Corporate Governance Hot Topics

Quarterly Update (November 30, 2017)

1. Corporate Governance Policies and Reports

- **ISS Publishes Final 2018 Voting Policies:** On November 16, 2017, ISS published updates to its benchmark proxy voting policies applicable to shareholder meetings held on or after February 1, 2018. ISS had previously released draft proposals on several of the topics in October. For U.S. companies, the key updates included vote recommendations on non-employee director pay, poison pills, gender pay gap and board diversity, pay-for-performance evaluation, and board responsiveness to say-on-pay.
- **Glass Lewis Releases 2018 Policy Guidelines:** On November 22, 2017, Glass Lewis released its 2018 policy guidelines as well as updates to its guidelines on shareholder initiatives. In addition to clarifying several existing policies, the 2018 policy update includes a significant change regarding the threshold for board responsiveness and new policies on board gender diversity, dual-class share structures and virtual-only meetings.
- **NYC Comptroller Launches Boardroom Accountability 2.0 Project:** On September 8, 2017, the New York City Comptroller Scott Stringer and the New York City Pension Funds launched the Boardroom Accountability Project 2.0. The original focus of the Boardroom Accountability Project was to implement proxy access bylaws to give shareholders more of a voice in the boardroom. The Comptroller is now calling on the boards of the 151 U.S. companies who previously received a proxy access proposal from the Comptroller and either adopted proxy access without it going to a vote, or lost the stockholder vote, to disclose the race, gender and skills of their directors in a standardized "matrix" format and to enter into a dialogue with the Comptroller regarding their board's "refreshment" process. The Comptroller's office stated that "this type of standardized disclosure would boost accountability and help shareowners like the New York City Pension Funds identify boards that have a lack of diversity or relevant expertise, and to engage those companies to recommend qualified, diverse and independent candidates."
- **Vanguard Announces Increased Focus on Board Diversity and Climate Risk:** On August 31, 2017, Vanguard released its annual Investment Stewardship Report. In the report, Vanguard emphasized these concerns are due to investment rather than ideological concerns – "there is compelling support for positive effects [of gender diversity] on shareholder value" and "climate risk has the potential to be a significant long-term risk for companies in many industries." It urged issuers to disclose their plans to incorporate appropriate diversity over time, with meaningful progress being assessed in engagement and voting decisions. While Vanguard supported two climate risk proposals this year, such proposals will be considered in the future based on the merits of the proposal and the issuer's past commitments and governance structure. Vanguard said it would focus on issuers' disclosure of the risk posed to it by climate change, as well as board and management oversight of that risk. In its annual report on proxy-voting activity in the year ended June 30, 2017, Vanguard disclosed 954 engagements with 680 companies. Fifty-eight percent of engagements included discussions of

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governance structures, 55% of executive compensation, 52% of board composition (including gender diversity), 16% of activism and contentious transactions, and 14% of risk oversight (including climate risk).

- **State Street Issued its Perspectives on Effective Climate Change Disclosure:** On August 14, 2017, State Street Global Advisors issued guidance on climate disclosures for "high-impact sector companies," noting that boards should regard climate change the same as any other significant risk to the business. In 240 climate-related engagements in the last four years, State Street found that few companies can effectively demonstrate to investors how they integrate climate risk into long-term strategy. It urged high-impact companies (oil and gas, utilities, and mining sectors) to disclose governance and board oversight of climate risk, long-term greenhouse gas emission goals, the average and range of carbon price assumptions and the impact of scenario planning on long-term capital allocation decisions.
- **State Street also released its Stewardship Activity Report for the Second Quarter of 2017:** State Street voted against 73% of proposals that sought an independent board chairman, supported 21% and abstained from voting on 6%. State Street indicated that its decreased support for these proposals was due to many companies incorporating the 2016 State Street guidance for enhancing the role of the independent lead director. The quality of engagement with the independent lead director was also noted as an important factor. Following adoption in 2014 of its board tenure guidelines, State Street has voted against 933 companies because of board tenure issues, with 31% of those companies subsequently refreshing their boards. State Street stated that attention to this issue has also resulted in a 32% drop in the number of companies with high tenure. In 2017, State Street sent a letter to over 600 companies in the U.S., UK and Australia that had no female directors, and in the first half of 2017, voted against directors at 394 U.S. companies for this reason. The Stewardship Activity Report is available here.
- **Council of Institutional Investors Initiatives:**
  - **CII Pushes for Prompt SEC Action in Several Corporate Finance Areas:** On September 7, 2017, Jeff Mahoney, the general counsel for the CII, sent a letter to the SEC recommending prompt action on the "Universal Proxy," "Listing Standards for Erroneously Awarded Compensation," and "Disclosure of Hedging by Employees, Officers and Directors" projects. All of the projects are listed on the SEC's Corporation Finance agenda as long-term actions.
  - **In September CII adopted the following policy:** "Shareowners also should have meaningful ability to propose bylaw amendments that become effective upon the approval of a majority of outstanding shares." This follows the adoption of an ISS voting policy last year to recommend against the election of governance committee board members at issuers where stockholders were unable to amend the bylaws.
  - **CII Urges SEC to Explore Human Capital Management Disclosure:** On October 10, 2017, CII sent a letter to SEC Chairman Jay Clayton urging the SEC to consider the need for enhanced corporate disclosure of human capital management. The letter noted that while human capital and talent development "clearly is a key value driver and potentially a key

competitive advantage for a company (and a critical risk if mismanaged), many of [its] members have concerns that public company disclosures in this area are not sufficiently robust."

- **Investor Groups Contest Myth of Shareholder Proposal "Overload":** On October 10, 2017, CII, CalSTRS, ICCR, CERES and other investor groups provided SEC Chairman Jay Clayton with data contesting the idea that shareholder proposals are excessively burdensome for U.S. public companies. Research on proposals filed in 2004–2017 shows that most U.S. companies do not receive shareholder proposals. CII's data indicate that only 13% of Russell 3000 companies received a shareholder proposal in a particular year, but larger companies were far more likely to receive shareholder proposals.

- **Broadridge Report Shows Rise of Virtual Shareholder Meetings Popularity:** On September 13, 2017, Broadridge released a report that included data that virtual-only annual meetings are growing in popularity. 163 companies had virtual-only shareholder meetings as of June 30, 2017, compared to 122 companies during the first half of 2016. Groups such as the New York City Pension Funds and CII have voiced concerns with the absence of in-person annual meetings.

- **2017 CPA-Zicklin Index:** The Center for Political Accountability-Zicklin Center at The Wharton School at the University of Pennsylvania released a study showing that 47% of the S&P 500 provide regular board oversight of political spending; there is a strong positive correlation between market cap and political disclosure and accountability policies; and 153 companies have adopted the voluntary political disclosure and accountability model proposed by CPA.

- **Conference Board Releases Report Reviewing Key Environmental and Social Proposals for 2017 Proxy Season:** On October 26, 2017, the business membership organization Conference Board released a report reviewing the key environmental and social (E&S) proposals between January 1 and June 30, 2017. Nearly half of the 465 proposals brought to shareholders at Russell 3000 companies related to E&S issues, and they received average support of only 21.4%, although support levels continue to increase, principally due to a shift in the voting policies of passive investors like BlackRock and Vanguard. Six proposals received majority support in 2017 – three on climate risk disclosure (18 proposals were made), two on board diversity (14 proposals were made) and one on publishing a sustainability report (10 proposals were made). The most common E&G proposal remains disclosure of corporate political/lobbying contributions and policy (57 proposals were made).

2. Boards and Committees

- **CEO "Overboarding" Continues to Be Key Area for Investors:** A study of S&P 500 companies by Equilar for the Wall Street Journal found that the median one-year total shareholder return was 8.2% at companies with a CEO who serves on multiple outside boards. In comparison, for companies whose CEO serves on one or no outside boards, the median one-year total shareholder return was over 15%, with a return for the entire S&P 500 of 14.4%. BlackRock voted against directors at 168 companies in 2017 due to "overboarding" concerns. Proxy advisors ISS and Glass Lewis generally recommend withholding votes at the outside boards for CEOs who serve on more than two public company boards in addition to their own.

- **MSCI Study Finds Company Performance and CEO Compensation Do Not Always Correlate:** Investment research firm MSCI Inc. released a study on CEO pay and company performance. The study found that CEO pay was "poorly aligned" with total shareholder return over a 10-year cumulative period for roughly 60% of the companies reviewed. For the 2006–2015 period, MSCI analyzed 423 of its MSCI USA Index constituents. The study found that when compared to sector peers, 23 companies underpaid their CEOs relative to performance and 18 overpaid relative to performance. Ninety-nine companies were considered to be "generally well aligned" per the study with average total shareholder return and average pay aligned.

3. Regulatory Developments

- **Federal Reserve Board Proposes Enhanced Supervisory Expectations for Public Boards:** On August 3, 2017, the U.S. Federal Reserve Board requested public comments on its proposed supervisory expectations for boards of directors at the country's largest financial institutions. The proposal aims to distinguish the roles and responsibilities of the board from those of management. Among other things, the proposal identified several attributes of an effective board, including the ability to set a clear, aligned and consistent direction regarding the firm's strategy and risk tolerance and hold senior management accountable; clarified that most supervisory findings should be reported to the firm's management for corrective action, rather than to the board; and provided that existing supervisory expectations of boards of directors that go beyond the core board expectations would be reviewed for elimination or revision.
- **SEC Staff Begins Taking Steps to Reform Shareholder Proposals:** On November 1, 2017, the SEC Division of Corporation Finance released Staff Legal Bulletin No. 14I with new guidance on the shareholder proposal process. The guidance contemplates board involvement in seeking no-action relief under the ordinary business exception and economic relevance exclusions; establishes procedural requirements for proponents to designate representatives; and clarifies that shareholders and issuers may use images in proposals.
- **SEC Issues New Guidance on Pay Ratio Rule:** On September 21, 2017, the SEC issued guidance substantially easing the burden of CEO pay ratio disclosure, which will be required for most U.S. public companies beginning with the upcoming 2018 proxy season. The guidance allows use of widely recognized tests to determine who is included as an employee, reinforces flexibility to use reasonable estimates and existing internal records to identify the median employee and allows the ratio to be described as an estimate. The issuance of this guidance highlights the need for companies to continue their preparations to comply with the pay ratio rule during the 2018 proxy season.
- **SEC Requirement to Include Hyperlinks to Exhibits in Filings Takes Effect:** As of September 1, 2017, SEC rules require registrants to include hyperlinks to documents listed in the exhibit indices in most registration statements and reports filed with the SEC. The new requirements apply to filings subject to Item 601 of Regulation S-K, and not to filings with exhibit requirements governed by other rules such as Schedules 13D or 13G. The SEC adopted these changes in Rel. No. 33-10322, Exhibit Hyperlinks and HTML Format (Mar. 1, 2017), which is available here.

- **SEC Considers NYSE Proposal to Permit Direct Listings:** On September 15, 2017, the SEC issued an order instituting proceedings to determine whether to approve or disapprove a proposed rule filed by the NYSE to amend Section 102.01B of the NYSE Listed Company Manual to permit qualifying private companies to list upon effectiveness of a Securities Exchange Act of 1934 registration statement without a concurrent IPO or registration under the Securities Act of 1933. The proposed rule would require companies to receive an independent valuation of at least $250 million to satisfy the listing requirement. If approved, the proposal would permit the NYSE to create liquid trading markets for large qualifying companies not seeking to raise capital, changing the approach companies use to go public. As an example, the online music streaming service Spotify (most recently valued at $13 billion) is reportedly considering a direct listing of its stock on the NYSE in 2018, instead of pursuing the traditional underwritten IPO route. The SEC indicated that further evaluation of the proposed rule is needed given the potential issues raised, including the implications for price discovery, the role of distribution participants, and the availability of information.

- **SEC Proposes Rules to Modernize and Simplify Regulation S-K Disclosure Requirements:** On October 11, 2017, the SEC proposed amendments to modernize and simplify disclosure requirements in Regulation S-K and to make parallel amendments to the investment company and investment adviser rules and forms. The amendments are intended to improve the readability and navigability of disclosure documents and discourage repetition and disclosure of immaterial information.

- **SEC Approves PCAOB's New Auditor Reporting Standard:** On October 23, 2017, the SEC approved the PCAOB's new standard enhancing the auditor's report to shareholders. Investor groups have advocated for a strengthened standard since it was first recommended by the U.S. Treasury Department in 2008. The CII stated that the "new standard will provide investors with tailored, audit-specific information directly from the independent auditor's point of view and should provide insights that will add to the mix of information that could be used in investors' capital allocation and voting decisions." The SEC indicated strong support for the new standard, stating that it will seek "more information about the audit itself – information that is uniquely within the perspective of the auditor and, thus, not otherwise available to investors and other financial statement users."

- **Department of Treasury Issued Report for Capital Markets Reform:** On October 2, 2017, the U.S. Department of Treasury provided President Donald Trump with a report containing recommendations to reform the U.S. capital markets regulatory system. The report recommends rolling back certain Dodd-Frank rules issued in response to the 2008 financial crisis. The Treasury's main recommendations are in line with several proposed changes in the Financial Choice Act of 2017 (CHOICE 2.0). Like CHOICE 2.0, the report recommends repealing Dodd-Frank provisions that directed the SEC to require disclosures regarding CEO pay ratio, use of conflict minerals, mine safety information, and governmental payments by resource-extraction issuers. The report also addresses limiting the number of shareholder proposals submitted to public companies through SEC Rule 14a-8 under the Securities Exchange Act of 1934. The report does not provide specific recommendations for ownership and resubmission thresholds. Instead, the report recommends the SEC "substantially" revise such threshold requirements.

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