# Corporate Governance

**April 2020**

# Topics

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- Purpose, Stakeholders, ESG & Sustainable Long-Term Investment
- New Paradigm of Corporate Governance

**Part II: Corporate Governance Landscape**

- Key Issues for Directors Relating to COVID-19
- Corporate Governance Trends
- The Role of Directors
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- Director Elections and Other Voting Issues

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# Part I: New Paradigm of Corporate Governance

- Purpose, Stakeholders, ESG & Sustainable Long-Term Investment
- New Paradigm of Corporate Governance

# Purpose, Stakeholders, ESG & Sustainable Long-Term Investment

- After years of growing alarm about short-termism, the sustainability and competitiveness of businesses over a long-term horizon, and the role of corporate policies in contributing to socioeconomic inequality, consensus is emerging that the prevailing corporate governance system is broken.
  - Initially, in the aftermath of the 2008 financial crisis, this critique was focused on short-termism as a root cause of systemic destabilization and decay.
  - In subsequent years, the concept of sustainability gained traction, and ESG principles were embraced by shareholders and corporations alike as the next frontier in corporate governance best practices.
  - This laid the foundation for the latest iteration of corporate governance modernization: the advent of stakeholder governance, and the realization that the pursuit of wealth maximization for shareholders as the sole *raison d'être* of corporate governance has fueled short-termism and socioeconomic inequality.
- The COVID-19 pandemic, with its massive economic toll, is sure to intensify focus on stakeholder governance and the failings of the old corporate governance paradigm.
- In 2019 each of the major index fund managers, the Business Roundtable, the British Academy, the UK Financial Reporting Council, the World Economic Forum and a number of other governmental organizations and NGOs announced that they did not support shareholder primacy and do support sustainable long-term investment and considering ESG matters.
- The fiduciary duty of a board of directors is to the corporation; not just to the shareholders. Much of the focus on stakeholder governance has shifted 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 do so.
  - Directors need to grapple with a host of questions about the practical implications of this new paradigm—such as how to adjust existing board functioning to reflect stakeholder governance, questions about the contours of the board's legal obligations, and how to communicate and engage with shareholders and other stakeholders.

# Purpose, Stakeholders, ESG & Sustainable Long-Term Investment

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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 that are not in the best interests of the corporation.
  - Shareholder 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.
  - Profits are not the sole objective of the corporation, but they are a core objective that a well-functioning corporate governance regime should seek to achieve.
- In addition, the exercise of considering multiple stakeholder interests, and the risks and opportunities they entail for the corporation and its business plan, is hardly 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.
  - In exercising their duties of care and loyalty, directors are afforded the safe harbor of the business judgment rule in seeking to promote sustainable long-term investment and ESG principles in a manner designed to enhance the long-term value of the corporation.

# Purpose, Stakeholders, ESG & Sustainable Long-Term Investment

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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 the shareholders are the only stakeholders to whom the directors have a fiduciary duty.
  - 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 the 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.
  - The special genius of Delaware law is that it has been animated by a fundamental sense of pragmatism and its fiduciary duty framework has afforded corporations the breathing room they need to address evolving business challenges as well as expectations of shareholders.

# Purpose, Stakeholders, ESG & Sustainable Long-Term Investment

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- 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.
- Stakeholder governance and consideration of ESG matters does not reduce or negate accountability; the goal of sustainable long-term growth in value remains.
- "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." (From the WEF definition of purpose.)

# Growing Recognition of Threat of Short-Termism

- Recognition has grown of the damaging effects of short-termism—including from activist hedge fund attacks—on shareholders, employees, communities and the economy; e.g.:
  - Academic studies discrediting the notion that activist attacks and shareholder-centric governance enhance long-term value.
  - Calls by BlackRock, State Street, Vanguard for corporations to resist financial engineering, pursue long-term strategies, embrace transparency and regularly engage with investors on performance and strategy.
  - Participation by institutional investors and other business leaders in organizations like FCLTGlobal.
  - International Business Council of the WEF's issuance of "The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth" (prepared by Martin Lipton).
  - Coalition for Inclusive Capitalism and EY launch of The Embankment Project for Inclusive Capitalism "to help define how firms create long-term value and offer potential ways to measure and report on that."
  - ISG "Framework for U.S. Stewardship and Governance," focused on combating short-termism, "promoting long-term value creation for U.S. companies and the broader U.S. economy" and promoting engagement.
  - Jamie Dimon and Warren Buffett June 2018 *WSJ* op-ed "encouraging all public companies to consider moving away from providing quarterly earnings-per-share guidance."
  - "Commonsense Principles 2.0", prescribing roles and responsibilities of boards and shareholders in contributing to good corporate governance (including focus on long-term value creation).
  - Increasing concerns about precipitous drop in number of U.S. stock listings over the past two decades.
  - Revised December 2018 version of Martin Lipton's *The New Paradigm*, including updates based on prevailing institutional investor policies and public statements and integrating concepts from other governance frameworks, codes and principles.
  - The Business Roundtable's August 2019 Statement on the Purpose of a Corporation, signed by 181 CEOs, embracing stakeholder corporate governance.

# New Paradigm of Corporate Governance

**Overview**

- Consistent with the above-described emerging norms regarding the purpose of the corporation, 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 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 facilitate direct engagement with directors if these investors request it.
  - 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 or episodic support by institutional investors of activist initiatives, but seeks to focus activism on improving companies that are truly underperforming.

# New Paradigm of Corporate Governance

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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 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 pursuit of short-term results at the expense of long-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.
- 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.

# New Paradigm of Corporate Governance

(cont'd)

**Paradigm Components (cont'd)**

- *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.

- 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

- Key Issues for Directors Relating to COVID-19
- Corporate Governance Trends
- The Role of Directors
- Risk Management
- Board Structure
- Director Elections and Other Voting Issues

# 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. Key issues and action items for corporate directors include:
  - Maintaining close contact with the CEO and working with management to ensure the safety and well-being of the company's employees, other stakeholders as well as the public at large.
  - Understanding the risks to the company and its stakeholders from COVID-19 and discussing, as a board, management's strategies for minimizing and mitigating these risks.
  - Reviewing the viability of the enterprise from both short-term and long-term perspectives and making appropriate changes to the corporate strategy to ensure that viability.
  - Receiving a board-level briefing on company indebtedness and understanding the company's near-term liquidity needs and working with management to secure liquidity needs.
  - Appropriately messaging the company's actions with respect to the crisis and providing the CEO and management with assistance in handling communication with internal and external constituents.
  - Communicating frequently with, and seeking guidance from, applicable regulators and other government agencies with oversight.
  - Responding to activist attacks and other actions by those seeking to take advantage of the situation and promote their own agenda.
  - Evaluating opportunities for transactions that are made available by the changed circumstances.
  - Working with management in engaging shareholders and other stakeholders on corporate operations, impact to strategy, and other important concerns, including ESG issues such as climate change and sustainability.
  - Reviewing compensation plans and considering whether changes are required, particulate with respect to equity arrangements, unforeseen employee cash needs and mission-critical personnel.
  - Evaluating the company's current and future dividend and buyback policy as well as capital allocation and liquidity generally.

# Corporate Governance Trends

- 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).
  - Widespread adoption has transformed the profiles of U.S. public companies.
- Nonetheless, the drive for "reform" to enhance shareholder rights and weaken takeover defenses continues.
  - 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.
- 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.
  - Expanded notion of stakeholder interests (including employees, customers, communities, and the economy and society as a whole) is a developing theme with policymakers, academics and investors.
  - Efforts to invigorate a more long-term perspective among both corporations and their investors highlight fundamental questions about the basic purpose of corporations.
- 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 board with skills and experiences most relevant to a particular corporation.
  - How to forge relationships with stakeholders that meaningfully enhance the company's credibility.

# Corporate Governance Trends

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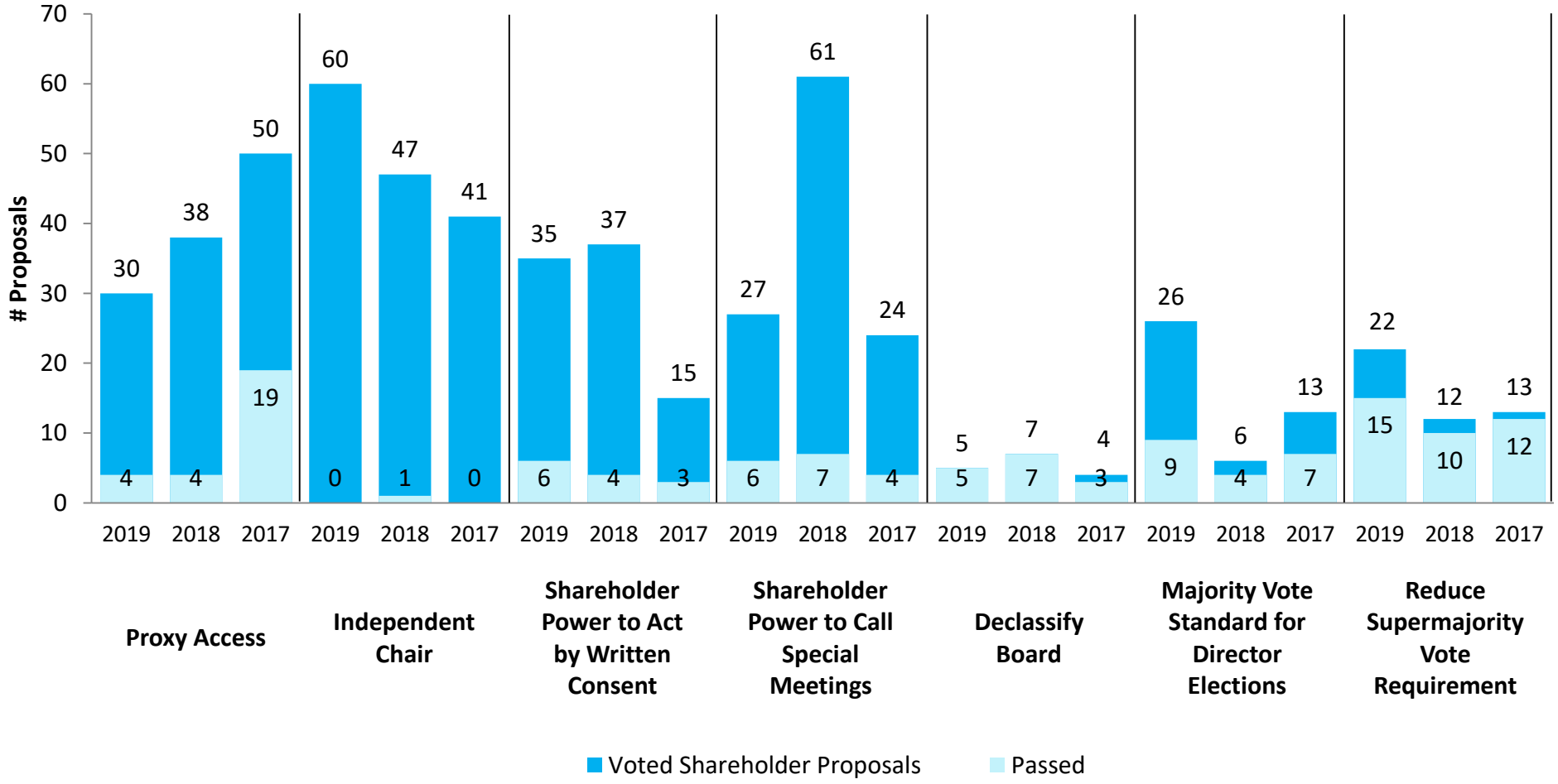
- Companies and investors alike have sought to address these "next generation" governance issues in a way that facilitates comparability, objective assessment and accountability.
- Impact of Trump administration on corporate governance has been driven to a large extent by the agenda of the SEC under Chairman Jay Clayton, who has been focused on reform of the proxy process—including proxy solicitation and voting, the shareholder proposal process and the role of proxy advisors—with a view to serving Main Street investor interests.
- The SEC has been studying short-termism and the nature and content of quarterly reports and earnings releases (though Chairman Clayton has stated that he does not "think quarterly reporting is going to change for our top names [*i.e.*, large companies] anytime soon").
- Legislative initiatives have emerged, as dissatisfaction with corporations is near the top of the political agenda for both the left and the right.
  - Senator Elizabeth Warren's "Accountable Capitalism Act" would federalize all companies with annual revenues of $1+ billion, preempt state corporation law and mandate board fiduciary duty to all stakeholders, not just shareholders, and require not less than 40% of directors be elected by employees.
  - In a February 2019 *NYT* op-ed, Senators Chuck Schumer and Bernie Sanders discussed introducing federal legislation that would prohibit share buybacks (and perhaps dividends) if corporations do not meet specified employee wage and benefit levels.
  - In March 2020, Representative Maxine Waters proposed a temporary ban on stock buybacks or dividends "until the impacts of the coronavirus on the American financial system have ended to ensure that companies are using their excess cash to pay workers, shore up their bottom lines, and invest in their communities."
  - Across the aisle, Senator Marco Rubio has proposed ending the preferential tax treatment of stock buybacks, seeking to provide incentives for domestic investment.

# Corporate Governance Trends

(cont'd)

- Independent chair and proxy-access amendment shareholder proposals remained prominent on 2019 ballots, while individual proponents have driven continued written consent and special meeting proposals.
- Proxy-access adoption and board declassification proposals have waned as these practices have been more widely implemented, particularly by larger companies. A CalPERS campaign directed at smaller companies without gender diversity drove the 2019 resurgence in majority-vote proposals.




*Source: ISS.*

# The Role of Directors

**Directors' Key Responsibilities**

- It is clear that the shareholder-value maximization model of corporate governance is politically and commercially unsustainable. Environmental and human capital risks, as well as the systemic instability generated by widespread economic inequality, are substantial and increasingly near-term risks for corporations operating in every business sector.
- Directors should meet this challenge by focusing not just on profits, but also on the corporation's broader purpose and role in the economic and societal ecosystem in order to build a sustainable and long-term value proposition. With this background and context, boards will be expected to:
  - Recognize the heightened focus of investors, special interest organizations and the public on "purpose" and "culture" and an expanded notion of stakeholder interests that includes shareholders as well as employees, customers, suppliers, communities, the economy and society as a whole;
  - Be aware that ESG and sustainability have become major, mainstream governance topics that encompass a wide range of issues, such as climate change and other environmental risks; systemic financial stability; worker wages, training, retraining, healthcare and retirement; supply chain labor standards and consumer and product safety;
  - Oversee management's development of analysis and metrics to understand the impact of these stakeholder interests on the value and strategy of the corporation, and oversee the integration and balancing of these interests to promote the long-term success of the corporation; in performing this oversight function, directors should recognize that balancing and allocating among all the stakeholder interests is protected by the business judgment rule;
  - Oversee corporate strategy (including purpose and culture) and the communication of that strategy to investors, in light of investors' expectations and keeping in mind that investors want to be assured not just about current risks and problems, but also threats to long-term strategy from global, political, social and technological developments;

# The Role of Directors

(cont'd)

**Directors' Key Responsibilities (cont'd)**

- Set the "tone at the top" to create a corporate culture that not only gives priority to ethical standards, professionalism, integrity and compliance in setting and implementing both operating and strategic goals, but that also is a reflection of, and a foundation for, the corporation's purpose;
- Oversee and understand the corporation's risk profile as well as its management of risks, including how risk is taken into account in the corporation's business decision-making, and respond to red flags if and when they arise;
- Choose the CEO, monitor the CEO's and management's performance and develop and keep current a succession plan;
- Have a lead independent director or a non-executive chair of the board who can facilitate the functioning of the board and assist management in engaging with investors;
- Together with the lead independent director or the non-executive chair, determine the agendas for board and committee meetings and work with management to ensure that appropriate information and sufficient time are available for full consideration of all matters;
- Determine the appropriate level of executive compensation and incentive structures, with awareness of the potential impact of compensation structures on business priorities and risk-taking, as well as investor and proxy advisor views on compensation;
- Maintain a working partnership with the CEO and management and serve as a resource for management in charting the appropriate course for the corporation;
- Recognize that shareholder engagement has become a central component of corporate governance, and participate, as appropriate, in efforts to communicate with and listen to shareholders;
- Work with management to anticipate possible takeover attempts and activist attacks in order to be able to address them more effectively, if they should occur;
- Meet at least annually with the team of company executives and outside advisors that will advise the corporation in the event of a takeover proposal or an activist attack;

# The Role of Directors

(cont'd)

**Directors' Key Responsibilities (cont'd)**

- Be open to management inviting a major shareholder or even an activist under appropriate circumstances to meet with the board to present the shareholder's or activist's opinion of the strategy and management of the corporation;
- Evaluate the performance of individual directors, the board and board committees on a regular basis and consider the optimal board and committee composition and structure, including board refreshment, expertise and skillsets, independence and diversity;
- Review corporate governance guidelines, committee charters and workloads and tailor them to promote effective board and committee functioning;
- Be prepared to deal with crises;
- Be prepared to take an active role in matters where the CEO may have a real or perceived conflict, including takeovers and attacks by activist hedge funds focused on the CEO; and
- Determine that appropriate records of the foregoing are timely created and maintained.

- To meet these expectations, corporations should seek to:
  - Have a sufficient number of directors to staff the requisite standing and special committees to meet investor expectations for experience, expertise, diversity and periodic refreshment;
  - Consider whether the corporation would benefit from the addition of management or board committees focused on safety, finance, risk management, compliance, human capital and ESG, or any other special need;
  - Compensate directors commensurate with the time and effort that they are required to devote and the responsibility that they assume;
  - Have directors who have knowledge of, and experience with, the corporation's businesses and with key developments and drivers that impact those businesses, even if this results in the board having several members who are neither "independent" nor "unaffiliated";

# The Role of Directors

(cont'd)

**Directors' Key Responsibilities (cont'd)**

- Have directors who are able to devote sufficient time to preparing for and attending board and committee meetings and engaging with investors;
- Provide directors with the data that is critical to making sound decisions regarding performance, strategy, compensation, ESG issues, capital allocation and stakeholder allocation;
- Provide directors with regular tutorials by internal and external experts as part of expanded director education and to assure that directors have the information and expertise they need to respond to disruption, evaluate current strategy, strategize beyond the horizon and integrate and balance the interests of varying stakeholders; and
- Maintain a collegial relationship among and between the company's senior executives and the members of the board that facilitates frank and vigorous discussion and enhances the board's role as strategic partner, evaluator and monitor.

# The Role of Directors

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**Shareholder Engagement**

- Engagement is no longer limited to the "proxy season," and traditional governance outreach has evolved to address financial and strategic matters.
  - Failure to engage adequately on these topics may lead to shareholders' withholding support.
- Engagement is increasingly a board-level issue with limited direct participation by independent directors, as appropriate and necessary.
- Expanded interaction with investors stems from many factors:
  - All parties seeking more regular dialogue on business and corporate governance matters.
  - Annual say-on-pay vote requires companies to explain compensation practices and consider feedback.
  - Appreciation for how dialogue can enhance board and management credibility, preempt shareholder resolutions and proxy fights and defuse potentially contentious situations.
  - Significant "behind-the-scenes" interaction and coordination among institutional investors.
  - Elevation of institutional ownership and passive investing, along with concomitant stewardship role.
- Disclosure and transparency are becoming more integrated with engagement strategy.
  - Companies are including disclosures about engagement efforts in their proxy statements, especially in response to negative say-on-pay votes.
  - Companies are proactively adding disclosures of particular interest to certain institutions to their proxy statements, SEC filings and websites.
- Institutional investors are articulating specific expectations regarding engagement and investor relations.
  - Investors are also setting ground rules with respect to engagement practices around activism (*e.g.*, T. Rowe Price: "If an activist or any other investor claims to represent T. Rowe Price's view on any investment or voting matter related to your company, please disregard this claim and contact us directly.").

# The Role of Directors

(cont'd)

**Shareholder Engagement (cont'd)**

- 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 specifically requested.
    - Coordinating director attendance alongside management at investor visits or at investor day events.
    - 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.
    - Growing appreciation that shareholder engagement can be handled in a practical and targeted manner in which quality of focused engagements, rather than quantity, delivers the most benefit.
- 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.
  - By forging relationships of trust and credibility with long-term shareholders, a company may expect to gain support for its long-term strategy.

# Risk Management

**Risk Management in the Current Environment**

- COVID-19 is a generational challenge to businesses of all profiles and an existential challenge for many.
- The risk oversight function of the board has never been more critical and challenging than it is today.
- 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.
  - In light of the growing number of successful cyber-attacks on even the most technologically sophisticated entities, lawmakers and regulators around the world have increased their attention to cybersecurity risk (*e.g.*, 2018 SEC guidance on cybersecurity disclosures and subsequent report on cyber threats and internal accounting controls; January 2020 FTC blog post on data security orders; recent SEC-OCIE observations on cybersecurity and resiliency) and implemented more aggressive enforcement and penalties.
  - California Consumer Privacy Act ("CCPA") January 2020 effectiveness and imposition of unprecedented data obligations on companies doing business in California.
- The evolving political environment further exacerbates the risks that corporations face.
- Corporate behavior has been blamed for accelerating environmental degradation and 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 have given rise to skepticism as to whether companies are sufficiently prioritizing consumer and product safety.
- Investors and asset managers have been actively embracing ESG and sustainability-related principles.
- Continued developments regarding sexual and other misconduct in the workplace make clear that setting the appropriate "tone at the top" is perhaps more important than ever before.
- 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 (including vote-no) or activist campaigns.

# Risk Management

(cont'd)

**Risk Management in the Current Environment (cont'd)**

- In addition to heightened expectations from institutional investors, legislators and other constituencies, a board's risk oversight responsibilities derive from state law fiduciary duties, federal and state laws and regulations, stock exchange listing requirements and certain established (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 progeny, including recent *Blue Bell* and *Clovis* cases).
- 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.
- In August 2019, the SEC proposed amendments to Regulation S-K Item 105 designed to make it easier for investors to identify the most important risk disclosures.
- In late 2019, the SEC issued a statement on the role of audit committees and reminders regarding oversight responsibilities.
- The Dodd-Frank Act mandated certain risk-management procedures principally for financial institutions.
- 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.
  - In recent years, investors have pushed for more meaningful and transparent disclosures on boards' activities and performance with respect to risk oversight.
- 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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**Observations**

- 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."
  - Risk appetite and risk tolerance; consistency of strategy with agreed-upon risk appetite and tolerance.
  - 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 of risks.
  - Measurement and hedging of risk; setting of risk limits and actions to be taken if limits are exceeded.
  - Assumptions and analyses underpinning determination of company's principal risks.
  - Company's preparedness for a possible cybersecurity breach (including sufficiency of internal audit function) and its action plan in the event that a cybersecurity breach occurs.
  - How risks are identified and reported up through company (including quality of information provided), 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 to all appropriate groups within company.
  - 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.

# Board Structure

**Elimination of Classified Boards**

- With a classified-board structure, generally one-third of directors are elected each year for three-year terms.
- Percentage of domestic S&P 500 companies with classified boards has sharply declined in recent years.
  - Approximately 11% as of year-end 2019 (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 ("SRP").
  - Between 2012 and 2014, the SRP advised institutional shareholders in connection with 196 declassification proposals at 129 S&P 500 and Fortune 500 companies that resulted in 121 companies agreeing to move towards declassification.
  - In 2019, shareholders at just five companies voted on shareholder-initiated declassification proposals—proposals averaged 80% support and all passed (vs. seven proposals with 87% average support in 2018, all of which passed).
    - Shareholders at 46 companies voted on management-initiated declassification proposals—proposals averaged 99% support and 37 passed (vs. 59 proposals with 99% support and 51 passes in 2018).
- As revised for 2020, 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. The policy also applies to supermajority vote requirements to amend the bylaws/charter and "[o]ther egregious provisions" that are "considered to be materially adverse to shareholder rights." Sunset provisions that are "reasonable" are deemed mitigating.
  - Many newly public companies feature a classified board, but in some cases these companies may have concentrated ownership, which would mitigate the effect of an adverse ISS recommendation.
- In its updates for 2018, ISS codified its policy providing for adverse director recommendations if companies opt into or do not opt out of state laws mandating classified boards.

*Source: SharkRepellent; ISS.*

# Board Structure

(cont'd)

**Separation of Chair and CEO**

- Fifty-three percent of S&P 500 companies separate the CEO and chair roles; 34% have an independent chair.
  - Seventy-five 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, considering factors including the scope and rationale of the proposal, current board-leadership structure, the company's governance structure and practices, the company's performance and other relevant factors.
  - In its updates for 2020, ISS added a list of factors that will increase the likelihood of a for vote (and relocated and updated language about application of the above set of factors to a Policy FAQs document).
- ISS FAQs also set out its policy on board responsiveness to majority-supported independent chair proposals:
  - Full implementation: separating chair and CEO positions, with an independent director serving as chair; policy that company will adopt this structure upon current CEO's resignation considered responsive.
  - Partial responses: evaluated case-by-case, depending on the disclosure of shareholder input obtained through outreach, the board's rationale and the facts and circumstances of the situation.
- Independent-chair shareholder proposals rarely receive majority support.
  - In 2019, shareholders at 60 companies voted on shareholder-initiated proposals to require an independent chair—proposals averaged 30% shareholder support and none passed. Forty-seven proposals voted on in 2018 averaged 32% support; one passed.
  - Notwithstanding lagging support for these proposals, supporters can apply pressure through a substantial, sub-majority vote.

*Source: 2019 Spencer Stuart U.S. Board Index; ISS.*

# Board Structure

(cont'd)

**Board Composition and Refreshment**

- Increasing focus on board composition and refreshment—as well as on associated disclosure—especially as to gender, diversity, age, tenure, independence and expertise:
  - Institutional investor calls for greater board diversity.
  - 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).
- Other notable recent developments:
  - In October 2019, the NYC Comptroller launched the "Boardroom Accountability Project 3.0" (following earlier iterations focused on proxy access adoption and disclosure of director gender, race and skill information as well as board refreshment), "calling on publicly-traded companies to adopt a policy requiring the consideration of both women and people of color for every open board seat and for CEO appointments, a version of the 'Rooney Rule' pioneered by the National Football League (NFL)."
  - CalPERS has been employing letter-writing, majority-voting proposal submission and vote-no campaigns in a multifaceted drive to increase board diversity.

*Source: 2019 Spencer Stuart U.S. Board Index.*

# Board Structure

(cont'd)

**Board Composition and Refreshment (cont'd)**

- As the push for gender diversity on U.S. boards has begun to take root, industry participants' diversity focus is expanding beyond gender and into leadership positions inside and outside of the boardroom.
- Boards overseeing implementation of enhanced anti-harassment policies, protocols for addressing allegations and employee training.
- Shareholders introducing proposals to address sexual harassment and gender pay-gaps, and maintaining pressure with board gender-diversity proposals.
- Invigorated policies, public statements and engagement efforts by institutional investors.
  - State Street Fearless Girl campaign, which resulted in 681 companies adding women directors, announced that beginning in 2020, it would vote against the entire nominating committee slate of a company with an all-male board that has not "engaged in successful dialogue on State Street Global Advisors' board gender diversity program for three consecutive years."
  - BlackRock call for companies to have at least two women directors on their boards.
- Proxy advisors 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, including the presence of a woman on the board at the prior annual meeting plus a commitment to appoint at least one woman to the board within a year, or other relevant factors.
- 2018 California law mandating quotas for women on boards is currently being challenged in federal and state courts. Selected other states (including New York) have followed with legislative initiatives focused on board diversity disclosure.
- Concerns about impact of activist hedge fund campaigns on gender diversity of management/boards (although selected dissidents putting forth diverse slates in alignment with institutional investors' focus).

# Board Structure

(cont'd)

**Observations**

- There is no one structure that is suitable for all public-company boards.
- Recent studies rebut the proposition that classified boards are associated with lower firm value and inferior outcomes for shareholders; they conclude that, to the contrary, staggered boards enhance long-term value.
- The board should have an independent leader, and should decide, based on the circumstances, whether to have separate or combined 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.
  - Board leadership structure remains an area in which major institutional shareholders have shown flexibility where a company conducts effective outreach.
- 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 also should 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.
  - Substantive director evaluation and re-nomination decisions will serve better than arbitrary policies.
- A substantial majority of the board should be independent. The board should consider all relevant facts and circumstances when evaluating independence.
  - Long-standing board service should not by itself disqualify a director from being considered independent.
- Conveying to shareholders the composition, quality and involvement of the board, including through annual proxy statement disclosure and other means, remains important.
  - Shareholders are also increasingly examining director selection and nomination processes.
- 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.
- SEC activity has gained momentum in recent years, culminating in 2019's proposed rule amendments.
  - 2014 SEC Staff regulatory guidance (Staff Legal Bulletin No. 20):
    - Confirmed that rote outsourcing of voting discretion to proxy advisory firms without engaging in ongoing and active oversight is inconsistent with investment adviser's fiduciary duties to clients.
    - Rejected notion that proxy advisory firm recommendations fall outside ambit of proxy rules and confirmed that furnishing of proxy voting advice generally constitutes a "solicitation."
    - Confirmed that investment advisers are not required to vote every proxy or at every meeting; instead, advisers and clients have flexibility to determine the extent to which they exercise proxy voting authority (if at all).
    - Clarified that, where an investment adviser does vote, it must adopt—and follow—reasonably designed protocols to ensure that proxies are in fact voted in the best interests of its clients.
    - Required proxy advisory firms to make specific, non-generic disclosure of certain conflicts.
  - Ahead of a November 2018 SEC staff roundtable on the proxy process, the Division of Investment Management staff withdrew two 2004 no-action letters that in practice had facilitated reliance by investment advisors on the recommendations of proxy advisors (but the staff left in place SLB No. 20, which draws on those letters).

# Director Elections and Other Voting Issues

(cont'd)

**Reform and Disintermediation of Proxy Advisory Firms (cont'd)**

- In August 2019, the SEC approved new guidance in two releases from the Division of Investment Management and the Division of Corporation Finance concerning the fiduciary responsibilities of investment advisers with respect to proxy voting, the use of proxy advisory firms, 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.
  - 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.
    - Guidance clarifies that an adviser is not always required to cast a vote on behalf of its clients on all issues, addresses steps an investment adviser can take to demonstrate that its voting determinations are in client's best interests and in accordance with its own policies and procedures, details factors an investment adviser should consider if it retains a proxy advisory firm, and addresses how investment advisers should handle potential deficiencies in a proxy advisory firm's analysis.
  - 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 or 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.

# Director Elections and Other Voting Issues

(cont'd)

**Reform and Disintermediation of Proxy Advisory Firms (cont'd)**

- 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 and 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.

- ISS subsequently filed suit against the SEC seeking to enjoin the Division of Corporate Finance release, including based on assertions that "[t]he SEC lacks authority to regulate proxy advice as though it were a solicitation" and that the release "is a substantive rule that the SEC failed to promulgate pursuant to the notice-and-comment procedures of the Administrative Procedure Act."
  - The parties agreed to a stay in the suit in January 2020, given the proceeding rulemaking initiative and the SEC's representation that the guidance will not be invoked during the stay.

- In November 2019, the SEC voted to propose amendments to the proxy solicitation rules (which were subject to a 60-day public comment period) "to enhance the accuracy and transparency of the information that proxy voting advice businesses provide to investors and others who vote on investors' behalf," including the following key elements:
  - Proxy Solicitation Rules Apply to Proxy Advisors. The proposed rules would amend Rule 14a-1(l) to codify the interpretation and guidance released by the SEC in August 2019 that proxy advisor vote recommendations are considered solicitations under the securities laws and thus are prohibited by the anti-fraud provisions of Rule 14a-9 from containing any materially false or misleading statement.

# Director Elections and Other Voting Issues

(cont'd)

**Reform and Disintermediation of Proxy Advisory Firms (cont'd)**

- Increased Disclosure Regarding Conflicts of Interest. The proposed rules would revise Rule 14a-2(b), which provides exemptions for proxy advisors from the information and filing requirements of the proxy rules. In order to continue to rely on these exemptions, proxy advisory firms would be subject to three conditions. The first is that they would have to disclose material conflicts of interest in their proxy voting advice, along with the policies and procedures that they have in place to identify and address these conflicts.
- Issuers and Non-Exempt Solicitors to Have Opportunities for Pre-Publication Review. The second condition is that proxy advisors must provide an opportunity for issuers and investors engaged in non-exempt solicitations (such as those conducting a proxy fight) to identify factual errors or methodological weaknesses in proxy advisor reports before they are published. The window for review would be brief and available only if the issuer files its proxy more than 25 calendar days prior to the shareholder meeting date. Issuers and non-exempt solicitors would also have the opportunity to review the proxy advisor's final report no later than two business days prior to its publication to clients.
- Issuers and Non-Exempt Solicitors to Have an Opportunity to Embed a Response in Proxy Advisor Reports. The third condition for a proxy advisor to rely on its exemption is that the final proxy advisor report as sent to clients would be required, if requested by the issuer or non-exempt solicitors, to include a hyperlink that allows clients to access the written views of the requesting party as to the proxy voting report as published.
- Any new requirements will be subject to a one-year transition period following publication of a final rule.
- While the proposed rules were generally applauded by companies as well as other market participants who share the concern that proxy advisory firms wield undue influence in the proxy voting process, many others expressed concerns, including that the amendments would be detrimental to shareholder rights and skew reports/recommendations to be more management-friendly.

# Director Elections and Other Voting Issues

(cont'd)

**Reform and Disintermediation of Proxy Advisory Firms (cont'd)**

- Congress has also been evaluating the role of proxy advisory firms and considering legislative action.
  - In 2017, the House passed (and the Senate in 2018 held hearings on) the "Corporate Governance Reform and Transparency Act of 2017," which would mandate registration and disclosure by proxy advisory firms, as well as afford companies the right to review and comment on draft recommendations. (Similar proposals had appeared in the "Financial CHOICE Act of 2017," which the House also had passed.)
  - Also in anticipation of the 2018 SEC roundtable, a bipartisan group of six Senators introduced the "Corporate Governance Fairness Act" to "help protect investors, strengthen corporate governance, and ensure proper oversight of proxy advisory firms" by requiring registration with the SEC under the Investment Advisers Act of 1940 (with exclusions for smaller firms) and periodic SEC examinations (including reviews of conflicts of interest policies and knowing false statements to clients) and consultations with stakeholders regarding additional investor protections.

# Director Elections and Other Voting Issues

(cont'd)

**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, the number of such proposals on company ballots continued to wane in 2019. While some companies avoid a vote by settling with proponents, widespread support among institutional investors (including BlackRock, CalPERS, CalSTRS, J.P. Morgan and Vanguard, among others) affects companies' ability to defeat proposals for shareholder proxy access.
  - In 2019, 76 companies adopted proxy access and a total of 30 proxy access shareholder proposals went to a vote:
    - 6 proposals to adopt proxy access (averaged 55% support), with 4 passing.
    - 24 proposals to amend proxy access right (averaged 29% support), with none passing.
  - Shareholder proponents continued attempting 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).
    - But companies appear to be able to include reasonable restrictions and defeat proxy access structures without group caps.
  - Hundreds of U.S. companies, including 77% of domestic S&P 500 companies, have adopted proxy access.
    - 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.
- 2019 also marked the first successful proxy access campaign: a co-founder and former director of a company nominated (via a trust) a hedge fund manager to the board pursuant to the company's proxy access bylaw. The company included the nominee on the ballot and he was elected with more than 99% support.

*Source: ISS; SharkRepellent; TheCorporateCounsel.net.*

# Director Elections and Other Voting Issues

(cont'd)

**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."
  - ISS provides factors for determining reasonableness, including that no sunset greater than seven years will qualify as such.
- In the face of mounting pressure from institutional investors following several high-profile multi-class IPOs, which in some cases featured no-vote shares, index providers S&P and FTSE Russell in 2017 took steps to exclude companies with certain such structures from their indexes.
  - Actions met criticism from BlackRock for potentially limiting "index-based clients' access to the investable universe of public companies and depriv[ing] them of opportunities for returns."
  - SEC Commissioner Robert Jackson also expressed concern with the "blunt tool" of banning dual-class companies from indexes, instead calling on stock exchanges to require sunsets on such structures.
  - MSCI decided instead to launch separate indexes that "account for unequal voting structures."
- CII has undertaken activities including petitioning the NYSE and Nasdaq in late 2018 to require companies that go public with multiple-class voting structures to sunset the provisions within seven years (or extend by a shareholder vote).
- 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.

# Director Elections and Other Voting Issues

(cont'd)

**Observations**

- If effected, proposed SEC amendments would increase accountability of proxy advisory firms and address conflicts of interest and lack of transparency.
  - Pending their implementation, investors should exercise independent, informed judgments on voting matters and engage constructively with issuers in a case-by-case, pragmatic manner.
- 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 interest in the company for a meaningful period of time, and contains reasonable procedural, eligibility 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: Shareholder Activism

- Shareholder Activism Trends
- Proxy Contests and Settlements
- Rule 14a-8 Shareholder Proposals
- Corporate Social Responsibility

# Shareholder Activism Trends

**Current State of Play**

- Some activists are seeking to opportunistically prey on soundly managed companies weakened by the effects of the COVID-19 pandemic (see following slide).
- Activist AUM remain at elevated levels, encouraging continued attacks on large, successful companies in the United States and abroad. Strong returns from multiple high-profile activist hedge funds in 2019 (alongside selected notable fund shutterings) will continue to draw capital and interest to the strategy.
- Deal-related activism remains prevalent, with activists instigating deal activity, challenging announced transactions (*e.g.*, the "bumpitrage" strategy of pressing for a price increase), 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."
- "Short" activists remain aggressive in both the equity and corporate debt markets. We have seen a rise in "default activism," where investors purchase debt on the theory that a borrower is already in default and then actively seek to enforce that default in a manner by which they stand to profit; borrowers seek to preempt by including drafting technology in new debt agreements that undermines key activist strategies.
- Elliott Management, followed by Icahn Associates, were the top activists by stake value in 2019. Elliott and Starboard Value were the most active by number of targets, with 17 and 13, respectively.
- The line between hedge fund activism and PE continues to blur, with some activist funds becoming bidders, and a handful of PE funds exploring activist-style investments in, and engagement with, public companies.
- Stockholder demands to inspect corporate books and records pursuant to Section 220 of the DGCL has increased in frequency, particularly in the M&A context. Notably, the Court of Chancery recently refused to permit affiliates of Carl Icahn inspect corporate documents for use in a proxy contest at Occidental Petroleum.
- In a January 2020 decision, the Delaware Supreme Court emphasized the importance of advance notice bylaws and the right of a company responding to a shareholder proposal or nomination to insist on strict adherence to the requirements, including deadlines, unambiguously specified in those bylaws. (An August 2019 Chancery Court opinion similarly upheld advance notice bylaw requirements in the context of a hostile bid.)

# Shareholder Activism Trends

(cont'd)

**COVID-19 Impact**

- As a result of the COVID-19 pandemic, a number of public companies have seen their market capitalization and value of their common stock decline precipitously.
- For many companies who are not currently facing an activist attack, director nomination and business matter proposal deadlines for annual meetings have passed for the current proxy season.
  - For those companies, in order for activists to take advantage of depressed stock prices through a proxy fight, the activist will need to focus on the 2021 annual meeting or consider carefully whether running a "withhold the vote" campaign, calling a special meeting of shareholders or taking action by written consent would be well received in the current environment.
- However, a number of activist investors continue to over-reach in their private (and public) demands of companies and are seizing the opportunity from reduced valuations to increase their positions in existing targets and build new positions.
- Recent 13D filings by activists reveal increased accumulations during late March as the markets plunged. Many of these activists are out in the market fundraising to have additional firepower in a depressed market.
- Aggressive buyback demands even continue to be made by activists, and ill-advised attempts to remove key board members and board leaders with the experience and judgment to help the company navigate the current crisis are also underway.
- In several instances, M&A-related activism has moved to a longer time horizon, with activists seeking to get major private equity funds as well as potential hostile bidders to return their phone calls as they scout future opportunities for a quick sale.

# Shareholder Activism Trends

(cont'd)

**Targets**

- Activists publicly targeted 839 companies worldwide in 2019 (down from 946 in 2018), including 470 U.S. companies—and significant activist activity takes place privately. Of these, 477 (258 in the U.S.) were targeted by primary, partial or occasional focused activists. Activists launched another 168 short campaigns worldwide (159 in 2018).
- Activist campaigns targeting non-U.S. companies have become commonplace, and meet varied success. Outside of the U.S., 369 companies publicly targeted in 2019, with significant activity in Europe (135, including 55 in the U.K.), Asia (107, including 58 in Japan), Australia (72) and Canada (48).
- A record number of campaigns in 2019 had an M&A-related thesis (*e.g.*, activists demanding a sale (HP), a break-up (Marathon) or opposing a transaction announced by the company (Occidental)).
- No company is immune:
  - Size is not a defense: 21% of targets in 2019 had a market capitalization of >$10 billion.
  - Activists targeting controlled companies, financial institutions, REITs and others that may once have seemed relatively immune or difficult to catalyze.
  - Target companies may face successive rounds of activism or multiple activists with competing agendas.

**Activists**

- The past decade has seen a remarkable increase in the amount of funds managed by activist hedge funds and an uptick in the prevalence and sophistication of their attacks on corporations.
- Institutional investors are working with activists both behind the scenes and by co-sponsoring an attack.
- Next-generation funds, PE funds, founders/former executives and other investors are assuming the activist role; activists, in turn, are expanding into PE, E&S and other bridgeable strategies.

*Source: Activist Insight; Financial Times; JPMorgan, "The activist revolution," January 2015; The Deal; Bloomberg.*

# Shareholder Activism Trends

(cont'd)

**Selected Activism Strategies and Tactics**

- Key strategies:
  - 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.
- Notable activist tactics:
  - Continuing to launch playbook "surprise-wolf-pack"/"shock-and-awe" attacks.
  - Innovating—and pushing boundaries—with approaches (*e.g.*, economic arrangements among funds; partnering with hostile bidder; calling special meetings for "referendum"; hybrid proxy fight/vote-no campaign; hybrid PE/activism; "matched positions" in transactions; net-short debt activism and other default activism by debt investors; holding out activism as option; "white-squire" activism).
  - Experimenting with fundraising strategies (*e.g.*, special purpose fund for investment in a single target).
  - Employing new methods of courting retail voters (*e.g.*, websites, video, social media, webcasts, other technology) and redoubling engagement efforts with institutions and proxy advisors.

*Source: news articles.*

# Proxy Contests and Settlements

**Proxy Contest Trends**

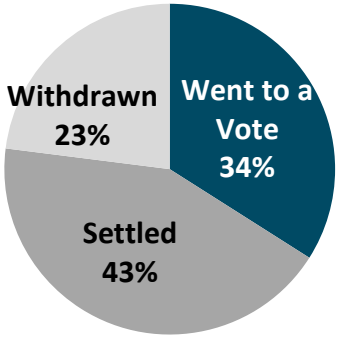
- Insights from recent proxy fights include:
  - Engagement efforts can help build credibility for the board and management and enable them to hear what long-term shareholders want.
  - Failure to have successfully engaged with major investors and understand their opinion of the company's operations 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.
  - Massive sums are being spent by both companies and activists in waging proxy battles.
  - 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 ultimately 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.
    - Hedge fund representatives as director nominees may present particular obstacles to settlement.

# Proxy Contests and Settlements

(cont'd)

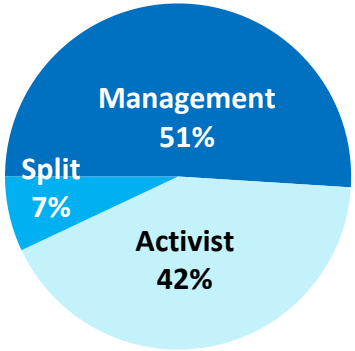
## Proxy Contest Outcomes

**Proxy Campaigns (2010–2014)**



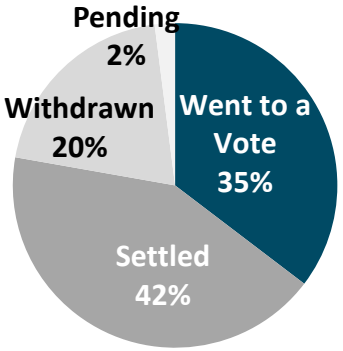

**Total: 453 Proxy Fights**

**Winner After Vote**



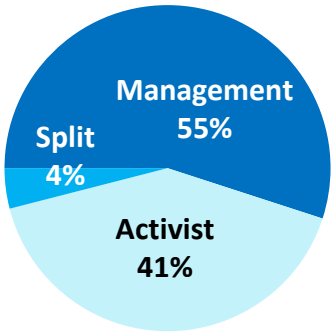

**Total: 152 Votes (77 Management Wins, 64 Activist Wins, 11 Splits)**

**Proxy Campaigns (2015–2019)**




**Total: 492 Proxy Fights**

**Winner After Vote**




**Total: 174 Votes (95 Management Wins, 73 Activist Wins, 7 Splits)**

*Source: SharkRepellent data accessed April, 2020. 2018 data separately counts proxy fights/wins by one dissident against a single fund family. Includes all proxy fight types. Percentages may not total 100% due to rounding.*

# Proxy Contests and Settlements

(cont'd)

**Settlements with Activists**

- Many companies choose to 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 activist's agenda.
    - The company's likelihood of success if the fight is taken to a stockholder vote.
    - Whether there is common ground that could form the basis of a settlement.
    - Whether the activist is willing to be reasonable and seek a 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 or formation of new board committees.
  - Standstill: activist agrees to drop the proxy fight and be bound by a standstill for a period of time.
  - 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.
  - Non-disparagement: typically mutual agreement that neither party will publicly criticize/disparage the other.
  - 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.

# Rule 14a-8 Shareholder Proposals

- Recent years have seen increasing calls for modernization of Rule 14a-8 shareholder proposal process (*e.g.*, Business Roundtable; Chamber of Commerce; Financial CHOICE Act of 2017; H.R. 5756).
  - Provisions under spotlight have included eligibility, resubmission and disclosure requirements.
  - Also have focused on SEC no-action process for exclusion of proposals from proxies.
  - Opponents to reform, such as CII in an August 2017 letter to the SEC, have cited "improvements to corporate governance and corporate disclosure that have resulted from the current rule."
- The SEC Division of Corporate Finance Staff ("the Staff") has provided several rounds of evolutionary guidance regarding the no-action process.
  - In November 2017, the Staff provided guidance on excluding certain Rule 14a-8 shareholder proposals (Staff Legal Bulletin No. 14I).
    - *"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.
    - *"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, as with the above, expect that no-action requests under Rule 14a-8(i)(5) will include a discussion of the board's analysis.
    - SLB 14I also sets forth documentary requirements for shareholder proposals submitted by third-party representatives and provides guidance as to when graphs and images may be excluded under Rule 14a-8.
  - The Staff offered further guidance on SLB No. 14I, including on enhancing the utility of its contemplated board analysis and the scope of the exclusions, in the October 2018 SLB No. 14J.
  - In September 2019, the Staff announced that, starting with the 2019-2020 proxy season, it may determine to respond orally, instead of in writing, to some no-action requests from companies seeking to exclude Rule 14a-8 shareholder proposals.

# Rule 14a-8 Shareholder Proposals

(cont'd)

- If the Staff declines to take a view on any particular exclusion request, "the interested parties should not interpret that position as indicating that the proposal must be included . . . and 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."

- In October 2019, the Staff provided additional guidance in SLB No. 14K on two key considerations for excluding Rule 14a-8 shareholder proposals under the "ordinary business" exception of Rule 14a-8(i)(7): the significance of the proposal's subject matter and whether it seeks to "micromanage" the company. (SLB 14K also addresses claims of technical deficiencies relating to a shareholder proponent's proof of ownership letters, noting that companies should not seek to exclude proposals if documentary support sufficiently evidences the requisite minimum ownership requirements.)
  - 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.

- In a bolder step, the SEC in November 2019 voted to propose modernizing amendments to Rule 14a-8 (which were subject to a 60-day comment period), including with respect to the following key elements:
  - <u>Ownership Requirements</u>:
    - Replace current $2,000 or 1% for 1 year holding requirement with the following alternatives:
      - Continuous ownership of $2,000 for three years;
      - Continuous ownership of $15,000 for two years; or
      - Continuous ownership of $25,000 for one year.
    - Require additional documentation for use of representatives for submitting proposals; and
    - Require proponents to state ability to meet with the company regarding the proposal and to provide supporting information regarding such availability.

# Rule 14a-8 Shareholder Proposals

(cont'd)

- "One Proposal" Rule: apply one-proposal rule to each person rather than each shareholder (so that a proponent of a proposal cannot act as a representative submitting another proposal for another shareholder for the same meeting; also, a representative could not submit proposals for more than one shareholder).
- Resubmission Thresholds:
  - Raise thresholds as follows:
    - Voted on once in last 5 years: from 3% to 5%;
    - Voted on twice in last 5 years : from 6% to 15%; and
    - Voted on three+ times in last 5 years : from 10% to 25%.
  - Add provision that a proposal voted on 3+ times in the last 5 years can be excluded, notwithstanding having received support of at least 25% of votes cast in the most recent submission if it:
    - Received less than 50% of the votes cast; and
    - Had a decline in support of 10% or more versus the most recent prior vote.

- The proxy advisors have also modified their policies regarding shareholder proposals:
  - As revised for 2020, the ISS policy on board accountability with respect to restrictions on shareholder rights includes a statement that management proposals to approve or ratify requirements in excess of Rule 14a-8 for submission of binding bylaw amendments generally will be treated "as an insufficient restoration of shareholders' rights."
  - As part of it its 2020 policy revisions, Glass Lewis will consider recommending against governance committee members when a shareholder resolution is excluded and the SEC has declined to state a view on whether such resolution should be excluded, and when the SEC has verbally permitted a company to exclude a shareholder proposal and the company has not provided disclosure concerning verbal receipt of no-action relief.

# 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 environmental and social ("E&S") matters with institutional investors:
  - BlackRock CEO Larry Fink's 2020 letter to CEOs stating that "[c]limate change has become a defining factor in companies' long-term prospects," and, accordingly, his belief that "we are on the edge of a fundamental reshaping of finance."
  - SSGA CEO Cyrus Taraporevala's 2020 letter to the board reiterating focus on "financially material" ESG issues as "a matter of value, not values," and confirming that SSGA will deploy its voting power in director elections to accelerate corporate action on ESG (leveraging new proprietary "R-Factor" ESG scoring system to benchmark companies against peers).
- 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.
  - Passage of the Improving Corporate Governance Through Diversity Act of 2019 by the House.
  - In August 2019, the SEC proposed Reg S-K amendments including human capital as a disclosure topic. (SEC facing criticism for not taking broader action on E&S disclosure.)
  - Larry Fink's 2020 letter advocating for standardized and accelerated sustainability disclosures and endorsing both the industry-specific standards developed by SASB and the climate-specific framework developed by TCFD as benchmarks.
- Proliferation of E&S ratings providers and efforts to consolidate many metric- and framework-related initiatives. Notably, in January 2020, a WEF task force proposed "core" and "expanded" sets of ESG-related metrics and disclosures aligned with the UN Sustainable Development Goals.
- Under a new 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

(cont'd)

**E&S Shareholder Proposals**

- Through end of July 2019, 469 E&S Rule 14a-8 shareholder proposals filed, including:
  - Environment/climate change (97) and sustainability reporting (22);
  - Political issues (100);
  - Labor/human capital management (55), human rights (53) and workplace diversity (17);
  - Board diversity (50); and
  - E&S link to executive pay (18).
- The withdrawal rate for 2019 through July (46%) remained elevated, and median support for proposals on the ballot hit another high (27%), while abstentions continued to drop to a record level (2%).
  - Withdrawal rate bolstered by settlements and proponents' desire to avoid negative SEC precedents.
  - Eleven E&S shareholder proposals received majority support.
- Renewed focus on lobbying and political-spending disclosure in light of the upcoming 2020 Presidential election (and Supreme Court's 2010 *Citizens United* decision). Four such proposals received majority support.
- Despite drop in proposals, continued activism around climate change and sustainability, particularly in the context of the late-2015 Paris Climate Accord and the Trump administration's deregulatory stance.
  - No such proposals received majority support, after a more eventful 2018 (8, with 7 passed).
- Board and workplace diversity remain in the spotlight, with institutional investors using engagement and voting power to express dissent. Four related proposals received majority support.
- Headline-capturing social issues are also resonating with shareholders, with two opioid-crisis proposals receiving 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.*

# Corporate Social Responsibility in the Activism Context

(cont'd)

**ESG and Sustainability: The Board's Role**

- Be aware that ESG and sustainability have become major, mainstream governance topics that encompass a wide range 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 significant amounts of quantifiable information on ESG issues that companies will be expected to disclose going forward.
- May want to receive regular briefings on relevant ESG matters and the company's approach to handling 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 of the company's approach, response and progress on these matters.
- 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 development of a common framework for ESG disclosures.
- If faced with an activist investor sounding ESG-linked themes, leverage prior preparedness and apply best practices to respond. If faced with a shareholder proposal addressing these matters, have an appropriate governance process for considering the proposal, its business implications and the company's options.
- Not every director or member of senior management can be an "ESG expert," but directors and appropriate company personnel should educate themselves on the key ESG issues facing the company and be able to converse comfortably on those issues that matter or present significant risks.