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Corporate Governance Update: The 2019 Proxy Season Hints at New Challenges

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While the 2019 proxy season did not feature any dramatic developments, an interesting element was the slight but noticeable growth of the nascent movement against the use of environmental, social, and political factors in corporate decision-making. Led by groups such as the Free Enterprise Project and Main Street Investors Coalition, shareholder proposals against progressive initiatives increased in both number and visibility. As the number of politically-oriented shareholder proposals has grown in recent years, and as progressive stances have dominated, it is not surprising that conservative-minded investors have attempted to mount a resistance. This small but potentially significant aspect of the 2019 proxy season is an early warning signal to CEOs and directors that a challenge in coming years will be to manage divisive political issues without alienating large groups of stakeholders. While companies must engage with investors and carefully consider issues raised in dialogue or through successful proxy proposals, they must do so in a manner that does not compromise corporate strategic success. This is likely to be an increasingly difficult task.

Shareholder Advocacy Initiatives

New initiatives by large asset managers virtually ensure that the 2020 proxy season will feature a continuation of ESG proposals (including political issues). One initiative is the Boardroom Accountability Project 3.0, led by NYC Comptroller Scott Stringer. Earlier phases of Comptroller Stringer's Accountability Project focused on proxy access and enhanced disclosure regarding board composition, and the focus of the third stage is diversity in hiring at the top levels of the corporation. Comptroller Stringer seeks broad implementation of the "Rooney Rule," a diversity-boosting protocol borrowed from the National Football League. The Rooney Rule in the NFL requires that a team interviews minority candidates for head coach positions and, as of this year, general manager positions and front office equivalents. In Comptroller Stringer's corporate governance

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initiative, the Rooney Rule would require companies to consider the candidacies of women and people of color when they seek to fill open chief executive and new board of director positions.

Comptroller Stringer has sent letters to 56 S&P 500 companies asking each to "adopt a diversity search policy *requiring* that the initial lists of candidates from which new management-supported director nominees and chief executive officers (CEOs) are chosen include qualified female and racially/ethnically diverse candidates." Stringer's letters state that such a policy would "institutionalize the board's commitment to achieving and maintaining racial and gender diversity over the long term." Comptroller Stringer has announced his intention to file shareholder proposals at companies "with lack of apparent racial diversity at the highest levels."

Additionally on board diversity, the NYC Retirement Systems revised their voting policy for members of a board's nominating committee. The Systems will vote against these directors if "the board lacks meaningful gender and racial/ethnic diversity, including but not limited to any board on which more than 80% of the directors are the same gender." The new policy also anticipates that the Systems' diversity expectations may become more explicit and more robust in the future.

On the environmental front, the New York State Common Retirement Fund released a Climate Action Plan in June 2019. Citing "immense investment risks posed by climate change" and "significant investment opportunities in the transition to the emerging low carbon economy," Comptroller of New York State and Trustee of the Common Retirement Fund Thomas DiNapoli has put forth the plan with the stated goal of "achieving a sustainable portfolio." To this end, Comptroller DiNapoli is engaging with portfolio companies in relevant industries to discuss transition plans and related business strategies. If he follows the lead of Comptroller Stringer, he will also submit shareholder proposals in certain circumstances.

Anti-ESG Initiatives

As ESG and political activism grows, led by large asset managers for the stated purpose of pursuing "sustainable long-term value," there appears to be growing opposition to corporate decision-making based on progressive ESG and political agendas. The Free Enterprise Project (FEP), begun in 2007 by the National Center for Public Policy Research, describes itself as "the leading voice for conservative-minded investors," and claims to file "more than 90 percent of all right-of-center shareholder resolutions." In 2019 the FEP filed identical proposals at companies including Amazon, Twitter, Facebook, and Apple asking them to adopt a policy—titled "True Diversity Board Policy"—of providing shareholders with specific disclosures about board composition, director qualifications, and nominees' ideological perspectives. In the supporting statement, FEP stated that "true diversity is diversity of thought" and that "ideological hegemony … can be a major risk factor for shareholders." The statement also posited that "a diverse board is a good indicator of sound corporate governance and a well-functioning board" and that this diversity "is best achieved through highly qualified candidates with a wide range of skills, experience, beliefs, and board independence from management." These "True Diversity Board Policy" shareholder proposals received low levels of shareholder support in 2019.

Main Street Investors Coalition (MSIC) is a campaign to counter the influence of large asset managers at the expense of individual investors. MSIC advocates on behalf of retail investors whose "overwhelming priority is to maximize the returns from their holdings." MSIC was formed in 2018 by the National Association of Manufacturers in partnership with American Council for Capital Formation and Savings & Retirement Foundation, Small Business & Entrepreneurship Council, and American Association of Senior Citizens. Its guiding principle is that retail investors "have little interest in, and understanding of, 'socially responsible' investing" but are either outvoted by institutions pursuing ESG agendas or, as public pension fund beneficiaries or holders of mutual funds, unaware that the power of their proxies can be and often is wielded in ways that do not maximize financial returns.

Data from the 2019 proxy season demonstrates that MSIC is correct in its belief that institutional investors and retail investors have different priorities. This difference is reflected in the average level of support for directors and shareholder proposals. According to data from a Broadridge/PwC report, among the 478 directors that failed to receive majority support in 2019, institutional shareholder support was at 30% and retail shareholder support was at 77%, while of the 1,726 directors that received less than 70% support, institutional support was at 47% and retail support was at 84%. With respect to corporate political spending proposals—support for which increased over the last five years from 20% in 2015 to 31% in 2019—institutional support was at 32% compared to retail support at 19%. With institutional and retail ownership overall at 70% and 30% respectively, it is apparent that the voice of retail investors is not heard loudly at the ballot box.

Corporate Diplomacy

The growing challenge for companies will be to engage with investors on the issues that are important to them while staying focused on strategic success. Directors are increasingly likely to be personally involved in investor engagement and should take care that they are communicating a message consistent with that of management in appropriate situations. (According to a recent EY report, more than half of Fortune 100 companies disclosed in 2019 that board members were involved in select investor engagement discussions. This percentage has grown rapidly from 29% in 2016.)

When confronted with opposing views among investors and conflicting requests for action, CEOs and directors must step up their corporate diplomacy. The key will be to use sustained engagement to find common ground, to finesse divisive issues, and to "get to yes" on strategic goals. When long-term and short-term interests appear to conflict, and when political hot-button issues loom large, corporate leaders may be able to align investors' interests by persuasively articulating a vision for success over the applicable strategic term. Navigating increasingly divisive and political shareholder advocacy will be no easy matter, especially in the age of social media, but signs from the 2019 proxy season indicate that it will be an unavoidable task in the years ahead. Companies need to be in a position to react quickly in these challenging situations in order to make sure that the interests of shareholders are protected.