2020 Proxy Season Preview

ICR

Entering 2020, numerous factors indicate this could be a landmark year in the evolution of Environmental, Social & Governance (ESG) as a central and lasting driver of shareholder engagement and asset allocation decision making. In forecasting the coming year, we should recall the core trends we witnessed in the 2019 Proxy Season, including:

1. **ESG**: Though ESG shareholder proposals were withdrawn at record levels, investors' pressure on E&S issues intensified
2. **Executive Compensation**: Percentage of Say-on-Pay (SOP) with support rates below 80% rose sharply
3. **Director Elections**: Percentage of directors receiving withhold votes from investors rose
4. **Anti-Takeover Governance Structures**: IPO-related anti-takeover governance structures (staggered boards, dual-class structures, supermajority voting) have been scrutinized, with proxy advisory firms becoming more strident against these structures

In monitoring the trends for the 2020 proxy season, **ICR Governance Solutions** expects the patterns from the 2019 proxy season to continue to evolve. We encourage each issuer to be mindful of the following focus areas when preparing for the 2020 proxy season.

ESG & 2020 Larry Fink's Letter to CEOs

BlackRock Chairman & CEO Larry Fink opened the 2020 proxy season dialogue with a bang. Whereas in previous years, Mr. Fink's message focused more on principle-driven recommendations for companies to be more socially responsible and take care of their stakeholders in their pursuit of profits, this year's letter[1] was a forceful and forthright salvo on how companies – including BlackRock – must prepare for climate change and a low carbon economy.

In the letter, Mr. Fink mentions that as a firm, BlackRock's active strategies will reallocate their capital to navigate climate risk in its investment strategy by:

- Making sustainability an integral part of portfolio construction and risk management
- Exiting from high-sustainability risk investments (e.g., thermal coal producers)
- Launching new products to screen fossil fuels
- Strengthening commitment to sustainability and investment stewardship activities

The letter in no uncertain terms states that BlackRock will seek a clearer disclosure on how companies are managing ESG, which should "extend beyond climate to questions around *how each company serves its full set of stakeholders*, such as the diversity of its workforce, the sustainability of its supply chain, or how well it protects its customers' data"[emphasis added].

As a part of this effort, BlackRock will now seek the following from the issuers:

- Disclosure in line with SASB guidelines (or similar sets of data) by the end of 2020
- Disclosure of climate risks in line with TCFD's recommendations

[1] https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

BlackRock will assess a company's ESG regime through these disclosures and engagements. ***If a company is not addressing these material issues, BlackRock will vote against board members***:

> "Where we feel companies and boards are not producing effective sustainability disclosures or implementing frameworks for managing these issues, we will hold board members accountable."

Though E&S shareholder proposals going to a vote had declined last year, with mainstream institutional investors like BlackRock disclosing their "active" approach on ESG issues, we anticipate this mainstream-ization of ESG integration will translate into a different voting implementation on E&S shareholder proposals this year.

Takeaways from Larry Fink's Letter to CEOs

There are many takeaways from Mr. Fink's 2020 Letter to CEOs, but there are some that are more salient than others for the issuers preparing for this new ESG landscape.

First of all, BlackRock, by naming SASB and TCFD as standards against which they expect ESG disclosure from companies, could provide an impetus for bringing greater clarity to the currently cluttered and crowded landscape of ESG measurement standards. It is important to note that the letter does not mandate SASB and TCFD as de facto standards, but encourages ESG frameworks that are similar in scope. What does this mean for issuers considering enhancing ESG disclosure to conform to investor expectations?

1. ***Materiality Matters***. Investors do not care for A+ ESG scores across the board, but only those ESG factors that are material to the business. By recommending SASB materiality framework, which is more sector-specific, than something more holistic/universal (e.g., GRI), BlackRock is signaling companies to define their material ESG factors using ESG frameworks that are sector- and business-relevant.

2. ***Strategy and Governance Matter***. By recommending TCFD for disclosing climate risks, BlackRock is hewing close to their approach to ESG: ESG or climate risk management should be integrated into how a Board oversees enterprise-wide risk management and long-term corporate strategy. "G" underpins E&S: meaning each Board (or Audit or Risk Committees) needs to oversee and centrally integrate ESG issues into their processes.

This brings into focus the point that BlackRock will vote against directors for not properly overseeing ESG issues. One important thing to note here is that BlackRock has always had a policy to hold directors accountable on these issues (versus, for example, voting for ESG shareholder proposals). But now that there is a more specific and prescriptive recommendation, what is more important is how this policy will now be carried out in implementation.

What is most important to remember is that aside from SASB and TCFD based ESG disclosure, Mr. Fink specifically calls out engagements as a primary means by which BlackRock Investment Stewardship (BIS) team will assess a company's ESG profile. In their letter to clients, BlackRock specified that the BIS team will focus engagements on UN Sustainable Development Goals, in addition to climate change-related topics. With the scrutiny on Board oversight of ESG issues, **every director needs to be conversant on these ESG topics**, and not for just BlackRock. ESG-forward active managers like Neuberger Berman, for example, have publicly specified that they expect **every** Board member to be aware of SASB standards, for example.

Speaking of active managers: the most important takeaway that is easy to miss in Mr. Fink's letter is that 2020 may be viewed as a signal year when ESG finally became a mainstream investment strategy. Whereas in previous years, ESG naysayers might have dismissed ESG is a marketing exercise or a check-the-box compliance drill, it is now fast becoming a central investment criterion exercised by the world's largest asset managers. There is a raft of ESG-related regulatory imperatives coming out of the EU in 2020, and UN PRI is requiring its investor signatories to disclose how they integrate ESG into their decision-making for over 50% of each manager's AUM. The issuers will see a cascading impact, as each of these asset managers look to be more ESG-integrated through their portfolios to be more competitive, not just in EU or Asia, but also for their global and US-strategies.

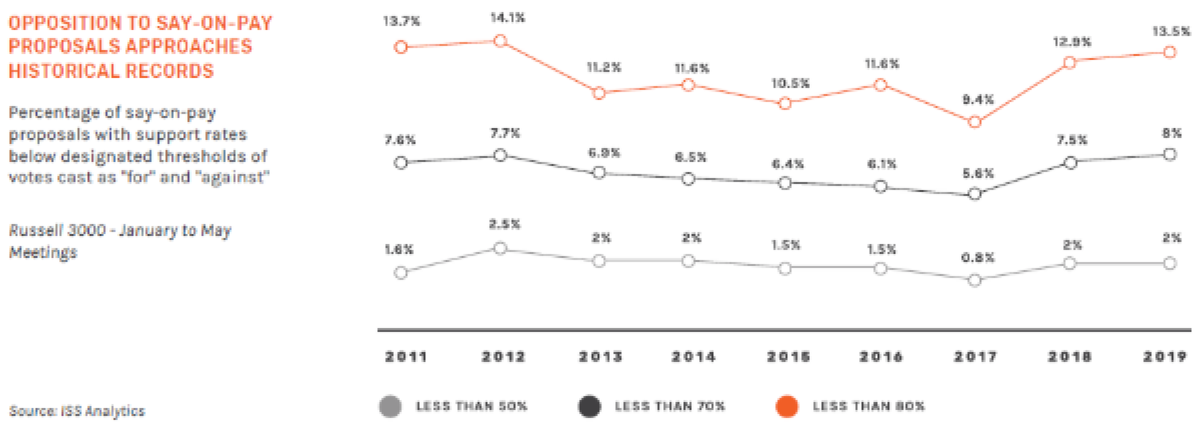
BlackRock has already publicly stated their divestment or screening out of ESG-adverse names from their active mandates. More asset managers will likely follow BlackRock's path in 2020, and **the only way issuers can attract and retain capital from these important investors is to have an ESG disclosure and strategy that resonates with these shareholders.**

Executive Compensation

There have not been any notable updates from proxy advisory firms, ISS and Glass Lewis, around their policies concerning executive compensation and Say-on-Pay. Though not a policy change per se, ISS is using Economic Value Added (EVA) metrics as a secondary quantitative screen in its Financial Performance Assessment (FPA) of companies (except for REITs because ISS is currently fine-tuning its classification of REITs to calculate their EVA). Those not familiar with EVA, which is similar to Economic Profit (EP) metrics, we encourage you to review resources available at ISS EVA Resource Center[2]. Though there are merits to using metrics such as EVA or EP to evaluate to gauge a company's wealth creation and profitability, we have not seen an indication that institutional investors have adopted such metrics widely. Given, however, that this metric is available on ISS research, each company should verify the information and also explain through shareholder engagements whether EVA evaluation is relevant to assess company performance.

As can be seen from the chart by ISS Analytics below, opposition to SOP proposals had sharply increased in 2019, with **nearly 13.5% of Russell 3000 companies receiving below 80%.**

[2] https://www.issgovernance.com/solutions/iss-analytics/iss-eva-resource-center



Many factors are contributing to this trend. Passive investors, who may have been more willing to provisionally support one-time retention or discretionary equity awards without performance contingencies, have been more strident on holding companies accountable through the proxy vote. And after years of assessing executive compensation, these investors have adopted a savvier, more proprietary approach to how they assess quantum of pay, pay-for-performance, and what compensation misalignment could signal in terms of independent Board oversight.

Heading into the 2020 proxy season, we recommend:

1. Disclosing responsiveness to lackluster SOP vote results through enhanced proxy disclosure to highlight the actions that the Compensation Committee took to improve the areas of concern, as well as shareholder engagement effort;

2. Reassess disclosure of compensation-related data for increased transparency, around short- and long-term incentivization goals and targets, as well as strengthened rationale around peer selection and compensation-related risk compliance; and

3. Most importantly, via Executive Summary or a letter from CEO or Board up front, highlight both the 2019 performance and the corporate strategy of the company that your shareholders can correlate back to the executive compensation metrics, targets, goals and payouts determined.

Director Elections

According to the Conference Board research[3], 54 directors failed to receive majority support in 2019, and 421 directors received less than 70% of votes, which is sharply up from previous years. Though in absolute terms, these numbers represent a very small minority of outlier directors, the rise in these negative votes represents a significant increase in the recent years.

Certainly, the more stringent over-boarding director policies from the investors led to some of these opposition votes. BlackRock, for example, allows maximum of 2 boards that a sitting CEO can serve on, and 4 boards for non-CEO directors (Vanguard: 2 maximum for CEOs, 5 for non-CEO directors).

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[3] http://www.shareholderforum.com/access/Library/20191200_TCB.pdf

Another driver behind negative director support was related to Board composition, mainly due to gender diversity expectations that large institutional asset managers are now implementing through their proxy voting policies. **For the 2020 proxy season, every issuer should monitor how each of their largest shareholders will implement proxy voting on gender diversity this year, if their Board does not have a sufficient number of women directors.** In 2019, 45% of new Russell 3000 Board seats were filled by women and roughly 1 out of 5 of Russell 3000 directors are women. Goldman Sachs CEO David Solomon added to the momentum by announcing recently that beginning this year his firm would not take a company public unless it has "at least one diverse board candidate, with an emphasis on women," and that in 2021, Goldman Sachs will require at least two diverse candidates. Given this mainstream context, institutional investors may adopt a more aggressive proxy voting against Boards (or Nominating/Governance Committee members) when issuers fall short against the expectations.

In 2020, ISS will now recommend against the Chair of the Nominating Committee if a Board does not have at least one woman director. It is important to note, however, that institutional investors may have a higher expectation than the ISS quota on women directors. BlackRock, for example, has communicated to its portfolio companies that it expects every Board to have at least 2 women directors, and it is expected that it will vote against relevant Board and committee members if their expectation is not met on gender diversity on Boards.

In this proxy season and beyond, every issuer should also monitor diversity factors other than gender. New York City Comptroller's Office rolled out their Board Accountability Project 3.0, exhorting companies to include diverse candidates for vacant seats – both Board- and executive-level – and specifically called out racial and ethnic diversity as well. Given that the NYC Comptroller was behind the influential proxy access movement and adoption with their Board Accountability Project 1.0, **it would be wise for every company and Board to broaden their diversity considerations beyond gender**, and also learn the perspectives on the diversity issue from their important shareholders.

Finally, Larry Fink's 2020 Letter makes it clear that **BlackRock now expects every Board to have oversight responsibility over ESG**. BlackRock put a special emphasis on engagements, aside from SASB/TCFD disclosures, as a means by which they will gauge a company's ESG profile, and stated that they will now vote against directors who fall short of this expectation. Though proxy voting implications won't likely impact director votes until 2021, as BlackRock is giving companies until the end of 2020 to provide ESG disclosures**, we encourage every Board to first become educated and conversant on the ESG issues, and proactively engage with all of their most important shareholders and share Board-level perspectives on key ESG issues**. ESG is a matter of utmost importance for these asset managers, who have a fiduciary duty to protect their client assets. Rather than making ESG a part of a proxy endgame (e.g., protecting directors from negative votes), we recommend companies proactively reach out this year to speak with the shareholders to hear directly from them any feedback on ESG, then create a bespoke, customized ESG and engagement plan in response to the feedback.

<u>New IPO Companies & Anti-Takeover Governance Structures</u>

In November 2019, ISS published updates to its proxy voting guidelines. Most of the material updates concern governance structures of new IPO companies that are typically built into "starter kit" IPO bylaws and charters. Under the revised ISS voting guidelines:

- **Multi-class Stock Structure:** ISS will generally recommend “vote against” or “withhold” from the entire Board if the company adopts a multi-class stock structure with unequal voting rights, either in connection with or prior to IPO
    - If there is a time-based sunset of 7 years for such a multi-class structure, ISS will consider such a sunset period reasonable

- **Materially-Adverse Bylaw and Charter Provisions:** ISS will generally recommend vote against relevant directors or the entire Board if certain bylaw or charter provisions that are materially adverse to shareholder rights, which include:
    - Supermajority vote requirements to amend bylaws or charter
    - Classified Board structure, or
    - Other egregious provisions
    - A reasonable sunset provision will be a mitigating factor in ISS’s recommendation

- **Bylaw Amendment Restrictions:** ISS will generally recommend vote against Governance Committee members if the company’s governing documents place “undue restrictions on shareholder’s ability to amend the bylaws. Such restrictions include:
    - Share ownership requirements, subject matter restrictions, or time holding requirements exceeding the SEC Rule 14a-8
    - Outright prohibition on the submission of binding shareholder proposals

Summary

There will always be the usual proxy vote issues concerning Say-on-Pay or director elections every proxy season, and this year is no exception. However, 2020 could possibly be regarded in retrospect as the landmark year when ESG became “mainstream” – both in terms of how the investors are using it as a criterion to make portfolio decisions, and also how it became a primary driver in fostering engagements and stewardship efforts. As investors are dealing with pressure from both their client base and regulatory frameworks on how they integrate ESG considerations, the cascading impact on the companies – via proxy voting and engagements – will also likely increase, year over year from now on.