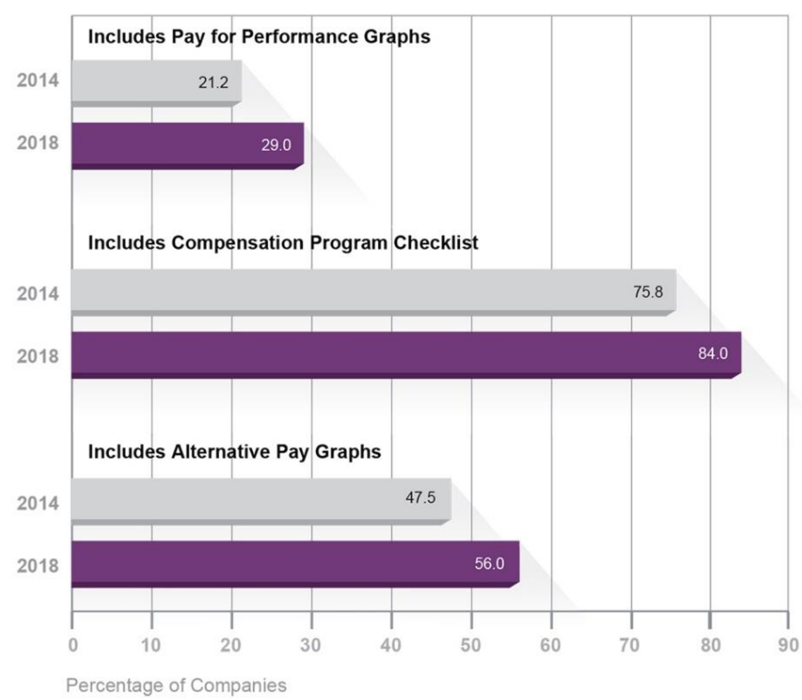
Within any executive position, there is going to be some degree of risk associated in the hiring process. However, the aforementioned concerns around performance in combination with the rise in CEO departures—whether planned or sudden—begs the question, how do corporations prepare for such circumstances and take them into consideration when setting pay packages? There is no correct answer to this question. However, compensation committees should be cognizant of this potential reality. When a corporation invests significant dollars into a particular executive, there is a strong possibility that it can either pay great dividends or possibly result in a failed experiment—a pitfall corporations most certainly want to avoid.

Addressing Scrutiny from the "New Investor"

The overarching theme of this new era of executive compensation really centers around one area of focus—the investor. The aforementioned new CalPERS approach serves as a prime example that there is no question that we currently live in the era of the investor, particularly a new age investor. Traditional tactics for engaging with shareholders on compensation matters may not have the same effect now as they did five years ago.

However, a number of tactics may be employed to ensure sound engagement practice with investors. A panel at the Compensation Committee Forum discussed this very issue. The panel explained that learning from peers is a critical element in the engagement process, particularly when it comes to disclosing compensation. The most effective approaches involve detailed disclosures, with some visual elements to depict trends. In fact, the Equilar *Innovations in Proxy Design* revealed that corporations are taking this into account at a higher rate, as the percentage of companies disclosing visual elements has increased steadily over the last five years (Figure 2).

Figure 2
Executive Pay in the Proxy
(percentage of Equilar 100 companies, 2014–2018)



Of course, the notion that companies should continually be engaging with their investors, regardless of whether there is an issue to address or not, still holds true. Investors want to see companies take a proactive approach as opposed to a reactive one. This sets the tone early and allows companies to be more defensible if and when they do come under scrutiny for pay packages.

Nevertheless, the landscape of executive compensation poses an interesting dynamic for compensation committees. While there will never be a correct approach to this particular compensation conundrum, the fact remains that if companies emphasize the importance of long-term growth when considering executive pay packages, then facing this new era will prove to be an achievable mountain to climb.

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Ten Years of Say-on-Pay Data

Posted by Terry Newth and Dean Chaffee, Pearl Meyer & Partners, LLC, on Sunday, June 9, 2019

Editor's note: Terry Newth is a managing director and Dean Chaffee is a consultant at Pearl Meyer & Partners, LLC. This post is based on their Pearl Meyer memorandum.

We researched 10 years of say-on-pay proxy advisory recommendations and results to understand how common it has been for a company to receive an "Against" vote recommendation or low say-on-pay support in a given year. The results are illuminating; more than 40% of Russell 3000 companies have received an "Against" vote recommendation from ISS, and almost half have received low say-on-pay support. The trend also suggests that these percentages will continue to increase each year.

Therefore, we believe companies would be well served to conduct regular, proactive stockholder outreach and engagement to mitigate the impact of a future negative vote recommendation.

The end of 2018 marked the 10-year anniversary of mandatory say-on-pay (SOP). Admittedly, the first two years were limited to financial institutions that received capital under the Troubled Asset Relief Program (TARP), but nonetheless this is an opportune time to evaluate how things have transpired over the past decade.

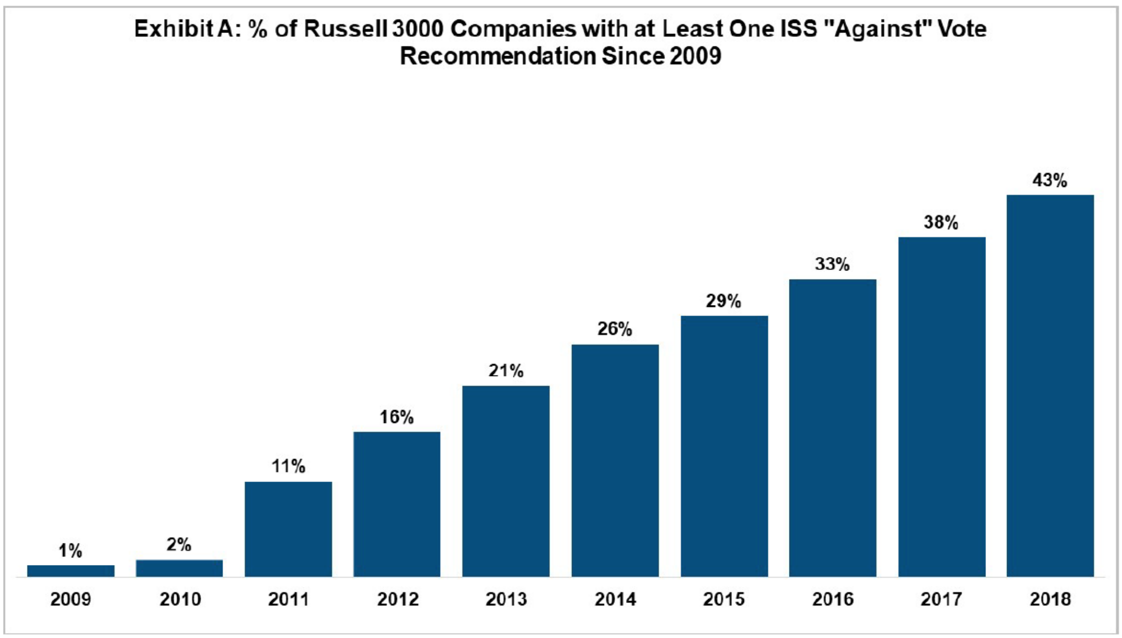
Say-on-pay first entered corporate America when, in early 2009, Treasury Secretary Timothy Geithner stated that recipient banks of TARP relief must hold SOP votes. By 2011, a vast majority of public companies across all industries became subject to these votes, triggered by President Obama's signing of The Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010. Today, SOP votes are as routine as the annual meetings in which they take place.

There have been many studies covering the frequency of negative say-on-pay votes, and the impact of negative shareholder advisory voting recommendations on actual vote outcomes, but we have yet to see a study on how common it has become for:

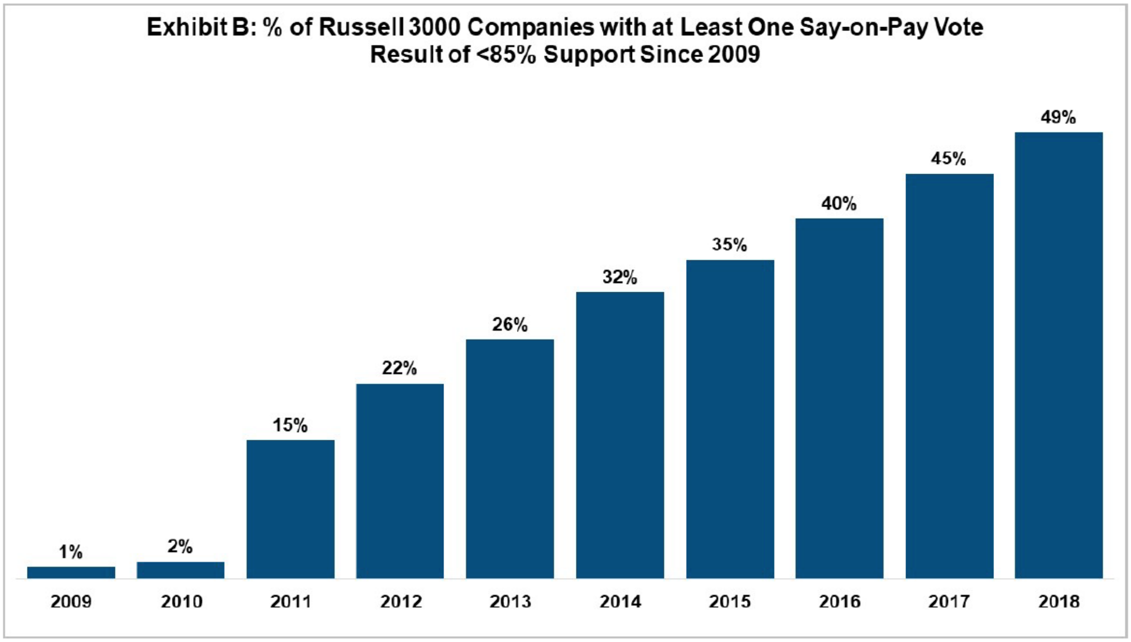
1. Companies to have received an "Against" vote recommendation from a proxy advisor in their history; and
2. Companies to have received suboptimal shareholder support (defined as less than 85%) in their history

This is a potentially important frame of reference to evaluate your own company's results. Management teams and compensation committees are loath to receive an "Against" vote recommendation from a proxy advisory firm. However, due to the structure of the models and evaluation approaches used to determine support of the say-on-pay proposal, it very well may be the case that the vast majority of public companies will eventually receive an "Against" vote recommendation. To research this, we collected Institutional Shareholder Services' (ISS) SOP vote recommendations and SOP voting results for Russell 3000 members from 2009 to 2018.

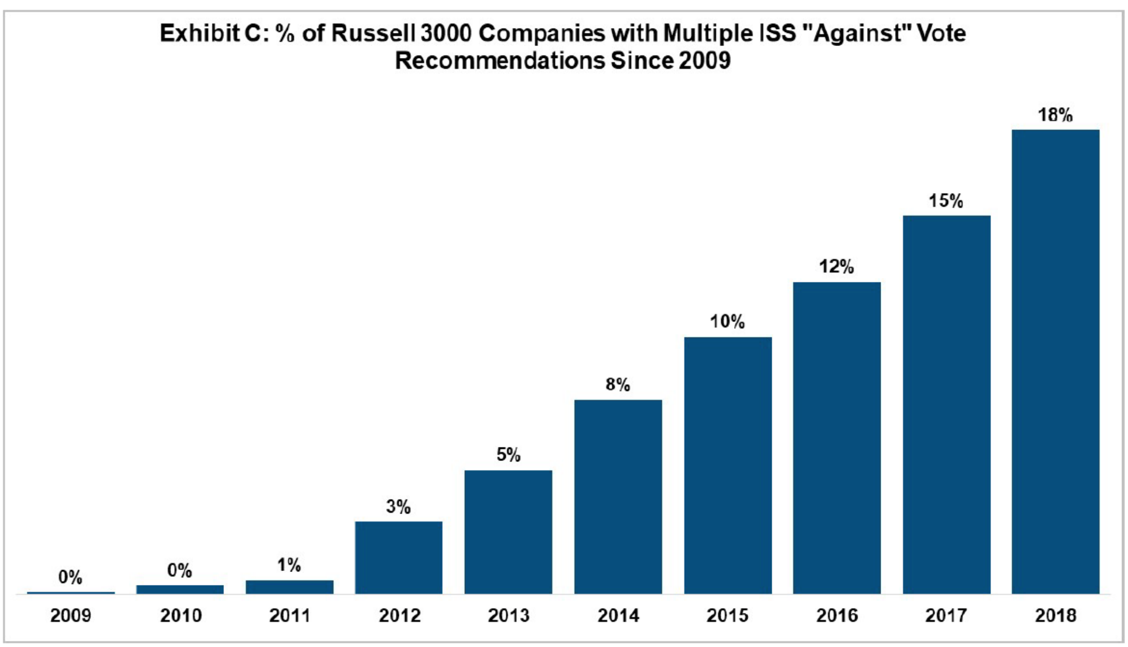
Exhibit A below shows this "build" where each year the number of companies that have received an "Against" vote recommendation from ISS in their history grows. We expect this growth to eventually level off as some companies have dynamics that will always fare well against the proxy advisory models (think of the founder-CEO who does not receive any long-term incentives). However, this levelling-off point is not anticipated in the near-term, and this number will certainly continue to trend upward for a while longer. It is reasonable to expect that at some point in the future, more than 80% of companies will have fallen victim to a negative vote recommendation at least once.

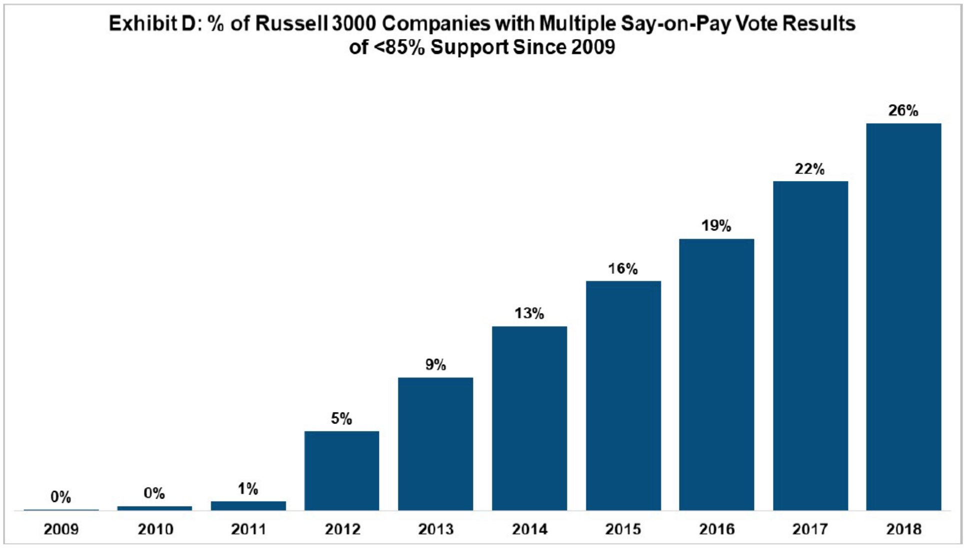


While Exhibit A is limited to data for the past 10 years on ISS say-on-pay vote recommendations, ISS is not the only influential proxy advisory firm. Unfortunately, we do not have 10 years of results from firms like Glass Lewis & Company, so we have used suboptimal shareholder support on say-on-pay (<85%) as a barometer for companies that have received an "Against" vote recommendation from any one of the major proxy advisory firms. Similar to Exhibit A, Exhibit B shows the buildup of companies that have received suboptimal support at least once over the past 10 years. As you can see, when making evaluations through this lens, we see that about half of all Russell 3000 companies have experienced a negative vote recommendation.



Another interesting area to explore is the likelihood of multiple negative vote recommendations or multiple years of suboptimal support. Cases of “multiple failures” with respect to both recommendations and vote outcomes are not uncommon. By 2018, about one in five (18.4%) Russell 3000 companies had experienced more than one ISS “Against” recommendation, and more than one in four (26.4%) had received lower than 85% say-on- pay support multiple times. Exhibits C and D below illustrate trends with respect to multiple negative outcomes; the increase has been substantial since say-on-pay votes began, and no pattern of leveling off or decreasing is evident.





We also researched variations and patterns in the results by industry sector and company size. More instances of less than 85% say-on-pay support occur as company sizes increase: 48%, 50%, and 52% of Small, Mid, and Large Cap companies, respectively, have had at least one occurrence of less than 85% SOP support since 2009. Additionally, the three size/sector segments with the highest occurrence of <85% support are all of the Large Cap group: Large Cap Health Care, Energy, and Communication Services.

Some sectors have it easier than others. Consumer Discretionary, Consumer Staples, and Utilities have relatively low prevalence of under 85% SOP support, across all size groups. Typically, however, rates fall between 40 and 60% for each size/sector segment. Please refer to Exhibit E, below, for more detail.

Exhibit E: One or More Say-on-Pay Votes with <85% Support Since 2009 by Sector (% of Companies)

	Small Cap	Mid Cap	Large Cap	**Total**
Consumer Discretionary	43%	52%	42%	45%
Financials	50%	54%	60%	53%
Consumer Staples	41%	31%	22%	32%
Information Technology	56%	49%	51%	53%
Industrials	44%	48%	50%	46%
Healthcare	44%	57%	65%	51%
Energy	64%	46%	65%	61%
Real Estate	45%	51%	48%	48%
Communication Services	43%	44%	65%	49%
Materials	53%	55%	50%	53%
Utilities	44%	29%	48%	39%
Total	48%	50%	52%	49%

Green: <40% Red: >60%

Implications and Recommendations

These findings highlight the potential exposure that companies have to negative vote recommendations from proxy advisors. To counterbalance this risk, companies should escalate the importance of shareholder outreach and engagement. Many companies currently perform annual governance- and compensation-related outreach and engagement, but for those who have not yet undertaken this exercise, consider the following key steps as a baseline:

1. **Define the scope of the outreach.** This covers (i) who the company would like to reach out to, and (ii) what the purpose of the outreach should be (i.e., just compensation, compensation and governance, etc.).
2. **Define the outreach team and their associated roles.** In our experience, outreach efforts are typically led internally by the Head of HR, General Counsel, and potentially the CFO. With certain significant stockholders, a member of the board—often the lead director or compensation committee chair—may participate. In many cases the company's proxy solicitor and outside compensation advisors are also involved in the strategy and execution of the process. There is also a team of people that supports this group from an operational
3. **Understand your stockholder voting guidelines before engaging with them.** Most of your large, significant stockholders will have their own internal policies on how they evaluate compensation and governance. In addition, tools are available that can provide insight into how closely these stockholders follow the main proxy advisors.
4. **Develop materials to serve as a conversation starter.** Before the company engages in discussions with stockholders, develop a set of slides that cover the key points of the topics to be discussed. Typically, these materials represent a summary of what is already available to the public (generally through the proxy statement, 10- K, or 8-Ks). Keeping to publicly-available information avoids inadvertent disclosure of material non-public information. The goal of these slides is to provide some background on the company, key highlights of the program, policies, decisions, etc. so that stockholders can have an informed opinion going into the discussions and can provide constructive
5. **Disclose your outreach and engagement efforts.** In each proxy statement, disclose the summary points of your outreach efforts. For example:
   - How many stockholders did you reach out to?
   - How many agreed to talk with you?
   - Who from the company participated in the discussions?
   - What were the key findings and themes?
   - What, if anything, did the company do to address those key findings or themes?

Going through the outreach and engagement efforts proactively, even if the proxy advisors have been supportive and the company's vote results have been good, can significantly benefit a company if or when a negative vote recommendation comes around.

2019 U.S. Executive Compensation Trends

Posted by John Roe and Kosmas Papadopoulos, ISS Analytics, on Tuesday, April 16, 2019

Editor's note: John Roe is Head of ISS Analytics, the data intelligence arm of Institutional Shareholder Services, Inc; and Kosmas Papadopoulos is Managing Editor and Executive Director with ISS Analytics. This post is based on an ISS Analytics memorandum by Mr. Roe and Mr. Papadopoulos. Related research from the Program on Corporate Governance includes The Growth of Executive Pay by Lucian Bebchuk and Yaniv Grinstein; and Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried.

As we enter the peak of proxy season, we review executive compensation trends in the U.S. based executive pay disclosures so far this year. Our key findings include:

- Compensation disclosures so far suggest continued increases in CEO pay across all market segments and almost all industries.
- The proportion of stock-based compensation as a percentage of total pay continues to increase, crossing the threshold of 50 percent of total pay for large companies for the first time this year.
- Performance-based equity compensation also continues to increase despite concerns of a potential reversal in the aftermath of the repeal of 162(m).
- CEO pay ratios remain relatively unchanged on aggregate, despite some fluctuations observed at individual companies.

More than two-thirds of S&P 500 companies and approximately half of all Russell 3000 companies have filed proxy statements containing executive pay information for the previous fiscal year. Same-store CEO pay levels show a healthy increase, with a median change in same-store S&P 500 CEO pay of approximately 6 percent compared to the previous fiscal year. These are companies that had the same CEO for the most recent two fiscal years. Non-S&P 1500 companies in the Russell index demonstrate the highest increase in same-store CEO pay with a median increase of 7.4 percent compared to the previous year.

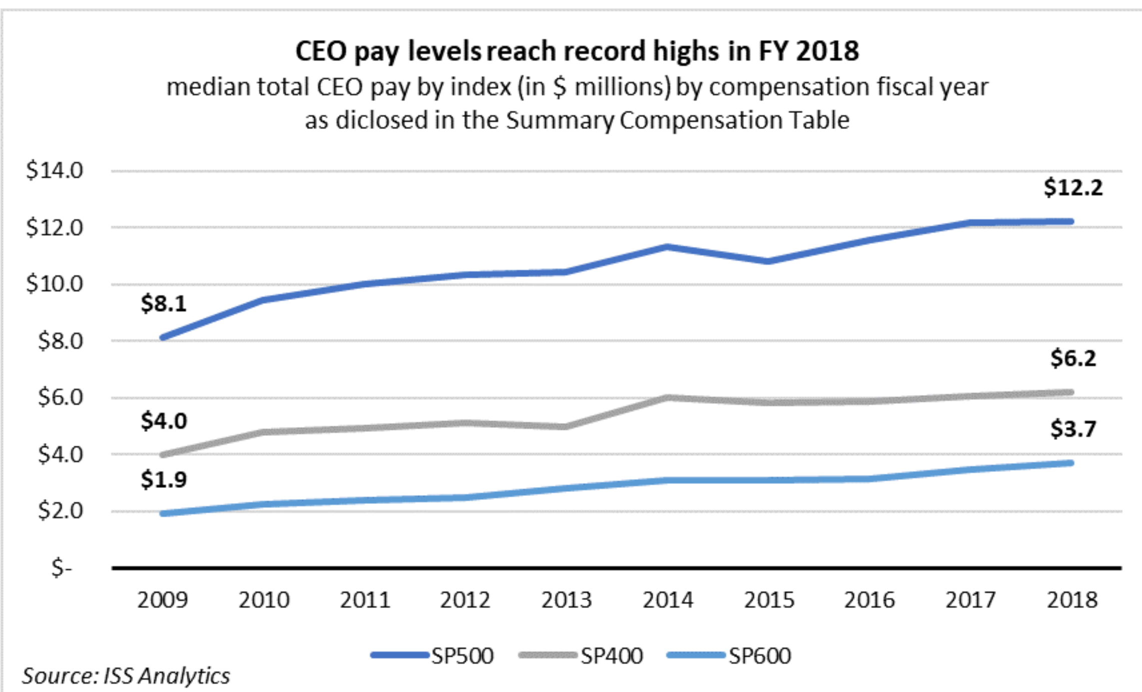
As of April 11, 2019	**S&P 500**	**S&P 400**	**S&P 600**	**Russell 3000 (excl. S&P 1500)**
Reporting Companies				
# Companies Reporting FY 2018 pay*	346	260	325	604

Same-store companies**	288	212	267	491
Median CEO Pay $ (Total SCT Disclosed)	12,214,523	6,180,516	3,693,084	2,725,666
Average CEO Pay $ (Total SCT Disclosed)	14,222,113	7,706,890	4,180,288	4,407,771
Median Pay Change (Same-store)	6.0%	4.5%	5.9%	7.4%

* FY 2018 pay defined as pay for any complete fiscal year ending on/after July 1, 2018
** "Same-store" means companies with the same CEO for the most recent two fiscal years.

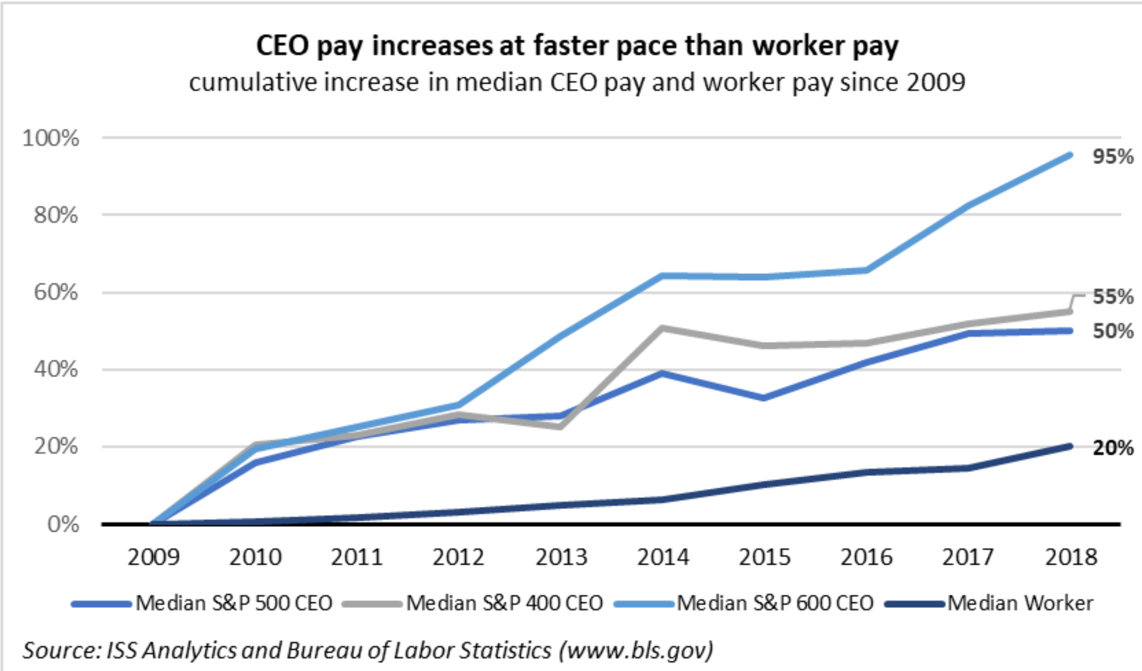
Quantum of Pay

During the past decade, CEO pay increased at a relatively fast pace. Median pay for S&P 500 CEOs rose to $ 12.2 million, showing an increase of 50 percent since 2009. The figure almost doubled for S&P 600 CEOs, with an increase of 95 percent since pay fiscal year 2009. For all our analyses in this article, we define "pay fiscal year" as any fiscal year ending in the period between July and June of each year. Therefore, companies with fiscal year ending from July 2017 to June 2018 fall within the 2017 pay fiscal year. The 2018 pay fiscal year covers companies with fiscal year ending on or after July 1, 2018.



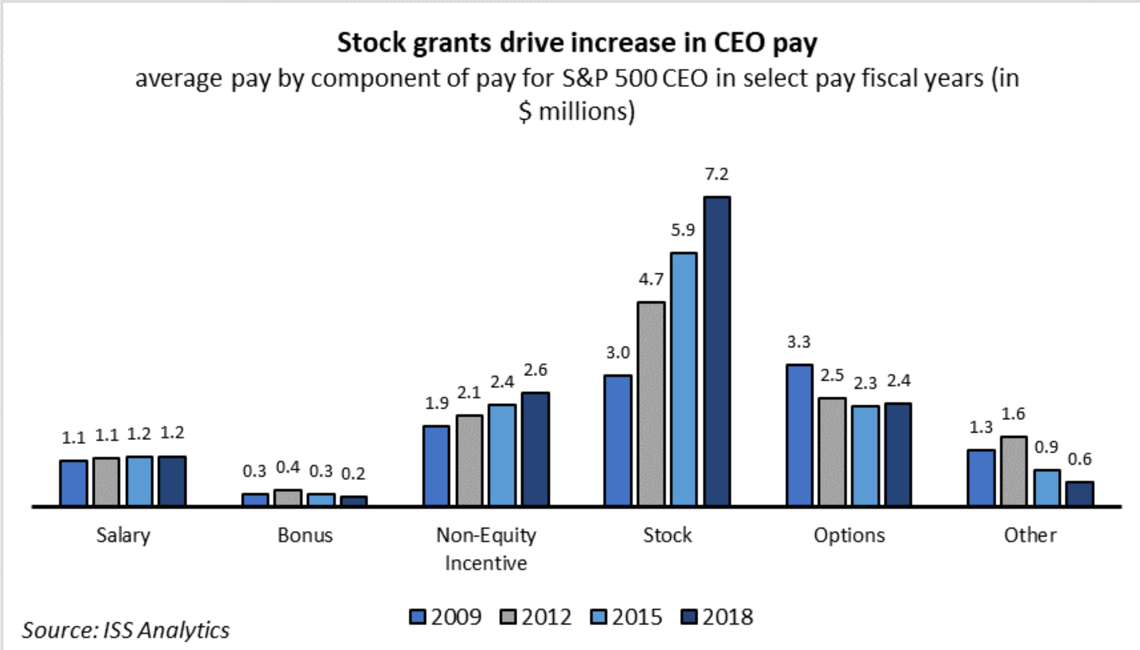
According to the Bureau of Labor Statistics, the cumulative consumer price index has increased by approximately 19 percent from January 2009 to December 2018, while median worker earnings increased by approximately 20 percent during the same period. The compound annual growth rate for median worker pay equals approximately 2 percent per year, compared to 4.6

percent for median S&P 500 CEO pay, 5 percent for median S&P 400 CEO pay, and 7.7 percent for median S&P 600 CEO pay. The chart below compares the cumulative increases in CEO pay and U.S. worker pay in the period since the financial crisis.

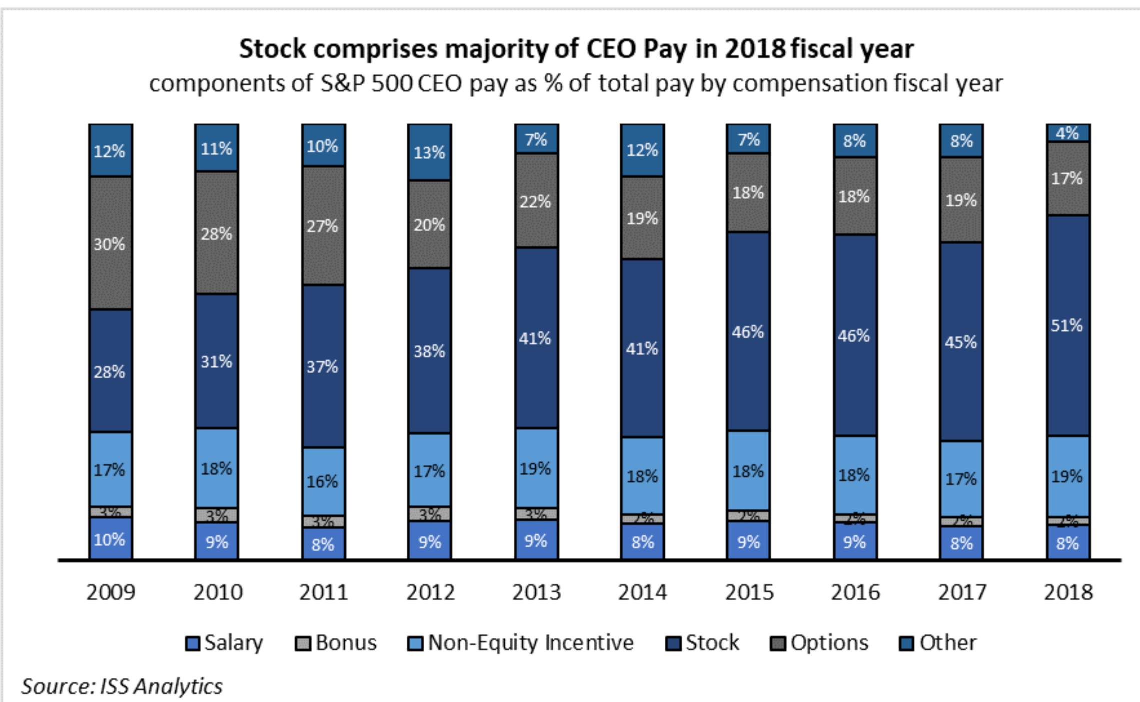


Components of Pay

Increases in compensation are primarily driven by greater portions of pay paid in stock. So far in pay fiscal year 2018, the average stock grant to S&P 500 CEOs amounts to $7.2 million, compared to $3 million in pay fiscal year 2009. Stock-based compensation continues to increase, while the aggregate of all other components of pay remains relatively unchanged.



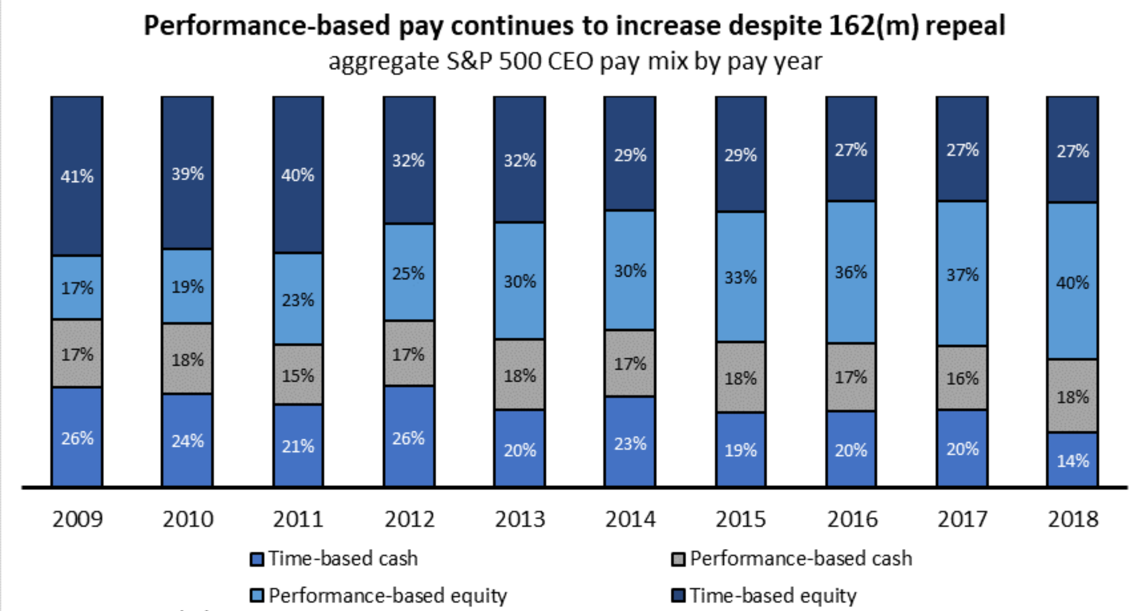
In fiscal year pay 2018, stock-based compensation comprises the majority of CEO pay at S&P 500 and S&P 400 companies for the first time. The trend is the same for smaller companies with stock-based compensation reaching 49 percent and 42 percent of total CEO pay for S&P 600 companies and Russell non-S&P 1500 companies, respectively.



CEO Pay Mix

The advent of say on pay and the increased engagement between companies and shareholders about executive compensation brought a focus on performance-based compensation. Equity-based compensation became increasingly performance-based in the past decade. As a percentage of total equity compensation, performance-based equity almost doubled between 2009 and 2018. Cash performance-based compensation has remained relatively unchanged. Overall, cash and equity performance-based compensation now make up approximately 58 percent of total pay, compared to 34 percent in 2019.

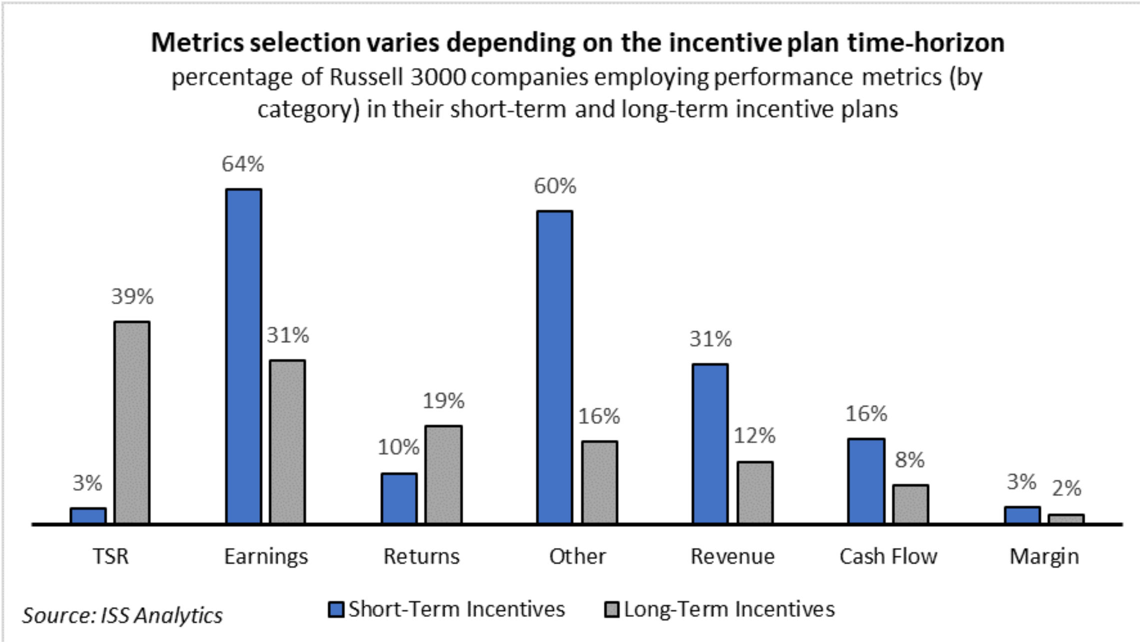
The increase in performance-based pay continued this year, despite concerns about a potential reversal. The 2017 U.S. tax reform removed tax deductions on performance-based pay previously allowed under provisions of Section 162(m) of the Internal Revenue Code. The repeal of these provisions raised concerns that companies would change course and increase the non-performance portion of executive payouts.



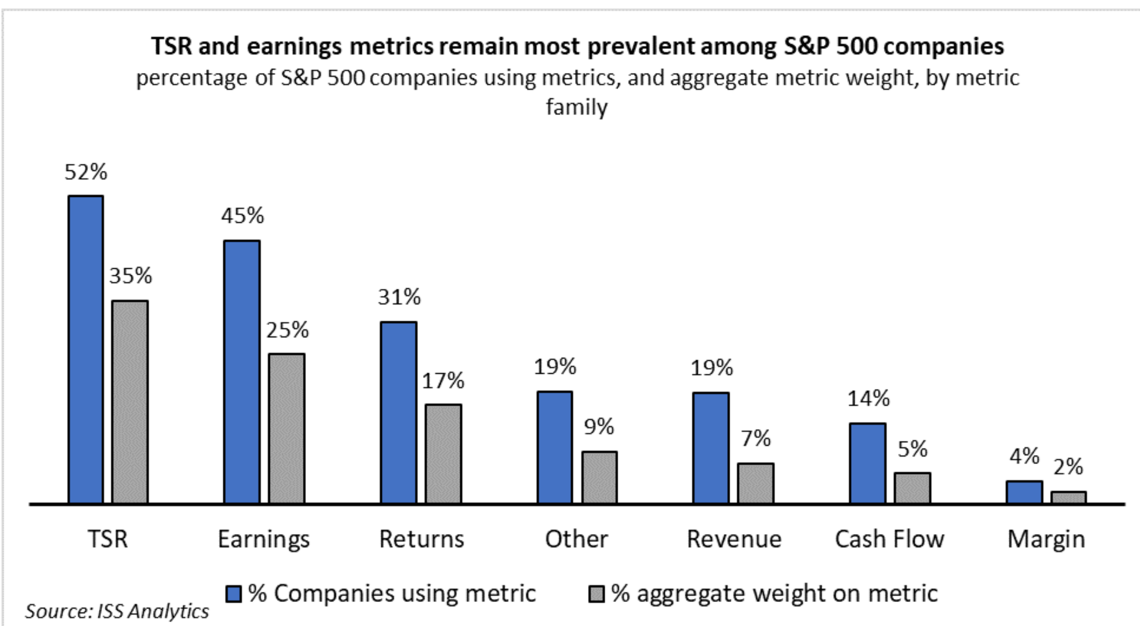
Source: ISS Analytics

Performance Metrics

With the prevalence of performance-based compensation, companies have evolved their selection of performance criteria. Long-term incentive plans use a wide variety of performance metrics at different weights, with TSR, earnings, and returns being the most popular performance measure categories. For short-term incentives, companies tend to use earnings, revenue, and “other” company-specific criteria.

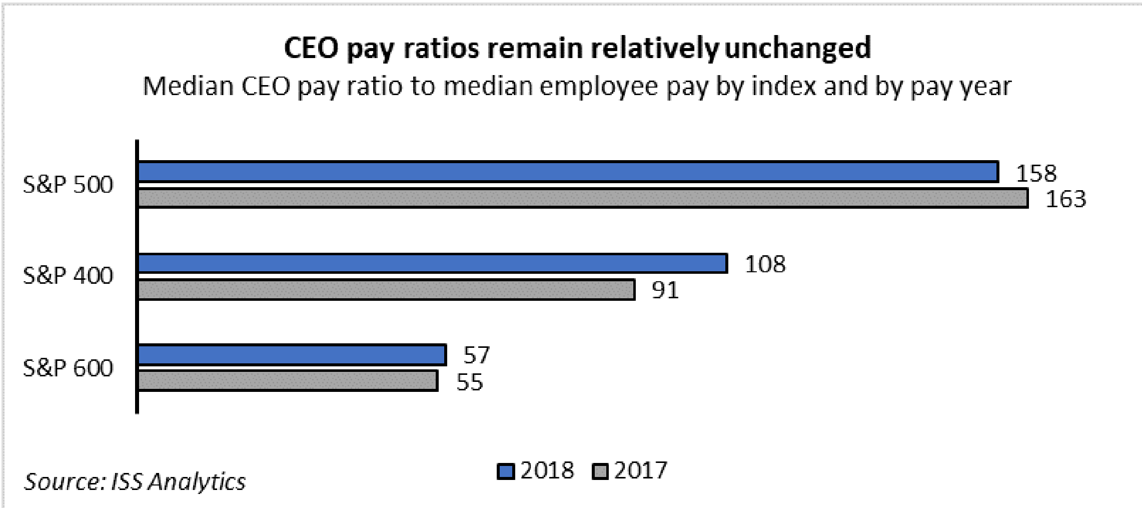


Taking a closer look at the S&P 500 universe, we observe a higher percentage of companies employing performance metrics, as large companies are more likely to have long-term incentive plans in place. Similar to the Russell 3000 universe, TSR, earnings, and returns are the most prevalent metrics categories used among S&P 500 companies.



CEO Pay Ratios

The 2010 Dodd-Frank Act mandated disclosures of CEO compensation relative to the pay of the median employee. The rule was adopted in 2015 and was implemented in last year's proxy disclosure filings for the first time. Companies maintain a level of discretion on the definition of median employee. So far, while one may observe a few significant fluctuations in the definition of median employee disclosures, on aggregate, the data indicates no changes in CEO pay ratios compared to last year. Median employee compensation levels remain similar to last year.



ISS will continue to monitor and report on trends in company disclosures on executive compensation.

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Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Seven Venial Sins of Executive Compensation

Posted by John Roe, Institutional Investor Services, Inc., on Tuesday, May 21, 2019

Editor's note: John Roe is Head of ISS Analytics, the data intelligence arm of Institutional Shareholder Services, Inc. This post is based on an ISS Analytics memorandum by Mr. Roe. Related research from the Program on Corporate Governance includes the book Pay without Performance: The Unfulfilled Promise of Executive Compensation, and Paying for Long-Term Performance (discussed on the Forum here), both by Lucian Bebchuk and Jesse Fried.

Compensation disclosures have grown significantly over the last decade (mostly for the better), and they continue to evolve with the ongoing engagement between companies and shareholders. Certain compensation practices are known for raising investor concerns, leading to difficult conversations between investors and boards and higher levels of investor opposition of executive pay programs. But beyond outright egregious practices, a careful review of the diverse set of compensation programs available may reveal some compensation practices that do not appear as significantly concerning but can raise pointed questions about a compensation program's alignment with shareholders' interests.

We call these potential transgressions the *venial sins* of executive compensation, and they are based on opinions and observations formed after several years of experience reviewing executive compensation disclosures and discussing compensation practices with investors. None of these opinions reflect an official ISS position or a preview of upcoming ISS voting policy, but they are meant to highlight potential risks related to otherwise sound incentive structures, as observed by the author.

Why seven *venial* sins? Well, we've already catalogued the seven *deadly* sins. More than four years ago, we began to collect the most commonly cited factors (other than simple ones, such as eye-popping pay quantum and severe pay-for-performance misalignment) contributing to headwinds in shareholder say-on-pay votes (typically support levels of less than 80 percent of votes cast). Although some of these factors have changed at the margin since 2014, most of the themes have remained surprisingly consistent. These seven themes—the seven "mortal sins" of executive compensation—that are most often associated with adverse vote outcomes include (in no particular order):

- An unresponsive or ineffective compensation committee;
- The granting of significant "special" awards without explanation or justification;
- Escalatory pay benchmarking practices, including "aspirational" peer groups and above-median targeting;
- Poor disclosure of performance metrics and goal mechanics;
- Lack of rigor on incentive targets;
- Multiple payouts on similar performance metrics; and

- Employment agreement issues, such as renewed excise tax gross-ups or guaranteed multi-year awards.

But these aren't the only problems that we see with executive compensation. What follows is a list of seven "venial" sins—meaning, they don't always (or even often) result in adverse voting outcomes, but we are finding that they are increasingly under scrutiny by institutional investors. Again, in no particular order:

1. Placing excessive focus on TSR-based awards

For years, companies and their third-party advisors have used total shareholder return (TSR) as a metric in compensation programs. There are a variety of ways to incorporate TSR in the compensation program: base relative TSR metrics (the most common by far), Market Stock Units (MSUs), simple stock price targets, and more. Companies and their advisors sometimes justify the use of TSR as a way to "satisfy investors and their proxy advisors" (although ISS never endorsed this metric and has quite emphatically stated being agnostic about metric selection going back to at least 2012). No matter the TSR award type, it may have some significant issues:

- *Point-to-point TSR measures over most executive compensation timeframes are more reflective of changing investor optimism than actual delivered performance.* TSR is best measured over the long-term—often measured in decades, rather than the three-year performance period in an LTIP cycle. The varying placing of companies during business cycles over a three-year LTIP cycle and the point-to-point nature of most measurement techniques make a relative TSR measure more of a lottery ticket than a performance measure.
- *Relative TSR awards may be interpreted as a "punt" on the part of the compensation committee.* Selecting the right metrics and establishing meaningful goals is hard—there's no doubt about it. But many companies claim that they implement a TSR program because projecting three years of financial data is simply too difficult for them; relative TSR solves that need by not requiring any projection. But boards should have the means and ability to create such projections, especially if these measures will help establish meaningful goals.
- *TSR is a levered measure.* In a bull market environment—which we've seen over the past 10 years—more financial leverage leads to higher returns; often companies with poorer fundamental performance but higher levels of leverage earn higher TSR than a similar company with lower leverage but stronger fundamental performance. However, when the market corrects, the situation will change significantly.
- *TSR awards do not give managers or investors clear line of sight.* It's hard for a CEO to get up in the morning and focus on "making more TSR." A CEOs job description should not include "stock price cheerleader-in-chief" as the main focus. Many investors agree that CEOs should focus on resource allocation and productivity, and excessive emphasis on TSR may distract from those priorities.
- *TSR awards can reward the executive multiple times for the same shareholder wealth creation.* Many alternative fund managers (hedge funds or private equity) have a concept of a "high watermark" in their fee structures; they are only paid once on value creation for their own investors. But we don't often see similar safeguards in TSR-based executive compensation awards. That opens the potential for executives to be rewarded multiple

times for creating the same shareholder wealth; the energy industry over the past four years has seen many such cases.

Many investors do recognize that having a relative metric in a compensation program is useful to encourage executives to look both outward and inward to assess their performance. And, even if we acknowledge that "cheerleader-in-chief" for the company's stock price may be an important part of the CEO's job, it should perhaps be encouraged more modestly. Some companies have chosen to use relative TSR as a modifier, adjusting LTIP payments up or down a moderate amount—say plus or minus twenty percent—as a way to accomplish these two aims. That may be a great way to incorporate TSR into a compensation program without motivating excessive focus. Certainly, there are many other ways to solve this issue that are just as effective.

2. Complicating the compensation program with too many metrics

Proxy advisors and investment professionals are reasonably sophisticated consumers of compensation data. They understand that modifier metrics, hurdle metrics, high watermarks, and other non-traditional structures can add value to a program. But there are some compensation programs that seem to take things to extremes. To illustrate, let's focus on the number of metrics of short-term incentive programs as an imperfect proxy for program complexity.

According to ISS Incentive Labs data, among S&P 1500 companies, the median number of metrics used in a short-term incentive plan is four, with the middle 50 percent of companies using between two and five metrics. In general, these aren't highly complex programs; even at the 75^{th} percentile, where there are five metrics in operation, the program is generally understandable, and investors can easily grasp the interactions among metrics in most cases. Perhaps more importantly, executives can focus management attention on improving those key metrics; there's clear line of sight to what the board wants management to prioritize.

But some companies take metrics to an extreme. There are some companies that have more than 50 metrics in their short-term programs (set aside an afternoon and go through the programs at **Consolidated Edison** or **Pinnacle West Capital**, for instance)—and many more companies have at least 15 metrics. When you ask the CEO to focus on everything (or, at least, too many things), you face the risk of losing the CEO's focus on the things that are most important.

Ninety percent of S&P 1500 companies include eight or fewer metrics in their short-term program. If a company employs more than eight metrics in their STIP, the program may be worth a closer look. One may at least look for a rationale as to why fewer metrics cannot be used.

On the long-term side, the median number of metrics used (including modifiers and hurdles) is three, with the middle 50 percent of companies using between two and four metrics. Only 10 percent of companies use six or more metrics—although we see some companies using significantly more than that.

3. Seeming to allow management and consultants drive the executive compensation agenda and program

Investors are not naïve. They know that deep executive compensation expertise is not a skillset that often appears on a board's director search criteria. Consequently, there's a lot of reliance on third-party advisors to design, benchmark, pressure-test, and disclose executive compensation programs. But what's essential is to have firm and effective boardroom oversight over these processes.

How does this practice become apparent? Well, one way is through shareholder engagement. Investors report that, in some engagements, companies bring along their compensation consultants or members of management to explain the compensation program, even though they have members of the compensation committee present in the room.

That's not to say that management and consultants don't play a vital role in the executive compensation process—they do, and there is nothing inappropriate with management and consultants playing a significant role in the process. But when the compensation program evolves to the point that compensation committee members have difficulty articulating the program's strategy, mechanics (not including the technical details that are beyond the board's remit, of course), and connection to company strategy, there's a problem.

Some proxy statements do an exceptionally good job of articulating the committee's involvement in the process, and, oftentimes, engagements with directors at those companies confirm the committee's understanding and direction of the program. However, far too many proxies leave the division of duties and the altitude of the committee's engagement in the compensation process to the reader's imagination—and, as some investors report, engagement meetings seem to confirm these suspicions.

4. Blurring the line between retentive pay components and incentive pay components

One of the seven deadly sins is the "special grant"—often called a retention grant. Certainly, that's an issue—but, at least in years when the formulas haven't failed, these grants are more symptomatic of a greater problem: the failure to structure pay programs with an appropriate mix of retentive pay and incentive pay. Of course, there are exceptions; when formulas obviously fail and pay low when operating performance is high, there may be a need for a supplemental grant, but those situations are relatively uncommon.

For the purposes of illustrating this argument, we categorize the various elements of compensation in two separate parts: retentive pay and incentive pay. The retentive pay program includes items such as base salary, time-vesting stock, perquisites, and pension adjustments—in other words, items that an executive could depend on receiving, no matter the level of performance of the company. The incentive pay program elements—including bonus, non-equity incentive program payments, and performance stock—are designed to reward executives for their performance-managing and operating the enterprise. (Stock options are conspicuously left out; there are good arguments for putting them in either the retentive or the incentive columns.)

However, today it seems that some companies are convinced that executives are entitled to part of incentive pay, even when performance doesn't pan out. Some companies have done this by including a minimum payout on below-target performance (doesn't that make those awards actually just time-based?), while others have resorted to other mechanisms—such as one of the “deadly sin” second-chance awards—to carry out this new philosophy. This practice also relates back to the first venial sin, since these special grants are more often made in relation to failed relative TSR awards.

Compensation Program	
Retentive Pay (not based on company performance)	**Incentive Pay (based on company performance)**
• Base Salary • Time-vesting stock • Perquisites • Pension Adjustments • (Stock Options)	• Bonus • Non-Equity Incentive Program • Performance Stock • (Stock Options)

Ideally, the magnitude of the aggregate of retentive components of pay should be enough to mitigate retention concerns, even in down years. If companies are looking to decide what the right split of performance versus non-performance pay is for their executive team, this should be a guiding principle, instead of presenting retentive pay in the guise of incentive pay.

5. Paying insufficient attention to director or NEO (non-CEO) compensation, particularly when investors may find it noteworthy

Compensation disclosures are often focused on CEO pay, with credit given to many companies who have evolved their named executive officer (NEO) pay disclosures, and a few have addressed director pay, as well. However, these two groups—directors and NEOs—also are often groups where pay disclosures are less than what investors would like to see.

ISS has been reviewing director compensation for some time. But, as announced last year, the ISS benchmark policy will start more systematic voting action based on excessive director compensation in 2020. And while many companies spend 20, 30, or more pages explaining the compensation program for executives, the explanation for director compensation decisions is frequently scant.

Recent editions of Governance Insights have extensively covered director compensation, so there won’t be a dissection of the numbers in this issue. In cases where there are issues that drive unusual director compensation (special committee assignments, strategic situations, new director grants, and more), giving a little insight into those special circumstances, and how they benefit shareholders in the long term, is helpful.

On the NEO side, a variety of issues are sometimes seen. At the extreme, some companies seem reluctant to name five NEOs; we’ve seen S&P 1500 companies that name only the minimal two named executives (CEO and CFO) rather than five. Do these companies, with market caps of more than $1 billion, really only have two individuals that meet the definition of Named Executive Officers? And if so, does that pose an issue for succession and organizational control?

Another issue pertains to pay outcomes for NEOs that separate from service. ISS has noted another wave of companies that disclose their executive is "retiring," yet severance benefits are paid upon their departure. When there are retirement benefits on top of severance benefits being paid, questions may arise: What triggered the severance payments? How did the payout help the shareholders' cause?

Paying more attention to director and NEO compensation—particularly in non-standard situations, such as fewer than five NEOs named, or NEO turnover, or special board activity—can impart investors with a lot more confidence in the compensation committee and the company in general.

6. Suffering from "snowflake syndrome"

"But we're different." How many times have you read proxy language or heard engagement dialogue that sounds along these lines? Of course, almost every company is different—different capital structure, different competitive dynamics, different geographic footprint, different labor sourcing model, different levels of automation, different points in the business cycle; the sources of difference are endless. But the struggles that almost all companies face when setting executive compensation programs are similar.

It's hard to gaze into the crystal ball and select metrics that will drive the company forward over the next three years. It's hard to set compensation goals that will play out over three years. And it's hard to project where the company might be in three years. These challenges have been faced time and time again by other companies; there aren't nearly as many snowflake situations as disclosures might attempt to establish. After all, every investment bank and credit rating agency develops projections on a company, and they're using outside-in data. Companies should be able to do at least as well.

To sophisticated investors, some of these situations often sound like companies aren't doing enough to think forward about their business. The "snowflake" argument is increasingly falling flat—particularly when companies use the argument to justify opaque or completely discretionary pay programs.

7. Assuming that everyone looks at compensation programs through the same lens

In years past, companies felt relatively safe in that if they addressed issues covered by voting policies at the significant proxy advisory firms, they would also be addressing the concerns of their largest holders. But times have changed; particularly since the advent of say-on-pay, sophisticated shareholders have invested in building significant executive compensation expertise. They've hired former compensation consultants and in-house compensation professionals, and they've cross-trained stewardship team members to be compensation experts.

Along the way, institutional investors have developed unique ways at looking at compensation, and they are taking bespoke perspectives on pay much more often than in the past. These perspectives may include views on realizable pay, pay leverage, metric turnover, outside-of-plan awards, alternative performance measures, alternative peer groups, longer timeframes, metrics that analyze aggregate NEO pay, and many, many more.

The point is, writing a disclosure in an attempt to satisfy the informational needs of the benchmark voting policies of major proxy advisors may be a great start, but it simply may not be enough. Addressing the company's shareholder base is what's most important. That means getting to know your shareholders (largely through engagement) and asking about their viewpoints on compensation. If you get answers from large shareholders that they don't pay attention to pay, there's a good chance you're not talking to the right person.

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Stakeholder Capitalism and Executive Compensation

Posted by Don Delves and Ryan Resch, Willis Towers Watson, on Wednesday, October 2, 2019

Editor's note: Don Delves and Ryan Resch are managing directors at Willis Towers Watson. This post is based on their Willis Towers Watson memorandum. Related research from the Program on Corporate Governance includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here) and 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).

The Business Roundtable recently revised its Principles of Corporate Governance to include a new Statement of Corporate Purpose. The new statement is a significant departure from the past in that it includes serving all "stakeholders," including customers, employees, suppliers, communities, the environment and shareholders. The prior statement only included shareholders.

While many in the legal profession, academia and various "moral" or "conscious" capitalism groups have articulated various forms of the stakeholder argument for a long time, the vast majority of investors, board members and executives of public companies have aligned with the "shareholder primacy" philosophy for the last 30-40 years. Shareholder primacy is based on the belief that generating profits and creating value for shareholders is the primary purpose, if not the only purpose of a corporation. Maximizing long-term shareholder value has been the well-accepted, core measure of success for most corporations, and their management teams and boards, at least since the 1980s.

So, the Business Roundtable's restatement of a corporation's purpose is a rather significant philosophical change. Some have used the word "tectonic." However, the concept that a corporation should deliver value to all of its stakeholders including the broader community is not new. In fact, much of what the Business Roundtable is stating is in line with what many investors and investment managers have already been saying. The Business Roundtable statement follows other groundbreaking statements by investors and fund managers about the importance of companies having a social mission or reason for existing beyond making money.

Increasingly, investors are interested in how companies score on various environmental, social and governance (ESG) measures, including human capital management (HCM). Many of these measures, in essence, capture how a company treats and values its various stakeholders. So, one could argue that the Business Roundtable is responding to investors by being more concerned about other stakeholders. Moreover, the longstanding core objective of shareholder value creation and expanding a company's purpose to better serve a larger group of stakeholders are not incompatible concepts; in fact, achieving the latter should be a means to the end.

A little history and context

Most for-profit corporations and virtually all publicly traded corporations have been operating under the shareholder-first business model for a long time. A large part of corporate governance and the way most boards of directors conduct business is built around this business model. Many would argue that this approach has been quite successful, if not wildly successful for a very long time.

Executive compensation has been heavily geared towards the shareholder primacy viewpoint since at least the 80s. Over the last 30 years, executive compensation professionals have consistently strived to "align the interests of management with those of shareholders." Starting in the 1980s, large stock and option grants—"mega grants"—were made to a few select CEOs. Others followed. Public outrage led to well-intentioned but poorly designed legislation like the million dollar pay cap (IRC Section 162(m)). The 90s saw an explosion of stock option grants to executives and, for a great many companies, to all employees. The mantra was that we wanted to "make employees think and act like owners." In large part, that is what happened. We actually made employees think and act like option holders, which fosters a higher level of risk taking than many shareholders might like, but the focus was still very much on alignment with shareholders, as opposed to any other stakeholder group.

This approach was strongly endorsed by the investment community and many in the academic community. Agency theory was and is the principle academic application of shareholder primacy to executive compensation. The theory, grossly simplified, states that management are the agents of the owners, and that they will act in their own best interests unless they are provided with powerful incentives to act in the interests of the owners. Hence, large grants of stock and options to "align" managements interests with those of the owners.

By the end of the 90s, it was apparent that heavy doses of stock and option compensation was an effective way of focusing management and employees on stock price and shareholder value creation. Some even argued that excessive stock option grants influenced the "irrational exuberance" of the economy and stock market of the 90s. For that and other reasons (like a market crash and recession), stock and option grants were toned down just a bit in the early 2000s.

Then, in 2005-2006, the Financial Accounting Standards Board implemented an expense for stock options in the form of Financial Accounting Standard 123R (now ASC 718). Almost overnight, companies shifted the mix (but not the size) of stock grants to include more restricted stock and performance-based stock. Long-term incentives became more sophisticated, but still maintained a very strong focus on shareholder value creation.

We now have a heavily tailored mix of stock-based compensation, including a preponderance of "relative TSR" based plans. Each company grapples with identifying the right mix of stock, options and performance plans for their industry, strategy and talent market. If anything, companies have become more sophisticated at tying management incentives and management interests to the interests of shareholders.

Implications for Corporate Governance

The Business Roundtable's statement was signed by 181 CEOs who commit to lead their companies for the benefit of all stakeholders—customers, employees, suppliers, communities and shareholders. Based on this fact alone, public and private company boards should probably engage in a conversation with management about what this means for the company going forward. How does the company see its purpose? What is the relative importance of each constituency? Has that mix changed over the last 5-10 years? For example, have employees become more critical to the long-term success of the company? Put differently, has the value of human capital become more important relative to financial or physical capital?

Will resources be allocated differently? Will the company invest more in its employees, or treat its customers or suppliers differently? Will it be more involved in local communities or pursue new environmental initiatives?

Companies may also want to engage in dialogue with investors to learn their views on the importance of other constituents and what they are looking for in terms of demonstrable results with those "other stakeholders." Our guess is that investor viewpoints may vary significantly. Note that while some large investment managers like Black Rock have stressed the importance of purpose and human capital management—in keeping with the Business Roundtable statement, the Council of Institutional Investors had a largely negative initial response to the Business Roundtable's new position.

Boards may need to determine whether change is needed in how strategy is articulated, priorities are established, and performance is measured and assessed. Will short- and long-term success include goals and measures around customers, employees, suppliers, etc.? How will the Board provide oversight over these areas? What committee will be responsible for which stakeholder group? What data will need to be reviewed and how often? How will success be defined?

Boards may want to work with management to develop "stakeholder scorecards" that provide an oversight view into how the company is performing with each constituency, and how that performance changes over time (and, possibly, how it compares to other companies).

Lastly, and perhaps most important—what new information will be shared with investors and the public about a company's commitment to, and results with each of their stakeholders?

These and other questions should be carefully discussed and evaluated in light of the evolving business and economic environment, the relative importance and value of various constituents in the firm's economic model, and the changing preferences of investors.

Please reference Willis Towers Watson's recent white paper on Company Purpose and Sustainable Human Capital for more on how effective human capital management enhances performance and value.

Implications for executive compensation

If companies are to shift their priorities from a heavily shareholder-centric model to one focused in a more balanced way on multiple stakeholders, it would follow that executive compensation should also change. How can and should this take place? Growth, profits and returns drive value creation. It is difficult to serve other stakeholders without providing returns and value to shareholders. So, we don't recommend any kind of radical departure from the time-tested shareholder value model of executive compensation. However, some possible actions include:

- **Include new measures in annual incentive plans.** A small percentage of companies currently include environmental, human capital or governance measures in their annual incentives. For most of these companies, it is a small percentage of the total incentive. This is a good place to start.
- **Add a "stakeholder modifier" to the long-term incentive.** We know of a few privately-owned companies that have such modifiers, or other factors in the long-term incentives. Privately-owned—and especially large family-owned—companies are more likely to acknowledge the importance of other stakeholders and include something significant in their long-term incentives to acknowledge this. For example, one company makes significant adjustments to LTI payouts based on how it scores on annual employee surveys that test how well the company lives by its values.
- **Track and adjust "sharing ratios."** Again, this is something we see more commonly at privately-owned companies. These companies calculate the percentage of profits shared with owners and executives, versus employees, the community and the environment. They are willing to reduce the percent to owners if they think it will create a healthier and more sustainable company in the long term.
- **Make long-term incentives truly long term.** Many have argued the main problem with the shareholder-first business model is an overly short-term focus on results and stock performance. A longer term focus would allow for investments in people, innovation, product development and other stakeholder interests to pay off and contribute to longer term performance. Hence, longer term vesting or holding requirements, or possibly longer term performance cycles, may help balance results for multiple stakeholders.

Executive compensation has been one of the principle tools of shareholder primacy for at least 30 years. Executive and management incentives have basically cemented this way of thinking into the fabric of most companies. If those companies, their CEOs and boards are serious about changing the business model to serve all stakeholders, and do so with accountability, executive compensation will have to change. People generally do what you pay them to do; so if you want them to do something different, their pay will have to also be different.

A principles-based approach

We at Willis Towers Watson have advocated a principles-based approach to the design and governance of executive compensation for many years. Executive compensation can be very complex and very controversial. There is rarely a 100% correct answer to a given set of challenges. Every company is different. In addition to publicly-traded, for-profit organizations, we also work with for-profit companies owned by founders, families, foundations, private equity investors and various combinations of owners. We work with co-ops owned by their customers or suppliers. We also work with a wide range of non-profit organizations, including health care providers, academic institutions and associations. Each has its own purpose, mission, strategy and set of constituents it serves. So, we are not strangers to the concept of an organization serving multiple stakeholders. Nor are we unfamiliar with designing and governing incentive programs geared towards those stakeholders.

Consequently, we operate by a set of Guiding Principles, which include detailed operating standards, and four overarching principles:

Purpose: Executive compensation programs must be aligned with, and promote the achievement of the organization's purpose, mission, strategy and objectives.

Alignment: Executive compensation programs should foster alignment between the interests of a company's management and those of its owners and other stakeholders—as well as alignment across business units and geographies, and among employees at multiple levels.

Accountability: Compensation and incentive programs are a core part of the accountability structure of most organizations. They are often the primary means by which goals and objectives are communicated and people are held accountable for their achievement.

Engagement: Compensation and incentive programs must be competitive, meaningful, understandable, fair, and tied to achievable yet challenging objectives. They should be powerful tools to communicate what is important and motivate desired behaviors and results.

These principles have been effective for the governance of most executive compensation programs for many years. As we move forward into a new age of stakeholder capitalism, we may need to add principles like stewardship, sustainability and responsibility to reflect both the broader purpose of corporations and the broader oversight role of boards. We look forward to partnering with our colleagues and clients in this fascinating and important evolution of business purpose, governance and pay.

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A Stakeholder Approach and Executive Compensation

Posted by Seymour Burchman and Mark Emanuel, Semler Brossy Consulting Group, LLC, on Tuesday, October 8, 2019

Editor's note: Seymour Burchman and Mark Emanuel are Managing Directors at Semler Brossy Consulting Group, LLC. This post is based on their Semler Brossy publication. Related research from the Program on Corporate Governance includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

What does it mean for boards and compensation committees that 181 CEOs from the Business Roundtable amended a long-standing statement of corporate purpose last month? The CEOs declared that the purpose of companies is to serve their five key stakeholders—shareholders, customers, employees, suppliers, and the community, not shareholders alone.

In putting their signatures to that idea, these CEOs challenged the notion of shareholder primacy, a principle of business for the last fifty years. Not surprisingly, the Business Roundtable's statement sparked a host of editorials in the business press, some arguing that the group had made a grievous error. Many writers seemed to suggest the choice is binary: You're either with shareholders, or you're not. The Business Roundtable, in contrast, implies the choice isn't either/or. It's both.

Rightly or wrongly, the question will now come up in many boardrooms and on many investor calls: What is being done to address the needs of all stakeholder groups? Some commentators may even point to academic research that shows a positive correlation between companies that promote the interests of stakeholders and better financial performance.

The challenge for management and boards, of course, is to take the Roundtable's broad principles statement and translate it into action. For companies that have not already traveled far along this path, we suggest three steps:

1. Identify key stakeholders and their interests: What do stakeholders need and expect so they give the company, in return, what it needs to create long-term value? What value proposition should be created for each?
2. Resolve tradeoffs: What are the company's highest priorities, and which stakeholders can support them? What will the company do, and what won't it do?
3. Create accountability for achieving priorities: How do you focus and align the efforts of executives through goal setting and pay?

Both executives and boards will be forced to respond to the stakeholder issues, and directors on the compensation committee in particular will have to adjust their thinking to establish accountability to stakeholders in executive compensation. What new kinds of information will the board and the compensation committee need? Which measures of performance should they ask management to see? How should they set goals tied to pay? How can the company respond to stakeholders and unleash value creating strategies?

Establishing Agreement on Stakeholder Needs to Address

As a first step, boards and management teams may want to back up and be more explicit about the company's mission and vision—explicit enough so the mission indicates how the company can and should create value for key stakeholders. CEOs and boards may even have to spend time refining key strategic priorities and initiatives to assure that stakeholders, as a group, eagerly provide the outside capital, employee talent, customer enthusiasm, and public support needed for company success.

The approach will require querying stakeholders and soliciting feedback on how to win their support. This feedback then serves as the basis for executives and the board to make tradeoff decisions. Which stakeholders' needs represent the greatest opportunities if their needs are met? Which represent the greatest risks if their needs are not met? Should the company focus on just needs and risks or simply doing no harm? Not all stakeholders' interests will get equal weight during this process, but each should get equal consideration.

Reflecting the Stakeholder Approach in Compensation

How the Annual Goals for a Retailer Might Look

Individual goals:

- HR—establish new hiring protocols; training in using hiring protocols, customer service and sales training, training managers in coaching skills
- IT—develop customer analytic tools, develop inventory management tools
- Store/region goals:
- Net promoter score/customer satisfaction score exceeding peers
- Average Sales dollars per full-time equivalent employee versus historical
- Gross margin exceeding peers
- Comparable trade area sales-growth (agnostic as to channel where purchase occurs)
- Employee turnover rate within 180 days of hire
- Corporate goals:
- Total sales growth exceeding peers
- Profit growth exceeding peers
- ROI exceeding peers
- Corporate-wide net promoter score and customer satisfaction score exceeding peers
- Employee engagement scores exceeding historical

Not surprisingly, this exercise does not relieve boards and management teams of the age-old task of weighing benefits against costs. Nor does it eliminate the need for executives and the board to solicit feedback and get buy-in from major investors on its choices. Does the strategy for involving stakeholders in maximizing corporate value make sense to shareholders? In yearly conversations with investors, does the head of the compensation committee explain the stakeholder rationale and let investors voice their opinions? How does everyone feel about the tradeoffs, especially those that, in the near term, depress shareholder value in the interest of boosting it three to five or more years hence?

Linking Stakeholder Needs to Executive Compensation

Once management and the board agree on the stakeholder value propositions (and the associated payoff for the company in return), the compensation committee can begin to consider how (if at all) it should establish accountability in the company's executive compensation programs. It will have to take into account three factors in the process: the status of the company's

- capabilities,
- economic or industry-level constraints,
- and acceptable standards of performance established through benchmarking.

Two questions stand out at this point: What is the company *able* to do? And what does good performance look like competitively on a long-term, sustainable basis?

This conversation about stakeholder expectations—and their linkage to executive compensation—must be reconciled against performance levels that are both reasonable and achievable within the given timeframe. Only then can the committee tie the goals to executives' annual and long-term incentive pay in a manner that appropriately supports stakeholder priorities and is driven by a rationale that will be compelling to institutional investors.

A Retail Case Study

As an illustration of how the stakeholder approach works, and how the directors of the compensation committee might go about setting goals, consider a company like Trader Joe's.

The food retailer has used the stakeholder approach for years, and it ranks as a top retail success story. Any visitor to a Trader Joe's store can see that the company relies on meeting the needs of both employees and customers as a means to deliver premium value to investors. In fact, Trader Joe's tops Forbes' list of best places to work and ranks second highest of all companies in customer satisfaction. By spending money on employees—through wages, training, and career opportunities—the company cultivates a high-quality, engaged workforce. The workforce, in turn, assures that the company creates an engaged, loyal base of customers—customers who enjoy the fruits of the employees' efforts.

Because it is private, we don't know what Trader Joe's board has approved as goals in its executive pay plans, but we can assume that making good on the value proposition promised to employee and customer stakeholders is top of mind for top executives. Providing that value allows Trader Joe's to differentiate itself with premium store-branded products, helpful, informed store employees who can tell customers about those products, and low prices without sales promotions in a store environment that, by constantly evolving based on employee input, invokes customer surprise and delight.

In this model, shareholders, customers, and employees win together—and we can guess that suppliers and communities do as well.

With Trader Joe's as a model of creating value through—rather than at the cost of—fulfilling the needs of stakeholders, let's illustrate how a compensation committee at a hypothetical retailer would take on the job of goal-setting to comply with the stakeholder approach. We don't need to assume the retailer follows Trader Joe's business model, only that the model chosen depends on stakeholders winning together. The goals in a pay plan then follow the model naturally.

Stakeholder Principles for the Compensation Committee

- Long-term sustained value creation is only possible when key long-term stakeholder expectations are met.
- As stakeholder expectations are interdependent, fulfilling them in a mutually supportive way grows value for everyone—the equation for value creation is not zero sum.
- Long-term incentive goals should demand continuous improvement and be tied to long-term stakeholder value.
- Short- and intermediate-term incentives should focus on milestones showing strategic execution that dovetails with long-term outcomes.
- When business today takes a stakeholder view, it also happens to fulfill its social responsibility, creating value for all stakeholders. Sacrificing one stakeholder to the outsized benefit of another is self-defeating.

To start, management at the retailer would ask shareholders, "What are your needs and expectations?" The board could then build goals from the answers. The likely result would be some conventional targets, for example, overall sales growth exceeding peers, profitability, return on investment above the company's cost of capital, and total shareholder return that outpaces peers.

Management would also ask the same question of customers: What are their expectations? The board might then choose targets related to the following: satisfying customer experience in terms of interacting, buying, and resolving customer-service issues; providing an appealing product selection in line with brand strategy; timely and convenient delivery and return options; and competitive pricing.

For the employee stakeholder, the board could affirm incentive goals such as adequate wages and benefits to meet personal and family obligations; adequate work hours and predictable or family-friendly work schedules; long-term career potential; and a satisfying or engaging work environment.

Executives could then get on with the job of making tradeoffs and accommodating realities. A variety of questions might come up at this point: Do the goals take into account the state of company systems to train and cultivate knowledgeable and engaged employees? Do they take into account the status of systems to curate the product line and manage inventories? What is the state of the fulfillment system?

After making adjustments for such factors, the compensation committee could set annual bonus-plan goals to support near- and intermediate-term strategies. It would link pay, for example, to management hitting significant, game-changing strategic milestones, often related to meeting stakeholder expectations that serve company interests. See the box for one possible formulation of goals for annual bonus plans for a retailer. Of course, the board would need narrow down the list of goals to a precious few, although using different goals at different levels does provide more flexibility.

The long-term incentive plan might then include both a conventional financial goal and some nonfinancial goals related to stakeholder outcomes, assuring that the company isn't leaving behind a constituency fundamental to long-term value creation. Because the long-term plan again has limited room for measures—two to three at most—directors might consider goals for key stakeholder outcomes such as total shareholder return exceeding peers, customer retention levels continuously improving, growth in average customer spending, and average employee tenure versus best-in-class for the industry.

Conclusion

Goals based on stakeholder expectations, as with any corporate goals, will remain in flux. They vary with the strategy and how the stakeholders' needs evolve over time. This doesn't suggest that a company accountable to many stakeholders is accountable to none. When executives choose to focus on stakeholders goals—and the compensation committee sets performance levels and links those goals to pay—the risk isn't that management will choose pet projects at the expense of shareholders, but that management and the board haven't aligned their views on strategic priorities (and the right goals) to win for shareholders through stakeholder interdependence.

Compensation committees sit at the nexus of solving an equation far more complex than in earlier decades. More variables go into how to motivate and reward executives for running a company to successfully compete for talent, customers, suppliers, and public support.

Committees have the responsibility to choose the right incentives to encourage value-creating decisions and behaviors. When they get it right, executives will do the bidding of shareholders—increase profits and returns—but also increase the wealth and satisfaction of the stakeholders that those profits depend on.

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Compensation Committees and ESG

Posted by Robert Newbury, Don Delves, and Ryan Resch, Willis Towers Watson, on Saturday, August 31, 2019

Editor's note: Robert Newbury is Director, and Don Delves and Ryan Resch are managing directors at Willis Towers Watson. This post is based on their Willis Towers Watson memorandum. Related research from the Program on Corporate Governance includes Socially Responsible Firmsby Alan Ferrell, Hao Liang, and Luc Renneboog (discussed on the Forum here).

Environmental, social and governance (ESG) issues are increasingly important to boards and their compensation committees, especially human capital management, as a critical part of the "S" in ESG.

Compensation committees realize it directly relates to their mission, long-term strategy and success, and they're being more proactive.

Here are three recent examples. We chose to not identify two of the companies.

- At Royal Dutch Shell plc., the company committed to use ESG as an executive compensation performance measure in an effort to reduce its net carbon footprint 20% by 2035 and 50% by 2050. Executives' pay will be linked, in part, to this target, through an energy transition measure within their 2019 long-term incentive award.
- Board members of a power generation company asked for more insights after a social responsibility report found a gender pay gap existed based on the ratio of average female pay to average male pay. The analysis examined demographics by level, pay gaps by level and job family, and promotion and pay increase trends by gender. Findings reinforced that the company was paying men and women in jobs of equal value at similar levels. However, the check also uncovered that more men worked at higher levels of the organization, and an inclusion and diversity strategy was needed to encourage a better gender balance at all levels of the organization.
- An integrated oil and gas company wanted better insights on key human capital metrics in support of the organization's people strategy so management proposed a series of measures in a dashboard that could be updated quarterly for review at each committee meeting (e.g., demo-graphics, promotion/turnover rates, talent pipeline, wellness, safety and productivity/ returns. The dashboard for the compensation committee provides greater context for each performance measure (i.e., historical trends and/or relative benchmarking against other organizations) and includes a mixture of leading and lagging indicators.

The growing role of the compensation committee in human capital management and measurement is driven by several fundamental, transformational forces including engaged institutional and activist investors, new regulation and more diverse boards.

External drivers only partly explain ESG's growing prominence among compensation committees' priorities. There's also a recognition among these directors that addressing broader human capital management issues are important for sound reasons.

Legal: Organizations attuned to human capital management tend to treat risk management more holistically, and work to minimize the risk of legal action based on unfair treatment or discrimination towards employees. The need to worry about this particular unsystematic risk is reduced, freeing boards and managements to turn their attention to intelligent risks that are connected to both financial performance and strategic goals.

Reputational risk: Inattention to ESG in general, and human capital management in particular, can damage an otherwise well-conceived and well-developed brand, resulting in lawsuits and negative press attention. Even more insidiously, it can subtly undermine talent acquisition and retention, as candidates with desired skills are drawn to employers with more attractive hiring practices, employee guidelines and culture.

Talent: Diverse, empowered workforces that are treated and paid fairly may perform better, a key determinant in the creation of sustainable, long-term value. As an example, a large Midwest tech company cites programs toward this end that include training to avoid unconscious bias in hiring and leadership development and actively pursues a more inclusive, diverse culture at all levels. The result is a greatly enhanced ability to develop and deliver new products to new customers through new channels.

A good start, but more needs to be done

Organizations are taking human capital management seriously, but fully integrating it into the compensation agenda will require more action.

Committees will want to consider changing their charters to reflect their broader mission. They should actively recruit members with diverse backgrounds and viewpoints. We believe that they will start to manage human capital in the organization similarly to how financial capital is managed, with a greater focus on improving return on investment, including:

- Managing both the costs and productivity of human capital investments.
- Effectively cascading performance goals throughout the organization.
- Understanding and targeting roles that disproportionally create value.

Human capital oversight will also need to consider dynamics that impact long-term sustainability: I&D, gender and fair pay, human capital-related risk, culture and its alignment with strategy and risk, and the changing nature of work.

The culture of both the organization and the board needs to be defined, assessed and monitored. How does culture impact key issues such as cybersecurity, reputation and safety, and is culture properly reflected and reinforced by compensation policies?

Recommendations for change

Companies face both top-down scrutiny by investors and bottom-up pressures from their work forces, and their compensation committees are pivotal to satisfying both these constituencies. It's imperative that management and boards assess whether their compensation committees are advancing human capital management and consider.

Roles and responsibilities: Compensation committees should analyze whether their role should be expanded, and what new decision-making authority, tools and data are needed to meet this expanded remit.

Information requirements: High-quality human capital management dashboards can help boards and compensation committees understand an organization's progress and provide data-driven, analytical information. This may also require independent advice to ensure that the right type of information is provided and monitored.

Process: Generic charters referencing HR philosophy or oversight need to become more specific. Changes such as revised decision rights, new reports, data and discussions with management need to be proposed to the full board and built into the compensation committee calendar so that oversight becomes a regular, institutionalized part of the board's responsibilities.

Reporting: Accountability and how an expanded role will affect what is reported to the full board, employees, shareholders and the public need to be discussed.

These important steps will help compensation committees evolve and oversee employee engagement, talent management and development processes that support greater diversity, deeper bench strength and tighter alignment with their total rewards programs. They will help contribute to a sustainable, long-term growth demanded by institutional investors.