Corporate Governance

May 2021

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Part I: New Paradigm of Corporate Governance

- Core Principles of Corporate Governance
- The New Paradigm

Core Principles of Corporate Governance

- After years of growing alarm about short-termism, risks to the sustainability and competitiveness of businesses over a long-term horizon, and rising socioeconomic inequality, a new consensus is emerging with respect to core principles of corporate governance:
  - Myopic focus on short-term shareholder wealth maximization is suboptimal.
  - A broadened focus on all of a corporation's stakeholders is conducive to economic and societal good.
  - The fiduciary duty of a board of directors encompasses the best interests of the corporation as a whole and is not a duty solely or just to the shareholders.
- The COVID-19 pandemic, with its massive economic toll, has heightened the need to revisit the core principles of corporate governance and the associated regulatory and policy framework.
- A strong and growing consensus of corporations, investors, academics and leading institutions—including the Business Roundtable, the British Academy and the World Economic Forum—have overwhelmingly embraced stakeholder governance, support for sustainable long-term investment and consideration of ESG matters.
- Much of the focus on stakeholder governance is shifting from the question of *whether* a board of directors should take into account the interests of stakeholders other than shareholders, to *how* a board should best do so.

Core Principles of Corporate Governance

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- The board's objective remains the long-term health and profitable success of the corporation, and it must continue to exercise its business judgment to achieve that outcome.
  - The essence of stakeholder governance is not about altruism, nor to promote the interests of some stakeholders at the expense of others for reasons not in the corporation's best interests.
  - Academic concerns about the prospect of zero-sum trade-offs between shareholders and other stakeholder interests should be mitigated to a large extent by the fact that shareholders are the ultimate beneficiaries of the financial value of the corporation and that failing to appropriately consider stakeholder interests can destroy value and create enterprise risk.
- The exercise of considering multiple stakeholder interests, and the risks and opportunities they entail for the corporation and its business plan, is not a novel endeavor for boards.
  - The core function of the board remains the same: it is tasked with overseeing the evaluation and synthesis of varying objectives, interests, risks and opportunities, while contributing the perspectives and experiences of directors to formulate a strategy and then determine the steps to execute that strategy.
- Nor is stakeholder governance inconsistent with well-established principles of corporate law and the existing fiduciary duty framework for directors.
- There is no legal impediment to embracing stakeholder governance. Instead, the board has a fiduciary duty to promote the best interests of the corporation, and in fulfilling that duty, directors must exercise their business judgment in considering and reconciling the interests of various stakeholders and their impact on the business of the corporation.

Core Principles of Corporate Governance

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- Key considerations in implementing stakeholder governance:
  - The purpose of a corporation is to conduct a successful business with a view to achieving sustainable long-term growth in value.
  - The shareholders do not own the corporation; they own shares in the corporation.
  - The directors are elected by the shareholders, but that does not mean that directors can outsource their decision-making to shareholders or that directors uphold their duties by ignoring stakeholder interests or corporate impacts on broader constituencies.
  - The basic fiduciary duty of the directors is to the corporation to manage its business to create sustainable long-term growth in value.
  - Directors have a fiduciary duty to promote the best interests of the corporation, and in fulfilling that duty, directors must exercise their business judgment in considering and reconciling the interests of various stakeholders and their impact on the business and long-term value of the corporation.
  - In discharging their fiduciary duty to the corporation to manage its business to create sustainable long-term growth in value, the directors have a fiduciary duty to use their business judgment to take into account the interests of all the stakeholders in achieving sustainable long-term growth in value.
  - As long as directors discharge their duty of care and loyalty in managing the business of the corporation to achieve sustainable long-term growth in value, they are protected by the business judgment rule from any liability to any stakeholder argument that they should have received greater consideration or value than any other stakeholder.

Core Principles of Corporate Governance

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- Key considerations in implementing stakeholder governance: *(cont'd)*
  - Relatively few asset managers and asset owners, in the aggregate, have a controlling interest in the corporation; therefore periodic engagement with those shareholders to achieve mutual understanding about the strategy the corporation is following is important.
  - "The best way to understand and harmonize the divergent interests of all stakeholders is through a shared commitment to policies and decisions that strengthen the long-term prosperity of a company." –World Economic Forum 2020 Davos Manifesto.

The New Paradigm

Overview

- Consistent with the above-described emerging norms regarding the purpose of the corporation and recognition of the threat of short-termism, the "New Paradigm" of corporate governance conceives of corporate governance as a collaboration among corporations, shareholders and other stakeholders working together to achieve long-term value and resist short-termism, in the interest of all stakeholders.
  - Integrates long-term corporate strategy with substantive corporate governance.
  - May reduce outsourcing by shareholders of governance and portfolio oversight to proxy advisors and activists.
- Major institutional investors and other industry participants are expressing that:
  - Clearly articulated plans are necessary to gain and keep their support. A company should not leave an opening for an activist with a more attractive long-term strategic plan.
  - Companies should communicate board participation in the development and approval of strategy in letters to these investors, annual reports and proxy statements.
  - Management of environmental and social issues is important.
  - Companies should develop and communicate procedures for engagement by management and directors with these investors and should be prepared to facilitate direct engagement that includes directors if requested by major investors.

The New Paradigm

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Overview ***(cont'd)***

- Companies should support national policies encouraging long-term value creation.
- Stock repurchases at the expense of long-term investment are disfavored.
- There is no need for quarterly earnings guidance if a company has a clearly articulated long-term strategy.

- Corporations that implement the governance "best practices" advocated by these investors can expect that these investors will support the corporation in resisting short-term pressures.
  - The New Paradigm does not foreclose activism, but seeks to encourage responsible investor stewardship that helps improve companies that are truly underperforming.

The New Paradigm

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Paradigm Components

- Governance
  - *Purpose and Strategy*. The board of directors and senior management should jointly articulate the company's purpose and oversee its long-term strategy, ensuring that the company pursues sustainable long-term value creation.
  - *Management and Oversight*. The board is responsible for overseeing the management of the company, monitoring company performance and preparing for senior management succession.
  - *Quality and Composition of the Board of Directors*. Directors should have integrity, competence and collegiality, devote the significant time and attention necessary to fulfill their duties and represent the interests of shareholders and other stakeholders. The board as a whole should include diverse backgrounds, experiences and expertise that are tailored to the company's needs.
  - *Compensation*. Executive and director compensation should be designed to align with the long-term strategy of the company and incentivize the generation of long-term value, while dis-incentivizing the myopic pursuit of short-term results.
  - *Corporate Citizenship*. Consideration should be given to the company's purpose and its stakeholders—including shareholders as well as employees, customers, suppliers, creditors and the community in which the company does business—in a manner that contributes to long-term sustainability and value creation.

The New Paradigm

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Paradigm Components ***(cont'd)***

- Engagement
  - *By the Company*. The board and senior management should engage with major shareholders on issues and concerns that affect the company's long-term value and be responsive to those issues and concerns.
  - *By Shareholders*. Asset managers and investors should be proactive in engaging in dialogue with a company as part of a long-term relationship and should communicate their preferences and expectations.
  - *Shareholder Proposals and Votes*. Boards should consider shareholder proposals and key shareholder concerns, but asset managers and investors should seek to engage privately before submitting a shareholder proposal.
  - *Interaction and Access*. Companies, asset managers, shareholders and other key stakeholders should provide each other with the access necessary to cultivate engagement and long-term relationships.

The New Paradigm

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Paradigm Components ***(cont'd)***

- Stewardship
  - *Beneficial Owners*. Asset managers are accountable to their investors—the beneficial owners whose money they invest—and they should use their power as shareholders to foster sustainable, long-term value creation for their investors and for the companies in which they invest.
  - *Voting*. Asset managers should actively vote on an informed basis consistent with the long-term interests of their investors, which aligns with the long-term success of the companies in which they invest.
  - *Investor Citizenship*. Asset managers and investors should consider value-relevant sustainability, citizenship and environmental, social and governance ("ESG") factors when developing investment strategies.

Part II: Corporate Governance Landscape

- Trends in Corporate Governance Practices
- Rule 14a-8 Shareholder Proposals
- Board Structure
- Director Elections and Other Voting Issues

Trends in Corporate Governance Practices

- Many long-salient corporate governance debates have been settled, with "best practices" codified in rules and regulations or voluntarily adopted by a majority of S&P 500 companies (*e.g.*, majority voting, proxy access).
- Yet the drive for "reform" to enhance shareholder rights and weaken takeover defenses persists.
  - Governance activists persist in advocating for more purported "best practices" (*e.g.*, mandatory removal of directors receiving sub-majority vote, hybrid vs. virtual-only shareholder meetings).
  - Drive to reach mid-sized and smaller companies has intensified.
  - Scrutiny of governance of newly public companies continues.
  - Domestic advocates are reaching globally to markets beyond the United States.
- As discussed above, there has been an awakening to the idea that corporate governance is not just about the allocation of decision-making authority and accountability as between corporations and shareholders and maximization of shareholder value.
- Increased recognition that corporate governance is inherently nuanced and less amenable to benchmarking and quantification. Evolution from a relatively binary, check-the-box mentality to tackling questions such as:
  - How to craft a well-rounded and diverse board with relevant skills and experiences.
  - How to forge relationships with stakeholders that enhance the company's credibility.
- Companies and investors alike have sought to address these "next generation" governance issues in a way that facilitates comparability, objective assessment and accountability.
- Legislative initiatives have emerged, as dissatisfaction with corporations is near the top of the political agenda for both the left and the right, even as broader surveys suggest that the public is increasing expectations of corporations and may hold corporate leaders in high regard and deserving of trust unless such trust is squandered.

Rule 14a-8 Shareholder Proposals

Submission and no-action requirements

- Recent years have seen increasing calls for modernization of the Rule 14a-8 shareholder proposal process.
- In September 2020, the SEC announced amendments to the eligibility requirements for shareholder proposals under Rule 14a-8, applicable for shareholder meetings held on or after January 1, 2022. The amendments:
  - replace current $2,000 or 1% for one-year holding requirement with a tiered approach to ownership;
  - require that the proponent state their availability, from 10 to 30 days following submission of the proposal, to meet with the issuer;
  - add information requirements for proposals submitted by shareholder representatives and clarify the existing one-proposal-per-shareholder rule; and
  - raise the resubmission thresholds required to exclude proposals.
- 2021 has seen some pressure on the SEC and Congress to reverse the foregoing amendments.
- In recent years, the SEC Division of Corporate Finance Staff has provided several rounds of evolutionary guidance regarding the no-action process.
  - In 2017 and 2018, the Staff provided guidance on excluding certain Rule 14a-8 shareholder proposals (Staff Legal Bulletin Nos. 14I; 14J).
    - *"Ordinary Business" Exclusion*: noting that often involves difficult judgment calls, SLB 14I expresses that these judgments are better made by the company's directors and states the expectation that no-action requests submitted under Rule 14a-8(i)(7) will include discussion of the board's analysis.

Rule 14a-8 Shareholder Proposals

(cont'd)

Submission and no-action requirements ***(cont'd)***

- In October 2019, the Staff provided additional guidance in SLB No. 14K for excluding Rule 14a-8 shareholder proposals under the "ordinary business" exception: the significance of the proposal's subject matter and whether it seeks to "micromanage" the company.
  - The key takeaway from SLB 14K is that the SEC looks more favorably upon arguments tailored to the circumstances of a particular company, eschewing one-size-fits-all or overly technical approaches in determining if no-action relief is appropriate.
- *"Economic Relevance" Exclusion*: going forward, the SEC Staff will give more weight to the 5% test in evaluating a proposal's significance to the company's business, but expect that no-action requests under Rule 14a-8(i)(5) will include a discussion of the board's analysis.
- The Staff may determine to respond orally, instead of in writing, to some no-action requests from companies seeking to exclude Rule 14a-8 shareholder proposals.
  - Even if the Staff declines to take a view on any particular exclusion request, the company may have a valid basis to exclude the proposal under Rule 14a-8.
  - The parties have the option to "seek formal, binding adjudication on the merits of the issue in court."
- The proxy advisors also provide policies regarding shareholder proposals and recommendation considerations when companies have excluded shareholder proposals (*e.g.*, Glass Lewis and ISS).

Rule 14a-8 Shareholder Proposals

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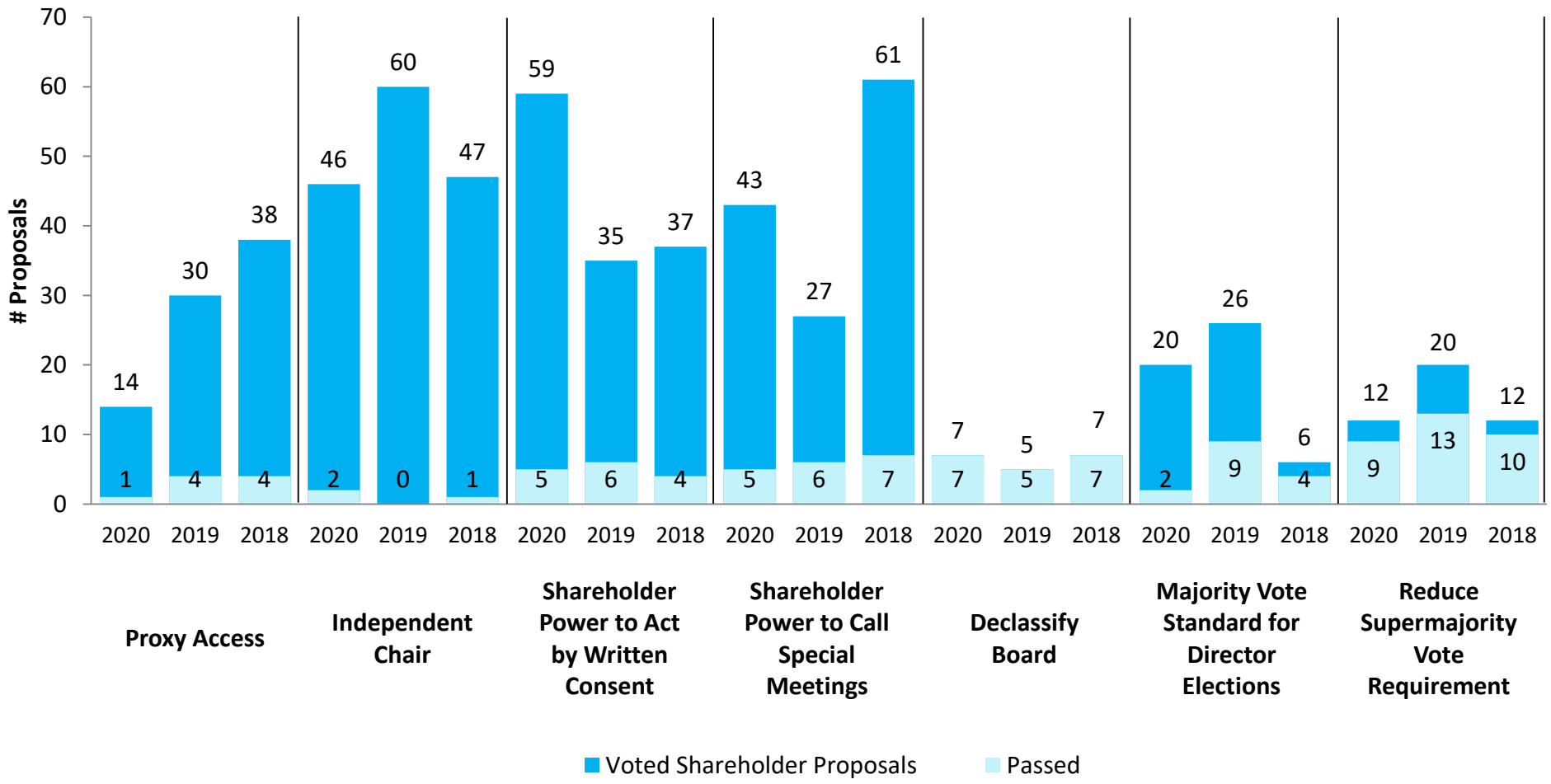
Shareholder Proposal Trends

- Proposals for action by written consent have seen a sharp increase during the COVID-19 pandemic, while proxy-access adoption proposals continue to wane as these practices have been more widely implemented.



Source: ISS.

Rule 14a-8 Shareholder Proposals

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E&S Shareholder Proposals

- Through end of July 2020, 430 E&S Rule 14a-8 shareholder proposals filed, with a record 20 receiving majority shareholder support.
- Proposals included environment/climate change (90), political issues (95), labor/human capital management (44), human rights (43) and workplace diversity (31), board diversity (21) and E&S link to executive pay (27).
- The withdrawal rate for 2020 through July (42%) fell relative to that in 2019, and median support for proposals on the ballot remained near 2019's peak level (26.5%).
- Political-spending proposals remained at the top in terms of resolutions filed. Seven such proposals received majority support – the most of any E&S-related category.
- Despite a drop in proposals, continued activism around climate change and sustainability.
  - Three such proposals received majority support, after zero in 2019.
- The COVID-19 pandemic and heightened focus on racial inequality have increased investor attention to human capital management and workforce diversity. Five such proposals received majority support.
- Look for proponents' testing of various strategies in support of ESG proposals (*e.g.*, individual use of exempt solicitations on Form PX14A6G to communicate views; litigation to enjoin mailing of proxy excluding proposal).

Source: ISS.

Board Structure

Trend Toward Elimination of Classified Boards

- Percentage of domestic S&P 500 companies with classified boards (where, generally, one-third of directors are elected each year for three-year terms) has sharply declined in recent years.
  - Approximately 12% as of year-end 2020 (down from 60% of all S&P 500 companies in 2000).
- Declassification proposal activity has waned in light of sustained success in this arena by activist campaigns—most notably Lucian Bebchuk's Harvard Law School Shareholder Rights Project.
- As revised for 2021, the ISS policy on problematic governance structures for newly public companies provides for negative recommendations in the event that the company or board adopted a classified board structure prior to or in connection with the company's public offering. Sunset provisions that are "reasonable" are deemed mitigating.

Source: SharkRepellent; ISS.

Board Structure

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Separation of Chair and CEO

- Fifty-five percent of S&P 500 companies separate the CEO and chair roles; 33% have an independent chair.
  - Seventy-three percent of S&P 500 boards have an independent lead or presiding director.
- Required disclosure in annual meeting proxy statement of whether CEO and chair are combined or separate, and, if combined, whether there is a lead independent director and what is its role. Also must disclose rationale for leadership structure.
- ISS recommends generally voting for shareholder proposals requiring an independent chair, but such proposals rarely receive majority support.
  - In 2020, shareholders at 47 companies voted on shareholder-initiated proposals to require an independent chair—proposals averaged 35% shareholder support and two passed. Sixty-two proposals voted on in 2019 averaged 30% support; none passed.
  - Notwithstanding lagging support for these proposals, supporters can apply pressure through a substantial, sub-majority vote.

Source: SharkRepellent as of March 2021; ISS.

Board Structure

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Board Composition and Refreshment

- Increasing focus on board composition and refreshment—as well as on associated disclosure—especially as to gender, racial and ethnic diversity, age, tenure, independence and expertise:
  - Institutional investor calls for greater board diversity *(e.g.*, State Street's Fearless Girl campaign and BlackRock's call for companies to have at least two women directors).
  - Policies tying director tenure to independence (*e.g.*, CalPERS).
  - Mandatory retirement ages (disclosed by 71% of S&P 500 boards) and, to a lesser extent, term limits (5%).
  - Tightened proxy advisory firm policies on director "overboarding."
  - Closer attention to related board practices, including onboarding, continued education, evaluation, succession planning/leadership rotation.
  - Demands for board refreshment as a response to (perceived) mismanagement/poor performance (may be accompanied by calls for implementation of proxy access or other governance changes).

Source: 2020 Spencer Stuart U.S. Board Index.

Board Structure

(cont'd)

Focus on Gender and Racial and Ethnic Diversity

- As the push for gender diversity on U.S. boards has begun to take root, and as racial equity has emerged as a societal priority, industry participants' diversity focus is expanding to racial and ethnic diversity and into leadership positions inside and outside of the boardroom.
  - For example, a shareholder lawsuit has alleged that Oracle's failure to appoint racially diverse directors and officers, while avowing a commitment to racial diversity, constituted securities fraud.
- Proxy advisors are also developing/tightening policies on board gender diversity.
  - ISS will provide for adverse recommendations for the nominating committee chair (or other directors case-by-case) at Russell 3000/S&P 1500 companies with no women on the board, considering mitigating factors.
- Legislative initiatives focused on board diversity disclosure and mandated quotas for women and racially diverse individuals on boards (which have been challenged in federal and state courts, *e.g. Meland v. Padilla*).

Source: 2020 Spencer Stuart U.S. Board Index.

Board Structure

(cont'd)

Further Observations

- There is no one structure that is suitable for all public-company boards.
- Recent studies indicate that staggered boards enhance long-term value; consequently boards should carefully weigh the pros and cons of declassification.
- The board should have an independent leader, and should decide, based on the circumstances, whether to combine chair and CEO roles. The board should explain its decision to shareholders, and, if the roles are combined, should appoint a strong lead independent director.
- The composition of a board should reflect a complementary diversity of thought, background, skills, experiences and tenures. The board should develop a system for identifying diverse candidates, including women and minority candidates, and for effectively integrating new members into the board dynamic.
- Board composition should also reflect a range of tenures. The board should consider whether policies such as a mandatory retirement age or term limits are appropriate, but board refreshment should be tempered with the understanding that age and experience can bring wisdom, judgment and knowledge.
- A substantial majority of the board should be independent. The board should consider all relevant facts and circumstances when evaluating independence.
- Conveying to shareholders the composition, quality and involvement of the board, including through annual proxy statement disclosure and other means, remains important.
- The board should evaluate the performance of directors, the full board and committees on a continuing basis.

Director Elections and Other Voting Issues

Reform and Disintermediation of Proxy Advisory Firms

- Major institutional investors have established significant proxy departments and/or guidelines, making decisions independent of ISS and Glass Lewis.
- Governance codes such as the ISG Framework are designed to operate independently from proxy advisors.
- In July 2020, the SEC adopted amendments to the proxy rules governing proxy advisors.
  - The rules amend Rule 14a-1(l) to codify the interpretation and guidance released by the SEC in August 2019 that proxy voting advice constitutes "solicitation" under the securities laws and is subject to anti-fraud rules.
  - With respect to proxy advisory firm policies and practices, revised Rule 14a-2(b) (and new sub-section Rule 14a-2(b)(9)) will require that proxy advisors comply with certain conditions to be able to rely on exemptions from the information and filing requirements of the proxy rules:
    - Increased disclosure regarding conflicts of interest; and
    - Proxy advisors must report to issuers at least simultaneously with distribution to clients and notify investors of issuer responses prior to voting.
  - The rules also include exemptions from the safe harbor requirements to provide advance or contemporaneous disclosures to companies and issuer response alerts to investors that would apply to most director election contests and certain M&A transactions where such matters "are subject to the Federal proxy rules' information and filing requirements, including the requirement to file and furnish a definitive proxy statement."
    - Notably, this accommodation does not reach "exempt solicitations (including solicitations as to M&A transactions or contested matters)."

Director Elections and Other Voting Issues

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Shareholder Proxy Access

- Under proxy access, a company must include in its proxy statement and on its proxy card director nominees proposed by shareholders or groups of shareholders that meet specified share-ownership and other criteria.
- In light of large companies' widespread implementation of proxy access (including 81% of domestic S&P 500 companies), the number of such proposals on company ballots continued to wane in 2020.
  - Typical terms include: 3%/three-year eligibility formula; capping the number of shareholders who may form a group to meet the ownership threshold, typically at 20; and capping the number of nominees, most often at 20% of the board with a minimum of two.
  - Shareholder proponents continue attempts to combat "proxy access lite" through proposals seeking to amend existing proxy access provisions or otherwise restrict companies from adopting proxy access provisions that deviate from CII and pension funds' "best practices" (*e.g.*, no/higher group caps, no re-nomination restrictions, counting of loaned shares).

Source: ISS; SharkRepellent; TheCorporateCounsel.net.

Director Elections and Other Voting Issues

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One Share, One Vote

- Along with IPO-company governance more generally, multiple-class stock voting structures—with multiple classes of stock having differential voting rights—are receiving scrutiny from governance industry participants.
- In its updates for 2020, ISS separated out and expounded upon its policy on problematic capital structures for newly public companies, providing for adverse director recommendations at companies completing public offerings with multi-class capital structures in which the classes have unequal voting rights without a "reasonable time-based sunset."
- Critics are also pushing for enhanced disclosure around insider ownership and voting power.
- Renewed interest in tenured voting and other means for making public markets attractive to founders and innovation, and for resisting short-term pressures.

Source: ISS; SharkRepellent; TheCorporateCounsel.net.

Director Elections and Other Voting Issues

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Further Observations

- The heightened disclosures and more balanced information resulting from the SEC's amendments relating to proxy advisory firms will ultimately improve the voting and engagement process and benefit long-term shareholders and other corporate stakeholders.
  - The new rules are an important step towards promoting accountability in voting, encouraging increased transparency into proxy advisors' methodologies and analyses, and reducing rote application of one-size-fits-all voting policies.
  - These changes may also facilitate and encourage independent, informed voting decisions by institutional investors, more open dialogue between companies and proxy advisors, and direct engagement between companies and their investors.
- Despite increased pressures, companies should carefully evaluate their own circumstances before adopting one-size-fits-all approaches to proxy access.
  - A company's appropriate framework, if any, should be tailored to complement other corporate governance practices that are already in place and limit potential for abuse or use by those seeking control of the company.
  - Given potential for disruptive effects, care should be taken to ensure that any proxy access regime promotes only the interests of shareholders who have had a meaningful, non-passing interest in the company, and contains reasonable procedural and disclosure safeguards.
- In determining whether a dual-class voting structure is appropriate, a company going public should consider company-specific factors, including the extent to which the structure may be valuable in preserving a "startup culture" and resisting short-term pressures.

Part III: More on the Role of Directors

- Key Issues for Directors Relating to COVID-19
- Directors' Key Responsibilities in Light of Increasing Focus on ESG and Stakeholder Governance
- Shareholder Engagement
- Risk Management

Key Issues for Directors Relating to COVID-19

- Directors play a vital role in navigating the path forward from the global effects of the COVID-19 pandemic and return to a "new normal." Key issues for directors include:
  - Carefully considering employee, customer and supplier health and safety.
  - Reviewing and, if necessary, updating compliance and oversight policies to cover any new regulations or increased regulatory scrutiny.
  - Reviewing and understanding management's plans for operating and reopening during the pandemic, including under different assumptions as to duration and severity.
  - Evaluating strategies for preserving liquidity or enhancing financial stability, and reviewing contingency plans to address shortfalls in a worst-case scenario.
  - Continuing to consider longer term outcomes when making short-term decisions.
  - Working with management to develop a general approach to internal and external communication, oversee timely disclosures and remain prepared to respond directly, cohesively and rapidly, considering that unexpected issues may arise as companies reopen.
  - Working with management in engaging stakeholders on corporate operations, impact to strategy, and other important concerns, including diversity and human capital management.
  - Preparing for a resurgence in shareholder activism and takeover activity as the threat of COVID-19 recedes.
  - Updating risk oversight processes to account for lessons learned from the pandemic, including the allocation of responsibilities within the board, coordination with management, and access to information and expertise.
  - Preserving culture and purpose and setting the "tone at the top."

Directors' Key Responsibilities in Light of Increasing Focus on ESG and Stakeholder Governance

- The ever-evolving challenges facing corporate boards, including, in the present environment, the coronavirus pandemic and resulting economic turbulence, combined with the wide embrace of ESG, stakeholder governance and sustainable long-term investment strategies, is propelling a decisive inflection point in the responsibilities of boards of directors.
- In this environment, directors need to grapple with a host of questions about the practical implications of this new paradigm, such as adjusting existing board functioning to reflect stakeholder governance, defining corporate "purpose" and shaping corporate "culture," integrating ESG considerations into long-term business strategy and measuring and delivering sustainable value to all stakeholders.
- Directors are also facing questions about the contours of the board's legal obligations, and what, if any, modifications should be made to communications and engagement efforts with shareholders and other stakeholders. In addition, the current pandemic has heightened the emphasis on effective and adaptive crisis management, and events of the past year have shone a light on the role of all market participants in combatting social and racial inequality.
- The legal rules as to directors' duties have not changed. What has changed are the expectations of investors and other stakeholders for (1) greater transparency, (2) deeper board engagement and oversight, (3) greater opportunity to engage with directors and (4) exercise of investor stewardship to further long-term, sustainable value creation.
- To this end, boards will be expected to recognize and play an active role in overseeing corporate strategy (including purpose and culture) and management's development of analysis and metrics to understand the impact of stakeholder interests on value and strategy.

Shareholder Engagement

- Engagement is no longer limited to the "proxy season," and traditional governance outreach has evolved to address financial and strategic matters. Engagement is increasingly a board-level issue with limited direct participation by independent directors, as appropriate and necessary.
- No "one-size-fits-all" structure for shareholder engagement. Companies may consider a range of approaches to facilitating meaningful long-term relationships, such as:
  - Ensuring general board-level oversight of company's investor relations and engagement efforts (board updated regularly at meetings).
  - Being open to providing major institutional investors with director access if requested.
  - Coordinating director attendance alongside management at investor visits.
  - Designating the chair/lead independent director as a primary liaison for director-level shareholder communication (with other directors involved as the subject matter warrants).
- The policies and arrangements best suited to any given company will depend on, among other things, directors' preferences, nature of existing relationships with shareholders, expressed preferences of shareholders and structure/staffing of existing shareholder relations programs.
- In case of an activist attack or other contested situation, the company's approach should be supplemented by an intensive campaign with participation by directors.
- Advance preparation, including regarding Regulation FD compliance and communication plans, is critical.
- Proactive, productive and effective engagement can yield significant benefits to a company's relationship with its largest institutional investors.

Risk Management

- The risk oversight function of the board has never been more critical and challenging than it is today.
- COVID-19 has amplified the scrutiny of ESG-related risks, human capital issues, business model and supply chain issues, and environmental degradation and climate change.
- Rapidly advancing technologies, new business models, deal-making and interconnected supply chains add to the complexity of corporate operations and the business risks inherent in those operations.
- The evolving political environment further exacerbates the risks that corporations face.
- Corporate behavior has been blamed for aggravating disparities in income and wealth.
- Safety scandals and product failures have affected public confidence in the ability of corporations to manage business risk and sufficiently prioritizing consumer and product safety.
- The reputational damage to companies, boards and management teams that fail to properly manage risk is substantial. Crises, or their perceived mismanagement, may invite governance or activist campaigns.

Risk Management

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- A board's risk oversight responsibilities derive from state law fiduciary duties, federal and state laws and regulations, stock exchange listing requirements and evolving best practices.
  - Delaware courts have taken the lead in formulating the national legal standards for directors' duties for risk management (*e.g.*, *Caremark* and the recent *Blue Bell*, *Clovis*, *Shabbouei* and *Hughes* cases).
- The SEC requires disclosures regarding risk oversight and risk factors, and has recently called on companies to focus disclosure on their response and planning related to the impact of COVID-19.
- To the extent that risks arising from compensation policies are reasonably likely to have a "material adverse effect" on a company, SEC proxy rules also require the company to discuss how its compensation policies and practices relate to risk management and risk-taking incentives.
- The DOJ and the SEC have pledged continued vigorous enforcement of the FCPA, and have brought significant enforcement actions against both individuals and corporations.
- NYSE governance standards impose risk-oversight obligations on listed company audit committees.
- Major institutional shareholders and proxy advisory firms consider risk-oversight matters in evaluating director elections and shareholder proposals, and routinely engage companies on risk-related topics.
- Various industry-specific regulators and private organizations publish suggested best practices for board oversight of risk management (*e.g.*, National Association of Corporate Directors Blue Ribbon Commission).

Risk Management

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- Boards should regularly assess the adequacy of companies' risk-management processes, including by considering:
  - Primary elements comprising the company's risk culture, including the "tone at the top," especially as it relates to employee safety and sexual misconduct.
  - Corporate risk appetite and tolerance and consistency of corporate strategies with these.
  - Framework for holding management accountable for maintaining risk-appetite framework and reporting to board.
  - Risk categories, including concentrations and interrelationships, as well as likelihood and impact.
  - Measurement and hedging of risk; setting of risk limits and action plans if limits are exceeded.
  - Assumptions and analyses underpinning determination of company's principal risks.
  - Company's preparedness for, and action plan in the event of, a possible cybersecurity breach.
  - How risks are identified and reported up through company (including qualitatively), how risk-management and oversight responsibilities are allocated and how management is incentivized.
  - Management's design and implementation of risk policies and procedures.
  - Independence of risk-management function and processes for addressing internal conflicts.
  - Means by which risk-management strategy is communicated through the organization.
  - Internal and external reports and communication regarding risks and risk-management functions.
  - Qualifications of directors, committees and board to oversee all facets of company's risk profile—including in specialized areas such as cybersecurity and the risks that are most critical and relevant to the company and its industry—and advisability of subject-specific risk education.

Part IV: Shareholder Activism

- Shareholder Activism Trends
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Shareholder Activism Trends

Current State of Play and COVID-19 Impact

- Some activists are seeking to opportunistically prey on soundly managed companies weakened by the effects of the COVID-19 pandemic (*e.g.*, overreaching demands, increasing positions, building new positions).
- Deal-related activism remains prevalent, with activists instigating deal activity, challenging announced deals ("bumpitrage"), pressuring the target into a merger or PE deal with the activist and/or offering to serve as financing sources to help "get the deal done."
- Elliott Management, followed by Third Point, were the top activists by stake value in 2020. Elliott and Starboard Value were the most active by number of campaigns, with 16 and 6, respectively.
- Stockholder demands to inspect corporate books and records pursuant to Section 220 of the DGCL have increased in frequency, particularly in the M&A context.
- The Delaware courts have recently emphasized the importance of advance notice bylaws and the right to insist on strict adherence to deadlines and other requirements prescribed in bylaws.

Source: Lazard 2020 Review of Shareholder Activism.

Shareholder Activism Trends

(cont'd)

Targets

- Activists publicly targeted 810 companies worldwide in 2020 (down from 896 in 2019), including 432 U.S. companies—and significant activist activity takes place privately.
- Activist campaigns targeting non-U.S. companies have become commonplace, and meet varied success. Outside of the U.S., 378 companies were publicly targeted in 2020, with significant activity in Europe (135, including 37 in the U.K.), Asia (116, including 66 in Japan), Australia (62) and Canada (49).
- The record number of campaigns in 2019 with an M&A-related thesis (*e.g.*, activists demanding a sale (HP), a break-up (Marathon) or opposing a transaction (Occidental)) has since declined in 2020.
- No company is immune, including large companies, controlled companies, and financial institutions.

Source: news articles.

Shareholder Activism Trends

(cont'd)

Selected Activism Strategies and Tactics

- M&A/deal activism: push for merger/sale/divestiture or after announcement seek appraisal, seek higher price, encourage topping bid, try to influence combined company/integration or try to scuttle deal.
- Operational activism: call for cost-cutting, strategy change, portfolio review or management turnover—often in partnership with potential replacement CEO and/or slate with deep industry experience.
  - Increasingly prominent attacks seeking to replace (or, on occasion, to retain) a company's CEO.
  - Several major funds have converted to more of a merchant-banking approach of requesting board representation to assist a company in improving operations and long-term strategy.
- Financial engineering/balance sheet activism: demand capital structure change, buyback, special dividend or tax optimization (tax overhaul plan expected to provide catalysts).
- Governance (and, more broadly, ESG) activism: ESG issues offer levers for activists to compel events at targets, and governance activism facilitates economic activism (*e.g.*, by eroding takeover defenses).
- Short activism: short position combined with negative public campaign, white papers, etc.

Source: news articles.

Corporate Social Responsibility in the Activism Context

Overview

- Corporate social responsibility is a major concern for companies and boards, as well as for investors. Growing prominence of E&S matters with institutional investors.
- Rise of E&S-oriented funds and strategies, including assumption of E&S mantle by activist hedge funds.
- Calls for broader E&S disclosure, including focus on sustainability measurement and diversity.
- Proliferation of E&S ratings providers and efforts to consolidate many metric- and framework-related initiatives.
- Under a March 2020 Climate Voting Policy, ISS will recommend votes against directors viewed as failing to adequately address climate-related risks and may also penalize directors of companies that do not publicly report sustainability metrics and companies that are also perceived to be failing to manage ESG risks.

Source: WSJ.

Corporate Social Responsibility in the Activism Context

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ESG and Sustainability: The Board's Role

- Be aware that ESG and sustainability have become major governance topics that encompass a host of issues, and consider how the company presents itself with respect to these matters.
- Recognize that the role of the board in these areas is generally one of partnership with management and appropriate oversight, rather than unilateral board-level mandates.
- Work with management to identify which ESG issues are most pertinent to the company's business and key stakeholders and to oversee implementation of appropriate policies and processes for assessing, monitoring and managing material ESG risks and opportunities, as well as the associated disclosures.
- May be prudent to receive regular briefings on ESG matters and the company's approach to them.
- As the public conversation on the role of companies in addressing ESG issues continues to evolve, consider how the board's risk oversight role specifically applies to various ESG-related risks.
- Be informed about the company's approach to dealing with investor requests for ESG-related engagement, external disclosure and reporting.
- Evaluate potential litigation and regulatory risks of proposed ESG metrics and be mindful of the path forward to adapt such metrics as the momentum grows towards a common framework.
- If faced with an activist investor sounding ESG-linked themes, leverage prior preparedness and apply best practices to respond. Establish a governance framework for handling a shareholder proposal addressing these matters.
- Not every director or member of senior management can or should be an "ESG expert," but directors and appropriate personnel should educate themselves on the key issues and risks.

Proxy Contests and Settlements

Insights from Recent Situations

- Engagement efforts can help build credibility for the board and management and enable them to hear what long-term shareholders want.
- Failure to have successfully engaged with major investors and understand their opinion of the company's operations and strategy has resulted in proxy fights that were lost or won by such a narrow margin that management change quickly followed.
- An activist with a multibillion-dollar investment is unlikely to sell the positon after a close proxy fight and will continue to pressure the company on issues raised in the fight. Moreover, an activist that has narrowly "lost" a proxy fight will likely contest preliminary results.
- An activist with a track record of success in urging change in long-term strategy rather than financial engineering can gain support from proxy advisors and major institutional investors.
- A large retail shareholder base does not guarantee company success in a proxy fight.
- Activists can make substantial inroads/attain board seats with relatively small percentage stakes, so long as they have institutional support.
- Activist overreach, including through demands for board control, may backfire with proxy advisors and shareholders and fuel target pushback. Activists may pare back slate/settle in anticipation.
- M&A deals are more likely to be successfully received in the face of an activist challenge when companies can contextualize them within a longer-term plan to create value.
- Accommodating activist demands through settlement may not always be what the board considers to be in the best interests of all shareholders; companies should carefully make this determination.

Proxy Contests and Settlements

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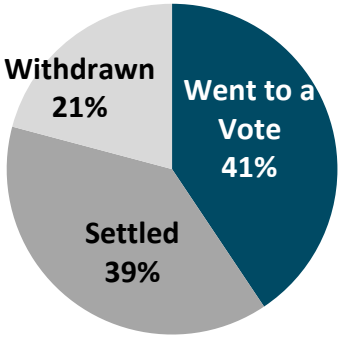
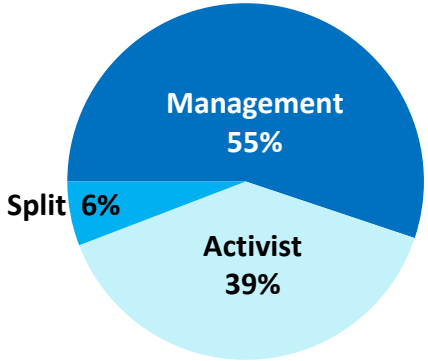
Proxy Contest Outcomes

Proxy Campaigns (2010–2015)



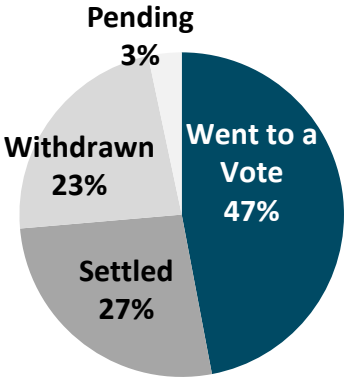
Total: 719 Proxy Fights

Winner After Vote



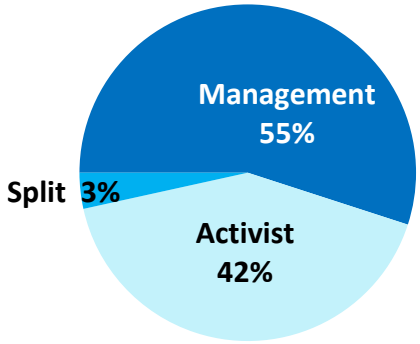
Total: 292 Votes
(161 Management Wins, 114 Activist Wins, 17 Splits)

Proxy Campaigns (2016–2020)



Total: 1,172 Proxy Fights

Winner After Vote



Total: 551 Votes
(303 Management Wins, 229 Activist Wins, 19 Splits)

Source: FactSet data accessed March 2021. Includes all proxy fight types, grouped by Announce Date. Percentages may not total 100% due to rounding.

Proxy Contests and Settlements

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Settlements with Activists

- Many companies choose to negotiate and even settle with an activist, if it can be done on acceptable terms, to avoid a public fight and an uncertain outcome.
  - The question of whether to settle will depend on a number of factors, including: the company's leverage, the activist's agenda, the company's likelihood of success in a stockholder vote, common ground to reach a settlement and the activist's reasonableness and willingness to compromise.
- Topics typically addressed in a proxy fight settlement include:
  - Board representation: activist nominees may be affiliated with activist, independent or a combination.
    - Agreement may cover committee representation/formation of new committees.
  - Standstill: activist agrees to drop the proxy fight and be bound by a standstill that limits public agitation as well as acquisitions.
  - Voting/support commitments: *e.g.*, activist commitment to vote in favor of board slate that includes activist nominees.
  - Situation-specific business or policy commitments: *e.g.*, commitments on capital allocation, exploration of strategic alternatives or implementation of cost-cutting measures.
  - Confidentiality and use of information given to activist's board nominees.
  - Mutual non-disparagement.
  - Any reimbursement of activist expenses.
- In the recent *Sarissa* case, the Delaware Chancery Court ordered specific performance of an oral activist settlement agreement that included the addition of two dissident directors to the company's board.