THE ADVISOR

Alliance™ ADVISORS

2018 PROXY SEASON PREVIEW
By Shirley Westcott

March 2018

Overview

This year's proxy season will once again bring attention to shifting investor priorities, with environmental and social (E&S) issues at the forefront of engagement discussions and shareholder resolutions. Changes over the past year to the policies and voting practices of several major index investors, along with a bold pronouncement by BlackRock that corporations should "serve a social purpose," underscore this progression.

How far this trend advances remains to be seen, but it will be a key development to watch throughout proxy season. Money managers are continuing to face pressure from social activists to align their voting practices with their stated positions on climate change—which was a driving force in catapulting three climate risk proposals over the majority threshold in 2017. More recently, elected officials have made demands that investment funds use their financial clout to pressure firearms companies to take steps to reduce gun violence. Activist hedge funds are also taking an increasing interest in corporate sustainability, which could lead to collaborations with other institutional investors on social responsibility campaigns.

As in 2017, E&S themes will dominate the shareholder proposal landscape. Of the submissions that have been publicized to date, nearly two-thirds deal with E&S topics and one-third of those fall into the environmental category. Like past years, many of these can be expected to be withdrawn following productive dialogues and company commitments. Others may be less likely to survive no-action challenges as a result of more flexible guidance from the SEC regarding ordinary business and economic relevance exclusions.

Filings of governance proposals will remain relatively low this season after reaching a high-water mark two years ago when there was a profusion of proxy access resolutions. Many standard governance measures—including proxy access—have already been widely adopted or are being addressed through engagement rather than proxy proposals.

Two standout issues from 2017—board diversity and climate change risk—are likely to gain more traction in 2018 as a result of stronger positions taken by several prominent asset managers. The recent deluge of sexual misconduct allegations and the #MeToo movement have also drawn investor attention to corporate culture and gender-related concerns, including pay equity, workforce diversity, and parental leave.

New and revived proposals on tap this year reflect media headlines, such as the opioid drug epidemic, fake news, cybersecurity, and gun violence. Also on activists' radar are contentious holdovers from 2017—the proliferation of virtual-only annual meetings and dual-class stock.

At least for this year, investors and proxy advisors Institutional Shareholder Services (ISS) and Glass Lewis are taking a wait-and-see approach to the long-awaited debut of CEO/median pay ratios. Shareholders will also be closely monitoring revisions to executive compensation programs resulting from changes to the rules governing performance-based pay under the Tax Cuts and Jobs Act.

Highlights of the upcoming proxy season are discussed in more detail below.

Alliance™ ADVISORS

Governance

Proxy Access

Shareholder proposals to adopt proxy access continue to diminish in volume after filings reached triple digits between 2015 and 2017. The pullback has been due to the increasing number of companies that have implemented the measure, which now stands at 66% of the S&P 500 Index, and because the lead sponsor—the New York City Comptroller (NYCC)—has moved on to another phase of its Boardroom Accountability Project.[1]

Even in the absence of proxy proposals, other companies—including the remaining S&P 500 firms—could fall into line by virtue of investor pressure. Beginning in March, State Street Global Advisors (SSGA) will start screening S&P 500 companies for their adherence to the Investor Stewardship Group's (ISG) governance principles.[2] Companies that fail to comply with at least three of SSGA's 13 screening guidelines or explain their reasons for non-compliance may face withhold votes from their independent board chair, lead director, or most senior independent director. Based on SSGA's review of 2017 proxy filings, 13% of S&P 500 companies are non-compliant, primarily due to a lack of proxy access rights.

Still plentiful this year are resolutions sponsored by individual investors John Chevedden, James McRitchie, Myra Young, and Kenneth Steiner which seek to amend specific provisions in existing proxy access bylaws—primarily to allow unlimited group aggregations to meet the ownership requirement. In some cases, they also want to raise the board seat cap, either to the greater of two directors and 25% of the board, or to a minimum of two to three nominees depending on whether the board size is above or below 12 directors.

Last year's "fix-it" resolutions—which essentially sought to increase aggregation limits to 40 or 50 shareholders—were excludable under Rule 14a-8(i)(10) if the petitioning company could demonstrate that it already had a meaningful proxy access right based on the makeup of its shareholder base. Issuers have been unable to exclude the 2018 proposals as substantially implemented because Staff concluded that their market standard proxy access bylaws did not compare favorably with the guidelines of the proposal. Nevertheless, support for fix-it proposals remains lackluster, averaging 27.6% so far this year, notwithstanding the backing of ISS. Glass Lewis generally opposes fix-it resolutions if the company's bylaw conforms to broad market practice.

Virtual-Only Meetings

The trend towards digitally-enabled annual meetings is expected to accelerate as companies take advantage of technology to cut costs and enhance shareholder accessibility. Broadridge Financial Solutions said it expects to facilitate over 300 virtual meetings in 2018, up from 236 in 2017, though about 20% will be hybrid events, combining a physical meeting with an audio or webcast component.[3]

Cyber-only meetings are a non-issue for most institutional investors since they do not typically attend annual meetings and conduct engagements with issuers throughout the year. However, these types of meetings are encountering resistance from activist shareholders who contend that online forums do away with their ability to directly confront boards and managements and raise challenging questions.

Last April, the New York City Pension Funds (NYC Funds) amended their voting guidelines to oppose nominating/governance committee members at S&P 500 companies that hold virtual-only meetings, which will be extended to all companies in 2018. Glass Lewis

[1] For a list of companies that have adopted proxy access see http://allianceadvisorsllc.com/whitepapers/updated-january-2018-proxy-access-issuer-list/.

[2] See SSGA's letter to S&P 500 firms at https://www.ssga.com/investment-topics/general-investing/2018/monitoring-compliance-with-investor-stewardship-group-principles.pdf. See ISG's governance principles at https://www.isgframework.org/corporate-governance-principles/.

[3] See Broadridge's 2017 report on virtual meetings at https://www.broadridge.com/_assets/pdf/broadridge-vsm-platform.pdf. Also see the ProxyPulse 2017 post-season report at http://proxypulse.broadridge.com/proxypulse/_assets/docs/broadridge-2017-proxy-season-review.pdf. For a list of companies with upcoming or previously held virtual meetings, see https://east.virtualshareholdermeeting.com/vsm/home.

recently adopted a similar policy, which takes effect in 2019, though it will give governance committee members a pass if shareholders are afforded the same rights and opportunities to participate in the virtual-only meeting as they would at an in-person event.

Shareholder proposals to reinstate physical meetings have also reemerged this year, even though all of those submitted in 2017 were omitted as ordinary business. To date, two of the targeted companies—ConocoPhillips and Union Pacific—have acquiesced to the request, while a third proposal is pending at Comcast. Chevedden's group is taking an indirect approach as well, by asking several firms—Alaska Air Group, PayPal Holdings, Intel and Union Pacific—to amend their proxy access bylaws, adopt written consent, or appoint an independent board chairman as a trade-off for their taking away shareholders' right to attend an in-person meeting.

Companies that are contemplating a virtual-only meeting should take into account a number of factors, including whether there are any controversial items on the ballot, whether the company is facing any significant shareholder dissent, and whether past annual meetings have been widely or lightly attended. Additional guidance was issued in a 2012 industry committee report, "Guidelines for Protecting and Enhancing Online Shareholder Participation in Annual Meetings," which is being updated for the 2018 proxy season.[4]

Dual-Class Stock

Multi-class share structures with unequal voting rights will continue to face investor scrutiny after several high-profile initial public offerings (IPOs) of non-voting stock last year unleashed a firestorm of criticism.

In response to market pressure, S&P Dow Jones and FTSE Russell began excluding certain multi-class companies from their broad market indices last summer.[5] MSCI has since extended its review of the matter, and in January issued a proposal to adjust the index weights of multi-class stocks to reflect both their free float and their disproportionate voting power.[6] If implemented, the plan will apply to new listings in November 2018 and to existing constituents in 2021.

ISS and Glass Lewis have also instituted policies to generally recommend against boards or governance committee members of newly public companies with unequal voting stock unless they include a sunset provision to phase out their supervoting shares.[7] Beginning this year, Glass Lewis will additionally apply its board responsiveness policy to dual-class companies based on a majority vote of the low-vote shares.

Although most investors support equal voting rights for shareholders, several—including BlackRock, Vanguard Group, and SSGA—have publicly decried the indices'

[4] See the working group's 2012 report at https://www.broadridge.com/_assets/pdf/broadridge-guidelines-for-protecting-and-enhancing-online-shareholder-participation-in-annual-meetings.pdf.

[5] See S&P Dow Jones' and FTSE Russell's new requirements for multi-class shares at https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true and http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf.

[6] See MSCI's proposal on multi-class shares at https://www.msci.com/documents/1296102/8328554/Consultation_Voting+Rights.pdf/15d99336-9346-4e42-9cd3-a4a03ecff339?utm_source=February+1%2C+2018+-+CII+Governance+Alert&utm_campaign=February+1%2C+2018+-+CII+Governance+Alert&utm_medium=email.

[7] See ISS's 2018 policies at https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf. See Glass Lewis's 2018 policies at http://www.glasslewis.com/wp-content/uploads/2017/11/US_Guidelines_2018.pdf and http://www.glasslewis.com/wp-content/uploads/2017/11/ShareholderInitiatives_2018_Guidelines.pdf.

Alliance™ ADVISORS

ban because it could limit returns for their clients.[8] SEC Commissioner Robert Jackson echoed those sentiments and called on the national securities exchanges to consider addressing perpetual dual-class stock in their listing standards.[9]

As of yet, the indices' ban has not deterred companies from going public with multiple classes of shares. According to the Council of Institutional Investors (CII), 19% of last year's IPOs had unequal voting stock, excluding foreign private issuers, special purpose acquisition companies, and master limited partnerships. However, 26% of these firms included time-based sunsets on their supervoting shares—a new record among IPOs.[10]

No-Action Requests

New guidance from the SEC is providing issuers with more leeway in omitting certain types of shareholder proposals. Under Staff Legal Bulletin (SLB) 14I, companies relying on the ordinary business or economic relevance exclusions may include a board-level analysis in their no-action requests to support their argument that the issue raised in the proposal is not significant to the company's business.[11] In the past, Staff has had to make difficult judgment calls in this regard, which it feels boards are better positioned to address in the first instance. SLB 14I also adds procedural hurdles for shareholders who submit resolutions through a representative ("proposals by proxy") and clarifies when issuers may exclude graphics and images from shareholder proposals.

To date, the Division of Corporation Finance has only rendered no-action decisions under the new framework in a handful of cases, though there many others pending dealing with proposal topics ranging from lobbying and political spending to climate change and human rights. Several cases where no-action relief was denied—Apple, AmerisourceBergen, Citigroup and Eli Lilly—are instructive regarding Staff's expectations. In downplaying the significance of a proposal to business operations, companies should include a quantitative or similar analysis in their no-action requests and adequately address past shareholder votes on the matter. They should also verify that they have not made any contradictory statements in other communications, such as social responsibility reports, that highlight the importance of the issue to the business.

While it is too early to assess the impact of the new guidance on omissions, issuers are hopeful that, in the absence of legislation to reform the 14a-8 process, it may help curb the number of shareholder resolutions that simply promote social and political causes and often generate low support.

The conflicting proposal exclusion is once again drawing investor criticism after the SEC limited its application in 2015 following some controversy over proxy access resolutions.[12] Earlier this year, AES and CF Industries Holdings were allowed to exclude proposals from John Chevedden to reduce the share ownership threshold for calling special meetings to 10%, based on Rule 14a-8(i)(9). In both cases, as well as several others pending, the management proposals are simply asking shareholders to ratify the retention of their current special meeting thresholds and provisions. Although there is precedent for the no-action decisions, CII protested to the SEC that companies are effectively "gaming the system."[13] In subsequent no-action letters

[8] According to an April 2017 report by SSGA, S&P 500 firms that have issued non-voting or low-voting shares have outperformed their equal voting counterparts by 26% cumulatively over the past decade. Excluding these companies from the S&P 500 would have resulted in underperformance of the index by 1.86% over the same period. See https://www.ssga.com/investment-topics/environmental-social-governance/2017/Shareholder-Rights-in-the-Age-of-Snap.pdf.

[9] See Commissioner Jackson's speech at https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty.

[10] See CII's report on dual-class stock at http://www.cii.org/files/Board%20Accountability/2017%20IPO%20Stats%20for%20Website.pdf.

[11] See SLB 14I at https://www.sec.gov/interps/legal/cfslb14i.htm.

[12] In Staff Legal Bulletin 14I, the SEC determined that it would not view a shareholder proposal as directly conflicting with a management proposal with similar objectives if a reasonable shareholder could logically vote for both, although he may prefer one over the other. See https://www.sec.gov/interps/legal/cfslb14h.htm.

[13] See CII's letter to the SEC at http://www.cii.org/files/issues_and_advocacy/correspondence/2018/January%202018%2014a-8(i)(9)%20FINAL.pdf. Related SEC no-action decisions at Illumina (2016) and Herley Industries (2007)

to eBay, ITT, JPMorgan Chase and Capital One Financial, Staff resolved the matter by concurring with omission as long as the company included the following disclosures in its proxy statement, consistent with Rule 14a-9:

- That it has omitted a shareholder proposal to lower the special meeting ownership threshold,
- That the company believes a vote in favor of ratification is tantamount to a vote against a proposal lowering the threshold,
- The impact on the special meeting threshold, if any, if ratification is not received, and
- The company's expected course of action, if ratification is not received.

With this outcome, issuers now have an avenue for omitting often persistent requests to reduce their special meeting thresholds to 10% or 15%, particularly since the SEC has not permitted exclusion of these resolutions on substantial implementation grounds. So far, Chevedden and his affiliates have floated upwards of 40 "special meeting improvement" proposals for 2018—a 40% increase over last year.

Separately, the SEC appears to have reversed course on omitting proposals calling for an independent board chairman that make reference to the New York Stock Exchange's (NYSE) definition of "independent director." In 2013, it permitted exclusion of such resolutions as vague and indefinite because they failed to explain the NYSE's independence requirements, which Staff considered a central aspect of the proposal. This year the SEC denied Bloomin' Brands and Sears Holding no-action relief for essentially identical proposals, though Staff did not provide any explanatory comments.

may be found at https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2016/mcritchieyoung031816-14a8.pdf and https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2007/herleyindustries112007-14a8.pdf.

Compensation

Pay Ratios

2018 marks the inaugural year for the disclosure of CEO/median employee pay ratios as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Yet, for all of the time and resources expended by issuers in preparing the calculations, they appear to be a non-event for many mainstream investors. In a recent interview, Vanguard said that the pay ratios will do more to "inflame than inform," while T. Rowe Price Group observed that this is "not an institutional investor issue—it's a local newspaper issue." Other institutions have indicated that they do not intend to use the pay ratios to inform their proxy voting or engagement unless they encounter extreme outliers or in cases of close calls on executive compensation votes. Similarly, the proxy advisors only plan to display the pay ratios in their research reports this year.

The key indicator this season—and the one that may cause more immediate backlash—is median employee pay. Labor and social activists may use it to fuel inequality campaigns, while employees may be demoralized if they discover they are paid below the median or that competitors pay more. To deflect adverse reactions, a few companies—such as AES and Marathon Petroleum—are including supplemental pay ratios or other context around their workforce, such as their use of part-time, seasonal, or temporary employees and foreign workers.

Although peer group comparisons won't be feasible this season, Equilar and ISS have done some preliminary benchmarking. Equilar conducted an anonymous survey of 356 companies to identify the pay ratios they plan to report in their 2018 proxy statements. The results showed that companies with the highest revenue or the greatest number of employees had the largest median ratios: 263:1 for companies with over $15 billion in revenue and 318:1 for companies with over 2,310 employees. By industry, consumer discretionary companies, including retail and hospitality, had the

highest median ratio (350:1) and energy firms had the lowest (72:1).[14]

ISS did an "outside-in" look at pay ratios across Russell 3000 firms using Bureau of Labor Statistics data for average employee earnings. It similarly found that company size and industry had a significant impact on the numbers. The median CEO pay ratio for S&P 500 firms was 172:1—five times higher than that of Russell 3000 firms outside of the S&P 1500. Among industry groups, food and staples retailers had the highest ratio (143:1) and banks had the lowest (15:1).[15]

The remaining Dodd-Frank rulemaking on compensation matters—clawbacks, employee and director hedging, and pay-for-performance—have been relegated to "Long-Term Actions" in the SEC's latest Regulatory Flexibility Agenda.[16] In a recent speech, SEC Chair Jay Clayton reiterated his commitment to completing these items and indicated that some of the executive compensation rules could be moved up to the short-term timetable when the next agenda is released.

Section 162(m)

Aside from pay ratios, companies will need to revisit their compensation programs due to changes to Section 162(m) of the IRS Code resulting from the Tax Cuts and Jobs Act. The new law eliminates the exception for qualified performance-based pay so that all annual compensation paid to a covered employee in excess of $1 million will no longer be tax deductible. The covered employee group now includes the CFO, and the status will be permanent for any executive who was a covered employee as of 2017. The new law also expands the definition of "publicly held corporation" to include companies that have publicly traded equity or publicly traded debt, as well as certain foreign private issuers. Compensation under written binding contracts in effect as of Nov. 2, 2017 will be grandfathered, so long as the contracts are not materially modified thereafter.

While the new regime will give issuers some additional flexibility in how they structure compensation plans, they need to be mindful that investors and proxy advisors will continue to expect pay programs to be largely performance-based. ISS, for example, said that it will continue to recommend against executive pay awards that are not reasonably linked to rigorous and transparent performance goals. Boards that switch to guaranteed or highly discretionary pay are likely to face investor backlash.

Director Compensation

In addition to executive plans, issuers will need to be more attentive to director compensation as a result of a change in ISS's voting guidelines and recent shareholder litigation.

Pursuant to its 2018 policy updates, ISS will begin recommending against board committee members who are responsible for approving or setting non-employee director (NED) compensation if there is a pattern of excessive pay over multiple years without a compelling rationale. Historically, ISS has considered NED pay figures above the top 5% of comparable directors based on the index and industry median to be extreme outliers.

A recent derivative action will also impact how director plans are structured. In December, the Delaware Supreme Court ruled in *In re Investors Bancorp, Inc. v. Stockholder Litigation* that discretionary grants of director awards may be subject to review under the entire fairness standard, rather than the more deferential business judgement rule, even if they were granted under a shareholder-approved equity plan that contained meaningful limits on director compensation.[17] The Court reasoned that the shareholder ratification defense would only apply when shareholders approved specific director awards or an

[14] See Equilar's pay ratio report at http://www.equilar.com/press-releases/94-equilar-ceo-pay-ratio-survey-results.html.

[15] See ISS's pay ratio report at https://www.isscorporatesolutions.com/library/execcomp-insights-the-truth-about-concentration-ratios/.

[16] See the Reg Flex Long-Term Actions at https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPubId=201710&showStage=longterm&agencyCd=3235.

[17] See the Delaware Supreme Court's opinion at https://www.courthousenews.com/wp-content/uploads/2017/12/investorsbancorp-2.pdf.

equity plan that contained self-executing grants to directors.

As a result of the decision, Delaware companies could face more shareholder challenges to director compensation as unfair and excessive. To guard against this, companies should have a robust process in place for evaluating and approving director compensation packages, including a peer review to assess whether their director pay is reasonable. New or amended equity plans being submitted for shareholder approval should, at a minimum, include meaningful director-specific limits. To avail themselves of the shareholder ratification defense, companies should consider using non-discretionary formulaic grants for directors and obtaining shareholder approval of any extraordinary director grants.

Environmental & Social

Social Responsibility

The evolving views of institutional investors—particularly index funds—has vaulted sustainability and social responsibility into the limelight this year. In his recent annual letter, BlackRock CEO Larry Fink declared that portfolio companies must demonstrate a positive impact on society, lest they lose BlackRock's support.[18] BlackRock is backing this up in its updated 2018 voting guidelines which stipulate that it may vote against the election of directors or support a shareholder proposal where it has concerns that a company may not be dealing with E&S matters appropriately.[19]

To support growing investor interest in E&S, ISS recently launched E&S QualityScore as a companion to its current governance ratings.[20] The new system evaluates the quality of companies' E&S disclosures relative to industry peers based on 380 factors used by certain standard-setters, such as the Global Reporting Initiative, Sustainability Accounting Standards Board, and the Financial Stability Board's Task Force on Climate-Related Financial Disclosure (TFCD). ISS will initially grade about 1,500 companies in industries most exposed to E&S risks, such as energy, materials, and capital goods, and expand its coverage by mid-year to over 5,000 global companies. Like its governance ratings, E&S scores will appear in ISS's proxy analyses but will not impact its voting recommendations.

Activist hedge funds are also jumping onto the environmental, social and governance (ESG) bandwagon. JANA Partners recently announced the launch of a social responsibility fund on the heels of a successful campaign with the California State Teachers' Retirement System (CalSTRS) that urged Apple to enhance parental controls on iPhones. ValueAct Capital Partners is also taking advantage of the growing $114 billion market in impact investing with its own ESG-themed fund. Others, such as Trian Partners and Blue Harbor Capital, have incorporated ESG principles into their investment strategies, which may help them leverage ties with index funds, pension plans and other investors for their traditional activist campaigns.

Despite this rising trend, prioritizing ESG has, in some cases, been at the expense of financial returns. Notwithstanding the long-running bull market, many public pension plans remain severely underfunded, which several studies attribute to politically-motivated investment decisions. According to the American Council for Capital Formation (ACCF), one third to one half of the worst-performing private equity (PE) funds in the portfolios of the New York City Employees' Retirement System (NYCERS) and the California Public Employees' Retirement System (CalPERS) are focused on ESG ventures, while none of their top-performing PE funds are in the ESG category.[21] The NYCC's recent decision to divest from fossil fuel companies over the next five years will undercut returns even more. A 2016 study by Boston College

[18] See Fink's letter at https://www.blackrock.com/corporate/en-us/investor-relations/larry-fink-ceo-letter.

[19] See BlackRock's 2018 voting guidelines at https://www.blackrock.com/corporate/en-br/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf.

[20] For details on ISS's E&S QualityScore see https://www.issgovernance.com/solutions/qualityscore/environmental-social/.

[21] See ACCF's reports, "Point of No Returns" at http://accfcorpgov.org/wp-content/uploads/2017/12/CalPERS-Report-Final.pdf and "Politics over Performance" at http://accfcorpgov.org/wp-content/uploads/2018/01/ACCF_New-York-City-Pension-Funds_FINAL.pdf.

found that pension plans in states with divestiture requirements underperformed the returns of their peers by 40 basis points.[22] Plan beneficiaries have also raised concerns. In a survey conducted by Spectrem Group, 86% of CalPERS members and 79% of NYC Fund members said that fund managers' primary goal should be maximizing returns and not advancing social or political causes.[23]

Board Diversity

Board diversity promises to be a dominant theme this proxy season and one where advocates are gearing up to make significant inroads. According to reports by Spencer Stuart and Equilar, female and minority representation on boards has increased only incrementally—typically 1% per year—though last year nearly half of S&P 500 board seats were filled by candidates from these groups. Small- and mid-cap companies still lag with 624 all-male boards among Russell 3000 firms, compared to only three at S&P 500 firms.[24]

After years of letter writing and engagement, some investors remain dissatisfied with the pace of change and are expressing it with their proxy votes. Last year, SSGA voted against the chair or most senior member of the nominating committee at 394 U.S. companies that had all-male boards, while BlackRock backed eight board diversity resolutions at U.S. and Canadian companies and voted against the nominating committee members at five of the firms. And among the record number of board diversity proposals filed in 2017, two received substantial—and in one case overwhelming (84.8%)—majority support.

In 2018, investors are raising the bar even more on companies. BlackRock's recently revised voting guidelines state that it expects to see at least *two* women on every company board. It plans to write letters to 300 Russell 1000 firms that do not meet this criterion to set a timeframe for improvement or potentially face votes against their directors in 2019. Similarly, CalSTRS revised its voting policies last fall to hold entire boards—not just nominating committees—accountable for a lack of progress on board diversity following engagement. California Treasurer John Chiang is further urging the two state pension plans to vote against boards that do not meet a diversity standard of 30% women and 30% diverse representation in terms of culture, ethnicity and sexual orientation by 2019.[25]

In keeping with this trend, Glass Lewis announced in its recent policy updates that beginning in 2019 it will recommend against nominating committee chairs of Russell 3000 companies with all-male boards, unless they provide a sufficient rationale or disclose a plan to address the lack of female directors. ISS only plans to flag companies that have no women on the board in its proxy analyses. However, this could eventually change considering that ISS has adopted a policy similar to Glass Lewis's for the Canadian market, which also takes effect in 2019.

Proxy access could become the next course of action for advancing diverse boards as well as specific director skill sets, such as environmental expertise. Last September, New York City Comptroller Scott Stringer launched a new phase of his Boardroom Accountability Project by calling on 151 portfolio companies to provide a standardized director skills and diversity matrix in their proxy statements.[26] The letter recipients

[22] See the Boston College study at http://crr.bc.edu/wp-content/uploads/2016/11/slp_53.pdf.
[23] See the Spectrem Group study at http://349ab54c3b58919c6638-ff70f51d4942f2bbd11ba0e41cfec577.r51.cf2.rackcdn.com/Spectrem%20Group%20-%20Tensions%20With%20Pensions.pdf.
[24] See Spencer Stuart's 2017 Board Index at https://www.spencerstuart.com/~/media/ssbi2017/ssbi_2017_final.pdf?la=en. See Equilar's reports at https://work.qz.com/1130589/there-are-624-public-companies-with-no-women-on-their-boards-heres-the-list/ and http://marketing.equilar.com/58-2018-gdi-q4-17.

[25] The California Senate also recently introduced legislation (Bill No. 826) that would impose board diversity quotas on public companies whose principal place of business is in the state. The bill would require firms to have at least one female director by Dec. 31, 2019, and two female directors (three if the board size is six or more) by July 1, 2021. Non-compliant companies would face fines equal to the average cash compensation for the company's directors for the first violation and triple the amount for second and subsequent violations. See https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB826.
[26] The matrix concept has been explored before. In 2015, the NYC Funds and eight other public pension plans submitted a rulemaking petition to the SEC to require companies to disclose their board nominees' gender, racial and ethnic identities, as well as their skills

Alliance™ ADVISORS

included 139 firms that have proxy access and 12 firms that are likely to adopt it in response to a majority-supported proposal in 2017.[27] Although this is primarily an engagement project, the NYC Funds have filed—and in some cases withdrawn—several proposals to provide the requested matrix, including at Exxon Mobil and NRG Energy.[28]

Corporate Culture

The recent wave of sexual harassment allegations has drawn investor attention not only to boardroom diversity but to corporate culture overall. One of the most high-profile cases to date—against Wynn Resorts founder and CEO Steve Wynn—exposed the potential for reputational and financial harm, including a $3.5 billion loss in market value and shareholder lawsuits. Yet a survey of 400 private and public company directors by Boardlist and Qualtrics found that 83% had not evaluated the company's risks regarding sexual harassment or sexist behavior in the workplace, and 88% had not implemented a plan of action as a result of recent revelations in the media. The most common reasons directors had not addressed the issue was a perception that it was not a problem for their company or they did not feel that it was a board-level matter.[29]

While boards should certainly be attuned to company policies and procedures on sexual misconduct—and even have an associated crisis response plan—shareholders are increasingly looking at gender diversity in the executive and managerial ranks as part of a broader solution.[30] Following the departure of several Amazon Studio executives over sexual harassment claims, Change-to-Win Investment Group (CtW) submitted a resolution to the company to increase gender diversity on both the board and the senior executive team. Trillium Asset Management has proposed that Alphabet diversify the board's executive committee in order to provide leadership and guidance to management in the wake of a Department of Labor investigation over gender pay discrimination. Both firms are also facing resolutions from Zevin Asset Management (ZAM) and Clean Yield Group to tie CEO pay to executive diversity goals. According to ISS, only 28 out of 2,300 U.S. firms include the improvement of culture or diversity in the performance goals for CEOs.

Problematic corporate cultures extend beyond sexual misconduct. Google is facing a class-action lawsuit for alleged discrimination towards employees with conservative viewpoints. This in turn inspired a new resolution by the National Center for Public Policy Research (NCPPR) that wants boardrooms to be inclusive of ideological diversity. The proponent notes that the targeted company—Facebook—and Silicon Valley in general operate in an "ideological hegemony" that eschews conservative people, thought and values. This was echoed by Facebook board member and Trump administration advisor Peter Thiel, who contends that Silicon Valley's conformity of thought could harm its ability to innovate.

Human Capital Management

Concerns over the treatment of women in the workplace extend to equal pay, paid-leave benefits and opportunities for career mobility, and are the focus of several shareholder initiatives this year.

Arjuna Capital and Pax World are continuing their three-year-old campaign requesting companies to measure, publish, and take steps to close gender pay gaps. Having made inroads at technology firms, the proponents are honing their efforts on financial institutions in 2018. Already they've scored successes with seven of their nine targets, including Citigroup and

---

and experience, in a chart or matrix format. One of the signatories--the North Carolina Retirement Systems—followed up with proxy proposals in 2016 at Exelon (withdrawn) and Ford Motor (omitted as substantially implemented).

[27] The NYC Funds' focus list and a sample matrix may be found at http://comptroller.nyc.gov/newsroom/press-releases/comptroller-stringer-nyc-pension-funds-launch-national-boardroom-accountability-project-campaign-version-2-0/.

[28] For an update on the Boardroom Accountability Project 2.0, see https://corpgov.law.harvard.edu/2018/03/01/boardroom-accountability/#more-105376.

[29] See the Boardlist/Qualtrics survey at https://medium.com/@theBoardlist/corporate-boards-arent-preparing-for-sexual-harassment-and-gender-discrimination-issues-24ba425d6497.

[30] CII developed a list of recommendations for boards and investors regarding sexual harassment at https://www.cii.org/files/publications/misc/03_01_18_corporate_boards_sexual_harassment.pdf.

Bank of America, which became the first banks to conduct and disclose the results of pay audits of their global workforces and commit to increasing the pay of women and minorities where warranted.[31]

Social investment funds are also focusing on banks and financial institutions in their requests for workforce diversity reports, which would break down companies' employee population by race, gender, and EEO-1 job categories. Last year these resolutions nearly tripled in volume and averaged 32% support, including a first-time majority vote at Palo Alto Networks. Another surge of proposals is on tap for 2018 in light of the Trump administration's decision to suspend an Obama-era initiative that would have required large employers to expand their EEO-1 reporting to include employee pay levels.

Retailers are similarly in the crosshairs of equality campaigns since, like the financial sector, women make up a large share of the workforce but hold relatively few leadership positions. At Walmart, which produced an expansive diversity and inclusion report in 2017, Arjuna Capital is now asking for details on the potential reputational, competitive, and operational risks the company may face from emerging public policies and legislation on equal pay.[32]

Separately, ZAM is working with Paid Leave for the United States (PL+US) to identify companies with weak approaches to family leave, which is a key factor in addressing gender pay gaps.[33] In conjunction with this, ZAM and other filers submitted first-time proposals at a handful of retail firms to report on their parental leave policies, which provide more generous benefits to birth mothers and corporate-level employees than to adoptive and LGBTQ parents and store-level workers. So far, most of the proposals have been withdrawn after the companies announced that they would expand their parental leave benefits for hourly workers.

Climate Change

2017 was breakout year for climate change campaigns with three landmark majority votes asking Exxon Mobil, Occidental Petroleum, and PPL to report on how they plan to adjust their business models in line with the Paris Accord's goal of limiting global warming to 2° Celsius ("2° scenario" or "2DS").

The results reflect a sea change in the attitude and voting practices of several major asset managers—BlackRock, Vanguard Group and Fidelity Management & Research—which for the first time supported some of the climate change resolutions last year. Of the three, Fidelity made the greatest shift in its voting, backing every one of the 2DS resolutions it voted on, while BlackRock and Vanguard only endorsed the two at Exxon and Occidental.[34]

Other institutional investors could follow suit, particularly as a result of pressure from their own shareholders and clients. Last year, Walden Asset Management withdrew proposals at BlackRock, Vanguard, and JPMorgan Chase after the firms agreed to review inconsistencies between their proxy voting records and their public stance on climate change. Walden and other filers have similar resolutions pending this year at Bank of New York Mellon and Cohen & Steers and withdrew a third at T. Rowe Price Group. Franklin Resources, which has received proxy voting review resolutions every year since 2014, wasn't retargeted in 2018 because it improved its approach by voting for 24% of climate risk proposals in 2017, compared to 10% in 2016.

The proxy advisors have also amended their voting policies for 2018 to reflect their general support of resolutions to disclose climate-related risks. ISS's policy now extends to proposals on how the company identifies, measures and manages such risks, in keeping with the recommendations of the TFCD, while Glass

[31] In addition to Citigroup and Bank of America, Arjuna Capital also reached agreements this year with American Express, Mastercard, Bank of New York Mellon, JPMorgan Chase, and Wells Fargo. Six of the institutions rejected gender pay gap proposals last year.

[32] See Walmart's "Road to Inclusion" report at https://cdn.corporate.walmart.com/11/0d/f9289df649049a38c14bdeaf2b99/2017-cdi-report-web.pdf.

[33] See PL+US's review of paid leave policies at http://paidleave.us/.

[34] See ShareAction's report on institutional investor voting on climate risk proposals in 2017 at https://shareaction.org/press-release/investors-inconsistent-climate-votes/.

Lewis will largely back requests for climate change scenario analyses at companies in extractive or energy-intensive industries.[35]

All of this has galvanized shareholder activists, who have filed a new round of 2DS proposals for 2018 with the expectation of generating a higher number of favorable votes or encouraging pro-action by companies. In addition to last year's three majority vote companies, Duke Energy and Marathon Petroleum have produced or committed to producing climate impact reports, even though 2017 proposals received less than majority support.[36] Several utilities targeted in 2018—CMS Energy, DTE Energy and WEC Energy Group—have also agreed to publish climate assessments.

Even so, not all company responses have satisfied investors. Exxon's newly released report has already drawn criticism from proponents for concluding that aggressive climate policies pose little risk to its reserves because the demand for fossil fuels will remain strong for decades. Individual investor Steven Milloy went a step further by characterizing these reporting exercises as mere "greenwashing" to improve companies' public image. In a proposal at Exxon that was later withdrawn, he asserted that many voluntary activities and expenditures touted as protecting the climate are a waste of corporate assets that fail to yield any meaningful benefits to shareholders, public health, or the environment. As a case in point, two years after BP and Royal Dutch Shell shareholders overwhelmingly passed 2DS resolutions, the companies still disclose only minimal information on how they are mitigating climate risks, and they have yet to set greenhouse gas (GHG) reduction targets or markedly improved their investments in low-carbon technology.[37]

Although 2DS will be the most-watched environmental category this year, other climate-related resolutions could generate significant support. As You Sow and Miller/Howard Investments have filed resolutions at nine oil and gas producers to report on their efforts to monitor and minimize methane leakage. Prior support on these proposals has been strong, averaging 31.7% in 2017, including two resolutions that received votes in the 40% range.

Aside from energy firms, proponents are targeting a broad range of industries with resolutions to set goals to reduce GHG emissions or increase renewable energy sourcing. In the past, these measures have averaged support in the 20% range, though several this year have already yielded commitments from AES, American Electric Power, and Western Union. A proposal variation favored by Jantz Management and Amalgamated Bank—to assess the feasibility of achieving net-zero GHG emissions by a specific date—continues to be excludable as ordinary business.

Political Spending and Lobbying

Often tied to climate change are shareholder proposals requesting more disclosure around corporate lobbying and election spending. The lobbying resolutions, in particular, seek to uncover payments made to trade associations that are used for lobbying purposes because some organizations, such as the U.S. Chamber of Commerce and National Association of Manufacturers (NAM), have lobbied against the expansion of environmental regulations.[38]

---

[35] See TFCD's guidelines at https://www.fsb-tcfd.org/publications/.

[36] See Exxon's, PPL's and Marathon Petroleum's climate assessment reports at http://cdn.exxonmobil.com/~/media/global/files/energy-and-environment/2018-energy-and-carbon-summary.pdf, https://www.pplweb.com/wp-content/uploads/2017/12/Climate-Assessment-Report.pdf and http://www.marathonpetroleum.com/Corporate_Citizenship/Climate_Related_Scenarios/.

[37] See ShareAction's reports on Shell and BP at https://shareaction.org/wp-content/uploads/2017/10/InvestorReport-AimingForA-Shell.pdf and https://shareaction.org/wp-content/uploads/2017/10/InvestorReport-AimingForA-BP.pdf.

[38] See InfluenceMap's reports on trade associations and climate change at https://influencemap.org/report/Trade-associations-and-climate-shareholders-make-themselves-heard-cf9db75c0a4e25555fafb0d84a152c23 and https://influencemap.org/report/Trade-Associations-and-their-Climate-Policy-Footprint-067f4e745c9920eb3dfaa5b637511634. See also the 50/50 Climate Project report, "Spending Against Change," at https://5050climate.org/wp-content/uploads/2018/02/FINAL-5050_Spending-Against-Change_022118.pdf. According to the CPA, 41% of S&P 500 companies disclose information about payments to trade associations and 30% disclose information about payments to social welfare organizations, or alternatively instruct these groups not to

This year, NCPPR has countered with a similarly styled lobbying proposal at Duke Energy, but with a conservative angle that takes issue with liberal activists that work to defund pro-business organizations by attacking their members. One example is the American Legislative Exchange Council (ALEC), which is cited in over half of the lobbying resolutions filed this year by left-leaning shareholder proponents. NCPPR is encouraging companies to take an active role in combating attacks on free speech and freedom of association rights and to better explain the benefits of their involvement with groups that advocate for smaller government, lower taxes and free-market reforms.

As in past years, about 50 lobbying and 30 political contribution proposals are expected in 2018, with McRitchie and Young becoming first-time filers.[39] Although these have rarely received majority backing, support levels could eventually creep up. The Center for Political Accountability (CPA) and Fund Votes reported that of the 114 fund groups they track, 56 increased their support for political spending disclosure resolutions between 2016 and 2017.[40] Nevertheless, some of the biggest mutual funds—BlackRock, Vanguard, Fidelity, and Capital Group's American Funds—have maintained their longstanding approach of opposing or abstaining on all election spending resolutions.

NorthStar Asset Management is switching gears this year with a new proposal that asks Intel and Home Depot to conduct a cost-benefit analysis of their corporate and PAC political and electioneering spending during the most recent election cycle. Since 2011, NorthStar has shifted between resolutions calling for a shareholder advisory vote on political contributions or an alignment of corporate values and election-related expenditures. None have generated more than single-digit support.

Opioid Crisis

A coalition of 44 labor, religious, and public pension funds are asking 10 drug manufacturers and distributors to report on how they are addressing business risks resulting from the abuse of opioid painkillers. In separate resolutions, the proponents are also advocating measures to improve accountability, including appointing independent board chairs and expanding clawback policies to recover pay from executives who inappropriately promote opioid drugs.

The initiative builds on a 2017 campaign by the International Brotherhood of Teamsters, which resulted in governance reforms at Cardinal Health and McKesson. Both companies committed to separating their chairman/CEO positions, and McKesson additionally agreed to review its pay practices and conduct an investigation into its opioid-related business practices.

The first opioid proposal of the season was voted down by AmerisourceBergen shareholders with 41.2% support. Nevertheless, this was a striking showing since Walgreens Boots Alliance Holdings owns 26% of the company's stock. Both ISS and Glass Lewis backed the initiative.

Drug Pricing

Faith-based organizations are revisiting the high cost of prescription drugs with two new proposals. One asks drug makers to review whether their executive incentive plans contribute to high drug pricing. The other asks them to report on business risks resulting from public pressure to curb prescription drug costs. Both are variations of 2017 proposals—all of which were omitted as ordinary business—which asked pharmaceutical companies to explain the price increases for their top-selling brand-name medicines over the previous five years.

Global Content Management

use company payments for election-related activity. See http://files.politicalaccountability.net/index/2017%20Index.pdf.

[39] See Walden's press release on 2018 lobbying proposals at http://waldenassetmgmt.com/wp-content/uploads/2018/03/Announcement-of-2018-Lobbying-Disclosure-Resolutions-correct-Walden-Logo.pdf. In addition, the CPA has updated its model resolution on election spending disclosure for 2018. See http://files.politicalaccountability.net/reports/transparency-and-accountability-3/CPA_Model_Resolution_Info_Packet.pdf.

[40] See the CPA/Fund Votes report at http://files.politicalaccountability.net/reports/cpa-reports/mutual-fund-support-for-political-spending-disclosure-jumps-in-first-year-of-trump-presidency/Mutual_Fund_Report_2017_.pdf.

Arjuna Capital and the Illinois and New York State Treasurers have targeted social media firms Alphabet, Facebook and Twitter to report on how they are addressing business risks arising from platform abuses—including fake news, election interference, online sexual harassment, and hate speech. Trillium Asset Management filed a related proposal at Facebook to establish a board risk committee to deal with comparable issues. Last year, similarly-themed proposals—on the enabling of fake news—received only single-digit support, primarily because of the high insider ownership at these firms.

NCPPR has offered up an alternative resolution at Comcast, Time Warner and Walt Disney to adopt policies to ensure that their media outlets do not engage in the production and delivery of fake news. The proposal was omitted at Walt Disney as ordinary business and at Comcast on technical grounds.

Cybersecurity

Last fall's massive data breach at Equifax, which affected 143 million Americans, has drawn heightened attention to companies' cybersecurity management. This year, the New York State Common Retirement Fund (NYSCRF) has submitted a proposal at Express Scripts Holding to report on actions it has taken to mitigate cyber risks, noting that the healthcare industry incurs a disproportionate share of hacking incidents, according to government reports. In a similar vein, Trillium Asset Management has asked Verizon Communications to report on the feasibility of linking executive compensation to cybersecurity and data privacy metrics. Equifax itself is facing several shareholder proposals—as well as a potential "vote no" campaign by CtW—in an effort to bolster board oversight in the wake of the crisis.

In February, the SEC issued interpretative guidance to assist public companies in preparing their disclosures about cybersecurity.[41] Expanding on guidance published in 2011, the release urges companies to inform investors about material cybersecurity risks and incidents in a timely fashion, including the concomitant financial, legal, or reputational consequences. It also expects firms to adopt policies and procedures to prevent corporate insiders from trading in the company's stock prior to information about a breach being made public.

Gun Safety

In the aftermath of the February school shooting in Parkland, Florida, gun manufacturers and distributors are once again on the hot seat. This time, however, so are fund managers. In a recent letter, Senator Elizabeth Warren (D-Mass.) called on nine investment firms—including BlackRock, Vanguard and Fidelity—to use their financial leverage to demand that firearms companies take steps to reduce gun violence, including tougher self-regulation.[42] So far, BlackRock has publicly detailed its engagement plans, while Vanguard and Fidelity are relying on "quiet diplomacy."[43] Other public officials are urging state pension plans to divest their holdings of gun stocks, while consumer advocates are pressing corporations to end their ties with the National Rifle Association.

After a one-year hiatus, faith-based investors have filed 2018 proposals at American Outdoor Brands and Sturm Ruger to report on steps they are taking to improve gun safety and to mitigate the harm associated with gun products. A third—at Dick's Sporting Goods—was withdrawn after the company agreed to stop selling assault-style rifles and high-capacity magazines and ban the sale of guns to anyone under 21. Walmart and Kroger followed suit by raising the minimum age for firearms purchases at their stores to 21. Past resolutions dealing with gun violence—to adopt the

[41] See the SEC's interpretative guidance on cybersecurity disclosures at https://www.sec.gov/rules/interp/2018/33-10459.pdf.

[42] See Senator Warren's letter at https://www.warren.senate.gov/imo/media/doc/2018-02-26_Letter_to_BlackRock_guns.pdf. Other letter recipients include Invesco Advisers, LSV Asset Management, Dimensional Fund Advisers, Voya Investment Management, the London Company of Virginia and First Eagle Investment Management.

[43] BlackRock posted on its website the questions it will be raising with civilian firearms manufacturers and retailers during its engagement discussions. See https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-approach-to-companies-manufacturing-distributing-firearms. SSGA and Bank of America are also probing weapons companies on how they will support safe and responsible use of their products.

Sandy Hook Principles—have received only tepid support.[44] However, this year's initiatives could gain traction in view of recent events, particularly since BlackRock is the largest holder of the two targeted companies.

Looking Ahead

As companies gear up for their upcoming annual meetings, several trends bear watching which will help shape post-season engagements and planning for 2019.

- **Board composition**: Investors are becoming laser-focused on director skill sets to ensure that boards can effectively drive corporate strategy and oversee risk, particularly in emerging areas such as cybersecurity and climate change. Requests for more robust disclosures and matrix-style presentations are likely to escalate to help investors more easily assess director competencies.

- **Board diversity**: Investors are stepping up their expectations on board gender diversity—both in terms of the number of female directors and the timeframe for achieving progress—and some will be leveraging their demands with votes against nominating committee members. Issuers should stay attuned to their major shareholders' policies on this issue and be prepared to articulate how they intend to improve the gender makeup of their boards.

- **Gender pay disparity**: Shareholder initiatives to close gender pay gaps are showing early success this year in the financial sector with a substantial number of negotiated withdrawals. Because the campaign will likely expand to other industries in the future, companies should consider preemptively conducting internal pay reviews.

- **Climate change:** Oil, gas and power companies should be braced for high, if not majority, votes on 2DS resolutions, particularly if BlackRock and Vanguard back more of them than the two last year. Firms in other industries should monitor votes on other popular environmental proposals since shareholder campaigns are broadening to more sectors.

- **Proxy access:** Companies that have not implemented proxy access should track the pace of adoptions and the extent to which they are migrating downstream to small- and mid-cap firms. Because of the proliferation of fix-it proposals and the difficulty of omitting them from ballots, issuers may wish to refrain from adopting access rights until they are approached with a shareholder proposal.

- **Pay ratios:** As investors digest initial pay ratio disclosures, issuers should be attentive to any negative reaction and media reporting. They should also review the disclosures of industry peers, which shareholders and proxy advisors may use for benchmarking in future years.

- **No-action requests:** In the coming months, issuers and investors will get more clarity on how the SEC is applying the SLB 14I framework in no-action decisions. This will aid companies in effectively challenging E&S resolutions in the future, as well as spur shareholder proponents to devise more reasonably crafted demands.

Overall, this year's proxy season could be pivotal on a number of fronts. As the year progresses, Alliance Advisors will keep issuers apprised of new developments as they materialize.

[44] The Sandy Hook Principles consist of 20 measures directed at gun and ammunition manufacturers, distributors and retailers to curb gun violence. See http://media.philly.com/documents/Sandy+Hook+Principles.pdf.