

The Era of Private Ordering for Corporate Governance

Following the 2016 election, corporate governance circles have focused intently on what will happen in the nation's capital with regard to a potential roll back of the current regulatory regime. The Trump Administration immediately signaled a strong desire for wide-ranging regulatory reform through a series of executive orders directed at federal agencies. Subsequent Congressional and agency actions initiated the potential unwinding of a broad swath of existing regulations. In the governance and disclosure world, the Republican-controlled Congress adopted a joint resolution suspending the resource extraction disclosure rules. In June, the House passed the Financial CHOICE Act which would repeal many of the governance-related provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (disclosures of CEO pay ratio and hedging policies) and limit the scope of other provisions (clawbacks), prohibit the SEC from mandating the use of universal proxy cards and increase shareholder proposal thresholds. Recently, the Securities and Exchange Commission revised its rule-making docket under newly appointed Chairman Clayton's leadership and pushed all of the unfinished Dodd-Frank related rules (pay-for-performance disclosure, clawbacks and disclosure of hedging policies) and some additional governance rule-making (universal proxy cards and board diversity) to the back burner.

While attention given to Congress and the SEC for the potential direction of corporate governance is not misplaced, future change in this arena will most likely come from investors, and they have their own agenda which is very different from that of the current administration. A recent survey of 75 North American and European institutional investors by [Rivel Research](#) indicates, not surprisingly, that most institutional investors oppose major changes in the U.S. governance regulatory framework. Fearing that a watered down Dodd-Frank Act will result in negative governance outcomes at public companies, a large plurality of the surveyed investors (43%) oppose efforts to pare back the Dodd-Frank Act, while only a small minority (18%) support it. Even if Dodd-Frank is pared back, the vast majority of these investors believe that companies should continue to abide by the original rules. In fact, many investors responded that they will be seeking expanded disclosure in a number of areas. In the event that key governance and

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disclosure mandates are repealed, nearly half of the investors said they would ramp up their efforts to engage companies on governance matters, and 41% said that they would be more inclined to support an activist.

The power of institutional investors to effect changes in the corporate governance framework in the absence of regulation has been demonstrated by the recent and dramatic rise of privately-ordered proxy access. Following authorization under the Dodd-Frank Act to establish rules governing access to proxy statements, the SEC adopted Rule 14a-11 in 2010. Litigation ensued, and Rule 14a-11 was ultimately vacated by the U.S. Court of Appeals for the District of Columbia Circuit which held that the SEC had not realistically weighed the rule's effect upon efficiency, competition and capital formation. When the SEC failed to pick up the ball on proxy access for several years after the ruling, institutional investors stepped into the breach led by the Office of the New York City Comptroller and other large pension fund managers. Primarily as a result of shareholder proposals and the shareholder engagement process, the number of companies that have adopted proxy access bylaws in the absence of any regulatory requirement increased from nine in 2013 to over 425 companies today, including more than 60% of the S&P 500, a trend that few public companies and their advisors had foreseen or even imagined. And pressure from investors continues even for companies that have adopted proxy access bylaws, as seen in the this year's round of proxy access "fix it" shareholder proposals and the July 2017 position paper on best practices for proxy access posted by the Council for Institutional Investors.

In addition, at a time when the technical disclosure requirements for proxy statements under SEC Schedule 14A and Regulation S-K have remained static, voluntary disclosures in proxy statements have mushroomed. Much of this has been driven by the need for public companies to present their case on executive compensation to shareholders for the "say-on-pay" vote which, notably, occurred during a period when Dodd-Frank-mandated SEC rule-making for pay-for-performance disclosure languished. Responding to investor demands for disclosure that is easy to understand, as well as a realization that proxy advisory firms provide competing versions of this information in their voting reports, companies have introduced proxy summaries, pay-for-performance graphics, alternative tables for realized and realizable pay and other voluntary disclosures in an effort to communicate their executive compensation programs in clear and compelling ways.

Recently, we have seen the advent of voluntary disclosures outside of executive compensation in other emerging areas of investor concerns, such as environmental, social and governance (ESG) matters. Investors are increasingly seeing ESG issues as linked to the long-term financial strength of a company, not merely a matter of moral conscience or political preference. The Chairman and CEO of BlackRock, Inc., the world's largest asset manager and a major shareholder in many companies, wrote "[o]ver the long-term, environmental, social and governance issues – ranging from climate change to diversity to board effectiveness – have real and quantifiable financial impacts." The Principles for Responsible Investment have garnered over 1500 signatories with \$62 trillion in assets under management who have agreed to incorporate ESG issues into

investment decision-making and seek related disclosures from companies in which they invest. A variety of organizations are now evaluating and rating public companies on their ESG performance, and investors are increasingly asking companies in a broad range of industries “What are you doing about sustainability?”

Environment and Sustainability

In response to these investor demands, prominent voluntary disclosures about environmental impacts and sustainability are finding their way into proxy statements and other SEC filings, even for companies outside of the energy and manufacturing sectors. See, for example, the 2017 proxy statement for Prudential Financial, Inc. In addition, shareholders put forward more proposals on environmental and social matters than on any other topic in 2017, and such proposals received greater support than in prior years, including majority support for climate change related proposals at three energy companies.

Looking ahead, the quantification of sustainability disclosures is expected to grow as the Sustainability Accounting Standards Board (SASB) moves forward with its mission to identify and maintain a set of material sustainability metrics tied to financial performance that public companies will need to consider disclosing in their SEC filings in order to meet investor demands. SASB’s board of directors and investor advisory group include representatives from many large asset managers and shareowners. In addition, on June 29, 2017, the Financial Stability Board’s Task Force on Climate-Related Financial Disclosure (TCFD), formed at the request of the G20, released its Final Recommendations Report for voluntary climate-related financial disclosure. The core elements of the final recommendations include disclosure of the governance, business impacts, processes, metrics and targets of a company’s climate-related risks and opportunities. The report was accompanied by a statement of support signed by approximately 100 entities, including major financial institutions, asset managers, pension funds, rating agencies, stock exchanges and companies in the chemical, steel, airline, mining, energy, consumer goods and other industries.

Board Diversity

Unlike some European nations, the United States does not mandate board diversity. While Democrats in Congress have requested that the SEC take up rule-making on board diversity, it is not a priority on the SEC’s recently updated rule-making agenda. Currently, the SEC’s proxy rules require only a statement as to whether and how diversity is considered in identifying director nominees and, if the company has a director diversity policy, how that policy is implemented and assessed. Until recently, this requirement typically yielded boilerplate disclosure to the effect that the company considers a variety of factors when reviewing director nominees, including age, gender, ethnicity, experience and skills. Investors are pressing for additional disclosure, however, believing that board diversity is tied to long-term shareholder value creation, and proxy statements in recent years have included increased voluntary disclosure regarding the importance of board refreshment and diversity, including charts and graphs breaking

down the composition of their boards.

More importantly, investors are now pushing for increased board diversity at the ballot box. For example, State Street Global Advisors reportedly voted against or withheld votes for the re-election of nominating committee chairs (or their equivalents) at 400 out of a total of 476 portfolio companies it identified as male-only boards this proxy season. BlackRock reportedly supported eight of nine shareholder proposals calling on companies to adopt board diversity policies or commit to disclose their plans to increase their board diversity, and also voted against the nominating committee members at five of the those companies for their alleged failure to address board diversity concerns. Shareholder proposals calling for greater board diversity received majority support at two companies in each of the past two years.

What's Next?

In July, the Human Capital Management Coalition (HCMC), a group of institutional investors with \$2.8 trillion in assets under management, requested that the SEC take up rule-making to require public companies to disclose information about their human capital management policies, practices and performance. HCMC believes that skillful management of human capital is associated with better corporate performance, risk mitigation and long-term value creation and is therefore material to investors when evaluating a company's prospects. The requested categories of disclosure are comprehensive, including workforce demographics, stability, composition, skills, culture, empowerment, health, safety, productivity, human rights, compensation and incentives. SASB has also identified human capital issues as material for some industries. The SEC's current rule with regard to required disclosure of workforce information is limited to the number of employees, and it is highly unlikely that the SEC will initiate human capital disclosure rule-making under the current administration. However, HCMC and other investors have already been requesting that companies provide workforce data and voluntary disclosure, and they are expected to broaden such requests in the future. Some companies, such as Unilever and Diesel & Motor Engineering plc are already making voluntary disclosures related to human capital. In addition, shareholder proposals relating to human capital issues such as workforce diversity and pay disparity increased substantially in 2017 over the prior year.

In conclusion, while the current regulatory requirements relating to corporate governance matters may be rolled back by Congress and the SEC in certain areas, public companies will need, first and foremost, to understand and be responsive to the priorities of their largest shareholders. In most cases, investor priorities will require actions and disclosures beyond what is mandated by the regulatory framework. Public companies should also anticipate increased quantification and metrification of environmental, social and governance indicators and related disclosures that facilitate spreadsheet comparison by market analysts. Regardless of, or perhaps in response to, any relief provided by Congress or the SEC, investors and groups of investors are likely to continue to push for greater shareholder engagement and enhanced disclosure and will use their voting power to effect change, especially in ESG and other non-

traditional performance areas where they see a strong tie to long-term value creation.