

**CORPORATE GOVERNANCE: FOSTERING A  
SYSTEM THAT PROMOTES CAPITAL FORMATION  
AND MAXIMIZES SHAREHOLDER VALUE**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON CAPITAL MARKETS AND  
GOVERNMENT SPONSORED ENTERPRISES  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED FOURTEENTH CONGRESS  
SECOND SESSION

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**CORPORATE GOVERNANCE: FOSTERING  
A SYSTEM THAT PROMOTES CAPITAL  
FORMATION AND MAXIMIZES  
SHAREHOLDER VALUE**

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**Wednesday, September 21, 2016**

U.S. HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON CAPITAL MARKETS AND  
GOVERNMENT SPONSORED ENTERPRISES,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 3:06 p.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Royce, Huizenga, Hultgren, Schweikert, Hill; Maloney, Sherman, Scott, Himes, Ellison, Foster, and Murphy.

Chairman GARRETT. Good afternoon. The Subcommittee on Capital Markets and Government Sponsored Enterprises will now come to order, albeit 1 hour and 5 minutes late due to votes.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Today's hearing is entitled, "Corporate Government: Fostering a System that Promotes Capital Formation and Maximizes Shareholder Value."

I thank the members of the panel who are here, and I thank the members of the subcommittee who are here. And at this point, I yield myself 5 minutes.

So today the purpose of this, and what the subcommittee will do, is continue our work to address and improve the laws and regulations impacting the governance of public companies in the United States and ensure that our capital markets remain what they are, the most robust and competitive in the world.

And so for that reason, I welcome all of our witnesses to the hearing. I thank you all for your flexibility in appearing because we had to reschedule. And I am sure you are aware, Congressional scheduling is not always the most predictable with first about scheduling this meeting and now rescheduling it for an hour later.

And so as we look into this, the Federal securities law, the bedrock, if you will, of our capital markets were put in place, when? Eight decades ago, and it was done so to promote transparency of security offerings and to mitigate and enforce against fraud in the markets. And it was created at the time the SEC to carry out this very important mission.

As this committee is well-aware, the SEC mission is threefold, to protect investors, maintain fair and orderly and efficient markets, and to facilitate capital formation. So Congress and market participants have long understood the SEC's missions as such, the three, and they have recognized that the securities laws were not created and were never intended to be a vehicle to advance a social or a political or other unrelated public policy goals.

In recent years, however, an increasingly number of activists, who are often well-funded and very powerful, have sought to turn the SEC's missions on its head and instead to advance their idiosyncratic agendas by the way of the security laws. And this has then resulted in consequences that range from minor nuisances to humanitarian disasters. Let me give you an example.

As was explained in the devastating 2014 Washington Post article and subsequent testimony before the Financial Services Committee, the Dodd-Frank conflict mineral provision has only served to deepen the humanitarian crisis in the Democratic Republic of Congo, and has driven actually more people into destitution and poverty.

Of course, the conflict mineral rule is just one extreme, but I think it is instructive in that it shows the type of folly that occurs when the security laws are used for purposes other than what they were intended for.

Today one of the most common vehicles for special interest groups to advance their agendas is the shareholder proposal process governed under Rule 14a-8 of the Securities Exchange Act.

And if you look at this, the mischief that has occurred under this rule, particularly in recent years, is caused by a combination of extremely low thresholds for eligibility, as well as the increasing tendency of the SEC to err on the side of proponents, or to the unpredictability in deciding whether issuers should be granted no-action letters and relief for excluding a proposal from their proxy.

To highlight just one example, the sudden decision last year by the SEC Chair Mary Jo White to reverse a staff decision regarding shareholder proposal at Whole Foods has eroded confidence in the SEC's ability to administer an objective and predictable no-action process.

What is even more troubling, however, is the increasing political and driven activism by public pension plans across the country. See, the overseers of many of these plans, who ostensibly actually owe a fiduciary duty to the plans' beneficiaries, they are increasingly aggressive in their use of shareholder proposals or other means to target industries or businesses that they simply do not like.

Not only is this a distraction for companies and their investors, it can also actually harm the workers and retirees who actually rely upon the income generated by these plans.

Why do I say that? Well, because a recent study shows that the more public pension plans engage in social or politically driven activism, the less likely they will achieve returns for their portfolio.

Keep in mind, state and municipal pension plans around the country are woefully underfunded, not because companies don't disclose enough about things like climate change, but because the political elites who are supposed to be looking out for the public work-

ers have overpromised on benefits while chronically underfunding the plans themselves. In fact, one recent study by the Hoover Institute earlier this year estimated that the unfunded liability has reached \$3.4 trillion.

So I hope today's hearing will allow us to explore ways to reform the shareholder proposal process administered by the SEC, while also ensuring that if a shareholder has a good idea, that it can garner support and that his voice is still heard.

This hearing will also examine the impact of some of the politicized corporate government provisions in Dodd-Frank, as well as the SEC's ongoing disclosure effectiveness initiative and mandates under the FAST Act to simplify disclosure obligation.

With that, I now yield to the gentlelady from New York for 5 minutes.

Mrs. MALONEY. Thank you. Thank you so much for holding this hearing. Corporate governance issues are often overlooked, but they affect the day-to-day operations of every public company in the country, both large and small.

The title of this hearing, Corporate Governance, Fostering a System that Promotes Capital Formation and Maximizes Shareholder Value, of course in order to raise capital from investors and thus promote capital formation, you can't constantly strip shareholders of basic ownership rights.

If you prevent shareholders from having any real say on how the company is operated, then you will certainly make management's life easier, but you will make capital formation harder. Investors simply won't buy shares if they get no ownership rights in return.

One of the specific topics that we are asked to address today, is the SEC's rule governing shareholder proposals, known as Rule 14a-8. This rule lays out when a public company is required to include a shareholder's proposal in its proxy statement that it sends out to all shareholders ahead of its annual meeting, and also when a company is permitted to exclude a shareholder's proposal.

In my view, both companies and the SEC should always err on the side of including shareholder proposals. After all, it is the shareholders who are the owners of the company.

Last year the SEC took an important step toward restoring shareholders' right to have their proposals voted on at annual meetings, when it reversed an earlier decision that would have allowed Whole Foods to exclude a shareholder proposal from their proxy just because it dealt with the same topic as one of management's proposals.

The SEC wisely reconsidered the Whole Foods decision and concluded that management should actually not be able to exclude a shareholder proposal that it doesn't like simply by submitting a similar one, but more management friendly proposal on the same general topic.

While this was an important step, I believe there is much more the SEC can do to encourage shareholder participation in the proxy process. For example, the SEC's overly expansive interpretation of when a shareholder proposal deals with ordinary business operations, still allows management to exclude a whole number of legitimate shareholder proposals.

I believe the SEC should undertake a full review of the ordinary business exclusion, just like it did in the Whole Foods matter, in order to recalibrate this exclusion and make it more shareholder friendly.

Finally, there has been a lot of debate on so-called universal proxy ballots recently. I think that this is important. Under current law, shareholders who vote by proxy in a contested director election have to vote either for the management's entire slate of candidates or the shareholder proponents' entire slate of candidates.

They cannot vote for some candidates from the management's slate and some from the proponents' slate. But if a shareholder attends the annual meeting in person, they can pick and choose from the two slates. This makes no sense at all.

Shareholders should be able to use the proxy voting system to do everything they could do if they were there in person. A universal proxy ballot would allow shareholders to do just that. It would be a single proxy card that would list both management's directors nominees and the proponents' nominees and would allow shareholders to vote for whatever mix of nominees they see fit.

This really should not be controversial. It is a common sense thing to do. So I was pleased last year when Chair White announced that she had directed the SEC staff to develop rulemaking recommendations on a universal proxy ballot. And I hope the staff will deliver their recommendations soon.

I would like to submit a letter on all of these topics from the Council of Institutional Investors for the record and ask unanimous consent to do so. I look forward to hearing the testimony of the witnesses, and I yield back.

Mr. SHERMAN. I would ask the gentlelady to yield her last minute?

Chairman GARRETT. Without objection so ordered, if the gentlelady yields her remaining time?

Mrs. MALONEY. I certainly yield to the gentleman from the great state of California.

Mr. SHERMAN. The most connected and powerful people in this country, the CEOs of the 1,000 or 2,000 largest corporations, anything that inconveniences them is branded as political, aggressive or a distraction.

The fact is that we should be concentrating on how the laws of the state of Delaware prevent us from getting shareholder value by having everything rigged in favor of those CEOs and nothing in the interest of those shareholders who may want to see a change in management.

And to say that investors are disadvantaged because they are given a chance to prevent themselves from investing in a company that is putting their money in Iran, in its oil fields, such a management is dumb and should be avoided and is financing the creation of nuclear weapons, which will have an adverse effect on corporate profits worldwide. I yield back.

Chairman GARRETT. Gentleman yields back.

And with that we turn now to the panel, and again, I welcome all the members here for the panel. For those of you who have not testified before us, your complete record will be and has been submitted for the record officially.

We will yield you 5 minutes. Somewhere in front of you should be a little clock that goes red, green—or rather, green, yellow and red. Green means that you have 5 minutes. When it comes up to yellow that means that is your one-minute warning, and then red means you are in overtime. So try not to do overtime.

So with that, starting from left to right, Governor Engler, welcome, and you are recognized for 5 minutes.

**STATEMENT OF THE HONORABLE JOHN ENGLER, PRESIDENT,  
BUSINESS ROUNDTABLE**

Mr. ENGLER. Good afternoon, Mr. Chairman, Ranking Member Maloney, and members of the subcommittee. I am John Engler, as you have indicated, president of the Business Roundtable, an association of CEOs of major U.S. companies, such as Congressman Sherman just mentioned, that operate in every sector of the U.S. economy.

And I want to thank you for the opportunity to provide the perspective of these U.S. business leaders and large employers on improving the regulatory environment that governs America's capital markets.

We appreciate the committee's attention to these important issues. In particular, Chairman Hensarling's Financial Choice Act represents a serious effort to reform provisions in Dodd-Frank that Business Roundtable CEOs have identified as detrimental to their ability to invest, to hire and expand.

I would like to focus on two issues today, the current U.S. public company disclosure regimen and the shareholder proposal process. First on disclosure, Business Roundtable believes the country needs a renewed commitment to the materiality standard, the bedrock principle for U.S. securities laws since 1933.

SEC Chairman White, I should note, has been forceful in her support of materiality, and we thank her for that support. As we documented in a white paper last October, the materiality standard ensures that required disclosure provides investors with the information that is essential to making effective investment in proxy voting decisions.

Unfortunately, the adherence to the materiality principle has eroded. Congress and the SEC have increasingly turned to the disclosure system to address social, political and environmental issues, issues more effectively addressed through other means and issues that certainly do not meet the materiality standard.

The results are higher costs to shareholders and an ever-increasing complexity, and the amount of information that reasonable investors receive that is unrelated to investment and proxy voting decisions.

America's business leaders strongly urge Congress to abstain from enacting new mandates and review earlier actions that are contrary to the materiality standard. We believe the Choice Act provides an opportunity to conduct such a needed review.

The second point today, the U.S. shareholder proposal process. The current process is outdated and is being abused. This abuse imposes significant costs on companies, limits their ability to focus their resources on the long-term creation of value for shareholders that Mr. Chairman you mentioned in your opening comments.

In too many cases, the current shareholder proposal process has been hijacked by corporate gadflies and political activists. These individuals often have insignificant economic stakes in target companies.

Their proposals pursue idiosyncratic, social or political agendas unrelated to the interests of shareholders as a whole. They impose significant costs on the corporation, which then are passed on to ordinary investors, senior citizens, savers, retirees. We believe two factors are driving this negative trend.

First, the threshold for submitting a proposal is too low. To be qualified to submit a proposal, a shareholder must own only \$2,000 in market value, or 1 percent, whichever is less of a company's outstanding stock released one year. The \$2,000 threshold in particular falls well short of any reasonable material ownership standard for public companies.

And second, it is difficult for a company to exclude proposals relating to general social issues. For several decades, the SEC permitted corporate managers to exclude proposals submitted "primarily for the purpose of promoting general economic, political, racial, religious, social, or similar causes."

In 1970, however, the D.C. Circuit Court of Appeals ruled against the SEC and broadened the types of proposals that could not be excluded. The result? An influx of proposals on social issues.

Last year, activist shareholders filed 479 social, environmental and political proposals. And this stream of proposals remains steady with more than 400 such proposals submitted for 2016 meetings.

These kinds of proposals are rejected repeatedly, mostly by overwhelming margins, only to be submitted again next year. In the interest of time, we believe the SEC should bring that \$2,000 holding requirement up to date. The current holding requirement for stockholders should be lengthened.

We would also strengthen disclosure requirements for proponents of shareholder proposals and modernize the exclusion process so companies can focus on material issues.

So thank you for the opportunity to be here today. We are committed to promoting an environment for U.S. capital markets that facilitates greater long-term value growth for our owners and investors, the employees and consumers.

[The prepared statement of Mr. Engler can be found on page 119 of the appendix.]

Chairman GARRETT. Thank you, Governor.

Now next up from the Manhattan Institute, senior fellow and Director of legal policy, you are recognized for 5 minutes, Mr. Copland.

**STATEMENT OF JAMES R. COPLAND, SENIOR FELLOW AND DIRECTOR OF LEGAL POLICY, MANHATTAN INSTITUTE FOR POLICY RESEARCH**

Mr. COPLAND. Thank you, Mr. Chairman, Ranking Member Maloney, and members of the subcommittee. I would like to thank for the invitation to testify today. My name is James R. Copland and I am a senior fellow with the Manhattan Institute for Policy



Research, a public policy think tank in New York City. I have directed the institute's legal policy efforts since 2003.

The shareholder proposal process governed by SEC Rule 14a-8, has constituted a significant focus of my research. In 2011, I helped launch the Manhattan Institute's proxy monitor database, a publicly available catalog of shareholder proposals at the 250 largest publicly traded American companies. Over the past 5 years I have periodically authored reports on the shareholder proposal process.

The SEC's Rule 14a-8 permits stockholders of publicly traded companies who have held shares valued at \$2,000 or more, as the governor just said, for at least 1 year to introduce proposals for shareholders' consideration at corporate annual meetings.

The SEC's process is ripe for reform. It has strayed far from the principal legal purpose authorizing the rule under the Securities Exchange Act. It has been used almost exclusively by a small number of investors with a focus potentially or actually centered on concerns other than maximizing share value.

And it has actually operated to permit such a minority of shareholders to extract corporate rents or influence corporate behavior to the detriment of the average diversified shareholder. My written statement discusses these issues in more detail, as do two reports included in the record, both of which are available here in hardcopy today.

I would like to emphasize the following facts drawn from my research. One, a small group of individuals, often referred to as corporate gadflies, repeatedly file substantially similar proposals across a broad set of companies.

In 2016, six gadfly investors and their family members have sponsored one-third of all shareholder proposals. Typically, as the governor suggested, these individuals own very small percentages of a company's stock.

For instance, John Chevedden, the most active sponsor of shareholder proposals dating back to 2006, has made substantially the same proposal at Ford Motor Company each of those years. In 2016, Mr. Chevedden owned 500 shares of Ford stock, which is equivalent to about 0.00001 percent of the company's outstanding float.

Number two, a large percentage of shareholder proposals concern social or policy goals that may not be related or at least have an attenuated relationship to share value. In 2016, to date, half of shareholder proposals have related to a social or policy issue, which is an all-time high.

Number three, these social and policy related shareholder proposals have consistently been rejected by most shareholders. Over the last 11 years, at Fortune 250 companies, 1,444 shareholder proposals related to social or policy concerns had been presented to shareholders for a vote over board opposition. All but two of those failed to garner majority shareholder support.

Number four, a large percentage of institutional shareholders vote their shares based on the advice of proxy advisory firms, whose power over shareholder voting is vast. A 2012 analysis I authored for the Manhattan Institute found that a recommendation that shareholders vote for a given shareholder proposal by the larg-

est proxy advisor firm, ISS, was associated with a 15 percentage point increase in the shareholder vote for any given proposal.

My research also shows that ISS has historically been almost eight times as likely as the median shareholder to support a shareholder proposal, in particular, social and policy oriented proposals.

Number five, over the last 10 years, 31 percent of all shareholder proposals were resubmissions of a preceding year's proposal. Under current SEC rules, any proposal that receives at least 10 percent shareholder support can never be excluded from a company's proxy ballot in future years for want of support.

The current SEC rule means that a single proxy advisory firm, ISS, effectively serves as the gatekeeper for shareholder proposal resubmissions. If ISS supports a proposal, it can remain indefinitely on the ballot.

And number six, the ultimate test of whether shareholder proposals are an effective tool is whether they enhance share value. Last year, the Manhattan Institute commissioned an econometric study on this issue by Tracie Woidtke, a professor at the University of Tennessee.

Woidtke found that public pension funds' social issue shareholder proposal activism appears to be negatively related to firm value. As such, shareholder proposal activism intended to affect corporate behavior in pursuit of social or policy goals may be harming the financial interests of the average diversified investor as well.

In conclusion, it is hard to argue that the 14a-8 shareholder proposal process is functioning well. Rule 14a-8 is a longstanding rule that has some utility, but activists have seized upon the SEC's outdated and overly permissive standards to push policy agendas in an effective end run around Congress.

Congress has an interest in addressing this situation and reorienting the SEC around its statutory obligation to promote efficiency, competition and capital formation. Thank you.

[The prepared statement of Mr. Copland can be found on page 40 of the appendix.]

Chairman GARRETT. And I thank you.

Moving next, Ms. Simpson from California Public Employees' Retirement System, you are recognized for 5 minutes.

**STATEMENT OF ANNE SIMPSON, INVESTMENT DIRECTOR,  
SUSTAINABILITY, CALIFORNIA PUBLIC EMPLOYEES' RE-  
TIREMENT SYSTEM**

Ms. SIMPSON. Thank you very much, Chairman Garrett, Ranking Member Maloney, and other members of the subcommittee. Thank you very much for inviting us to testify at today's hearing. I am Anne Simpson. I am the investment director for sustainability at CalPERS.

We greatly appreciate the subcommittee's focus on corporate governance and on ways to foster a system that promotes capital formation and maximizes shareowner value. This is a subject of vital importance to CalPERS, which is the largest public pension in the United States with over \$300 billion in global assets.

We own shares in over 10,000 companies worldwide and we are a fiduciary. We invest for our 1.8 million members, who include public servants such as the police, firefighters, judges, and others.

For every dollar that we pay out in benefits to our members, fully 65 cents are generated by investment returns, which is why the topic of today's hearing is so important. Just as a sense of how important we are in our own local economy, we pay out close to \$20 billion in retirement benefits every single year.

So the topic of today is important to us because we are a significant provider of capital to U.S. financial markets which, as the Chairman rightly said, are the largest and the most dynamic in the world.

We rely on the safety and soundness of those capital markets to advance our long-term investment strategy, which in turn we see supports the growth in the wider economy. The CalPERS principles are the framework by which we advocate for smart regulation that is designed to spur that economic growth upon which we rely and to ensure that our capital markets prosper.

As you will be aware, the chaos of the financial crisis caused our fund to lose something in the order of \$70 billion. We went into the crisis overfunded, and we believe it will take us 30 years to grow back to being fully funded. And we are still living with the impact of that catastrophe in the markets.

The principles also guide how we execute our shareowner proxy voting responsibilities and a copy is attached to our written testimony. We believe that a system that operates with accountable and transparent corporate governance, which promotes capital formation to achieve the best returns for shareowners over the long term is the objective of today's hearing, which we fully support.

Although my testimony does not capture all the elements that we think are important, I would like to call out a few elements which are considered today. The first is executive compensation. The second is corporate governance and transparency. These three are crucial to strengthening the U.S. financial system for the benefit of long-term investors like CalPERS.

First, we advocate executive compensation which is fully disclosed and aligns interest between management and long-term owners. Accordingly, we strongly support the SEC rulemakings related to both say-on-pay, as it is known, executive compensation clawbacks, and also to pay ratio disclosure.

Secondly, we firmly embrace accountable corporate governance. That is why we support the renewal of an SEC rulemaking for proxy access, which would allow long-term significant owners to nominate board candidates to the ballot.

The use of Rule 14a-8, which by most large owners like ourselves was modeled on the vacated SEC rule, is a good example of how engaged owners can bring important reform into the market.

We welcome the opportunity to vote on proposals put forward by fellow shareholders, whether they be large, like ourselves, or whether they be small. Often issues are raised, which is of interest and draw to the attention of other owners and of management. These small shareholders can be the eyes and ears of the company, if you like, a canary in the mine.

We also want to ensure that proxy advisory firms are well-regulated and transparent. But with our view that regulation should be smart, we do oppose efforts to create an unduly burdensome regulatory regime.

Third, our focus is on corporate financial reporting, which is vital. We want to ensure transparent and relevant information about economic performance and condition of businesses. And with the greatest respect, given that the reports are for the benefit of investors, we consider that it is investors who should determine the range and scope of what is material.

Transparency is vital to us in all matters, and we consider that the current disclosure regime review of Regulation S-K is exceptionally helpful. We have provided detailed comments to the SEC.

We do see great advantage in technology in spurring new areas of reporting, for example on new risks like those related to climate change. Finally, we urge full funding for the SEC in order that it can properly do its vitally important job. Thank you. I look forward to answering any questions you may have.

[The prepared statement of Ms. Simpson can be found on page 126 of the appendix.]

Chairman GARRETT. And I thank you.

Finally last but not least, from the Society of Government Professionals, President and CEO Ms. Stuckey. You are recognized for 5 minutes.

**STATEMENT OF DARLA C. STUCKEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SOCIETY FOR CORPORATE GOVERNANCE**

Ms. STUCKEY. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. Thank you very much for the opportunity to testify. I am Darla Stuckey. I am CEO of the Society for Corporate Governance, which represents about 1,000 public companies.

U.S. public companies are bearing the brunt of a broken and outdated disclosure system. How did we get here? In the 1970s, social activists had no better way to disseminate their message broadly than to use a public company proxy.

Today, however, we have the Internet. The need to use a corporate proxy statement as a public forum for social issues is now moot, yet the disclosure regulations have not kept up with the pace of this change.

My testimony today will focus on abuses associated with corporate disclosure, in particular Rule 14a-8. The purpose of Rule 14a-8 is to foster communication between shareholders and companies, as well as among shareholders themselves on issues of importance.

However, it has limits designed to protect a small minority of shareholders from burdening others. One of these limits is Rule 14a-8i12, the resubmission thresholds. A company can exclude a proposal if the proposal fails to receive 3 percent support the first year, six the second and 10 the third year.

This means, as I think has been said by Jim, if a proposal receives 10 percent of support or more, it can be resubmitted each year indefinitely, or what some have called the tyranny of the 10 percent. In fact, Con Ed shareholders voted on the same executive comp proposal from Evelyn Y. Davis every year for 16 years.

The commission should raise these thresholds. They have not been changed since 1954 when President Eisenhower was in office.

In 1997, the commission tried to raise them from the 3, 6, 10 percent, to 6, 15 and 30 percent. However, they failed to do so because of serious concerns from special interest shareholders who were afraid that too many of their social proposals would be excluded.

But times have changed. Given current voting patterns, 96 percent of all proposals now pass the 3 percent threshold in the first year, so this is really not a meaningful threshold at all. Comparing the voting data in 1997 and 2015 shows that a failure rate under the 3, 6, 10 percent regime would compare to about 5 percent, 15 percent, 25 percent today. So at a minimum, we need to go back to where the commission tried to go in 1997.

Second, the proposal process is being abused by non-shareholders. Rule 14-8b requires a proponent to hold at least \$2,000 worth of stock for a year in order to submit a proposal. This means at a minimum the proponent must own the shares and have an economic stake in the company.

Despite this rule, commission staff routinely allow individuals, advisors and others to submit 14a-8 proposals on behalf of shareholders without requiring them to have an economic stake. We call this proposal by proxy, and it should be stopped.

A shareholder who has no interest in submitting a proposal, can lend his shares to someone who does and a company can't then deal with the actual shareholder. Companies have sought relief in Federal courts and won, even though the staff refuses to grant relief.

We don't understand why this is the case since it undermines the purpose of the rule, which again is to foster communication between shareholders and the company or amongst shareholders themselves. We believe the right to submit a shareholder proposal is not freely assignable.

There is one other limit on proposals known as the relevance rule. It provides that a proposal can be excluded when it relates to operations that account for less than 5 percent of the company's total assets and net earnings and is not otherwise significantly related to the business.

The staff interpretations of this exclusion have effectively eliminated the 5 percent economic thresholds in the rule. For example, assume a proponent doesn't believe Acme Corp should be doing business in Myanmar because of human rights concerns in the country.

Even if Acme Corp's annual revenues from Myanmar are less than 1 percent, the company must include the proposal in its proxy because the commission staff has said that the issue of human rights is a significant policy issue.

If a shareholder want to access the corporate proxy, he or she should demonstrate that the issues are relevant to at least 5 percent of the company's business. That is the rule, but it is not being enforced.

Turning to the materiality standard, we also believe that the standard in TSC v. Northway works and should be not be changed. We applaud the SEC for undertaking disclosure effectiveness. We just worry that it may open avenues to new special interest disclosure.

Three things to remember, the SEC under your oversight and jurisdiction, is the agency responsible for public company disclosure. It should not let others who claim to be standard setters usurp that role. The SEC should write the rules.

Number two, writing an actual materiality rule would be impossible as a practical matter. What is material for one company is based on the facts and circumstances of that company.

And three, not every piece of information that is important to an investor is material, and not every piece of information that is important needs to be in a publicly filed document.

Companies can and do communicate outside of 34f filings. In fact, a great deal of helpful sustainability reporting is on corporate websites and published reports.

Apologies, I refer to the rest of my testimony. Thank you.

[The prepared statement of Ms. Stuckey can be found on page 231 of the appendix.]

Chairman GARRETT. That is fine. Thank you very much. I thank everyone for their testimony, and at this time, I will yield myself 5 minutes to begin the questions, and I guess I will jump around.

Governor Engler, so you brought up, and Ms. Stuckey you ended it there, on the issue of materiality. Maybe not the most exciting discussion in the world, but let us just spend 30 seconds or a minute on that. As was indicated by a couple of the panelists, and you yourself included that there is a push now to, what, redefine what materiality is?

The SEC issued a concept released earlier this year that posed a question of whether if you change the definition to expand it, as you refer to in your testimony. Can you just spend 30 seconds addressing what the consequences of expanding the definition of materiality would be to include such things as sustainability and such things as climate change, or whatever else it could be expanded into?

Mr. ENGLER. Thank you—

Chairman GARRETT. Yep.

Mr. ENGLER. —Mr. Chairman for the question. I think that expanding it further would render it almost moot. The concept going back I think to—I mentioned to the beginning, 1933, really was what is essential for that investor to know?

And there are an unlimited number of topics that we could ask a company to respond to, but many of those have little to do with the company and its operations and its worthiness as an investment.

Chairman GARRETT. And who—okay. And who should be defining then what materiality is? Is that the SEC? Is that Congress? Is that the investors?

Mr. ENGLER. Well, it used to be the SEC. That is who we delegated the regulation of the, you know, the corporate sector to, and that is why we set up this commission. We thought it—I wasn't around in the 1930s when they were doing this, but I think that the thought was that the SEC would take on this responsibility.

What has happened in recent years, there have been requests, some of it reflected in some of the testimony today from panelists about adding to that, for instance, political disclosures, duplicating that. That is covered—there are other laws doing that.

Congress stepped in with CEO pay ratio, one of the more useless requirements that have come down in a long time.

We have seen, you know, on conflict minerals, as you mentioned in your opening testimony, the adverse impact and the unexpected impact of some of this. And what we end up doing is overloading that proxy statement. We will get a proxy statement the size of a phonebook, I am afraid.

Chairman GARRETT. Is that isn't the case where sometimes too much information, that you lose the significance of it?

Mr. ENGLER. That would be our position.

Chairman GARRETT. Right. And isn't it also the case, correct me if I am wrong, is the case some companies make some decisions unilaterally, I guess, outside the materiality issue to say we are going to address the issue of sustainability or what have you. And they have the ability and the right to do this, though, right?

Mr. ENGLER. That is correct. And there are many companies who independent of any of their obligated reporting—

Chairman GARRETT. Obligated.

Mr. ENGLER. —will issue sustainability reports. We at the Roundtable actually publish an annual sustainability report.

Chairman GARRETT. Well, there you go.

And Ms. Stuckey, then you made mention on the resubmission thresholds, and actually, did I hear Ms. Simpson, did you say that one of the criteria should be long-term significant owners? Did I hear that correctly as far as—I am jumping around there I guess—as far as who should meet the threshold for proposing? Did I hear those terms, long-term significant owners in your testimony?

Ms. SIMPSON. Yes. I—

Chairman GARRETT. Yep, yep, yep.

Ms. SIMPSON. Excuse me. I didn't push the button. That is our view with proxy access—

Chairman GARRETT. Yes, right.

Ms. SIMPSON. —because this is actually addressing a fundamental issue in the governance. Our view on the other issues which were mentioned—

Chairman GARRETT. No, let me just stay on that one. So a long-term significant owner because the rule is how long do I have to own it right now?

Ms. SIMPSON. There isn't a rule—

Chairman GARRETT. Okay, and so when you say—

Ms. SIMPSON. —it was vacated in court—

Chairman GARRETT. When you are suggesting long term, what should long term be?

Ms. SIMPSON. For us it is a minimum of 3 years holding continuously.

Chairman GARRETT. Okay. And I see, Mr. Copland, you just popped your hand, so did you want to chime in on that? And then I will go to Ms. Stuckey.

Mr. COPLAND. Oh, well, the rule is 1 year for shareholder proposals. That it has to be an ownership period for 1 year and \$2,000 worth of stock.

Chairman GARRETT. Right. And is that satisfactory?

Mr. COPLAND. Well, I tend to agree with the governor that the \$2,000 is quite low. The direct cost that is imposed on the com-

pany, just the cost of printing, duplication, distribution substantially exceeds.

Now the time period is a bit of a tricky question. And this is where I may not always agree with the corporate side to some degree on these because I am not—

Chairman GARRETT. But something longer than what we have right now?

Mr. COPLAND. —adverse to things like hedge funds or things like that, that are coming in. If they have a big stake and they are trying to turn a company around—

Chairman GARRETT. Yes.

Mr. COPLAND. —you know, to say they can't have a shareholder proposal if they are buying 9 percent of the company to me doesn't necessarily make sense.

Chairman GARRETT. And in my—okay. And in the last 13 seconds as to where I was going to go, Ms. Stuckey, as far as the re-submission rate, those numbers in that area are surprising to me. Do you want to address what you were saying—

Ms. STUCKEY. What do you mean? Well, we think it should go at least back to where they proposed in 1997. Yes, we need to get it there because basically it is a sieve and everything is going through.

Chairman GARRETT. So basically no matter how many times—once you hit that threshold, no matter how many times you will—

Ms. STUCKEY. Once you hit 10 percent every year then you don't have to—you can put it in forever. And the purpose is, you know, there are a lot of good shareholder proposals. As Jim said, 50 percent of them are the social proposals. There are 50 percent that are not.

Also, I want you to know that a lot of good comes about, the communication between shareholders and companies when proposals get made.

Chairman GARRETT. Yes.

Ms. STUCKEY. In fact that is why they put a sustainability disclosure on their website. So we are not saying that they are all bad. We are just saying that the rules are not being enforced accurately by the SEC.

The 10 limits one a little too much, a little too investor friendly, and we would like the timeframes and the thresholds to be readjusted.

As far as the initial \$2,000, it was changed from \$1,000 to \$2,000 in 1998. If you kept up with inflation now—

Chairman GARRETT. Yes, what is that?

Ms. STUCKEY. —it would be—sorry—it would be \$3,000. It would be \$3,000.

Chairman GARRETT. That is what I was going to say, it doesn't get that high. I would have thought it would be higher than that, but—

Ms. STUCKEY. I know.

Chairman GARRETT. —by inflation. Well, I guess we haven't had any inflation for the last 8 years because everything been flat under this administration, right? There is no economic growth so you don't have any inflation.



So with that, I will now turn to the gentlelady from New York for 5 minutes.

Mrs. MALONEY. Thank you.

Thank you Mr. Chairman.

And I would like to ask Ms. Simpson, I would like to ask you about board diversity. And as you know, I have introduced a bill with bipartisan support that would require public companies to disclose the gender composition of their board in their proxy materials.

And that they would send it to shareholders. Now, this would just not be any more paperwork. It would just be checking another box and telling whether or not you have gender diversity. And this came about because of organizations such as yours that was asking for this information, wanting to know more about it.

And there were two studies that were reported in a GAO report that talked about companies that had gender diversity. It increased their bottom line profits by roughly 5 percent. Now, I want to thank you for the letter that you wrote in support of the bill, and that you have long been an advocate of even greater board diversity.

I was focusing on gender because that was what the research had shown the differential on. But can you talk about the importance of board diversity from an investor's perspective? And is there evidence that greater boardroom diversity helps increase the company performance beyond the two financial services reports that were previously issued?

Ms. SIMPSON. Thank you for the question. CalPERS has conducted a very extensive research of the evidence on such topics in a database that is freely available called the Sustainable Investment Research Initiative. We have over 2,000 papers and you can search by topic if you would like to find the detail.

The research that we have reflected on shows that diversity is good for two aspects of investment, both risk management because diversity challenge is group think. And you will recall that after the financial crisis, even the IMF said, group think was the corrosive common factor in boardrooms that led it to the brink of so much trouble. So group think is a problem.

Different perspectives are important, particularly when companies are facing complexity and new issues for the long term. Climate change is a very good example. The other thing that we are finding though is that diversity is good for talent recruitment.

If you confine yourself to the existing small, relatively well-known member of, for example, putting in criteria such as a former CEO of a Fortune 500 company, you will unfortunately be fishing in a very small pool.

And if you throw the net more widely, then the talent that companies need for global competitiveness is more readily available. And that is why the CalPERS definition is multifaceted.

We see gender, race, ethnicity and very interesting, we had a presentation from Credit Suisse to our board, which showed that for the LGBT community evidence that companies were inclusive in this regard was also associated with recruiting better talent and the result was better performance, particularly where financial services companies were concerned.

Mrs. MALONEY. Mr. Chairman, I ask permission to place in the record CalPERS' letter on gender diversity and corporate leadership, as well as a letter in support of my bill from the Chamber of Commerce.

Chairman GARRETT. Without objection, it is so ordered.

Mrs. MALONEY. Thank you.

Ms. Simpson, as you know the SEC's rule on proxy access was overturned by the D.C. Circuit Court back in 2011. And while the SEC did not appeal that ruling, or re-propose proxy access, I understand that institutional investors such as CalPERS have still been relatively successful in engaging with companies in order to achieve proxy access to invigorate board elections and make boards more accountable.

Can you discuss CalPERS' efforts on this issue since 2011?

Ms. SIMPSON. Yes, thank you. I would be glad to. Again, it is important to know that this element of good governance is associated with better performance. You will have seen last year, the CFA, the Charter Financial Analysts producing a study which drew together the details here.

Our view is that accountable corporate governance will underpin long-term creation of shareholder value. Because of the overturning of the SEC rule, which we and others supported, I have to say, it was important to be able to use Rule 14a-8 to, if you like, have a do-it-yourself effort on something that is so important.

We now have over 200 major companies where votes have been won to introduce proxy access. And I would like to applaud the leadership of New York City, which established a board accountability project.

What is important here is an issue which once upon a time was viewed as rather innovative and perhaps on the sidelines of a minority interest is now winning significant support.

Last year for example, over 60 percent of shareholders supported proxy access being introduced at Exxon, as an example of a company where we see a real potential for board refreshment. And now the owners of the company have the ability to engage in that dialog with the company.

Mrs. MALONEY. My time has expired. Thank you very much.

Chairman GARRETT. The gentlelady's time has expired.

Mr. Huizenga is recognized for 5 minutes.

Mr. HUIZENG. Thank you, Mr. Chairman, and first I would like to welcome my governor, Governor Engler from Michigan. And it is good to see you here. I want to drill down a little bit on some recommendations that you have and explore a little bit about the conflict minerals and some of the pay ratio issues and those kind of things.

I can't help but note my astonishment that we are talking about some of the issues that we are. I would have to note first and foremost, my mother has owned a business. My sister has owned a business. I have been involved in female-owned businesses for a long time and fully understand the benefits of diversity.

The Wall Street Journal article recently talked about the benefits of having some gender diversity on boards and what that meant for the bottom line. I am a little confused though that gender is none of our business when people are using a bathroom, but suddenly

it is very relevant if they are in the boardroom. So that seems an odd direction to go to me.

But, Governor Engler, I do want to talk a little bit about the DRC and the conflict minerals provisions. That is something that my subcommittee, the Monetary Policy and Trade Subcommittee has dealt with it pretty extensively.

And, you know, I believe that the rule really has not decreased violence or poverty in those nine countries surrounding the DRC, or I guess eight surrounding the DRC and nine with them.

And Ms. Stuckey, you talk a little bit about some of those direct costs that are being incurred. And I wondered if you could just drill down a little bit on that, Governor Engler, and then maybe Ms. Stuckey, if you could follow up?

Mr. ENGLER. I can respond to the question, Congressman, with perhaps more anecdotal than specific facts. I didn't come prepared to talk about that today. But what I have heard is the following.

And we would be happy to try to follow up on this, but in some cases, the complexities of the supply chains of these major companies are such that literally decisions were made to try to avoid sourcing in that region completely.

And so in that case, the idea was can we find any other alternative to bringing this into play.

Mr. HUIZENGA. If I could interrupt one moment. The Minister of Mines from Rwanda sat right where you are and talked about this isn't about conflict-free, it is about Africa-free minerals. And that they are finding that as well, that people are leaving Africa and Central Africa to go find a different source for their minerals.

Mr. ENGLER. That is consistent with what I have seen reported on, and as I said, have heard anecdotally. I can't document company by company or which even sector, but that has arisen.

The second challenge that has been talked about is simply the sheer cost of trying to run down a supplier to a supplier, down that chain where the risk is such that it accelerates this trend to maybe even move off the continent someplace else because the risk of making a mistake is too great.

And despite your best efforts, there might be a tier three supplier who suddenly has bought something in a market that you were not monitoring them. They were reporting to you but this is the challenge with this.

And I think there is no one, certainly among the membership of the Business Roundtable who would knowingly do anything that would further violence in Africa. But at the same time, asking them to try to play this kind of a policing role is a very difficult challenge.

Mr. HUIZENGA. Ms. Stuckey, do you mind?

Ms. STUCKEY. Yes, there is a new Tulane University and Accent Compliance Group study that says the cost of compliance with conflict minerals rule is now estimated to be about \$710 million.

And when you read that against the GAO report from last month, you see that companies still, even at this cost, companies still can't tell whether they have minerals from the Congo or not.

And I have heard the exact same things that Governor Engler's heard about, you know, people not going to Africa and, you know,

there are issues with different mines all feeding into one smelter, and then there is the fact that you have to have it audited.

You know, why would you take the risk that you are going to make a mistake, if this stuff—if you have to sign on the dotted line for it? Again, that is the problem with putting stuff in the 34 Act documents.

Mr. HUIZENGA. Not to mention the fact that countries that were not big producers of many of these have now suddenly overnight become big producers where those minerals are coming out of even because the fall outside those nine defined countries.

But with that, I know that my time has expired. And I appreciate the opportunity.

Chairman GARRETT. The gentleman's time has expired.

The gentleman from California is now recognized for 5 minutes.

Mr. SHERMAN. Mr. Chairman, this has been an interesting week for corporate governance. We learned that one of the most respected institutions on Wall Street, countenanced 2 million bank fraud transactions committed by 5,300 people. And that the top corporate managers devised the system to put incentives and threats of firing on the lower ranking employees.

That they maintained this system, knowing that there were at least 1,000 employees they had fired for fraud, and that they failed to monitor whether these accounts were actually authorized.

And so in this week, when we find about 2 million criminal fraudulent transactions at just one big corporation, we are told that the only problem in corporate governance is that CEOs are annoyed having to talk about shareholder proposals.

A real corporate governance hearing would not be one where we would consider a bill put forward by the chairman of the full committee that would eliminate the clawback provisions applicable to this case.

Clearly those who left the company, or those who are staying with the company and got \$100 million bonuses and incentive packages should be called to answer, but the SEC hasn't finalized the regulations.

We are throwing around the term gadfly. And so I check with Jeff Foxworthy about what it means. If you care about conflict minerals, you might be a gadfly. If you don't want Iran to have a nuclear weapon, you might be a gadfly. If you get proxy advice rather than simply automatically signing whatever management wants you to sign, you might be a gadfly.

If you fail to get your proposal adopted the first time, and have this stick-to-itiveness to provide it to propose it again, you might be a gadfly. And if you believe that Wall Street values are not the sole determinant of human morality, you might be a gadfly.

This is a hearing about whether we are going to have real capitalism, where the owners control the companies, or whether we are going to continue to have crony capitalism, which is so much more popular. The PACs that contribute to members of Congress are all controlled by the CEOs.

And we have the crony capitalism that says whatever management wants to do they get to do, and the owners of the company have no right to stop them. Now, part of the attack on capitalism

is to tell investors that it is virtually illegal for them to consider anything other than earnings per share in making an investment.

That if they choose to care about not investing in Iran, that they are prohibited from doing so and they won't be given the information. I would say that it is the SEC's job to protect investors and that means all investors, including those who care about Iran's nuclear programs, about conflict minerals, about the money that is going from corporate treasuries to this end around our campaign finance laws.

Investors who are deprived of the right to know basically have their money stole—well, taken from them. They can't make their own investment decisions.

Ms. Simpson, we are here to protect shareholder value. Is it true that your organization controls—is the shareholder for far more shares than all the rest of the panelists combined?

Does PERS have more than Mr. Copland's organization? How many billion are we talking about?

Ms. SIMPSON. CalPERS is responsible for over \$300 billion as a fiduciary for—

Mr. SHERMAN. Okay. If anyone on the panel controls over \$100 billion, can you please raise—no hands are going up. So we are here to protect shareholder value, but we only have one major shareholding organization testifying.

Mr. Engler, you proposed that the \$2,000 figure was too small. But then you said, it should be a longer holding period than 1 year.

Our tax laws define long-term investor sometimes as 6 months, at best 1 year. If we are going to say, that you are not a long-term investor for purposes of the proxy statement, shouldn't we take away your capital gains allowance as well on the same basis?

Mr. ENGLER. Well, let me be clear. You are making some headway in your effort to regulate corporations. In 2000, we had 6,000 of them and you have it down to 4500 now. So there are fewer of these companies to be worrying about that are incorporated. I think that—

Mr. SHERMAN. Mr. Engler, are you talking about publicly traded corporations?

Mr. ENGLER. Publicly traded, yes.

Mr. SHERMAN. Okay, so that you—

Mr. ENGLER. That is what we are talking about I think, those regulated by the SEC, and there is a diminishing number of those, and I would submit that some of the regulatory overkill has something to do with that.

Mr. SHERMAN. And then that part of it also is the corporate merger mania that occurs on Wall Street where one of those corporations buys another one of those corporations.

Mr. ENGLER. And why do they do that?

Mr. SHERMAN. Then we have a lot of private equities making a lot of money.

Mr. ENGLER. Well, I—

Mr. SHERMAN. Anyway, are you holding out for more than a 1-year period of time that somebody has to invest in a company in order to put forward a proxy proposal?

Mr. ENGLER. I want to restore some balance to a process, and I think \$2,000 ownership share, held for 1 year—

Mr. SHERMAN. I am asking about the length of time.

Mr. ENGLER. —is not enough.

Mr. SHERMAN. Length of time. Are you arguing—I know you are arguing for more \$2,000.

Mr. ENGLER. Yes.

Mr. SHERMAN. Are you arguing for longer than 1 year?

Mr. ENGLER. I would personally make that a little bit longer, yes.

Mr. SHERMAN. If we do the tax code as well, I will be with you. I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Hultgren is recognized for—

Mr. HULTGREN. Thank you, chairman. Thank you all for being here. I have the privilege of representing Illinois, just west of Chicago. We have a number of outstanding public companies headquartered in Illinois. John Deere is one of the best respected brands in the country. It also employs thousands of people in Illinois and across the country.

Farmers in my district absolutely depend on their products and my constituents own shares in the company and depend on its success for their retirement security.

There was recently a shareholder proposal requesting the company generate a plan for it to reach net zero greenhouse gas emission status within the next 15 years.

While I agree companies should be striving towards energy efficiency, it doesn't see to make sense that someone with an incredibly small stake in the company should be able to have such a powerful influence over its affairs. Some would describe this as tyranny of the minority.

Governor Engler, in your testimony, you discussed the need for modernizing the current shareholder proposal process due to it being hijacked by a very small minority. I wondered, could you talk about the cost the current process imposes on public companies?

Mr. ENGLER. Congressman, yes. I mean, we think the cost is substantial and it is worsened by the fact that even after that proposal with those minimal requirements is presented once and voted down, it could be resubmitted again the next year and the year after that. So these costs are accretive over time.

We do think that looking at the company's financial reports, a company's performance and the material information is the way investors ought to make a decision on whether they own or not own a company.

You know, this is a big challenge. You know, in Illinois with the public pension funds what kind of trouble they are in with the investments they have made and their performance isn't terrific.

We would like to see, I think obviously, more growth in America so that we have an economic performance that is much greater than we have today. But we would also like to see U.S.-headquartered companies regulated by the SEC being able to perform better, with better results. And I don't have a specific dollar amount. It varies company by company.

But as my colleague, Mr. Copland testified, when you are down to 0.00001 percent, you know, it is a pretty de minimis investment to create cost for a company and then those costs are borne by the investors.

Mr. HULTGREN. Yes, I would like to get into that a little bit just with the \$2,000 ownership threshold for submitting a shareholder proposal. Do you know when that was originally put into place? From your testimony, it doesn't sound like you think this is really a reasonable threshold anymore.

For example, John Deere currently has a market cap of about \$26 billion, so a \$2,000 investment would be about 0.000008 percent stake, and yet being able to have that kind of sway. So—

Mr. ENGLER. Wait, I can't answer, but Ms. Stuckey can.

Mr. HULTGREN. Okay.

Ms. Stuckey?

Ms. STUCKEY. Hi—

Mr. HULTGREN. Hey.

Ms. STUCKEY. —1998 is when it went up from \$1,000 to \$2,000.

Mr. HULTGREN. Okay.

Ms. STUCKEY. I guess that \$1,000 was probably the original number. And let me just—on a number for the cost of shareholder proposals just direct cost, \$90 million a year.

Mr. HULTGREN. Wow.

Ms. STUCKEY. Doesn't sound like a lot, but it doesn't include the board's time and the other people in the corporation's time that they have to deal with it.

Mr. HULTGREN. Okay. We talked a little bit about the 1-year holding period requirement for submitting a proposal. Do you think that 1 year is sufficient?

Governor Engler, I will address this to you.

Mr. ENGLER. Sure.

Mr. HULTGREN. Are we certain that these are investors who are interested in the long-term growth of the company? Again, if they only hold it for a year, do we have that long-term commitment?

Mr. ENGLER. Well, I mean, I know we previously had an effort to kind of link this to tax law, but I think we are really talking about, you know, tax policy is tax policy. Right now we are in a big fight with the E.U. about some of their, what I think are wrong tax policy. But in this case, we are talking about management of a company, which, you know, is over many years.

And we know that companies are bought and sold. Companies emerge and some become obsolete and go away. But for the longer term interest, I would think that a shareholder would want to—and we would want investors to be around for more than 360 days. And that is what we are saying.

We are not here to—we are actually working on a paper to kind of try to be even more granular about what we think might be a better idea. What we are saying, what we have today is clearly inadequate.

Mr. HULTGREN. Let me jump to one thing real quick. I just have a little bit left. Retirement security is an incredibly important issue for my constituents, as you have mentioned. I have championed the Encouraging Employee Ownership Act in the Financial Services Committee.

And also recently co-sponsored the Empowering Employees Through Stock Ownership Act, which allows an employee to elect to defer income attributable to certain stock transferred to the employee by an employer.

What I find really frustrating with some of the shareholder proposals is that they are clearly politically motivated instead of focusing on the company's growth. I wonder what this means for my constituents who depend on sound investments, especially if they are depending on their pension plan to uphold its fiduciary responsibilities.

Quickly, Mr. Copland, can you give me a sense of how many shareholder proposals are submitted each year that don't contribute to beneficial information for investors, and instead just impose unnecessary costs on these investors?

Mr. COPLAND. Well, if we are just focusing on the proposals that involve social or policy issues, this year that was 50 percent, half of all proposals.

And I would also like to refer the committee, as I mentioned before what we have included in the record is our study by Professor Tracie Wooldtke, which shows specifically for public employee pension plans, that those public employee pension plans that have been pushing those social proposals through shareholder activism, it has associated negatively with firm value.

So it is something that I would worry about as a policymaker there in Illinois, or in any other state.

Mr. HULTGREN. My time has long since expired. I yield back, but may follow up with written questions, if that is all right, just to get some more information from y'all. Thank you very much for your time. Appreciate it.

Chairman, I yield back.

Chairman GARRETT. You are on, Mr. Scott?

Mr. SCOTT. Yes, sir, thank you very much, Mr. Chairman. I would like to address this to the entire panel and maybe get your thoughts on this because, I think it is very important and deals with Section 13-F in the reporting requirements. And a recent petition to the SEC uncovered what I personally believe is a shortfall in today's disclosure requirements for institutional investors.

And that is this. As written today, Section 13-F requires reporting requirements in the Securities Exchange Act. It requires that institutional investors report their long positions in companies within 45 days after each quarter. But not included in that disclosure are the short positions that they take.

And we tried in Dodd-Frank to fix this by giving the SEC authority to require short position reporting. But the deadline for these reports was once every month. So you see, there is a mismatch here, one is 45 days, the other is 30 days. So I think it would be helpful for us to know from each of you, are you aware of this discrepancy in the first place?

And then secondly, what is the impact of this disclosure and the inconsistency of it, and what will this impact be on the markets—45 days, 30 days.

Ms. STUCKEY. I can start if you want?

Mr. SCOTT. Yes, Ms. Stuckey.

Ms. STUCKEY. And maybe you will—13-F is part of what is called the Beneficial Ownership Rules. It has 13-D, as well, which is a 10-day rule. We think that these rules, again, as an example of, they are outdated. The timeframes haven't been brought into the, you know, modern era.



The idea about 45 days to put in your long positions I think was around because you needed the time to actually produce those numbers. Now those numbers can be produced in a day. So we don't need the 45 days.

The short positions I am not as familiar with, but I will tell you what I do know, that the short positions aren't disclosed at all except in the aggregate amount by the exchanges. So that might be the 30 days you are talking about.

We believe that the 13-F long positions are—that those time-frames need to be way shortened, and then the short position should match, whatever that is.

Just to leave to you with this, corporate directors and officers have to disclose their holdings in 2 days, their purchase and sales in 2 days. Companies have to disclose what they do, anything that is of interest on an 8-K in 4 business days.

Activist hedge funds who seek to buy up a lot of shares and then go after companies have 10 days, that is 13-D, and but investment managers have 45 days. So it doesn't quite seem fair. We think this needs to be looked at and needs to be—

Mr. SCOTT. Yes. Okay. Yes, anyone else here?

Ms. SIMPSON. Yes, thank you for the question. I think this is an excellent example of where the rules have completely been outdated by events. And we have highlighted in Regulation S-K disclosure the importance of making good use of technology. We are not arguing to go back to previous rules. We want to look ahead.

I think the other emphasis for us is we want to ensure that the disclosure regime favors the long-term, and, you know, we have said elsewhere that the rules are designed for shareholders. But in reality, we have a regime where you have owners, you have traders and you have raiders.

And on frequent occasion, CalPERS has stepped forwards to stand up for and run proxy campaigns against short-term activists to protect companies. We have done this at Apple with Carl Icahn. We have done it at DuPont with Trian. And we think that a lot of the short-term trading and activist pressure on companies is really detracting attention in companies from the long term.

Short-term executive pay has just thrown fuel onto the fire. But really this disclosure regime does need trimming up. It is a piece of unfinished business from Dodd-Frank. And another good reason why the SEC needs to have the money it needs to complete the job it has been given.

Mr. SCOTT. So do you see this as something that the SEC can do with how we move forward on this? Or is there something additional that this committee should be looking at to fix this situation, number one?

Ms. STUCKEY. There are two petitions for rulemaking in right now. My belief is that they, SEC, can act on them if they want.

Mr. SCOTT. Good. Thank you.

Chairman GARRETT. Thank you.

The gentleman from Arizona is recognized for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. Part of this is my own curiosity, so some of this is the education of David. Is it Ms. Simpson? You are CalPERS, correct? Yes? I have actually had a cu-

riosity, particularly haven't been around a number of the public pension systems.

At least in Arizona, we had always had the discussion that, okay, return to principal and maximizing safe yield was, you know, our sort of fiduciary, and sort of moral, ethical obligation to our current members and our retirees that—and yet, I know around the country, we have had a number of public pension systems that have that sort of specialized sort of fiduciary relationship with their participants.

And parts of their investment committee have gone on certain tangents. When you view the world and those special relationships and special requirements you have to maximize safety and maximize yield, don't you see sort of a conflict of chasing what may be perceived as a good cause, away from your obligation?

Ms. SIMPSON. Thank you for the question. You are highlighting the single most important issue for all pension funds and that is fiduciary duty. CalPERS fiduciary duty is set out in the California constitution.

Mr. SCHWEIKERT. Yes.

Ms. SIMPSON. So it cannot be overwritten by special initiatives, proposals or the legislature.

Mr. SCHWEIKERT. Well, but exactly to that point, because I don't mean to use CalPERS because I don't know enough about CalPERS. But let's say I have a system that is only funded the 70 percent, so I have a substantial shortfall in my actuarial soundness. And sometimes when an investment board gets together, we often appoint people who may represent certain union groups or political groups or professional staff.

And I get someone who has a, shall we say, a bug under the bonnet over certain social or societal issues. What happens when that starts becoming, either being woven into proxy fights, board seats, investment policy? How do you avoid that?

Ms. SIMPSON. It is avoided by having the fiduciary set out at the highest law of the land. There is no room in California law for the situation that you just described to take place.

Mr. SCHWEIKERT. Okay. So in that sort of situation—so would you ever consider that maybe those who is in financial services should consider maybe even a Federal additional shoring up of that fiduciary? That if we ever saw a particularly public pension system that actually had a shortfall, so they said, that if they were to violate that safety, soundness, yield sort of principle, that there might be penalties to be paid.

I mean would that be a rational approach for us just to make sure that the fidelity to the fiduciary, if you can say it that way, is upheld?

Ms. SIMPSON. My thought here is that you already have that. California constitution on fiduciary duty—

Mr. SCHWEIKERT. No, no. I am thinking sort of across the land.

Ms. SIMPSON. Then you are into a legal discussion about Federal versus state law rights. I do want to repeat, and I don't think you were here, sir. CalPERS went into the financial crisis over funded. We lost \$70 billion.

Mr. SCHWEIKERT. Well, we are actually—I know you say that—

Ms. SIMPSON. And—

Mr. SCHWEIKERT. —but I actually have a couple things in front of me that I should talk about there were some actuarial issues. Now, it wasn't actually CalPERS. It was your political, you know, some things done in the 1980s, some things done in the 1990s, some participation that would have done in your retirement curve. But that—

Ms. SIMPSON. Yes, you can find all of that on our website. We are very transparent.

Mr. SCHWEIKERT. Yes. No, no. And I actually love your website. And so—

Ms. SIMPSON. Thank you.

Mr. SCHWEIKERT. Okay, and I had two other questions, but Mr. Copland, you had something you wanted to share—

Mr. COPLAND. Yes. Well, I just wanted to—

Mr. SCHWEIKERT. —but I beg you to do it quickly.

Mr. COPLAND. —point out to the committee that I also co-authored a report looking at this specific pension fund issue in February of this year with my Manhattan Institute colleague, Steve Malanga. It is noted in footnote 106 on page 30 of my written testimony. So you can check it out if you—

Mr. SCHWEIKERT. I can't believe I missed that footnote.

Mr. COPLAND. But it is—in fact, CalPERS has at least 111 directives on environmental social governance, ESG issues. And in fact, in 2000, the board of CalPERS decided to invest in a lot of state and local real estate, doubled the exposure in real estate in the portfolio that CalPERS held over the next 6 years.

And that is one reason why their real estate portfolio dropped in half by 2009.

Mr. SCHWEIKERT. Well—

Mr. COPLAND. So I think these are real important things. And we flesh out a lot of the principles for governing.

Mr. SCHWEIKERT. Forgive me because we are done, and I am going to steal another 15 seconds. Look, I always want to make a little difference between what are investment decisions and what are sort of societal passions of those who end up on an investment committee.

You and I can argue about often where we place money, was it smart, did it meet the safety and soundness? This here sort of violates the concept of I need to put safety and soundness and yield.

And if there is a second round, Ms. Stuckey, I have a fascination with also why we don't do a better job sort of using the Internet, electronic disclosure, harmonization of timelines, even down to, okay, set back those thresholds of something for a proxy fight, but have the participation of that be requested through a website.

So you may be able to raise the thresholds, but it is a clear, cleaner, faster, easier way to get there and less costly.

I yield back, Mr. Chairman. Thank you.

Chairman GARRETT. Yes, the gentleman yields back.

Mr. Ellison is now recognized for 5 minutes.

Mr. ELLISON. I thank the chairman and the ranking member. You know, we have been talking quite a bit about corporate governance all week long, and I don't think anybody in America missed the situation in the Senate where John Stumpf, CEO of Wells

Fargo was questioned and in the banking hearing yesterday by every senator.

The CEO of Wells Fargo created a corporate culture that demanded low level bankers, folks making 12 to 13 bucks an hour to sell customers eight different products. You know, I guess I am not surprised, but it obviously led to a very difficult situation, 5,300 people selling over, making over 2 million fraudulent transactions.

So to me, you know, I think that the real question should be how do we promote good corporate governance, protect the public? I guess I don't accept that the only legitimate corporate governance issues are accessing capital and providing shareholder value.

You know, I think what some people might call, you know, their passions, I think there are a lot of other legitimate stakeholders whose interests should be brought into consideration in terms of corporate governance. Customers, community members, employees, the environment and, of course, shareholders, I think are all legitimate conversations and should be part of the overall question.

You know, in Sarbanes-Oxley and in Dodd-Frank Wall Street Reform and Consumer Protection Act, we clarified what good corporate citizenship means. Obviously, it should not require staffers to open 2 million fraudulent accounts in order to earn a living wage.

But it should be more than that. And when executives enable fraud there should be consequences. One of those consequences should be clawbacks of executive compensation. And we know who the people who would be responsible.

And whether or not they admit to the responsibility that they bear in these over 2 million fraudulent transactions are not, when you are running the show, you can hardly deny that you were deeply implicated in it. And there should be some level of accountability.

And I think that it is this single-minded pursuit of just shareholder value that probably leads to problems like this. And so I think it is good that we open up a broader lens.

So, let me just ask a few questions. Ms. Simpson, does CalPERS support Dodd-Frank's clawback requirement?

Ms. SIMPSON. Thank you, sir. We support the clawback provision in full. And prior to that there was a longstanding policy of CalPERS to ask companies to have a clawback provision because if someone is paid money that they have not earned, then you are transferring funds from the shareowners. And we have a sacred duty, a fiduciary duty to our members.

And if money is being wasted, or distributed to those who did not earn it, it is surely a matter of common sense, common economics. It is sad in a way that we have to request a rule to put something that obvious into effect.

But it is a good example of where Dodd-Frank did help to strengthen the corporate governance framework. And it is only a matter of regret that the SEC hasn't had the time and the funding to complete the job.

Mr. ELLISON. You know, also Ms. Simpson, I would like to get your opinion, can you describe the importance of say-on-pay provisions? You know, there is a provision that would require companies

to disclose a ratio of the compensation of its chief executive officer to the median compensation of employees.

I guess one of the witnesses didn't think this was a meritorious idea. But I wonder if you would offer your views on what you think about this particular provision?

Ms. SIMPSON. We found say-on-pay to be extremely beneficial because it has gotten companies' attention. I would say in CalPERS' experience in the 10,000 companies we invest in, as say-on-pay has become introduced into different markets, companies want to answer your phone call, because there is now a vote on something of great importance to the executives. So we have their attention. That is very important.

Secondly, what it has done is give us a halfway step if we are unhappy with the board's decisions. I think that many investors worry if pay is going wrong, is this something where you should just vote against board members, the compensation committee?

So I think many investors have found it is a very important signal. In other words, you can say no, but you can say it in a safe way. We typically have voted it against 20 percent of the proposals that have come our way.

There is much in excess actually of the proxy advisory firms that were being discussed earlier as though they lead the investors by the nose. And I would say quite the reverse, so a good example of that.

And also we have seen improvement as a result of investors' greater oversight, for example, lengthening of performance periods for pay plans. And that really gets at the heart of a real challenge in the capital markets, which is getting incentives aligned with the long term so that executives are thinking long term in the same way that we the owners are.

Mr. ELLISON. Thank you, Ms. Simpson.

Chairman GARRETT. Thank you. The gentleman yields back.

Mr. Hill is recognized now for 5 minutes.

Mr. HILL. I thank the chairman, and I thank the panel for being here this afternoon. Good discussion so far and one that certainly the committee's been interested in for the past year. I do want to start out talking about the proxy firms, ISS and Glass Lewis. And I haven't heard much discussion about them since I have been in the room.

So I would like to have the panel comment on those. The question would be what are the feelings about them serving in this capacity as sort of the proxy advisor and vote recommender, and yet they sell services to the companies that they oversee.

We will start with you Governor Engler?

Mr. ENGLER. We stated on the record and have written to the SEC relative to our belief that there are conflicts that exist when you are on both sides of the transaction, where you are on one hand making recommendations relative to different aspects of corporate governance.

And at the same time offering to sell to the company a strategy for them to solve those problems and then get their score higher. So we have encouraged some of the work that has been done, both in Congress and some of the work that is under way at the SEC to begin to address this.

Mr. HILL. Is your problem with the fact that it is just on paper an obvious sort of conflict, or do you think that they are—you don't agree with the advice?

Mr. ENGLER. Well, sometimes the advice is based on incomplete, inaccurate information. And one of the remedies that we have suggested is that before the proxy firms go out, and sometimes they go out very late in the process, and there is no time for the company to correct the record, that there ought to be, if you will, a draft report that at least the company has an opportunity to comment on and say, you are factually wrong.

There have been these cases where it was discovered and corrected, but there have been other cases where it simply came too late and it was not able to be corrected.

Mr. HILL. Yes. Ms. Simpson—I will return to you Mr. Copland, but let me ask Ms. Simpson about that, just representing from the pension side, your comments. You are certainly big enough, if you wanted to, you could not rely on proxy advisory firms. So what is your view on that?

Ms. SIMPSON. Thank you for the question. We don't rely on proxy firms. As you rightly say, CalPERS has a very large, well-qualified staff. We engage with typically over 1,000 companies a year directly talking, visiting them, them visiting us. And our primary source of information is the company. And that is extremely important to us.

However, we do find it useful, as we do with all of our financial decisions, to have a wide range of different information. And you can see from CalPERS' proxy voting record that it doesn't reflect the advice of the proxy voting firms that we use.

But on any investment decision we buy data, we buy information, Bloomberg, MSCI, Standard & Poor's, Moody's, a wide range of financial analysis. And we see this as helpful as going into the mix.

Mr. HILL. What—

Ms. SIMPSON. So we make our own voting decisions. That is essential.

Mr. HILL. Yes. You can do that, and I think that is terrific, but a lot of people, like the rest of us, you know, can't. And so I am an economic investor. I am interested in maximizing the value long term of my retirement assets, for example. And so I, as a personal investor, I might not put a big premium on ESG-type proposals, personally, let us say.

But don't I have to live with that because the 401(k) or the mutual fund companies that I use a lot of them, are using one of these two companies? So doesn't it take away a right maybe of an individual investor?

Mr. Copland, what do you think on that?

Mr. COPLAND. Yes, I do think that is a significant consideration. And I have done a fair amount of research on proxy advisory firms. It is available in Section—I think it is Section 4—no, Section 5 of my written testimony. And ISS has a hard job, as does Glass Lewis. I want to make that clear at the outset.

I mean by its own estimation, it helps 1,600 clients execute 8.5 million ballots, representing more than 2 trillion shares annually. And to do that, it has an annual budget of about \$120 million, as

of 2 years ago when it was owned by a publicly traded company, with about 700 employees. So that is a very tricky job to execute.

The problem is, as I stated before, but the problem is there is a misalignment between what ISS does and what the median shareholder wants. And ISS, nevertheless, has a significant impact on the percentage vote that you see on—because of smaller institutional investors. Big pension funds don't have to compete for capital. Mutual funds out there in the market do.

And so they are doing everything possible to minimize their cost structure. What that means is being a more efficient voter isn't a smart strategy for them. A big company, like a Vanguard or a Fidelity can do it, but smaller mutual funds aren't going to do it. They are going to rely on the proxy advisor.

And what that means is based on our econometric analysis, controlling for other factors, ISS acts as effectively a 15 percent owner of the Fortune 250 when it comes to shareholder proposal voting. That is an enormous amount of influence that is placed into play.

Now, it is not necessarily going to tip the ballots over. These social policy proposals that ISS is more likely to support, they are eight times more likely to support a shareholder proposal than the median investor is. That is what our research finds.

So what it means though, is that ISS can be subject to capture by the institutional investors that have an interest in certain issues, be they social investing funds or be they public pension funds that are often led by, as New York's funds are, partisan elected officials.

And in doing so, they can move ISS' positions away from that of the median shareholder. And precisely because of these very low resubmission thresholds that the governor and Darla talked about, it means ISS can effectively keep an item on the ballot indefinitely, even when 88 percent of shareholders are voting against it every year.

Chairman GARRETT. The gentleman's time has expired.

I think we have been around one time and without objection we go around a second time as we wait. So I guess it is, as we go back and forth.

Mr. SHERMAN. Oh, good.

Chairman GARRETT. I will go.

Mr. SHERMAN. Ms. Simpson, obviously you make your own voting decisions—

Chairman GARRETT. Never mind. I will restart the clock. I was going to make my comment, but—

Mr. SHERMAN. Okay. Not everyone has your large a staff. Would you prefer your fellow voters and shareholders get professional advice or just rubber-stamp whatever management tells them?

Ms. SIMPSON. Independent advice is always a good idea. The interests of shareowners and management, they are usually pretty well aligned. You know, ultimately we are on the same side.

Mr. SHERMAN. Yes.

Ms. SIMPSON. We want companies to do well. We want prosperity. We want good returns. Unfortunately—

Mr. SHERMAN. Okay. I represent a lot of your members. I couldn't agree more.

Ms. SIMPSON. But unfortunately there are areas of conflict. Executive compensation is a great idea. And for a small investor to look at that executive compensation disclosure, so complicated, and working out how it has changed over time, how to compare it with other companies, how to relate it to the financial performance.

Gee whiz, you need a Ph.D. in something to work that out. So I think that in the free flow of information in the markets—

Mr. SHERMAN. Would you feel better as a major owner of Wells Fargo if they had a good clawback procedure that would make sure that any executive who perhaps left the company recently with over \$100 million would have their compensation adjusted for what was really happening?

Ms. SIMPSON. CalPERS has had a policy on clawbacks in favor of clawbacks, which is simply unearned rewards, which come out of shareowner funds. We have had that policy before Dodd-Frank.

We will continue to have it and hope the SEC rulemaking is possible and, you know, it will all be finished and wrapped up soon. But it is an essential—

Mr. SHERMAN. Yes.

Ms. SIMPSON. —it is an essential principle of fairness, of common sense, of alignment of interests.

Mr. SHERMAN. I would point out if Dodd-Frank had been promptly implemented, Wells Fargo executives might have the right incentives and Wells Fargo might have 2 million fewer accounts. But it has taken the SEC a long time. We hope they get there.

I will also point out that if the chairman's legislation is passed, then all future corporations will not have the clawbacks that would have been relevant to Wells Fargo.

Now, I have heard an estimate of \$90 million as the cost of some level of shareholder democracy. One of the witnesses said that that was the cost of dealing with these proposals, didn't include board member time.

How much shareholder value is lost because of crony capitalism, where boards prevent mergers, acquisitions that would have increased shareholder value but were not in the interest of the board members and especially not in the interest of the management that kind of selected them?

Do you think that if every board decision on whether to agree to a merger was made in the shareholder interest that shareholders might be enriched by an amount, say, over \$90 million?

Ms. SIMPSON. Looking at the numbers just on Wells Fargo, we have about \$1 billion in that company, equity and debt. And then we have lost—

Mr. SHERMAN. So you have lost—

Ms. SIMPSON. —I would have to say about 11 percent.

Mr. SHERMAN. Yes.

Ms. SIMPSON. So something over \$90 million, just in the one—

Mr. SHERMAN. Just on that—

Ms. SIMPSON. —reaction throughout the market that—

Mr. SHERMAN. —one company just from one—

Ms. SIMPSON. Yes.

Mr. SHERMAN. —series of 2 million decisions that were not in the public interest. And there can, significant—you know, corporations choose to incorporate under the laws of whatever state does the



best job of protecting management and furthering the goals of crony capitalism.

Would CalPERS be in a better position if the corporation codes of all the states had the same level of shareholder protection that California does? At least as applicable to the two or—you know, the major publicly traded corporations?

Ms. SIMPSON. Well, two of the shareowner rights that we think are most important are majority voting. That is the ability to vote no, as well as yes, on a directors' election, and proxy access, which gives us, the owners, the right to put forward candidates on to the ballot.

And I am going to have to ask my learned colleagues. There are one or two states which have those provisions, but the main states where incorporation is popular, Delaware, California and more actually do not have that in the default—

Mr. SHERMAN. Delaware is out there advertising, in effect, we will protect management. We will defeat efforts to enhance shareholder value. Incorporate here. And needless to say, that has caught the attention of management. We ought to have shareholder protections that are national in nature. I see the governor would like to comment, but I think I am—

Chairman GARRETT. Well, since we are already going over here a little bit.

Mr. ENGLER. Well, I am amused at these questions and the aspersions being cast here that there are these boards of directors running amok, somehow doing something that is in a breach of their fiduciary duty. And I am also somewhat assumed at citing CalPERS. You have mentioned how many constituents. I am looking at the Bloomberg report.

CalPERS last year earned a rousing 0.6 return and Ted Eliopoulos, the chief investment officer, said, you know, that is below the assumed rate of 7.5 percent. He said, "That's a significant policy issue."

If I were worried about somebody's dad, I would be worried about somebody who is hoping to get a pension from CalPERS with that puny rate of return. And maybe it is crony capitalism that is doing it. Maybe it is investment strategy. I don't know, but—

Mr. SHERMAN. Good Governor, not everyone can make a 7.5 percent return in this particular economy.

Mr. ENGLER. Zero point six.

Mr. SHERMAN. And many, many investors lost a lot of money, last year. And she just lost—or rather the organization she represents, just lost hundreds of millions of dollars because of the bad corporate governance that we would like to see ended, by enforcing and passing the regulations for clawback, rather than supporting legislation that would eliminate this.

Mr. ENGLER. I don't think that is factually accurate and is—

Mr. SHERMAN. You don't think she has lost hundreds of millions of dollars on Wells Fargo stock?

Mr. ENGLER. Nope.

Mr. SHERMAN. As the stock price has—

Ms. SIMPSON. I would be happy to—

Mr. ENGLER. As of what date?

Ms. SIMPSON. —share the numbers. No, it is that—

Mr. ENGLER. As of when?

Ms. SIMPSON. I am happy to follow up with the detail, and we can—

Mr. SHERMAN. Anyone who owned a billion dollars, that level of corporate stock has lost an awful lot of money as the stock has declined by 10 percent—as we have learned that management can't prevent 2 million frauds.

Mr. ENGLER. They did fire 5,300 employees that they found and that—

Mr. SHERMAN. That they hired—

Chairman GARRETT. The gentleman's time—we are going down a different road here from corporate governance here. So—

Mr. SHERMAN. Thank you.

Chairman GARRETT. So the gentleman's time has expired.

I recognize myself for 5 minutes. And I wasn't going to go down this road, but Ms. Simpson, one of the previous questions was with regard to clawback provisions. And I am sort of growing in this field as far as clawback provisions.

Because you look back at 2008 and the crisis of 2008, and you look at the larger financial institutions. You look at the management of those institutions at the time. And the collapse that occurred in them.

You looked at the banking and financial institutions that were then bailed out by all of us, by the American taxpayers. But there was never any clawback in those cases, was there?

Ms. SIMPSON. Yes—

Chairman GARRETT. Not to speak of.

Ms. SIMPSON. No, we had a policy throughout those periods. And it was dubbed pay for failure.

But Darla has a comment about Sarbanes-Oxley.

Ms. STUCKEY. Sarbanes-Oxley has a clawback provision for the financial institutions, and most all of the big finance—well, all the big financial institutions I can almost assure you have clawback provisions.

Chairman GARRETT. But we saw a number of the CEOs and the COOs getting fairly large salaries during that time and afterwards. And we saw those companies then basically fail or be wrapped around by the government. And I don't remember that I saw them, any clawbacks from their salaries. And then we also saw—

Ms. STUCKEY. What the reason why you might not have seen it, is because they don't always publish who they take money back from, and—

Chairman GARRETT. Well, I have asked some of them actually—

Ms. STUCKEY. Okay.

Chairman GARRETT. —these former COOs whether they were clawed back and they said no. And we also saw another thing, a phenomena that was called—what was it called, bureaucratic parachutes for some of these companies who then when their COOs or what have you, leave the companies and they basically get paid to go into government.

But, heck, we see that our own secretary of Treasury, don't we? That they get paid lavish salaries. The company fails. And there are absolutely no clawbacks.

Mr. Copland?

Mr. COPLAND. Well, yes, I just want to shed some empirical light on this, because you have a number of shareholder proposals that involve executive claw backs or what are so-called golden parachutes that really change in control or government service types of provisions. They almost universally are voted down by a majority of shareholders.

Part of the reason for that is I think that there is a concern, in terms of recruiting the right talent about that. Things like government service are things that a company's shareholders may want to have.

And what they are usually are involving are situations where they have options that haven't vested and they will accelerate those so there is no conflict of interest for the executive when entering the government. But I just want to emphasize that—

Chairman GARRETT. Well, let me finish—

Mr. COPLAND. —by and large shareholders vote against those proposals.

Chairman GARRETT. Let me just go to the Governor Engler here. And some—one of my opening comments, let us talk back again. This is the no-action letters by the SEC. Right? You saw them back in Cracker Barrel in 1997.

I made reference to the one by Mary Jo White back in 2015, where she reversed course on that. Can you spend 30 seconds on that, of the process that the SEC currently uses. The reversal process that the SEC currently has engaged in.

And so does the current no-action process, is it an effective method that they are using right now? Or is this creating uncertainty, as I guess they call it, a decentralized issue by issue process that is going on right now in the market?

Mr. ENGLER. It certainly is issue by issue, but I would say it is the uncertainty is what is the problem in the—I am looking for my written—oh, there we go. Thank you. It was in the broader testimony, I didn't get a chance to speak this, but we had suggested revisions to the no-action letter process.

And we said since it is done at the staff level, it kind of—we were arguing maybe it ought to come up to the actual appointees, the commissioners themselves, because they actually bear the ultimately responsibility. And when you get it down at the staff level, issue by issue, situation by situation, it leads to inconsistent guidance. And that is the difficulty.

Chairman GARRETT. And I keep going off of the previous comment prior to this as for—Mr. Copland, you were making reference, and I am trying to—I can't get your exact words, but I will throw it out and you can bring me back to it.

So you are saying, some of these institutions or actually investment firms are, you know, politicized, if you say, as far as who is actually running them. They are politicians, and I don't think that was your exact words. Can you talk again about that? Because as their returns, their involvement, their position on the issues versus what you call the average?

Mr. COPLAND. Yes, what Professor Woitke's study which should be included in the record—

Chairman GARRETT. Yep.

Mr. COPLAND. —showed was that the social issue investing, when that was the focus of the shareholder proposal activism by public pension funds—

Chairman GARRETT. Yep.

Mr. COPLAND. —they had lower—it was associated with lower firm value than with those focused exclusively on other issues, or than private pension funds, which was really sort of the test case there.

Chairman GARRETT. And then you push that to who is actually making these decisions. And I thought you referred to, well, these are appointed people, elected officials?

Mr. COPLAND. Well, that is certainly part of it. Part of the Copland-Malanga paper that I referenced that came out in February, is looking at the actual board governance of the pension funds.

Chairman GARRETT. Right. Right.

Mr. COPLAND. They focus a lot on the board governance of corporations. But when you actually look at their board governance, it tends to be abysmal by the same standards they want to hold corporations to.

And looking at, say, New York, where the sole fiduciary is an elected partisan official and then is filing most of the shareholder proposals—the funds are filing most of the shareholder proposals involving corporate political spending, we think that is an issue particularly where we have found an association between the likelihood that a Fortune 250 company draws a shareholder proposal involving corporate political spending and lobbying, and the propensity of that company's PACs and executives to give disproportionately to Republican candidates.

Chairman GARRETT. So is it fair to say the bottom line on that is that you see a poorer rate of return when these social issues are involved where, and it is truly the case of crony capitalism, but it is crony capitalism in the worst sense because it is connected to politics and the politicians being involved with it.

Mr. COPLAND. Sure, sure. At the end of the day, the pension funds don't have to compete for capital. And at the end of the day, often there are constitutional backstops so the taxpayers will make up the deficits that the governor was talking about.

Chairman GARRETT. Got you. Thank you.

Mr. Ellison? You are recognized.

Mr. ELLISON. Thank you. Now, I would like to just ask about what the potential impact of some of the provisions we are looking at regarding disclosure might be.

Section 450 and 451 of the chairman's Wrong Choice Act would repeal the registration requirement for private equity fund advisors in Dodd-Frank and with it all the other protections in the Investment Advisors Act, aside from books and recordkeeping requirements that the SEC may impose.

Similarly, we just considered H.R. 5424 on the House floor, which would have diminished the number of protections for investors in private equity funds, including basic disclosures like the change in ownership of advisor funds—a fund's advisor.

And so I wonder if you all care to share any views on this issue? I would like to know what you think the importance of the current

disclosures and other requirements that apply to private equity advisors and whether there is a need for even greater disclosure.

Maybe we can go to other panelists but, I would like to start with Ms. Simpson.

Ms. SIMPSON. Thank you for the question. Over half of CalPERS' portfolio is invested in public markets. But about a quarter is invested in private markets. And we have to understand that companies may begin in the private markets and graduate. And sometimes they are in the public markets and, you know, go back into the private markets.

So for us, looking at the question of transparency and accountability, we are providers of capital into both public and private markets. So it is extremely important for us that the private equity universe matches our requirements for transparency and accountability. So this proposal is a matter of great regret.

We don't think that it will assist with investors providing capital into this form of asset class. And it is one which is exceptionally important for our overall rate of return. So capital formation is just as important for companies coming to market as it is for those returning back to the private markets. And we need to see a level playing field.

We think that is good for capital formation, and therefore, it is ultimately good for the companies, too. And if the companies do well, we do well. And that is how our investment returns will improve, is if the market returns improve, which is why the governance agenda is so important.

Mr. ELLISON. Any other panelists want to offer a view?

Mr. COPLAND. Well, I will offer one, just in the sense that I think it is important to distinguish between a publicly traded corporation or a broad-based mutual fund and a private equity fund.

I mean we have a system of securities laws that applies to publicly traded corporation under the premise that we are protecting small shareholders that may not be sophisticated, and so we want to make sure that enough information is getting out there to protect those small investors. Private equity funds are quite different.

There is a reason why we are seeing more private equity, 144A types of capital, being raised. They are raised from so-called sophisticated investors, qualified investors, tend to be high net worth individuals and often pension funds and other investors, mutual funds, et cetera, that can take positions in those companies. So those are more sophisticated investors.

I don't think it is correct to say that there should be an apples-to-apples disclosure regime between the two, because they are two very different types of investment.

Representative Sherman, who is standing up, made the case earlier that maybe it is the private equity markets and the vibrancy of private capital that partially explains the decrease, the significant decrease, we have seen in publicly traded corporations over time.

That may or may not be true, but we certainly don't want to discourage that option by applying rules that are intended for small investors to qualified, sophisticated investors.

Mr. ELLISON. Thanks a lot.

I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

The gentleman from California will have the last word, I believe.

Mr. ROYCE. Thank you very much, Mr. Chairman. Thank you witnesses for being with us today. And, you know, I guess one of the things that really weighs on us, since the amount of income per worker is partly dependent upon investment per worker, and that is dependent upon productivity, which is dependent upon the money in our capital markets that go in it, and were invested.

And yet, if we looked at this trend, the U.S. has half as many publicly traded companies traded on exchanges today, as it did in 1996. That is a pretty precipitous drop. And that trend is particularly alarming for a Californian like myself because, you know, the startup capital of the world is out in our neck of the woods.

And so firms that would otherwise go public have been deterred and arguably, if you listen to the firms, they say they are deterred by unnecessary hurdles on compliance, which what was it Aristotle said, balance in all things which are unbalanced?

And the consequences of that is unrealized economic growth that might otherwise occur, and job creation that might otherwise be driven.

So Governor Engler, the stockholder proposal resubmission thresholds have not been changed since President Eisenhower's term here, and clearly they are outdated.

But Rule 14a-8, also allows shareholders who have held \$2,000 of a company's stock for 1 year to submit a proposal to be included in a company's proxy statement. So looking at that in its totality, what are the consequences for companies and everyday shareholders of this seemingly arbitrary and relatively low \$2,000 floor? And I am just thinking this through.

For example, just 20 shares or 0.000000003 percent of Apple's worth then you have that included in the company's proxy statement. How will scaling this barrier of entry to a company's valuation benefit shareholders and how would it benefit public companies? How would it benefit the economy?

Mr. ENGLER. Congressman, it is a great question. I think when there is additional cost, whatever is the reason for it, and this is a set of circumstances that do raise costs. You heard a \$90 million number tossed out earlier, but depending on the company, it can be more or less substantial.

There is reputation risk also that can be brought into play. That is hard to put a value on. But it raises costs, and I would argue then diminishes shareholder value. And that shouldn't be a desirable thing, especially when the other side of this argument is that the question, or the proposal in this case, might have been around the track two, three or more times and has very low likelihood of any success.

Yet it does distract however much from management time, from legal time, and it adds also, I think, complexity to a proxy statement which ought to be focused, as I testified earlier, in the most material things that can help an investor decide do I want to own this stock, or should I sell it?

Mr. ROYCE. So again, we have half as many publicly listed companies trading on the exchanges. So I will ask you Governor Engler also about no-action letter decisions from the SEC that have been

arguably erratic and inconsistent, especially since the Whole Foods case.

Mr. ENGLER. Right.

Mr. ROYCE. How has the growing failure to dismiss immaterial proposals impacted shareholders? And is keeping this decision process at the commission staff level appropriate? What does—

Mr. ENGLER. Well, I—

Mr. ROYCE. —Congress do here? How could Congress help on this?

Mr. ENGLER. Congressman, I think that the first step is can we get the SEC back to work on this and can the commission itself address this? They have it within their own rulemaking authority to handle this problem.

It was really created, we felt, by the staff initially. We are surprised that it wasn't addressed. There is a division clearly in thinking over at the commission, and so they punted on it. But the punt ended up putting a lot more, I would say, proposals with relatively little merit before shareholders, and it was unnecessary.

Mr. ROYCE. Well, I thank you. I thank the panel here and Mr. Chairman, I think my time has expired.

Chairman GARRETT. I am sorry. The gentleman yields.

Mr. ROYCE. I yield.

Chairman GARRETT. The gentleman yields back. And with that, I thank you all again for your time and input and the answering of the questions. We obviously touched upon some things that were off where we thought we were going to go, But that is all good as well.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And with that, I thank all the witnesses. And without objection, this hearing is adjourned.

[Whereupon, at 4:58 p.m., the hearing was adjourned.]





# **A P P E N D I X**

September 21, 2016



Statement to the House Committee on Financial Services  
Subcommittee on Capital Markets and Government Sponsored Enterprises

**Hearing on Corporate Governance:  
Fostering a System that Promotes Capital Formation and Maximizes Shareholder Value**

September 21, 2016  
2:00 p.m.  
Rayburn House Office Building, Room 2128

***SEC Rule 14a-8: Ripe for Reform***

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*The Manhattan Institute for Policy Research does not take institutional positions on legislation, rules, or regulations. Although my comments draw upon my long-running research on shareholder proposals and corporate governance as an Institute scholar, my statement before the subcommittee is solely my own, not my employer's.*

### About Mr. Copland

James R. Copland is a senior fellow at the Manhattan Institute, where he has served as director of legal policy since 2003.<sup>1</sup> He has authored many policy reports; book chapters; articles in academic journals including the *Harvard Business Law Review* and *Yale Journal on Regulation*; and opinion pieces in publications including the *Wall Street Journal*, *National Law Journal*, and *USA Today*. Mr. Copland has testified before Congress as well as state and municipal legislatures; speaks regularly on civil- and criminal-justice issues; has made hundreds of media appearances in such outlets as PBS, Fox News, MSNBC, CNBC, Fox Business, Bloomberg, C-Span, and NPR; and is frequently cited in news articles in periodicals including the *New York Times*, *Washington Post*, *The Economist*, and *Forbes*.

In 2011, Mr. Copland helped launch the Manhattan Institute's Proxy Monitor database,<sup>2</sup> a publicly available catalogue of shareholder proposals at the 250 largest publicly traded American companies, by revenues, as determined by *Fortune* magazine.<sup>3</sup> Mr. Copland has periodically authored or co-authored findings and reports on the shareholder-proposal process,<sup>4</sup> as well as writing on the subject in popular<sup>5</sup> and academic<sup>6</sup> journals. In 2011 and 2012, Mr. Copland was named to the National Association of Corporate Directors "Directorship 100" list, which designates the individuals most influential over U.S. corporate governance.<sup>7</sup>

Prior to joining the Manhattan Institute, Mr. Copland served as a management consultant with McKinsey and Company in New York and as a law clerk for Ralph K. Winter on the U.S. Court of Appeals for the Second Circuit. Mr. Copland has been a director of two privately held manufacturing companies since 1997 and has served on multiple government and nonprofit boards. He holds a J.D. and an M.B.A. from Yale University, where he was an Olin Fellow in Law and Economics and a Teaching Fellow in Macroeconomics and Game Theory; an M.Sc. in Politics of the World Economy from the London School of Economics and Political Science; and a B.A. in Economics, with highest distinction and highest honors, from the University of North Carolina at Chapel Hill, where he was a Morehead Scholar and was awarded the Honors Prize in Economics.

<sup>1</sup> See James R. Copland, <https://www.manhattan-institute.org/expert/james-r-copland>. The Manhattan Institute is a non-profit, non-partisan think tank developing ideas that foster economic choice and individual responsibility. See About MI, <https://www.manhattan-institute.org/about>.

<sup>2</sup> See Proxy Monitor, <http://www.proxymonitor.org/> ("ProxyMonitor.org is a unique, publicly available database that tracks shareholder proposals in real time.").

<sup>3</sup> See Fortune 500, <http://beta.fortune.com/fortune500/> ("In total, Fortune 500 companies represent two-thirds of the U.S. GDP with \$12 trillion in revenues, \$840 billion in profits, \$17 trillion in market value, and employ 27.9 million people worldwide."). Because several of the Fortune 250 companies are not publicly traded, some of the companies among the 250 largest that are subject to SEC proxy rules are from the broader Fortune 300 group.

<sup>4</sup> See Proxy Monitor, Reports and Findings, [http://proxymonitor.org/Forms/reports\\_findings.aspx](http://proxymonitor.org/Forms/reports_findings.aspx).

<sup>5</sup> See, e.g., James R. Copland, *Getting The Politics out of Proxy Season*, WALL ST. J., Apr. 23, 2015, available at <https://www.manhattan-institute.org/html/getting-politics-out-proxy-season-5461.html>; Copland, *Politicized Proxy Advisers vs. Individual Investors*, WALL ST. J., Oct. 7, 2012, available at <https://www.manhattan-institute.org/html/politicized-proxy-advisers-vs-individual-investors-3863.html>.

<sup>6</sup> See James R. Copland, *Against an SEC-Mandated Rule on Political Spending Disclosure: A Reply to Bebchuk and Jackson*, 3 HARV. BUS. L. REV. 381 (2013).

<sup>7</sup> See NACD 2012 Honorees, <https://www.nacdonline.org/directorship100/2012honorees.cfm> ("Each year, NACD Directorship identifies the most influential people in the boardroom community, including directors, corporate governance experts, journalists, regulators, academics and counselors.").

### Written Statement

Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee, my name is James R. Copland. Since 2003, I have been a senior fellow with and director of legal policy for the Manhattan Institute for Policy Research, a public-policy think tank in New York City. Although my comments draw upon my research conducted for the Manhattan Institute,<sup>8</sup> my statement before the subcommittee is solely my own, not my employer's.

I would like to thank you for the invitation to testify today. One of the topics of focus for today's hearing has constituted a significant focus in my recent research: the shareholder-proposal process governed by the Securities and Exchange Commission's Rule 14a-8. I will leave discussion of new disclosure rules under the FAST Act and Dodd-Frank Act to other witnesses, although I will share some of my specific research related to proposed additional disclosures of corporate political spending and lobbying, which are a matter of current controversy.

### Summary of Argument

The SEC's Rule 14a-8 permits stockholders of publicly traded companies who have held shares valued at \$2,000 or more for at least one year to introduce proposals for shareholders' consideration at corporate annual meetings.<sup>9</sup> The SEC's process is ripe for reform:

- The shareholder-proposal process has strayed far from the principal legal purpose authorizing the rule under the Securities Exchange Act—namely ensuring that shareholders obtain adequate, non-deceptive disclosures to inform their investment decisions.
- The shareholder-proposal process has been used almost exclusively by a small number of investors, with a focus potentially or actually centered on concerns other than maximizing share value—the principal state corporate law focus that defines directors' and managements' fiduciary duties.
- The shareholder-proposal process has actually operated to permit such minority shareholders to extract corporate rents or influence corporate behavior to the detriment of the average diversified shareholder.

Potential solutions to this problem include:

<sup>8</sup> Some language in this testimony may be identical to that in the author's previous publications. In addition, I have included the following Manhattan Institute reports as appendices, to be incorporated by reference: James R. Copland & Margaret M. O'Keefe, *Proxy Monitor: A Report on Corporate Governance and Shareholder Activism* (Manhattan Institute 2015), available at [http://www.proxymonitor.org/Forms/pmr\\_11.aspx](http://www.proxymonitor.org/Forms/pmr_11.aspx); Tracie Woidtke, *Public Pension Fund Activism and Firm Value* (Manhattan Institute 2015), available at <https://www.manhattan-institute.org/html/public-pension-fund-activism-and-firm-value-7871.html>. Some data and analysis in this testimony draw upon that developed for the Manhattan Institute's 2016 Proxy Monitor report, to be released later this fall, authored by myself with Ms. O'Keefe.

<sup>9</sup> See 17 C.F.R. § 240.14a-8 (2007) [hereinafter *14a-8*].

- Revisiting the SEC’s 1976 rule forcing companies to include on their proxy ballots most shareholder proposals that involve “substantial policy . . . considerations”—an approach I have publicly favored.<sup>10</sup>
- Forcing shareholder-proposal sponsors to reimburse the corporation at least some portion of the direct costs of assessing, printing, distributing, and tabulating their proposals if any proposal fails to receive majority or threshold shareholder support—an idea suggested by Yale Law professor Roberta Romano.<sup>11</sup>
- Revising the SEC’s rule permitting companies to exclude resubmitted shareholder proposals if they fail to garner minimum threshold shareholder support within the preceding five calendar years<sup>12</sup>—an idea suggested by the U.S. Chamber of Commerce and other business groups in a 2014 rulemaking petition submitted to the SEC.<sup>13</sup>

I focus my testimony on the following subjects:

- (1) the legal background surrounding Rule 14a-8;
- (2) the principal sponsors of shareholder proposals;
- (3) the principal subject matters of shareholder proposals;
- (4) shareholder-proposal voting results;
- (5) the role of proxy-advisory firms;
- (6) shareholder-proposal resubmissions;
- (7) the controversy surrounding corporate disclosure of political spending and lobbying; and
- (8) the potential value-destroying impact of social-issue investing on public-employee pension funds.

### ***I. Legal Background***

Pursuant to its authority under the Securities Exchange Act of 1934,<sup>14</sup> the SEC first promulgated a “shareholder proposal rule”—the antecedent to the current Rule 14a-8—in 1942.<sup>15</sup> Then-SEC chairman Ganson Purcell explained the purpose of the rule to the House Interstate and Foreign Commerce Committee as follows:

Once a shareholder could address a meeting[;] today he can only address the assembled proxies which are lying at the head of the table. The only opportunity that the stockholder has of expressing his judgment comes at the time when he considers the execution of the proxy form, and we believe, whether we are right and whether we are wrong—and I think

<sup>10</sup> See James R. Copland (2015), *supra* note 5.

<sup>11</sup> See Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. REG. 174, 229–49 (2001).

<sup>12</sup> See 14a-8, *supra* note 9, at 14a-8(i)(12).

<sup>13</sup> See Thomas Quaadman, Request for Rulemaking to Amend Rule 14a-8 under the Securities Exchange Act of 1934 Regarding Resubmission of Shareholder Proposals (Apr. 9, 2014).

<sup>14</sup> Pub. L. No. 73-291, Ch. 404, 48 Stat. 881 (1934) (codified at 15 U.S.C. §§ 78a–78oo (2006 & Supp. II 2009)), at §§ 78m, 78n & 78u; 15 U.S.C. §§ 80a-1 to 80a-64 (2000) (pursuant to Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 841 (1940)).

<sup>15</sup> See Securities Exchange Act of 1934 Release No. 3347 (Dec. 18, 1942), 7 Fed. Reg. 10,653 (1942).

we are right—that that is the time he should have the full information before him and the ability to take action as he sees fit.

The proxy solicitation is now in fact the only means by which a stockholder can act and can perform the functions which are his as owner of the corporation. It, therefore, seems clear to us that only by making the proxy a real instrument for the exercise of those functions can we obtain what the Congress and this committee called for in the form of “fair corporate suffrage.”<sup>16</sup>

In a 1945 opinion release, the director of the SEC’s division of corporate finance explained:

Speaking generally, it is the purpose of [the shareholder proposal rule] to place stockholders in the position to bring before their fellow stockholders matters of concern to them as stockholders in such corporation; that is, such matters relating to the affairs of the company concerned as are proper subjects of stockholders’ action under the laws of the state under which it was organized. It was not the intent of [the rule] to permit stockholders to obtain the consensus of other stockholders with respect to matters which are of a general political, social or economic nature. In short, [the rule] should operate so as to leave intact the primary substantive regulation which state law seeks to achieve.<sup>17</sup>

The opinion release was predicated on the well-founded understanding that the Securities Exchange Act’s delegation of powers overseeing the proxy process to the SEC did not alter the substantive rights governing such measures, which would remain largely a question of state corporate law.<sup>18</sup> In 1952, the SEC again emphasized that companies could exclude shareholder proposals that were introduced “primarily for the purpose of promoting general economic, political, racial, religious, social, or similar causes.”<sup>19</sup>

<sup>16</sup> Hearings on H.R. 1498, H.R. 1821, and H.R. 2019, Before the House Committee on Interstate and Foreign Commerce, 78th Cong., 1st Sess., pt. 2, at 174-75 (1943).

<sup>17</sup> Securities Exchange Act Release No. 3638 (Jan. 3, 1945), 11 Fed. Reg. 10,995 (1946).

<sup>18</sup> As the Supreme Court emphasized in its 1987 decision in *CTS Corp. v. Dynamics Corp.*, “No principle of corporation law and practice is more firmly established than a State’s authority to regulate domestic corporations, including the authority to define the voting rights of shareholders.” 481 U.S. 69, 89. The section of the Securities Exchange Act upon which Rule 14a-8 is promulgated, § 14(a), is principally designed to ensure corporate disclosures to shareholders to afford investment information and prevent deception. *See J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964) (“The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation.”). In its 1990 *Business Roundtable* decision, the D.C. Circuit Court of Appeals explained further:

That proxy regulation bears almost exclusively on disclosure stems as a matter of necessity from the nature of proxies. Proxy solicitations are, after all, only communications with potential absentee voters. The goal of federal proxy regulation was to improve those communications and thereby to enable proxy voters to control the corporation as effectively as they might have by attending a shareholder meeting.

*Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (“While the House Report indeed speaks of fair corporate suffrage, it also plainly identifies Congress’s target—the solicitation of proxies by well informed insiders ‘without fairly informing the stockholders of the purposes for which the proxies are to be used.’” (citing H.R.Rep. No. 1383, 73d Cong., 2d Sess. 14 (1934))). *See also* S.Rep. No. 792, 73d Cong., 2d Sess. 12 (1934) (characterizing purpose of proxy protections as ensuring stockholders’ “adequate knowledge” about the “financial condition of the corporation”).

<sup>19</sup> Exchange Act Release No. 4775, 17 Fed. Reg. 11,431, 11,433 (1952).

That rule would exist until the early 1970s, when a decision by the D.C. Circuit Court of Appeals challenged the application of the rule by the SEC staff, which in April 1969 had issued a no-action letter to Dow Chemical permitting the company to exclude a shareholder proposal from the Medical Committee on Human Rights asking that the company cease manufacturing napalm.<sup>20</sup> The circuit court invoked the “philosophy of corporate democracy” in sharply questioning the rule as applied:

No reason has been advanced in the present proceedings which leads to the conclusion that management may properly place obstacles in the path of shareholders who wish to present to their co-owners, in accord with applicable state law, the question of whether they wish to have their assets used in a manner which they believe to be more socially responsible but possibly less profitable than that which is dictated by present company policy. . . . We think that there is a clear and compelling distinction between management’s legitimate need for freedom to apply its expertise in matters of day-to-day business judgment, and management’s patently illegitimate claim of power to treat modern corporations with their vast resources as personal satrapies implementing personal political or moral predilections. It could scarcely be argued that management is more qualified or more entitled to make these kinds of decisions than the shareholders who are the true beneficial owners of the corporation; and it seems equally implausible that an application of the proxy rules which permitted such a result could be harmonized with the philosophy of corporate democracy which Congress embodied in section 14(a) of the Securities Exchange Act of 1934.<sup>21</sup>

Technically, the court did not overturn the SEC’s rule but rather remanded the case to the agency for reconsideration so that “the basis for (its) decision (may) appear clearly on the record, not in conclusory terms but in sufficient detail to permit prompt and effective review.”<sup>22</sup> Dow decided to include the proposal on its proxy ballot, and the Supreme Court, on *certiorari*, vacated the lower court decision as moot.<sup>23</sup>

Although there certainly would have been a state-law basis for excluding proposals such as that faced by Dow,<sup>24</sup> the SEC decided instead in 1972 to narrow its rule.<sup>25</sup> Rather than the earlier

<sup>20</sup> See *Med. Comm. for Human Rights v. Sec. & Exch. Comm’n*, 432 F.2d 659, 663 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972); see also 17 C.F.R. § 240.14a-8(c) (1970).

<sup>21</sup> *Med. Comm. for Human Rights*, 432 F.2d at 681.

<sup>22</sup> *Id.* at 682.

<sup>23</sup> 404 U.S. 403.

<sup>24</sup> See *Guth v. Loft*, 5 A2d 503, 510 (Del. 1939) (“Corporate officers and directors . . . stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.”); see also 8 Del. C. § 141(a) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”); cf. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (“A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.”).

<sup>25</sup> See Exchange Act Release No. 9784, 37 Fed. Reg. 23,178, 23,180 (1972).

language intended to permit companies to exclude proposals motivated primarily by social, economic, or policy concerns, the new release merely permitted companies to exclude shareholder proposals “not significantly related to the business of the issuer or not within its control.”<sup>26</sup> In 1976, the SEC issued an interpretive release stating that shareholder proposals related to the “ordinary business” of the corporation could only be invoked to exclude proposals that “involve business matters that are mundane in nature and do not involve any substantial policy or other considerations”<sup>27</sup>—essentially inverting the prior rule.

Today’s Rule 14a-8 is written in a question-and-answer format setting forth the circumstances in which companies may exclude shareholder proposals. Companies wishing to exclude a shareholder proposal from the proxy ballot typically seek a “no action” letter from the SEC staff suggesting that the agency will take no action if the proposal is excluded.<sup>28</sup> The SEC issues no-action letters to petitioning companies if the agency’s staff determines that a shareholder proposal does not comply with SEC rules. Procedurally, the shareholder must establish his ownership in the company and meet filing deadlines.<sup>29</sup> Substantively, a company would be permitted to exclude a shareholder proposal that was too vague or indefinite to implement, that asked the company to do something that it had already done or lacks the power to implement, that conflicted with state law, that duplicated or conflicted with another ballot proposal, or that involved the company’s ordinary business operations.<sup>30</sup> Companies are also permitted to exclude repeat proposals that failed to gain minimal shareholder support in earlier years.<sup>31</sup>

## 2. *Shareholder Proposal Sponsors*

For each of the last eleven years tracked in the Manhattan Institute’s Proxy Monitor database,<sup>32</sup> a small group of shareholders has dominated the process of introducing shareholder proposals:

<sup>26</sup> *Id.*

<sup>27</sup> See Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999, 41 Fed. Reg. 52,994, 52,997–98 (1976).

<sup>28</sup> See *No-Action Letters*, SEC, <http://www.sec.gov/answers/noaction.htm>.

<sup>29</sup> See 14a-8, *supra* note 9.

<sup>30</sup> See *id.*

<sup>31</sup> See *id.*

<sup>32</sup> As discussed in notes 2 and 3 and the accompanying text, the Proxy Monitor database contains all shareholder proposals for the 250 largest publicly traded companies by revenues, as listed by *Fortune* magazine. These companies constitute a substantial majority of the total stock market capitalization held by diversified investors. Notwithstanding this fact, some shareholder activists and their supporters have objected to Proxy Monitor data on the grounds that many companies that receive shareholder proposals are not included in the database. See, e.g., Heidi Welsh, *Accuracy in Proxy Monitoring*, HLS Forum on Corporate Governance and Financial Regulation, Sept. 16, 2013, <https://blogs.law.harvard.edu/corpgov/2013/09/16/accuracy-in-proxy-monitoring-2/>. A broader dataset, however, risks obscuring the impact of shareholder-proposal rules on the average diversified investor, given the broad variance in market capitalization among companies. Even among the large companies comprising the Proxy Monitor dataset, there are significant variations in market capitalization; the five largest companies in the Fortune 250 have a combined market capitalization almost 18 times as large as companies 246 through 250 on Fortune’s list. (The five largest companies by revenues in the 2015 Fortune 500 list—Walmart, Exxon Mobil, Chevron, Berkshire Hathaway, and Apple—had a combined market capitalization of more than \$1.7 trillion on September 1, 2016, which constitutes 7.6% of the U.S. total stock market capitalization, based on the Wilshire 5000 Price Full Cap Index. The companies listed as 246 through 250 on the list—DTE Energy, Ameriprise Financial, VF, Praxair, and J.C. Penney—had a combined market capitalization of \$96 billion, or 0.4% of the U.S. total stock market capitalization. Overall, the S&P 100 alone contains more than 54% of the U.S. total market capitalization.) Thus,



- A. A very small group of individuals and their family members—often referred to as “**corporate gadflies**”<sup>33</sup>—repeatedly file substantially similar proposals across a broad set of companies. Typically, these individuals own very small percentages of a company’s stock. For instance, John Chevedden, the most-active sponsor of shareholder proposals dating back to 2006, has made substantially the same proposal at Ford Motor Company each of those years, individually or through a family trust. In its 2016 proxy statement, Ford disclosed that Mr. Chevedden owned 500 shares of the company’s stock<sup>34</sup>—an investment valued at \$6,750 at the close of trading on the company’s March 16 record date—approximately 0.00001% of the company’s market capitalization. All told, Mr. Chevedden and four individual gadfly investors and their family members sponsored 29% of all shareholder proposals from 2006–15 (**Figure 1**); six gadfly investors and their family members have sponsored one-third of all shareholder proposals to date in 2016 (**Figure 2**).<sup>35</sup>
- B. Institutional investors focusing on “**socially responsible**” investing,<sup>36</sup> which expressly concern themselves with social or political issues apart from solely share-price maximization, are very active in sponsoring shareholder proposals. Such investors include special-purpose social-investing funds, as well as policy-oriented foundations and various retirement and investment vehicles associated with religious or public-policy organizations.<sup>37</sup> Such investors sponsored 27% of all shareholder proposals across the ten-year period from 2006 through 2015 and 38% of all shareholder proposals to date in 2016. Many of these investors, like corporate gadflies, sponsor shareholder proposals in companies in which they have very small investments. For instance, in 2016, a social

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from the average shareholder’s perspective, the Proxy Monitor data set paints a significantly more accurate picture than do the vote tallies of most shareholder activists, who simply straight-line-average votes across a much larger data set of companies, without regard to market capitalization.

<sup>33</sup> See Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1895 (1992); Jessica Holzer, *Firms Try New Tack against Gadflies*, WALL ST. J., June 6, 2011, <http://online.wsj.com/article/SB10001424052702304906004576367133865305262.html>.

<sup>34</sup> See Ford Motor Co., *Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934*, proposal no. 5 (Apr. 1, 2016).

<sup>35</sup> Jonathan Kalodimos, a professor and former SEC staffer, is a new corporate gadfly in 2016. See Jonathan Kalodimos, *A Gadfly’s Perspective on “Gadflies at the Gate.”* Sept. 2, 2016. Kalodimos introduced multiple proposals seeking to encourage companies to pursue share buybacks in lieu of paying cash dividends. Kalodimos’s prior experience with the SEC did not help him to draft a shareholder proposal that garnered widespread shareholder support. Indeed, more than 97% of shareholders voted against each of his proposals, meaning that none will be eligible for resubmission for five years.

<sup>36</sup> See Michael Chamberlain, *Socially Responsible Investing: What You Need to Know*, FORBES, Apr. 24, 2013, <http://www.forbes.com/sites/feonlyplanner/2013/04/24/socially-responsible-investing-what-you-need-to-know> (“In general, socially responsible investors are looking to promote concepts and ideals that they feel strongly about”). The modern push for “corporate social responsibility” generally traces to a pair of 1970s books, *Where the Law Ends*, by Christopher Stone (1975), and *Taming the Giant Corporation*, by Ralph Nader, Mark Green, and Joel Seligman (1976). For a critique of the early concept of corporate social responsibility advocated by these authors, see David L. Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1, 1 (1979) (“Any mandatory governance reforms intended to spur more corporate altruism are almost sure to have general institutional costs within the corporate system itself. . . . But the proponents of “more” corporate social responsibility have never bothered to analyze or examine, from any clearly defined starting point, even just the benefits they anticipate from reform . . .”).

<sup>37</sup> Religious organizations’ pension plans are generally exempt from the fiduciary requirements of the Employee Retirement Income Security Act (ERISA). 29 U.S.C. § 1003(b).

investor known as Holy Land Principles, Inc. sponsored shareholder proposals, relating to employment practices in areas governed by Israel and the Palestinian Authority, on the ballots of seven of the 231 Fortune 250 companies to hold annual meetings by the end of August. In each case, its investment was a miniscule percentage of the company's outstanding market capitalization; in Pepsico, it owned a reported 55 shares,<sup>38</sup> worth \$5,932.85 on the company's February 26 record date—approximately 0.000003% of the company's market capitalization.

- C. Apart from investors with a social or policy orientation, the principal institutional investors involved with sponsoring shareholder proposals are **labor-affiliated pension funds**—including “multiemployer” plans affiliated with labor unions such as the American Federation of Labor–Congress of Industrial Organizations (AFL–CIO) or American Federation of State, County, and Municipal Employees (AFSCME), as well as state and municipal pension plans, particularly those representing New York City and State. Overall, labor-affiliated investors sponsored 32% of all shareholder proposals from 2006–15 and 21% to date in 2016.<sup>39</sup> Typically, these plans have substantial investment stakes in the companies at which they file shareholder proposals, though the private labor unions have been known to file such proposals from investment vehicles with small holdings. For example, in 2016, the AFL–CIO sponsored a human-rights-related proposal at Mondelez International, but reportedly held only 925 shares,<sup>40</sup> valued at \$38,803.75 on the March 9 record date, approximately 0.00006% of the company's outstanding market capitalization.<sup>41</sup>

<sup>38</sup> See Pepsico, *Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934*, proposal no. 7 (Mar. 18, 2016).

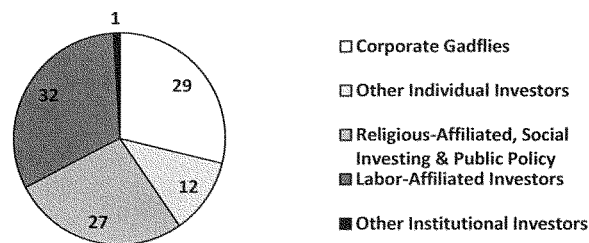
<sup>39</sup> The low sponsorship numbers in 2016 are somewhat deceptive, in that the most-active labor-affiliated shareholder proponent over the last eleven years, the New York City pension funds, withdrew a large fraction of its shareholder proposals. Most of the shareholder proposals sponsored by the New York City pension funds in 2015 and 2016 involved “proxy access,” the idea that shareholders should have the right to place their own nominees for director on corporate proxy ballots to compete with boards' own director nominees. These proposals mirrored the SEC's previously released Rule 14a-11, which would have mandated that publicly traded companies list shareholders' nominees for director on their corporate proxy ballots, as long as the nominating shareholder had held at least 3% of a company's stock for a minimum of three years. The SEC promulgated the rule in August 2010, but the D.C. Circuit rejected it as “arbitrary and capricious” in July 2011. See *Business Roundtable v. SEC*, 647 F.3d 1144, 1152 (D.C. Cir. 2011). The SEC did not appeal the decision but instead approved amendments to Rule 14a-8—the rule for shareholder proposals—to allow shareholders to introduce proxy-access rules on their own. See Abigail Caplovitz Field, *Proxy Access Debate Far from Over*, CORPORATESECRETARY.COM., (Sept. 9, 2011), <http://www.corporatesecretary.com/articles/proxy-voting/12000/proxy-access-debate-far-over/>. In 2015, most of the New York City funds' proxy-access proposals received majority shareholder backing, and in 2016, most of the companies in the Fortune 250 that faced a New York City-sponsored shareholder proposal involving proxy access reached an agreement to adopt a form of proxy access rule, prompting the sponsor to withdraw the proposal.

<sup>40</sup> See Mondelez International, Inc., *Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934*, proposal no. 6 (Mar. 28, 2016).

<sup>41</sup> Labor unions may choose to engage in socially oriented shareholder activism through small-investment vehicles rather than multiemployer private pension plans to avoid fiduciary strictures of ERISA, which govern their investment approaches, unlike state and municipal plans or religious plans. See 29 U.S.C. § 1003(b). This approach may or may not shift going forward, given the Department of Labor's Interpretive Bulletin 2015-01, an October 2015 rule broadening the fiduciary scope for private pension plans' investments in “economically targeted investments.” See *Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments*, <https://www.federalregister.gov/articles/2015/10/26/2015-27146/interpretiv.e-bulletin-relating-to-the-fiduciary-standard-under-erisa-in-considering-economically>.

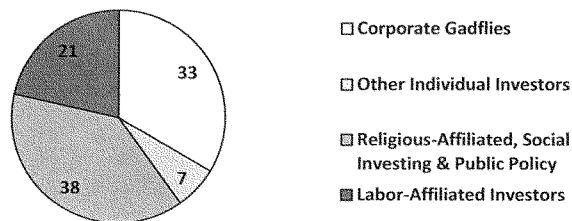
Only 1% of shareholder proposals introduced in the decade between 2006 and 2015 involved institutional investors without a labor affiliation or social, religious, or policy focus. No institutional investor without such an affiliation or focus has sponsored a shareholder proposal in 2016.

**Figure 1. Percentage of Shareholder Proposals, by Proponent Type, 2006–15**



Source: ProxyMonitor.org

**Figure 2. Percentage of Shareholder Proposals, by Proponent Type, 2016\***



\*Based on 231 companies holding annual meetings by August 31

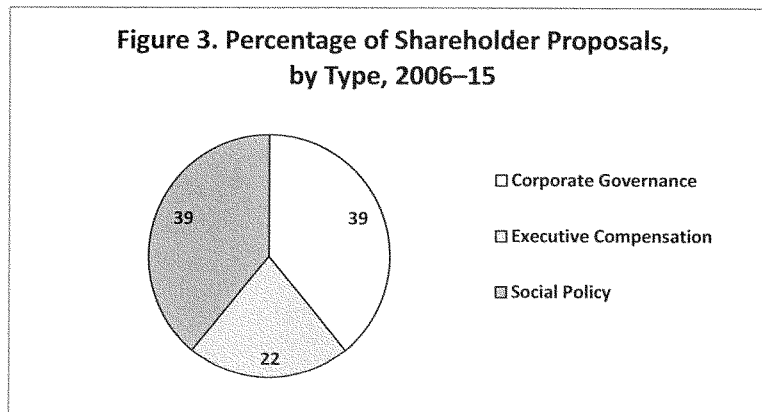
Source: ProxyMonitor.org

### 3. *Shareholder Proposal Subjects*

Shareholder proposals tend to be broadly divided among:

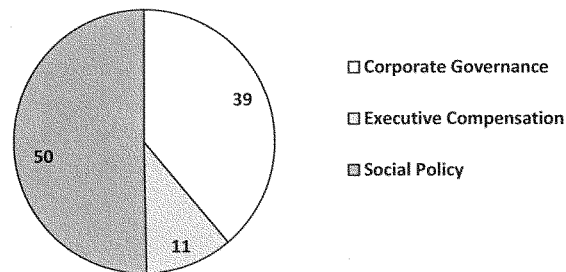
- A. Proposals that seek to modify the process by which the companies allocate powers between the board and shareholders (“**corporate governance**” proposals);
- B. Proposals that seek to influence corporate management by altering **executive compensation**, purportedly to better align management’s incentives with shareholders’ interests; and
- C. Proposals that seek to reorient a company’s approach to align with a **social or policy** goal that may not be related—or at least has an attenuated relationship—to share value.

Over the ten-year period from 2006 through 2015, most shareholder proposals related to corporate governance or to social/policy concerns—39% apiece, with 22% of shareholder proposals relating to executive compensation (**Figure 3**). In 2016, to date, **half** of shareholder proposals have related to a social or policy issue (**Figure 4**). The most commonly introduced proposals, in each year from 2014 through 2016, have been those involving environmental issues or the company’s political spending or lobbying (**Figure 5**).



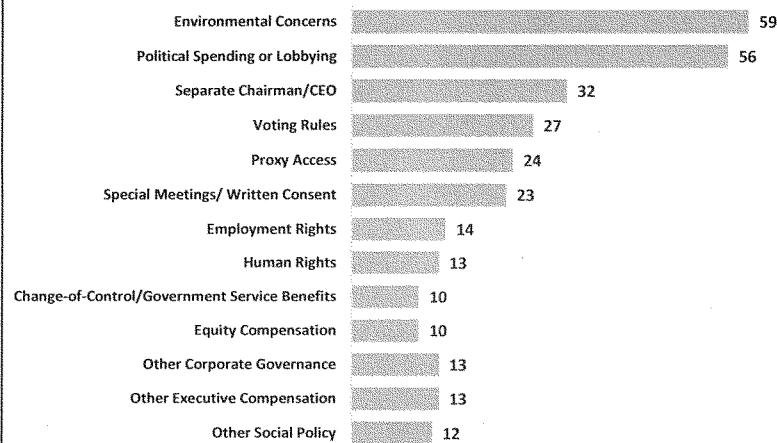
Source: ProxyMonitor.org

**Figure 4. Percentage of Shareholder Proposals, by Type, 2016\***



\*Based on 231 companies holding annual meetings by August 31  
Source: ProxyMonitor.org

**Figure 5. Shareholder Proposals, 2016\***



\*Based on 231 companies holding annual meetings by August 31  
Source: ProxyMonitor.org

#### 4. *Shareholder Proposal Voting*

Shareholder proposals are commonly introduced at large publicly traded companies, but they very rarely garner majority shareholder support (**Figure 6**).<sup>42</sup> Proposals that have been relatively likely to pass have involved altering rules on director elections—by requiring that shareholders be permitted to vote on all directors annually, rather than in “staggered” board terms (like the U.S. Senate); by requiring that companies refuse to seat directors who receive less than majority shareholder support in an uncontested election; or, most recently, by granting shareholders above a certain ownership threshold and holding period “proxy access” to place some of their own director nominees on the company ballot.

In contrast to some shareholder-proposal activism related to corporate governance, shareholder proposals related to social or policy concerns have consistently failed to garner broad shareholder support. Among the companies in the Fortune 250, not a single shareholder proposal involving social or policy concerns won majority shareholder support over board opposition over

<sup>42</sup> In determining shareholder support for shareholder proposals, the Manhattan Institute counts votes consistent with the practice dictated in a company’s bylaws, consistent with state law. Some companies measure shareholder support by dividing the number of votes for a proposal by the total number of shares present and voting, ignoring abstentions. Other companies measure shareholder support by dividing the number of favorable votes by the number of shares present and entitled to vote—thus including abstentions in the denominator of the tally. Neither practice necessarily skews shareholder votes in management’s favor: whereas the latter method makes it relatively more difficult for shareholder resolutions to obtain majority support, it also makes it more difficult for management to win shareholder backing for its own proposals, such as equity-compensation plans.

Although shareholder-proposal activists prefer to exclude abstentions consistently in tabulating vote totals, without regard to corporate bylaws—which necessarily inflates apparent support for their proposals—such a methodology is inconsistent with federal law. The SEC’s Schedule 14A specifies that for “each matter which is to be submitted to a vote of security holders,” corporate proxy statements must “[d]isclose the method by which votes will be counted, including the treatment and effect of abstentions and broker non-votes under applicable state law as well as registrant charter and bylaw provisions”—clearly indicating that corporations can adopt varying counting methodologies in assessing shareholder votes and that state substantive law governs the parameters of vote calculation. Schedule 14A, Item 21. Voting Procedures, <http://taft.law.uc.edu/CCL/34ActRIs/rule14a-101.html> (last visited August 16, 2013).

Under the state law of Delaware, in which most large public corporations are chartered, “the certificate of incorporation or bylaws of any corporation authorized to issue stock may specify the number of shares and/or the amount of other securities having voting power the holders of which shall be present or represented by proxy at any meeting in order to constitute a quorum for, and the votes that shall be necessary for, the transaction of any business.” Del. Gen. Corp. L. § 216. As a default rule, absent a bylaw specification, Delaware law specifies that “in all matters other than the election of directors,” companies should count “the affirmative vote of the majority of shares of such class or series or classes or series present in person or represented by proxy at the meeting,” *id.* at 216(4)—the precise inverse of shareholder-proposal activists’ preferred counting rule.

The SEC staff has adopted a rule that for the very limited purpose of determining whether a proposal has met the “resubmission threshold” to qualify for inclusion on the next year’s corporate ballot—a permissive standard requiring merely a minimum 3%, 6%, or 10% vote, respectively, in successive years, *see* Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 40,018; 63 Fed. Reg. 29,106, 29,108 (May 28, 1998) (codified at 17 C.F.R. pt. 240)—“[o]nly votes for and against a proposal are included in the calculation of the shareholder vote of that proposal,” ignoring abstentions. SEC Staff Legal Bulletin No. 14, F.4., July 13, 2001, <http://www.sec.gov/interp/legal/cfs14.htm> (last visited August 16, 2013). Because this is a staff rule not voted on by the Commission; because it exists for a limited purpose (with multiple rationales, including reducing workload in processing 14a-8 no-action petitions and adopting a permissive standard for ballot inclusion); and because it contravenes clear and longstanding deference to substantive state law in the field of corporate governance, the notion that this limited SEC staff vote-counting rule should dictate counting methodology, irrespective of state law and governing corporate bylaws, is untenable.

the entire 2006–15 period. In 2016, one of 155 shareholder proposals with a social or policy purpose won majority (52%) shareholder backing: a politics-related proposal at Fluor Corporation that sought disclosure of “[p]olicies and procedures for making, with corporate funds or assets, contributions and expenditures (direct or indirect) to (a) participate or intervene in any political campaign on behalf of (or in opposition to) any candidate for public office, or (b) influence the general public, or any segment thereof, with respect to an election or referendum,” as well as disclosure of amounts given to each identified recipient and the corporate officer responsible for decision-making.<sup>43</sup> The Fluor proposal is certainly anomalous:<sup>44</sup> among 446 shareholder proposals related to corporate political spending or lobbying in the Proxy Monitor database, it is the only shareholder proposal, opposed by management, to receive majority shareholder support;<sup>45</sup> and it is the only shareholder proposal of 1,444 related to social policy concerns to receive majority shareholder support at any Fortune 250 company from 2006–16.<sup>46</sup>

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<sup>43</sup> Fluor Corp., Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934, proposal no. 4 (Mar. 10, 2016).

<sup>44</sup> As a major construction company, Fluor is heavily involved in government-contracting work, which may make shareholders particularly sensitive to its political engagement. Moreover, the company’s market capitalization fell more than 43% from the record date for its 2014 annual meeting and its 2016 annual meeting, when it missed its earning target. A proposal by the New York State Common Retirement Fund on greenhouse gas emissions also received more than 40% support at Fluor, suggesting broader shareholder dissatisfaction with the company in 2016 or an idiosyncratic shareholder base.

<sup>45</sup> In 2006, a shareholder proposal at Amgen related to political-spending disclosure received 67 percent shareholder support, with the board of the company supporting the proposal.

<sup>46</sup> Note that this statement holds true for the current Fortune 250, but a shareholder proposal at KBR, Inc. did receive 55% shareholder support over board opposition in 2011, when the company was in the Fortune 250 list. (KBR is currently ranked number 501.) That proposal, sponsored by the New York City pension funds, encouraged the board to amend the company’s equal-employment opportunity policy to prohibit discrimination based on sexual orientation. Also, in addition to the political-spending-related proposal at Amgen, four other shareholder proposals received majority shareholder support with the board of directors backing the proposal, including one in 2016—an animal-rights-related proposal introduced at Kellogg that applauded the company for switching to eggs produced by cage-free chickens.

**Figure 6. Shareholder Support by Proposal Class, 2016\***

Proposal Class	Proposals Introduced	Proposals Defeated	Proposals Winning Majority Support
<b>Corporate Governance</b>	<b>119</b>	<b>100</b>	<b>19</b>
Separate Chairman and CEO	32	32	0
Proxy Access	24	11	13
Shareholder Action by Written Consent	12	12	0
Shareholder Power to Call Special Meetings	11	10	1
Eliminate Supermajority Provisions in Bylaws**	8	5	3
Change Vote-Counting Standard	8	8	0
Change Stock Classes or Voting Rights	6	6	0
Majority Voting for Directors	4	2	2
Other	14	14	0
<b>Executive Compensation</b>	<b>33</b>	<b>33</b>	<b>0</b>
Change-of-Control/Government Service Benefits	10	10	0
Equity Compensation Rules	10	10	0
Other	13	13	0
<b>Social Policy</b>	<b>155</b>	<b>153</b>	<b>2</b>
Environmental Issues	59	59	0
Political Spending or Lobbying	56	55	1
Employment Rights	14	14	0
Human Rights	13	13	0
Other***	13	12	1

\*Based on 231 companies holding annual meetings by August 31

\*\*A fourth shareholder received majority support but failed because it was presented as an amendment to the company's certificate of incorporation, requiring unanimous support.

\*\*\*The shareholder proposal winning majority support was supported by board of directors.

Source: ProxyMonitor.org



### 5. *The Role of Proxy Advisory Firms*

Prior to the 1980s, institutional investors had generally paid little attention to shareholder voting matters, but the wave of hostile takeover actions in that decade forced institutional investors to take at least occasional notice. Some institutional investors' broader need to assess shareholder voting issues, including proxy proposals, took on added significance in the late 1980s when the U.S. Department of Labor required retirement benefit funds governed by the Employee Retirement Income Security Act (ERISA) to vote their shares according to a "prudent man" standard.<sup>47</sup> In 2003, the SEC clarified that similar fiduciary duties attach to mutual funds and other registered investment companies.<sup>48</sup> These requirements place significant burdens on institutional investors: according to a 2010 report by the Investment Company Institute, Russell 3000 companies faced more than 20,000 proxy ballot items annually<sup>49</sup>—even before Dodd-Frank-required executive compensation voting.<sup>50</sup>

Concurrent with these trends, institutional investors have managed an increasing percentage of U.S. equity market holdings: from 1997 through 2009, the equity percentage of the 1,000 largest U.S. publicly traded companies by assets held by institutional investors increased from 60% to 73%.<sup>51</sup> In 2009, the SEC approved amendments to the New York Stock Exchange rules that eliminated stockbrokers' ability to vote discretionarily the shares of their individual investors for director elections;<sup>52</sup> and in 2012, the NYSE applied the limitation to a broader array of issues.<sup>53</sup> In essence, this combination of trends has substantially increased the relative power of institutional investors in proxy voting matters, even as such matters have multiplied in complexity.

To manage their proxy voting, institutional investors rely heavily on a pair of proxy advisory firms, Institutional Shareholder Services, or ISS, which is today owned by private-equity firm Vestal Capital Partners;<sup>54</sup> and Glass, Lewis & Co., a subsidiary of the Ontario Teachers' Pension

<sup>47</sup> See Letter from U.S. Dep't of Labor to Helmut Fandl, Chairman of Retirement Board, Avon Products, Inc. (Feb. 23, 1988); see also 73 Fed. Reg. 61731 (Oct. 17, 2008).

<sup>48</sup> See 68 Fed. Reg. 6585 (Feb. 7, 2003) ("The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own." (internal citations omitted)).

<sup>49</sup> See Investment Company Institute, Trends in Proxy Voting by Registered Investment Companies, 2007–09, 16 Research Perspective 4 (Nov. 2010), <http://www.ici.org/pdf/per16-01.pdf>.

<sup>50</sup> Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, publicly traded companies must hold shareholder advisory votes on executive compensation annually, biennially, or triennially, at shareholders' discretion. See Pub. L. No. 111-203, 124 Stat. 1376, § 951 (2010).

<sup>51</sup> See Matteo Tonello & Stephan R. Rabimov, The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition, The Conference Board Research Report, No. R-1468-10-RR, 27, 2010, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1707512](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1707512).

<sup>52</sup> See SEC Rel. No. 34-60215, <http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf>.

<sup>53</sup> See NYSE, Information Memo No. 12-4, Application of Rule 452 to Certain Types of Corporate Governance Proposals (Jan. 25, 2012), available at [http://www.nyse.com/nysenotices/nyse/rulechanges/pdf?memo\\_id=12-4](http://www.nyse.com/nysenotices/nyse/rulechanges/pdf?memo_id=12-4).

<sup>54</sup> See Press Release, Vestal Capital Partners Completes Acquisition of Institutional Shareholder Services, <http://www.issgovernance.com/vestar-capital-partners-completes-acquisition-of-institutional-shareholder-services> (last visited Sept. 3, 2014).

Plan Board.<sup>55</sup> Together, these two proxy advisors control approximately 97% of the market for proxy advisory services, with ISS alone having about a 61% share.<sup>56</sup> By its own estimation, ISS helps more than 1,600 clients execute nearly 8.5 million ballots representing more than 2 trillion shares.<sup>57</sup>

These proxy advisory firms' power over shareholder voting is vast. A 2012 analysis I lead authored for the Manhattan Institute found that an ISS recommendation "for" a given shareholder proposal—controlling for other factors including company size, industry, proponent type, proposal type, and year—was associated with a 15-percentage-point increase in the shareholder vote for any given proposal.<sup>58</sup> Thus, in the shareholder-proposal context, ISS acts like a 15% owner of the largest publicly traded companies in terms of its influence over the voting market. As Leo Strine, a former chancellor on the Delaware Court of Chancery, observed: "Powerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues."<sup>59</sup>

Notwithstanding its influence, ISS is a relatively small operation. Prior to its 2014 acquisition by Vestal, ISS was owned by MSCI, a publicly traded company; at that time, the world's largest proxy advisor had fewer than 700 employees and just over \$15 million in profits on \$122 million in revenues.<sup>60</sup> A significant fraction of those revenues came not from sales to the institutional-investment community itself but rather from the company's "Corporate Sales" division, which offers governance and proxy advice to corporations—in essence, the very companies on whose proxies ISS advises institutional investors on how to vote. In 2013, ISS's Corporate Sales group generated 29% of its revenues, up from 21% two years earlier.<sup>61</sup>

The probable reason for the disconnect between ISS's cash flows and influence is that institutional investors simply do not place a very large economic value on the services it offers. In almost all situations, there is little competitive advantage to be gained from being a "better voter" on proxy items, at least those proposed by shareholders through the 14a-8 process.<sup>62</sup>

<sup>55</sup> See Robyn Bew & Richard Fields, *Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers 6* (Tapestry Networks, Inc. & Investment Research Center Institute, June 2012), <http://www.tapestrynetworks.com/issues/corporate-governance/upload/Voting-Decisions-at-US-Mutual-Funds-June-2012.pdf>.

<sup>56</sup> See James K. Glassman and J. W. Verret, *How to Fix Our Broken Proxy Advisory System 8* (Mercatus Center, George Mason Univ., 2013), available at [http://mercatus.org/sites/default/files/Glassman\\_ProxyAdvisorySystem\\_04152013.pdf](http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf).

<sup>57</sup> Institutional Shareholder Services, *About ISS*, <http://www.issgovernance.com/about/about-iss>.

<sup>58</sup> James R. Copland et al., *Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism 22–23* (Manhattan Inst. for Pol'y Res., Fall 2012), available at [http://www.proxymonitor.org/Forms/pmr\\_04.aspx](http://www.proxymonitor.org/Forms/pmr_04.aspx).

<sup>59</sup> Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 688 (2005).

<sup>60</sup> See MSCI 2013 Annual Report 70, "Summary of Operations," "Governance," available at [http://files.shareholder.com/downloads/MSCI/3458217323x0x739303/DAB046E7-737E-43C7-9114-040465AD560E/2013\\_Annual\\_Report.pdf](http://files.shareholder.com/downloads/MSCI/3458217323x0x739303/DAB046E7-737E-43C7-9114-040465AD560E/2013_Annual_Report.pdf).

<sup>61</sup> Compare *id.* at 10 with MSCI 2011 Annual Report 9, available at [http://files.shareholder.com/downloads/MSCI/2008427917x0x554571/96AD1F8D-CC19-4BFD-9E47-6EFD2079886C/264713\\_007\\_MSCI\\_BMK\\_AR.pdf](http://files.shareholder.com/downloads/MSCI/2008427917x0x554571/96AD1F8D-CC19-4BFD-9E47-6EFD2079886C/264713_007_MSCI_BMK_AR.pdf).

<sup>62</sup> Cf. BRYAN CAPLAN, *THE MYTH OF THE RATIONAL VOTER* (2007). Institutional investors compete aggressively for investor dollars, and they gain competitive advantages largely through higher returns and lower fees. Investing in proxy-voting information raises institutional investors' costs while giving no competitive advantage in increasing

Large institutional investors, like Fidelity or Vanguard, with sufficient resources to make their own proxy voting decisions and not lose appreciable cost advantage to competitors surely find ISS's analytical tools useful but rely little on their proxy voting guidelines; smaller funds wanting to minimize their investment in voting find hiring ISS a useful way to discharge fiduciary voting obligations at low cost. But the very fact that the cost is low—less than \$80 million in annual revenues<sup>63</sup> in the context of \$26 trillion in assets—shows that ISS's services are not that highly valued by institutional investors, which also helps explain the lack of significant competitors and dearth of new entrants into the proxy advisory space.

Such forces enable ISS (and Glass Lewis) to support ballot items that are generally rejected by most investors, without fear of reprisal. My research shows that ISS has, historically, been almost eight times as likely as the median shareholder to support a shareholder proposal.<sup>64</sup> ISS's current policy guidelines continue to reflect this disconnect. Among the class of most-introduced shareholder proposals involving corporate governance issues that ISS is "generally for,"<sup>65</sup> shareholder reaction varies significantly:

- Proposals to declassify boards of directors, to grant shareholders proxy access to nominate directors under the terms of the prior SEC rule, or to eliminate supermajority voting provisions are more likely than not to pass;
- Proposals calling for majority votes to elect directors, or for shareholder power to call special meetings, or act through written consent, gain occasional support; and
- Proposals calling for separating the company's chairman and CEO roles, or enabling cumulative voting for director nominees, almost always fail.

Beyond corporate-governance proposals, the disconnect between ISS and the median shareholder is even starker. My research reveals that ISS supported shareholder proposals related to a company's equity compensation plan 75% of the time;<sup>66</sup> but only two of 275 such proposals introduced at Fortune 250 companies from 2006 through 2016 have received the support of a majority of shareholders. Among shareholder proposals involving social or policy concerns, as previously discussed, only one proposal of 1,444 coming to a vote at a Fortune 250 company over the last 11 years has received support from a majority of shareholders, over board opposition. In contrast, ISS is "generally for" certain classes of animal rights, employment rights, human rights, environmental, and political-spending-related shareholder proposals; against others; and decides others on a "case by case" basis.<sup>67</sup> Historically, ISS has backed some 70% of shareholder proposals related to political spending, 45% of those related to employment rights,

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investment returns, at least for smaller, diversified investors who have low ownership shares—and whose individual votes on proxy ballot items are therefore unlikely to be dispositive. For a fuller discussion of these dynamics, see James K. Glassman & Hester Peirce, *How Proxy Advisory Services Became So Powerful* (Mercatus Ctr., June 18, 2014), <http://mercatus.org/publication/how-proxy-advisory-services-became-so-powerful>.

<sup>63</sup> At least as of 2013, just over \$79 million of ISS's revenues come from its advisory services business, as opposed to corporate contracts. See MSCI 2013, *supra* note 61, at 9–10.

<sup>64</sup> See Copland et al., *supra* note 58, at 23.

<sup>65</sup> See generally ISS, *United States Summary Proxy Voting Guidelines: 2016 Benchmark Policy Recommendations 19–29* (Dec. 18, 2015), <https://www.issgovernance.com/file/policy/2016-us-summary-voting-guidelines-dec-2015.pdf>.

<sup>66</sup> See Copland et al., *supra* note 58, at 23.

<sup>67</sup> See ISS, *supra* note 65, at 57–66.

and 35% of those related to human rights or the environment<sup>68</sup>—a sharp contrast to the dearth of average shareholder support for these proposal classes.

Although the gap between ISS recommendations and the median shareholder could be explained by simple disagreement, it is worth noting that an increase in shareholder voting support for various proposals also increases the incentive for public companies to enter into consulting contracts with ISS to mitigate such costs. In addition, the absence of market constraints on ISS means that it may be subject to capture by some of its clients who do place more emphasis on shareholder ballot items than do other institutional investors and most individual investors—namely, labor pension funds and social-investing funds, each of which are very active in sponsoring proposals. Even if ISS support is generally unlikely to tip the balance of shareholder support in favor of a given proposal—and the evidence suggests that it is not, at least for social and policy proposals—the 15-percentage-point bump that an ISS “for” recommendation tends to generate will ensure that with ISS support, shareholder-proposal activists’ preferred issues remain on the proxy ballot as long as their proponents wish them to remain there, under current SEC resubmission standards.

#### **6. Shareholder Proposal Resubmissions**

The SEC’s current rules stipulate that companies cannot exclude identical shareholder proposals filed year after year, even if vast majorities of shareholders vote against them repeatedly. Under the SEC’s permissive standard, over a five-year period, companies can only exclude a shareholder proposal if it received less than 3% shareholder support in a preceding year, 6% if introduced for a second year, or 10% if introduced at least three times previously.<sup>69</sup> Given the empirical evidence that a recommendation by the proxy-advisory firm ISS that shareholders vote “for” a given shareholder proposal is associated with a 15-percentage-point boost in the proposal’s shareholder vote, all else being equal, the current SEC rule means that ISS (and probably Glass Lewis, its principal competitor) effectively serves as the gatekeeper for shareholder-proposal resubmissions: if ISS supports a proposal, it can remain indefinitely on the ballot.

The ability of shareholders to continue to place items up for a vote without winning sizable shareholder support matters. Submission of shareholder proposals is not cost-free to the company and to other shareholders; a 1998 analysis by the SEC determined that it cost the average company \$37,000 to decide whether to place a shareholder proposal on the ballot and another \$50,000 in costs to print, distribute, and tabulate the proposal;<sup>70</sup> aside from printing and distributing, such costs have doubtless risen over time. At least one individual shareholder, former corporate gadfly Evelyn Davis, displayed a profound ability to manipulate the shareholder-proposal process to extract corporate rents:

<sup>68</sup> See Copland et al., *supra* note 58, at 22–23.

<sup>69</sup> See Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 40,018; 63 Fed. Reg. 29,106, 29,108 (May 28, 1998) (codified at 17 C.F.R. pt. 240).

<sup>70</sup> See Amendments to Rules on Shareholder Proposals, 17 C.F.R. 240 (1998) (Release No. 34-40,018) (describing 80 firms reporting on proposal inclusion determination costs and 67 reporting on printing and other direct costs).

Davis . . . publishe[d] a yearly investor newsletter, *Highlights and Lowlights*, which earn[ed] her an estimated \$600,000 annual income. According to one media account, Davis [sold] the \$495, 20-page newsletter in part by “cajol[ing] the nation’s business titans into subscribing . . . with a minimum order of two copies.” Company executives also regularly shower[ed] largesse on Davis to stay in her good graces. According to one report in the 1990s, executives of all three major American car companies offered to deliver any car she purchased to her. Lee Iacocca reportedly said that he would do so in person.<sup>71</sup>

Among the 153 shareholder proposals that Davis submitted to the companies in the Proxy Monitor database since 2006, only one received majority shareholder support: a 2006 proposal at Bank of New York Mellon seeking cumulative voting (allowing shareholders to aggregate their ballots for directors into a single candidate), which received 51% of the shareholder vote. (The bank decided not to act on the narrow vote, and Davis continued to submit the proposal each year through 2012, when she “retired” from shareholder activism. The proposal never again received more than 38% shareholder support.)

Though Davis is an extreme case of a single shareholder being able to profit from other shareholders through the shareholder-proposal process, other shareholder activists obviously find merit in continuing to place items on company ballots that do not garner shareholder majorities, year after year. Indeed, the social-investing funds and religious orders that regularly place losing proposals on proxy ballots are predicated upon just this idea. At a minimum, such efforts use the proxy process to gain attention to their cause. In other cases, these social-issue activists may be able to prompt changes in corporate behavior along their desired lines, even when shareholders vote down their proposals—much as Davis’s efforts encouraged companies to spend money out of corporate coffers to placate her.

One approach that the SEC could take to discourage the continued submission of shareholder proposals unrelated to share value is to revise its 1976 rule limiting companies’ ability to exclude from proxy ballots only those “ordinary business” issues “that are mundane in nature and do not involve any substantial policy or other considerations.”<sup>72</sup> I have argued that the SEC should consider just this approach.<sup>73</sup>

Another idea, suggested by Yale Law professor Roberta Romano, would be to force shareholders who place on corporate proxy ballots proposals that fail to receive majority shareholder support to reimburse the company at least some portion of the direct costs of assessing, printing, distributing, and tabulating their unsuccessful proposals.<sup>74</sup> Such a rule would make it cost-prohibitive for corporate gadflies such as Davis to utilize the shareholder-proposal process to extract corporate rents and would force social-issue activists to internalize the costs of their efforts rather than have them subsidized by other shareholders.

<sup>71</sup> Copland et al., *supra* note 58, at 9 (citations omitted).

<sup>72</sup> Adoption of Amendments Relating to Proposals by Security Holders, *supra* note 27.

<sup>73</sup> See Copland (2015), *supra* note 5.

<sup>74</sup> See Romano, *supra* note 11, at 229–49.

A third idea, suggested by the U.S. Chamber of Commerce and other business groups in a 2014 rulemaking with the SEC,<sup>75</sup> would be for the SEC to revise its rule permitting companies to exclude resubmitted shareholder proposals if they fail to garner minimum threshold shareholder support within the preceding five calendar years.<sup>76</sup> The remainder of this section examines empirical evidence shedding light on the impact of the SEC's resubmission rule and the Chamber's pending rulemaking petition.

#### *Empirical Overview*

Overall, of the 3,392 shareholder proposals introduced on the proxy ballots of companies in the Proxy Monitor database between 2007 and 2016 (through August 31, 2016), 1,063—31% of all shareholder proposals—were resubmissions of a preceding year's proposal. Of shareholder proposals introduced between 2006 and 2013, 100 were resubmitted three or more times. A plurality of shareholder proposals resubmitted (39%) involved social or policy concerns, and 36% of shareholder proposals resubmitted three or more times were social- or policy-related (slightly below the 41% that involved corporate-governance issues).

ExxonMobil was, by a significant margin, on the receiving end of the greatest number of resubmissions, with 26 different proposals being resubmitted and two proposals submitted nine times over the 11-year span from 2006 through 2015 (**Figure 7**). Both of Exxon's nine-time proposals involved social or policy concerns. One of these, sponsored by the Catholic order the Sisters of St. Dominic, has called on the company to set and disclose greenhouse gas emission goals. That ballot item appeared on ExxonMobil's ballot every year from 2007 through 2015, and at least 69% of shareholders voted against the proposal each time; presumably, the proposal was not on the ballot in 2016 only because in 2015 it fell below the SEC's meager 10% threshold for a third-time submission.

The other nine-time ballot item for ExxonMobil was sponsored by the New York City or State pension funds each year from 2006 through 2014; it called on the oil company to formally amend its equal-employment-opportunity (EEO) policy to include sexual orientation and gender identity. (The company repeatedly maintained in its own proxy statements that it did not discriminate on those grounds and that it included sexual-orientation harassment as an example in its training manuals.) The proposal never received more than 40% shareholder support; but the company changed its EEO policy in 2015, following an Obama administration executive order requiring companies to include sexual orientation and gender identity in formal equal-employment-opportunity policies to receive federal government contracts.<sup>77</sup>

Exxon does not, however, hold the record for the most resubmitted proposals over the last decade: Ford Motor Company and Wells Fargo faced the same corporate governance-related shareholder proposal each year from 2006 through 2016. Each year, 62% or more shareholders voted against the proposals. As previously noted, the sponsor of the Ford proposal, corporate gadfly John Chevedden, owns approximately 0.00001% of the company's outstanding shares.

<sup>75</sup> See Thomas Quaadman, *supra* note 13.

<sup>76</sup> See 14a-8, *supra* note 9, at 14a-8(i)(12).

<sup>77</sup> See Chris Johnson, *Exxon Mobil Adopts LGBT-Inclusive Non-Discrimination Policy*, WASHINGTON BLADE, Jan. 30, 2015.

The value of Chevedden's holdings, \$6,750 as of the 2016 annual-meeting record date, is substantially less than both the average and the median company cost to print, distribute, and tabulate a shareholder proposal, and substantially less than the average and median company cost to determine whether to include a proposal on the ballot.<sup>78</sup>

**Figure 7. Frequently Resubmitted Shareholder Proposals, 2006–16\***

Company	Proposal	Total Number	First Year	Last Year	Min. Vote %	Max. Vote %
Ford Motor	One Share – One Vote	11	2006	2016	19	37
Wells Fargo	Separate Chairman & CEO	11	2006	2016	16	38
AT&T	Political Spending	10	2006	2016	13	39
General Electric	Cumulative Voting	10	2006	2016	11	35
Home Depot	Employment Diversity Report	10	2006	2016	22	36
Exxon Mobil	Amend EEO Policy	9	2006	2014	20	40
Exxon Mobil	Greenhouse Gas Emission Goals	9	2007	2015	10	31
Ford Motor	Special Meetings	9	2007	2016	10	26
Nucor	Majority Voting for Directors	9	2006	2014	34	46

\*In 2016, based on 231 companies holding annual meetings by August 31

Source: ProxyMonitor.org

AT&T faced an identical social-policy shareholder proposal in 10 of the last 11 years: a political-spending disclosure proposal sponsored by the social-investing fund Domini Social Investments. In 2006 and 2007, the proposal received only 15% and 13% of the vote, respectively. It was nevertheless placed again on the ballot in 2008, when it received almost 32% shareholder support—a 19-percentage-point increase from 2007 and 17 percentage points more than in 2006—after the proxy-advisory firm ISS changed its position and began recommending a vote “for” the proposal.<sup>79</sup> The proposal has since remained on the ballot every year except 2010; shareholder support has varied between 24% and 39%.

Home Depot also faced an identical social-policy proposal in 10 of the last 11 years: a proposal asking the company to prepare a “report on employment diversity,” sponsored alternatively by the social-investing funds Trillium Asset Management and Walden Asset Management and the Benedictine orders the Sisters of Mt. Angel and the Sisters of Boerne. (For some reason, the proposal did not appear on the company’s 2015 proxy ballot.) In each year, 64%–77% of shareholders voted against the proposal. ISS supports these ballot initiatives.<sup>80</sup>

<sup>78</sup> See Romano, *supra* note 11, at 241 (“In a 1998 release regarding proposed reforms of the proxy proposal rule, the SEC indicated that respondents to a 1997 agency-administered questionnaire reported an average (median) expenditure of approximately \$50,000 (\$10,000) on printing, distribution and tabulation costs for including a shareholder proposal, and \$37,000 (\$10,000) on the determination whether to include a proposal.”).

<sup>79</sup> See Domini Social Investments, Key Proxy Advisor Recommends Vote Against AT&T Management on Political Contributions Disclosure, Apr. 21, 2008.

<sup>80</sup> See ISS, *supra* note 65, at 61.

Nucor, a Charlotte-based steel company, faced an identical corporate-governance proposal from the pension fund for the United Brotherhood of Carpenters each year from 2006 through 2014. The proposal sought a bylaw change such that director nominees who failed to garner majority shareholder support in uncontested directors elections would not be seated on the board. The proposal received the backing of 33%–47% of shareholders each year, and 41% in the last year it was introduced (2014). Notwithstanding that a majority of shareholders had voted against the shareholder proposal for nine consecutive years, the company ultimately decided to adopt the majority voting rule; in its 2016 proxy statement, Nucor sought an amendment to its certificate of incorporation adopting a majority voting rule for seating directors—concurrent with a repeal of its previously existing cumulative voting rule;<sup>81</sup> this board proposal passed overwhelmingly.

#### *Analysis of Hypothetical Changes to the Rule*

Were the SEC to adopt a modest reform that significantly raised resubmission thresholds, it would block low-support shareholder proposals from being submitted repeatedly on the ballot without blocking shareholders' ability to continue proposing ideas that garnered at least some shareholder support from appearing essentially every year. For example, were the SEC to make its baseline threshold for shareholder support 10% rather than 3%, 149 of the 608 shareholder proposals to be resubmitted at least once would not have been eligible for resubmission over a five-year window.

Consider the case of animal rights–related shareholder proposals, which the proxy-advisory firms generally oppose. From 2006 through 2016, 67 animal rights–related proposals appeared on company proxy ballots. Two of these were “laudatory” or “complimentary” resolutions praising a company action that the board approved, and which won broad shareholder support. Among the other 65 proposals, more than 90% of shareholders voted against 63 of them, and shareholder opposition averaged 95%. Yet 49 of the 63 overwhelmingly rejected proposals were eligible for resubmission, and 14 of them were actually resubmitted proposals. It is hard to see how allowing a shareholder proposal rejected by 95% of shareholders is in the median shareholder's interest.

Were the SEC to adopt a 33% threshold as an intermediate (or even ultimate) floor for multiple shareholder-proposal resubmissions (a level sufficiently high that it would require at least some shareholder voting support beyond votes that merely follow proxy-advisory firms' guidance), 215 of the 608 resubmitted proposals would have been ineligible for resubmission—an only modestly higher number than those rejected under a baseline 10% rule. Conversely, 393 of 608 proposals that were resubmitted at least once would have been eligible for essentially perpetual resubmission. Thus, even a 33% threshold would be rather generous, only weeding out 35% of currently resubmitted proposals. Of course, the SEC may wish to adopt an even higher ultimate threshold—at or near 50%—since the propriety of permitting a minority of shareholders to

<sup>81</sup> See Nucor Corp., *Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934*, proposal no. 3 (Mar. 21, 2016). A cumulative voting rule, which Nucor previously had, allowed shareholders to aggregate all their votes for directors up for election on a single preferred candidate. The company had long maintained, in response to the Carpenters Fund proposal, that the board could not adopt the fund's preferred rule for not seating any director not receiving a majority of votes in an uncontested election in light of the company's cumulative voting mechanism.



perpetually introduce a ballot item that two-thirds of shareholders reject is questionable, at best.<sup>82</sup>

## 7. Corporate Political Spending and Lobbying Disclosures

Ever since the Supreme Court's 2010 decision in *Citizens United v. Federal Election Commission*<sup>83</sup>—which determined that independent political expenditures were speech protected by the First Amendment, even if funded by for-profit corporations—corporate political engagement has been much debated.<sup>84</sup> The decision drew a rebuke from President Obama in his

<sup>82</sup> By way of comparison, it is worth noting that many states with initiative ballot processes prevent reintroduction of the same or substantially similar ballot item when a voter-sponsored initiative fails to receive 50% support. See NCSL: Restrictions on Repeat Measures. For example, in Massachusetts, when an initiative is proposed on a ballot, then voted on and ultimately rejected, the law provides: "A measure cannot be substantially the same as any measure that has been qualified for submission or appeared on the ballot at either of the two preceding biennial state elections." *I.e.*, there is a six-year ban on any resubmission. Rules such as Massachusetts's both put a stay on unpopular resubmission attempts for an extended period and anticipate the submission of similar "new" submissions in an effort to get around the rule, hence the "substantially the same" language. Of course, state-law initiatives would tend to be binding, not merely precatory; so the SEC would probably prefer to permit any shareholder proposal that receives 50% support just once to be resubmitted multiple times, if not acted upon, for a number of years—regardless of subsequent shareholder votes.

<sup>83</sup> 558 U.S. 310 (2010).

<sup>84</sup> For the purposes of this statement, I take no position on the constitutional issues underlying the Supreme Court's controversial decision in *Citizens United*. Indeed, under *Citizens United*, Congress may be able to regulate certain further disclosures of political spending, corporate or otherwise, without running afoul of the First Amendment. See *id.* at 366–67 (citing *McConnell v. FEC*, 540 U.S. 93, 198 (2003)) (rejecting facial and as-applied challenges to disclosure requirement).

That said, many proponents of a government-mandated disclosure regime in this area have too casually assume the constitutionality such proposals, without giving careful consideration to the distinction between facial and as-applied constitutional challenges and the Supreme Court's focus, in the *Citizens United* decision itself, on the potential harassment of speakers, including corporations. See, e.g., Lucian A. Bebchuk & Robert J. Jackson, Jr., *Shining Light on Corporate Political Spending*, 101 GEO. L.J. 923, 954–55 (2013) (arguing that it is "clear" that "that the Constitution leaves ample room for disclosure rules of this kind") (citing Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83, 107–11 (2010) (asserting that "the constitutional permissibility of the disclosure requirements that [they] propose is straightforward"))).

Political spending disclosure requirements do not necessarily or easily pass constitutional muster. Rather, the Supreme Court "has subjected these requirements to 'exacting scrutiny,' which requires a 'substantial relation' between the disclosure requirement and a 'sufficiently important' governmental interest." *Citizens United*, 558 U.S. at 366–67 (citing *Buckley v. Valeo*, 424 U.S. 1, 64–66 (1976)).

Even in cases in which a disclosure statute passes constitutional muster on its face, it may fail an "as applied" challenge when there exists "a 'reasonable probability' that disclosure of its contributors' names 'will subject them to threats, harassment, or reprisals from either Government officials or private parties.'" *Id.* (citing *McConnell*, 540 U.S. at 198 (quoting *Buckley*, 424 U.S. at 74)). In *Citizens United*, the Court reaffirmed this principle, see *id.* at 916 (observing that a disclosure statute "would be unconstitutional as applied to an organization if there were a reasonable probability that the group's members would face threats, harassment, or reprisals if their names were disclosed"), but noted that "*Citizens United* . . . ha[d] offered no evidence that its members may face similar threats or reprisals. . . . [and indeed] ha[d] been disclosing its donors for years and ha[d] identified no instance of harassment or retaliation." *Id.*

In contrast to the dearth of evidence demonstrating that disclosure of donors to *Citizens United* raised the risk of harassment or retaliation, ample evidence exists that companies would be subject to reprisals for donating to some of the very trade associations and business groups specifically targeted by the proponents of corporate political spending disclosure. See Letter from Comm. on Disclosure of Corp. Pol. Spending, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 10 n.29 (Aug. 3, 2011), available at <http://www.sec.gov/rules/petitions/2011/petn4->

2010 State of the Union address, with many of the Supreme Court justices in front of him.<sup>85</sup> In 2011, several U.S. senators, including 2016 Democratic presidential candidate Bernie Sanders of Vermont, proposed amending the First Amendment in response.<sup>86</sup> Also in 2011, several professors of corporate and securities law petitioned the SEC seeking to have the agency establish rules for publicly traded companies to disclose fully their political spending, direct and indirect.<sup>87</sup> The rulemaking petition has become increasingly politicized in 2016, as U.S. Senators have openly clashed with the chairman of the SEC, Mary Jo White, over the agency's failure to respond to the petition;<sup>88</sup> and some of these same senators have even seized on the issue to block President Obama's new appointees to the SEC.<sup>89</sup>

Although agitation with the SEC over corporate political spending traces largely to *Citizens United*, efforts to inject the issue into the 14a-8 shareholder-proposal process predate the controversial court decision. In 2003, Bruce Freed, a former Democratic congressional staffer, founded an organization, the Center for Political Accountability (CPA), exclusively to "campaign for corporate political disclosure and accountability."<sup>90</sup> Dating back to 2006, the first year covered in the Proxy Monitor database, at least 19 shareholder proposals on companies' political engagements have been placed on Fortune 250 corporations' proxy ballots each year (**Figure 8**). The number of such proposals started to increase after *Citizens United*, peaking at 67 in 2014, before falling somewhat in 2015 and 2016. Nevertheless, as was the case last year, proposals related to corporate political spending or lobbying were the second-most-common class of shareholder proposals introduced in 2016.

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637.pdf [hereinafter the Petition] (asserting that disclosure of "contributions to intermediaries that spend a large fraction of their funds on politics . . . seems warranted," and singling out the U.S. Chamber of Commerce). Both social-investing funds, such as Walden Asset Management, and government agents managing public-employee pension funds, such as the New York City Comptroller, have harassed and implicitly threatened reprisals against companies known to be affiliated with the U.S. Chamber. See Press Release, Walden Asset Mgmt., Investors Call on Companies Sitting on The U.S. Chamber of Commerce Board to Evaluate Their Role (Jan. 31, 2011), available at <http://climate.bna.com/climate/document.aspx?ID=153882>; Press Release, N.Y. City Comptroller, Comptroller Liu Calls on Siemens AG To Cut Ties to U.S. Chamber of Commerce (Jan. 24, 2011), available at [http://comptroller.nyc.gov/press/2011\\_releases/pr11-01-007.shtm](http://comptroller.nyc.gov/press/2011_releases/pr11-01-007.shtm). In addition, the activist group Color of Change harassed companies known to be affiliated with the American Legislative Exchange Council, causing several such companies to drop their membership. See Press Release, Color of Change, Color of Change Applauds Procter & Gamble's Decision to End its Membership in ALEC: More Than a Dozen Companies Have Left the American Legislative Exchange Council (Apr. 23, 2012), available at <http://www.colorofchange.org/press/releases/2012/4/23/colorofchange-applauds-procter-gamblesdecision-en/>.

<sup>85</sup> See Adam Liptak, *Supreme Court Gets a Rare Rebuke, in Front of a Nation*, N.Y. TIMES, Jan. 28, 2010, [http://www.nytimes.com/2010/01/29/us/politics/29scotus.html?\\_r=0](http://www.nytimes.com/2010/01/29/us/politics/29scotus.html?_r=0).

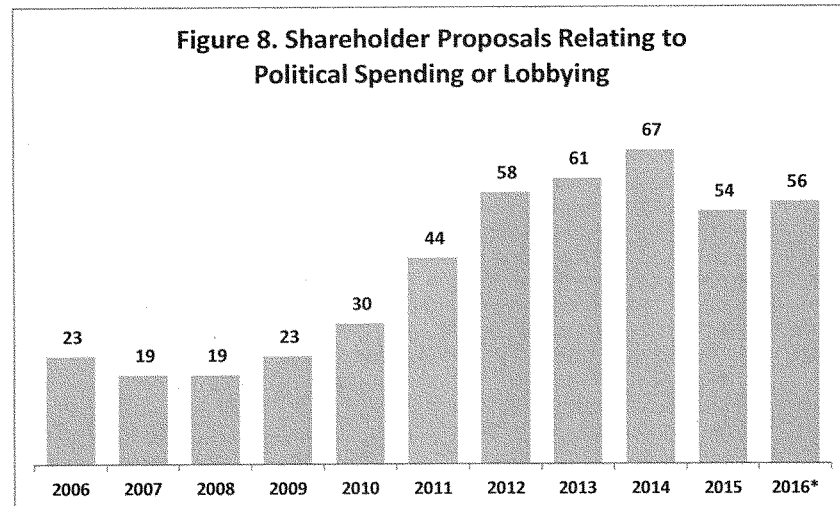
<sup>86</sup> See Pete Kasperowicz, *Sanders Proposes Amendment to the Constitution That Would Limit Free Speech*, THE HILL, Dec. 9, 2011, <http://thehill.com/blogs/floor-action/senate/198343-sanders-offers-constitutional-amendment-to-strip-corporations-of-first-amendment-rights>.

<sup>87</sup> See Petition, *supra* note 84. For a fuller response, see James R. Copland, *supra* note 6.

<sup>88</sup> See Francine McKenna, *Schumer Says SEC's White Is 'Poisoning' Politics*, MARKETWATCH, Jun. 15, 2016, <http://www.marketwatch.com/story/schumer-says-secs-white-is-poisoning-politics-2016-06-14>.

<sup>89</sup> Andrew Taylor & Marcy Gordon, *Democrats Block SEC Nominees*, U.S. NEWS & WORLD RPT., Apr. 7, 2016, <http://www.usnews.com/news/business/articles/2016-04-07/democrats-block-sec-nominees-over-political-money-fight>. I should disclose that I went to law school with one of the stalled nominees, Hester Peirce, whom I consider a friend.

<sup>90</sup> Center for Political Accountability, About the CPA, <http://politicalaccountability.net/about/about-us>.



\*In 2016, based on 231 companies holding annual meetings by August 31

Source: ProxyMonitor.org

As previously noted, the submission of shareholder proposals on this topic has not translated into majority shareholder support. From 2006 through 2016, companies in the Proxy Monitor database have faced votes on 446 board-opposed shareholder proposals that relate to corporate political spending or lobbying; 445 have failed to garner majority shareholder support. These actual shareholder votes held in recent years on the numerous shareholder proposals introduced on corporate political spending clearly show that a majority of shareholders believe that increased disclosure of corporate political spending as called for in shareholder proposals and in the professors' rulemaking petition with the SEC is not in their interests as shareholders.

It is not hard to understand why. As a threshold matter, the amount of money that publicly traded corporations spend on politics—including through trade associations and other intermediaries—is not material by any reasonable standard. Among the political committees organized under Section 527 of the Internal Revenue Code, are, after *Citizens United*, political action committees that can, independently of candidate campaigns, spend money for political purposes (so-called "Super PACs"); contributions to and expenditures by such organizations must be fully disclosed. In the 2012 political cycle, such PACs raised over \$838 million and spent over \$631 million<sup>91</sup>—significant sums, to be sure, but a pittance in comparison with overall public-company budgets: the combined revenues of the 200 largest U.S. companies in 2012 exceeded \$9.4 trillion.<sup>92</sup>

<sup>91</sup> See Super PACs, CTR. FOR RESPONSIVE POL., <http://www.opensecrets.org/pacs/super/pacs.php?cycle=2012>.

<sup>92</sup> See Fortune 500, CNN MONEY (May 21, 2012), [http://money.cnn.com/magazines/fortune/fortune500/2012/full\\_list/](http://money.cnn.com/magazines/fortune/fortune500/2012/full_list/) (listing top 500 U.S. companies by revenues). Note that certain of the Fortune 200 companies are not publicly held. That said, the 42 largest companies on the

Moreover, contributions to these Super PACs from publicly traded companies have proved virtually nonexistent.<sup>93</sup>

Of course, the clamor for increased disclosures of corporate political spending would not rest on disclosed dollars given to Super PACs but rather non-disclosed groups including social-welfare organizations and trade associations organized respectively under sections 501(c)(4) and 501(c)(6) of the Internal Revenue Code, which can make political expenditures but do not have to publicly disclose their donors.<sup>94</sup> But the total amount spent by all outside groups in the 2012 election—including Super PACs, 527 committees, and 501(c) organizations (not only social-welfare organizations and trade associations but also labor unions)—was just over \$1 billion (drawn from all sources, corporate or not).<sup>95</sup> That's equivalent to 0.011% of the Fortune 200 companies' 2012 budgets—less than the development cost of a single biotechnology product,<sup>96</sup> and less than the amount that automobile manufacturers and dealers spent on television advertising spots with local broadcasting stations in the third quarter of 2012.<sup>97</sup> It is impossible

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2012 Fortune 200 list, with a combined revenues exceeding \$5 trillion, are publicly traded (Fannie Mae and Freddie Mac, however, were delisted upon entering government receivership). The two largest American private companies, Cargill and Koch Industries do not show up on the *Fortune* list, presumably due to data limitations. See Andrea Murphy & Scott DeCarlo, *America's Largest Private Companies*, FORBES (Nov. 28, 2012), <http://www.forbes.com/largest-private-companies/>. The largest company on the 2012 Fortune list that is not a public C corporation is State Farm, a mutual insurer, at 43rd. While the presence of such companies marginally inflates the revenues of the Fortune 200 attributable to public companies, it is also of course the case that many companies, beyond the 200 largest, make money, are publicly listed, and may be involved directly or indirectly in political spending.

<sup>93</sup> See, e.g., Anna Palmer & Annie Phillip, *Corporations Don't Pony Up for Super PACs*, POLITICO (Mar. 8, 2012), <http://www.politico.com/news/stories/0312/73804.html> ("When super PACs emerged two years ago, critics howled that corporations would take advantage of a newfound tool to flex their muscle in politics. But so far this campaign season, publicly traded companies have shied away from the outside groups—giving less than one half of a percent of all the contributions raised by the most active super PACs."). As I noted in my article in the *Harvard Business Law Review*:

Five [Super] PACs spent over \$20 million in the 2012 campaign: the pro-Romney Restore Our Future, the pro-Obama Priorities USA Action, Karl Rove's American Crossroads, and Super PACs supporting Senate and House Democrats; all told, these five PACs raised and spent a majority of all Super PAC dollars in the campaign (raising and spending \$428 million and \$380 million, respectively). Only one publicly traded corporation was among the top fifty organizational donors to any of these Super PACs: the small-cap, family-controlled but Nasdaq-listed Clayton Williams Energy, which contributed \$1 million to American Crossroads. And the top-fifty donor list comprised most of each Super PAC's funding, in total over \$314 million of the \$428 million these five political committees raised.

Copland, *supra* note 6, at 388 (citations omitted).

<sup>94</sup> Cf. NAACP v. Alabama, 357 U.S. 449 (1958) (holding that organization's freedom of association rights prevented Alabama from requiring disclosure of its contributor lists).

<sup>95</sup> See 2012 Outside Spending, by Group, CTR. FOR RESPONSIVE POL., <http://www.opensecrets.org/outsidespending/summ.php?cycle=2012&type=p&disp=O>.

<sup>96</sup> See Joseph A. DiMasi & Henry G. Grabowski, *The Cost of Biopharmaceutical R&D: Is Biotech Different?*, 28 MANAGERIAL & DEC'N ECON. 469–79 (2007) (estimating the total development cost of a biotechnology product at \$1.2 billion).

<sup>97</sup> See Top 25 Local Broadcast TV Categories, Spot TV Q3, TVB Local Media Marketing Solutions, <http://www.tvb.org/trends/4705> (citing Kantar Media) (showing local spot TV "automotive" spend of \$925 million and "car and truck dealers" of \$273 million in the third quarter of 2012).

*SEC Rule 14a-8: Ripe for Reform*

Hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises

to conclude that political spending, on its own, is material to investors' pecuniary interests as shareholders.<sup>98</sup>

Rather than involving a financial interest for investors, shareholder proposals filed seeking additional political spending or lobbying disclosures appear to be premised on a *political* goal: namely, to chill corporate political speech. Across the 2006–16 period, fully 53% of shareholder proposals related to corporate political spending have been sponsored by labor-affiliated pension funds (**Figure 9**)—representing interests that themselves spend heavily on the political process, often in opposition to corporations. State and municipal pension funds—including the two most-active sponsors of these types of proposals, the funds for public employees in New York City and State—are often wholly or significantly controlled by partisan elected officials whose political interests may be adverse to corporations' interests. Indeed, my prior research has shown that labor-affiliated pension funds' sponsorship of such shareholder proposals has tended to target companies whose executives and political action committees gave disproportionately to Republicans.<sup>99</sup> Aside from labor-affiliated investors, most political-spending-related shareholder proposals have been sponsored by social-investing funds, which by definition are not oriented solely around share value and may have social or policy goals opposed to the corporations they are targeting.

The public record amply demonstrates that many of the same sponsors of shareholder proposals seeking additional corporate disclosures of political spending also seek to influence corporations to disassociate from trade associations or to dissuade such groups from taking positions contrary to the special-interest sponsors' particular political preferences. For instance, in January 2011, leaders of the AFL-CIO Office of Investment, Domini Social Investments, Green Century Capital Management, the Nathan Cummings Foundation, and Trillium Asset Management—each

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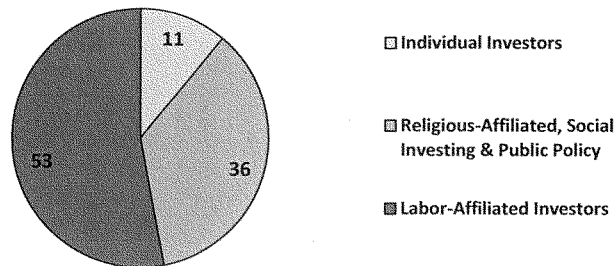
I am not the first to make this sort of comparison. In a 2010 blog post, UCLA's Stephen Bainbridge compared total 2008 political spending to Procter & Gamble's 2008 advertising on soap and toilet paper. See Is Citizens United the death of democracy, PROFESSORBAINBRIDGE.COM (Oct. 19, 2010), <http://www.professorbainbridge.com/professorbainbridgecom/2010/10/is-citizens-united-the-death-of-democracy.html>.

<sup>98</sup> Auditors typically assume that for publicly traded companies, an item is not material if it is "not greater than 5 percent of net income before income taxes." Audit Manual Excerpt: Materiality Guidelines, Williams & Adams, CPAs, [http://highered.mcgraw-hill.com/sites/dl/free/0078025435/928516/WA\\_Materiality\\_Guidelines\\_8e.pdf](http://highered.mcgraw-hill.com/sites/dl/free/0078025435/928516/WA_Materiality_Guidelines_8e.pdf). Consistent with this general principle, under SEC rules, shareholder proposals are deemed not relevant and excludable from a publicly traded corporation's proxy statement "[i]f the proposal relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year . . . ." 17 C.F.R. § 240.14a-8(i)(5) (2008). (Shareholder proposals involving corporate political spending, like other cases involving "political and moral predilections," can appear on proxy ballots under an exception to this rule discussed in section 1, *infra*.) Similarly, under Regulation S-K, the SEC deems that legal proceedings are not material "if the amount involved, exclusive of interest and costs, does not exceed 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis." 17 C.F.R. § 229.103(2) (2008).

<sup>99</sup> See James R. Copland & Margaret M. O'Keefe, *Proxy Monitor: A Report on Corporate Governance and Shareholder Activism 2* (Manhattan Institute 2014) ("The 43 Fortune 250 companies facing shareholder proposals sponsored by labor-affiliated investors in 2014 were twice as likely to orient their political efforts to support Republicans than was the average Fortune 250 company. A majority of shareholder proposals sponsored by labor-affiliated investors in 2014 have involved corporate political spending or lobbying, and only one company targeted by these proposals gave more money to Democrats than Republicans."), available at [http://www.proxymonitor.org/Forms/pmr\\_09.aspx](http://www.proxymonitor.org/Forms/pmr_09.aspx).

a regular sponsor of political-spending-disclosure shareholder proposals—all co-signed a letter sent to 35 companies serving on the board of the U.S. Chamber of Commerce urging the companies “to evaluate” their role with the trade association and objecting to the Chamber’s “education and lobbying efforts to defeat legislative [sic] and regulation related to climate change, consumer protection, and financial reform.”<sup>100</sup> Former New York City Comptroller John Liu, who manages the city’s five pension funds for retired public employees, sent a similar letter to at least one company in which the funds invested.<sup>101</sup> Bruce Freed’s CPA has both led and joined coalition letters pressuring companies to vocalize disagreement with trade association political positions.<sup>102</sup> It is hard to escape the conclusion that the highly politicized push for greater corporate disclosures surrounding political spending and lobbying is about political rather than financial goals.

**Figure 9. Percentage of Politics-Related Shareholder Proposals by Proponent Type, 2006–16\***



\*In 2016, based on 231 companies holding annual meetings by August 31  
Source: ProxyMonitor.org

#### 8. The Costs of Pension Funds’ Social-Issue Activism

For sound policy reasons—most notably federalism and comity shown to the states—federal law governing pension plans exempts state and municipal plans for public employees.<sup>103</sup> Nevertheless, the operation and solvency of plans is a matter of significant public-policy concern: public pension funds for state and municipal workers in the United States have accumulated, by most recent estimates, approximately \$4 trillion in obligations—roughly one-

<sup>100</sup> Press Release, Walden Asset Mgmt., *supra* note 84.

<sup>101</sup> See Press Release, N.Y. City Comptroller, *supra* note 84.

<sup>102</sup> See CPA Leads Effort to Press Companies on Climate-Change Misalignment; Company Cuts Chamber Dues, CTR. FOR POL. ACCOUNTABILITY NEWSLETTER (Nov. 2009), <http://www.politicalaccountability.net/index.php?ht=a/GetDocumentAction/i/2663>.

<sup>103</sup> See 29 U.S.C. § 1003(b).

fourth of U.S. GDP and almost 130 percent of state and local governments' annual budgets—to fund government workers' retirements.<sup>104</sup> Actual assets available to fund these obligations, however, total only about \$3 trillion, leaving a \$1 trillion shortfall that threatens to jeopardize public employees' retirement security and/or burden the public fisc—potentially squeezing out vital spending on health, education, and infrastructure.<sup>105</sup> I and many of my Manhattan Institute colleagues have written about at some length;<sup>106</sup> so I wanted to bring to the attention of Congress some of the research we have sponsored that relates to the impact of such pension funds' social-investing activism on share value.

The ultimate test of whether shareholder proposals are an effective tool—at least from the standpoint of the average diversified investor—is not whether they win majority shareholder support but whether they enhance share value.<sup>107</sup> Individual investors might, of course, have different priorities, and certain institutional investors are designed to have different priorities. But precisely because most investors inherently disagree about many issues of public concern, corporate governance has tended to assume that shareholder value is the orienting concern for equity investors; such concerns are implicit in the fiduciary duties that pension funds owe to retirees.<sup>108</sup>

To study the relationship between public-employee pension funds' shareholder activism and share value, the Manhattan Institute commissioned an econometric study by Tracie Woidtke, a professor at the Haslam College of Business at the University of Tennessee.<sup>109</sup> Building on a

<sup>104</sup> Pew Charitable Trusts and Laura and John Arnold Foundation, *State Public Pension Investments Shift over Last 30 Years* 1 (June 2014),

<http://www.pewtrusts.org/en/research-and-analysis/reports/2014/06/03/state-public-pension-investments-shift-over-past-30-years>. GDP data are available at

<http://www.bea.gov/national/an1.htm>. State and local budget data are available at <http://www.census.gov/govs/local>.

<sup>105</sup> See Pew Charitable Trusts, *supra* note 104.

<sup>106</sup> For a fuller discussion, see James R. Copland & Steven Malanga, *Safeguarding Public-Pension Systems: A Governance-Based Approach* (Manhattan Institute 2016), available at <http://www.manhattan-institute.org/html/safeguarding-public-pension-systems-governance-based-approach-8595.html>.

<sup>107</sup> Traditionally, corporate law has oriented corporate boards and managers' fiduciary duties around a single variable, share value, see *Dodge v. Ford Motor Co.*, 170 N.W. 668. (Mich. 1919) (holding that corporate fiduciary duties flowed to shareholders, not employees or other interests), which avoids the ownership costs—chiefly conflicts of interest that arise among various owners—that are inherent in non-corporate ownership forms. See generally HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 35–49 (1996) (arguing that the costs of collective decision-making best explain the predominance of the corporate equity-ownership form in large-scale for-profit enterprise); see also Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006) (arguing that increasing shareholder power imposes significant costs in reduced managerial authority). Since shortly after *Dodge v. Ford* was decided, an academic debate has proliferated between those arguing for a social responsibility for corporations, see E. Merrick Dodd, Jr., *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932) (arguing for the view that “the business corporation as an economic institution which has a social service as well as a profit-making function”), and those supporting the traditional rule centered on share value, see Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932).

<sup>108</sup> 29 C.F.R. § 2509.08-2(1) (2008) (requiring pension plan managers to “consider only those factors that relate to the economic value of the plan’s investment” and not to “subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives”). These fiduciary duties under ERISA do not apply to pension plans for state and municipal employees or for those affiliated with religious institutions. See 29 U.S.C. § 1003(b).

<sup>109</sup> See *The University of Tennessee Knoxville*: Tracie Woidtke, <http://finance.bus.utk.edu/Faculty/TWoidtke.asp>.

research methodology initially developed for her doctoral dissertation, Woidtke examined the valuation effects associated with pension fund influence, measured through ownership, on Fortune 250 companies, during 2001–13.<sup>110</sup> Firm value was assessed through industry-adjusted Tobin's Q, with various controls added to the analysis, including firm leverage, research and development expenses, advertising expenses, index membership, assets, positive income, stock transaction costs, insider ownership, and year fixed effects.

Woidtke finds that “public pension funds’ ownership is associated with lower firm value” and, more particularly, that “social-issue shareholder-proposal activism appears to be negatively related to firm value.”<sup>111</sup> As such, public employee pension funds’ use of the shareholder-proposal process in an effort to affect corporate behavior in pursuit of social or policy goals may be harming the financial interests of plan beneficiaries—and ultimately state and local taxpayers—as well as, by inference, the average diversified investor.

### Conclusion

In sum, it is hard to argue that the 14a-8 shareholder-proposal process is functioning well. A small group of shareholders dominates the process—including idiosyncratic individual “corporate gadflies” and institutional investors whose interests diverge from the ordinary diversified investor, namely labor-affiliated pension funds and social-investing funds. Increasingly, the 14a-8 process has tilted toward social and political concerns with little relationship to share value, market efficiency, or capital formation. By co-opting proxy advisory firms with substantial power over voting outcomes but limited resources, these activists are able to finance their agendas at other shareholders’ expense—even when most shareholders vote down the activists’ ideas repeatedly. At least some shareholder-proposal activism appears to be depressing share value.

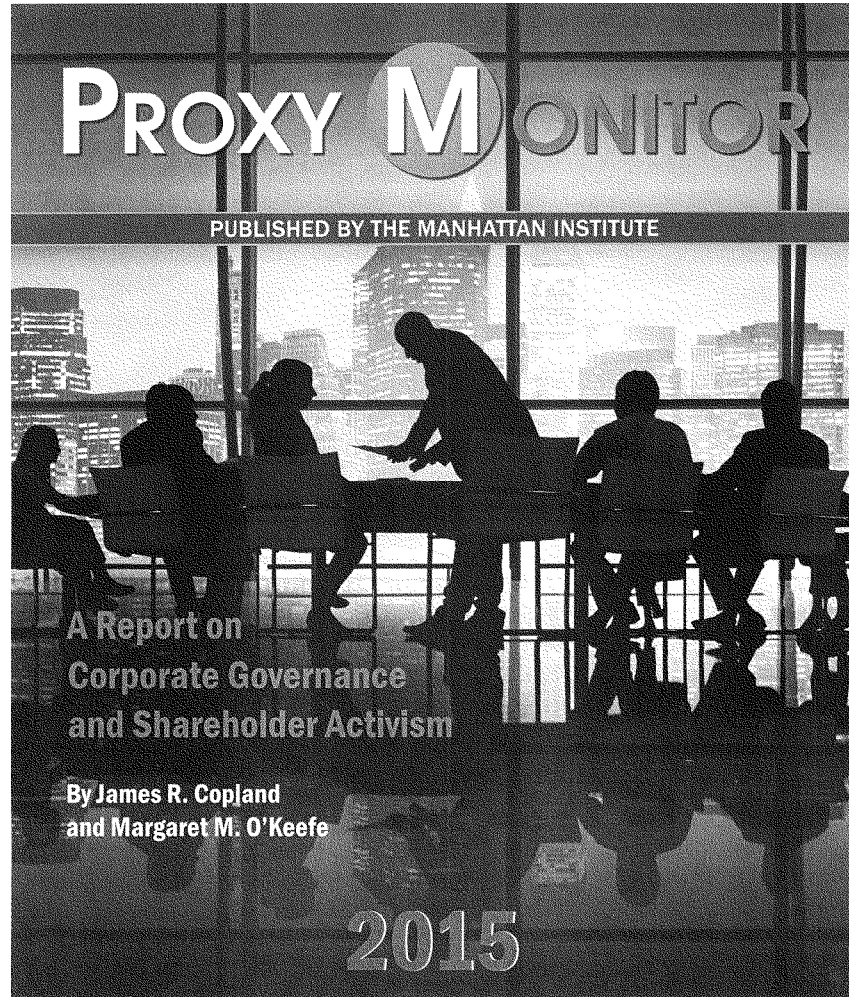
Rule 14a-8 is a long-standing rule that has some utility, but activists have seized upon the SEC’s outdated and overly permissive standards to push policy agendas—and chill political speech—in an effective end-run around Congress. Congress has a vested interest in addressing this situation and reorienting the SEC around its statutory obligation to “promote efficiency, competition, and capital formation.”<sup>112</sup>

<sup>110</sup> See Woidtke, *supra* note 8, at 3.

<sup>111</sup> See *id.* at 16.

<sup>112</sup> 15 U.S.C. § 78c(f).





## PROXY MONITOR 2015

### A Report on Corporate Governance and Shareholder Activism

#### EXECUTIVE SUMMARY

In the last two decades, shareholders have gained power relative to corporate boards. One way shareholders exert influence over corporations is by introducing proposals that appear on corporate proxy ballots. In 2015, shareholders were both more active and more successful in these efforts:

- **The number of shareholder proposals is up.** The average large company faced 1.34 shareholder proposals in 2015, up from 1.22 in 2014. This is the highest level of shareholder-proposal activity since 2010. The increase in 2015 has been driven largely by the New York City pension funds' push for "proxy access," which would give large, long-term shareholders the right to nominate their own candidates for director on corporate proxy ballots.
- **The Securities and Exchange Commission has been more lenient in allowing shareholder proposals on the ballot.** Another reason for the uptick in shareholder-proposal activity in 2015 is a more permissive stance adopted by the SEC in assessing shareholder proposals' appropriateness for proxy ballots. In January 2015, the agency suspended the application of its "conflicting proposals" rule—and several companies this year faced shareholder proposals that conflicted with management proposals on the ballot. In 2015, the SEC issued 82 letters assuring companies that it would take no action if they excluded a shareholder proposal from their proxy ballot, down from 116 in 2014; the agency declined to issue no-action letters on 68 petitions in 2015, up from 50 in 2014.
- **A small group of shareholders dominates the shareholder-proposal process.** As in 2014, one-third of all shareholder proposals in 2015 were sponsored by just three individuals and their family members: John Chevedden, the father-son team of William and Kenneth Steiner, and the husband-wife team of James McRitchie and Myra Young. The NYC pension funds sponsored 11 percent of all proposals in 2015, but the overall percentage of shareholder proposals sponsored by labor-affiliated pension funds—28 percent—is

below historical norms because private labor unions' pension funds have been less active. Institutional investors without a labor affiliation or a social, religious, or policy orientation sponsored only one proposal.

- **A plurality of shareholder proposals involve corporate-governance issues.** Forty-three percent of 2015 shareholder proposals involved corporate-governance concerns—including 11 percent that sought proxy access. Forty-two percent involved social or policy issues, including 19 percent that focused on the environment. Although shareholder proposals focusing on corporate political spending or lobbying remained common—17 percent of all proposals—the overall number of such proposals fell to 51, down from 67 in 2014.
- **The percentage of shareholder proposals receiving majority shareholder support is up.** Eleven percent of shareholder proposals were supported by a majority of shareholders in 2015, up from just 4 percent in 2014. This uptick was due to substantial support for proposals seeking proxy access: 23 of 35 proxy-access proposals won majority shareholder backing. Aside from proxy-access proposals, only 4 percent of shareholder proposals—ten in total—received majority shareholder votes. Among the companies in the Fortune 250, not a single shareholder proposal involving social or policy concerns won majority shareholder support over board opposition—as has been the case for the past ten years.

In addition to capturing overall shareholder proposal trends, this report and a companion econometric analysis by University of Tennessee professor Tracie Woidtke assess shareholder-proposal activism by public-employee pension funds:

- **Public-pension fund shareholder-proposal activism is associated with lower stock returns.** Fortune 250 companies targeted by shareholder proposals by the five largest state and municipal pension funds from 2006 through 2014 saw their share price, on average, underperform the broader S&P 500 index by 0.9

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percent in the year following the shareholder vote. Companies targeted by the New York State Common Retirement Fund, which in 2010 launched an aggressive shareholder-proposal effort focused on social issues, such as corporate political spending, saw their share price drop by 7.3 percent, relative to the broader market.

- **Social-issue-focused shareholder-proposal activism helps explain a negative share-value effect associated with public-pension fund ownership.** Controlling for various factors, companies in which public-pension funds invested from 2001 through 2013 were less valuable than those owned by private pension funds and other investors. This negative ownership effect was particularly pronounced for companies targeted by the New York State Common Retirement Fund with social-issue proposals and does not exist for the 2001–07 period, when that fund did not sponsor social-issue proposals.
- **Shareholder votes supporting 2015 proxy-access proposals are associated with a negative stock-price reaction.** When shareholders approved a Fortune 250 company's proxy-access proposal in 2015, the company's share price underperformed the S&P 500 index by 2.3 percent, on average, in the days following the annual meeting. Conversely, when shareholders voted down a company's proxy-access proposal, the company's share price outperformed the market index by an average of 0.5 percent.

In light of these findings, states and municipalities should consider how their public-employee pension funds should engage in future shareholder-proposal activism, if at all.

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## ABOUT PROXY MONITOR

The Manhattan Institute's ProxyMonitor.org database, launched in 2011, is the first publicly available database cataloging shareholder proposals<sup>1</sup> and Dodd-Frank-mandated executive-compensation advisory votes<sup>2</sup> at America's largest companies. This is the fifth annual survey and 35th publication in a series of findings and reports by Manhattan Institute Center for Legal Policy director James R. Copland, each drawing upon information in the database to examine shareholder activism in which investors attempt to influence corporate management through the shareholder voting process.<sup>3</sup>

## DATA

The ProxyMonitor.org database includes the 250 largest publicly traded American companies, by revenues, as determined by *Fortune* magazine. Although we loosely refer to this list as the "Fortune 250," the fact that several of the Fortune 250 companies are not publicly traded means that some of the companies among the 250 largest that are subject to the proxy rules of the Securities and Exchange Commission (SEC) are from the broader Fortune 300 group.<sup>4</sup>

Because the Fortune list changes annually, some companies in the Proxy Monitor data set, while among the 250 largest companies in 2010, 2011, 2012, or 2013, fell out of the list in 2014, the baseline year for the 2015 proxy season. Eleven companies whose annual-meeting shareholder-vote results appear in the ProxyMonitor.org database are excluded from this analysis for 2015 because their 2014 revenues placed them outside the 250 largest companies.<sup>5</sup> Eleven companies not listed in the database for previous years are among the largest 250 companies for the 2014 base year and are included in the 2015 analysis—to the extent that they have filed materials for annual meetings.<sup>6</sup> (Another 13 companies listed in the ProxyMonitor.org database for previous years no longer existed as independent U.S.-based publicly traded companies for the 2015 proxy season, due to going private, change-of-control, or relocation actions.)<sup>7</sup> Although historical numbers will be consistent with those previously reported, these adjustments may marginally alter data reported in earlier findings for 2015.<sup>8</sup> Data for 2015 are current to August 31, at which time 229 companies had held their annual meetings and 235 had filed proxy documents.

Because the ProxyMonitor.org database is limited to the 250 largest companies by revenues, the analysis in this report does not capture the full set of shareholder-proposal activism. Some shareholder activists have objected to Proxy Monitor data on these grounds,<sup>9</sup> but the companies in the ProxyMonitor.org database encompass the majority of holdings for most diversified investors in the equity markets, making this analysis appropriate for the average shareholder. From the average shareholder's perspective, the Proxy Monitor data set paints a significantly more accurate picture than do the vote tallies of most shareholder activists, who simply straight-line-average votes across a much larger data set of companies, without regard to market capitalization.

## INTRODUCTION

During the last 15 years, shareholders in publicly traded equity markets in the United States have gained power relative to corporate boards of directors.<sup>10</sup> In part, this trend has been driven by shifts in how individuals hold equity investments, as fewer individuals hold shares directly, leading to increasing influence by institutional investors.<sup>11</sup> In part, the trend is the result of legal and regulatory changes.<sup>12</sup>

In this new environment, shareholder activists have increasingly sought to leverage their influence to change corporate behavior.<sup>13</sup> Such activism varies, from hedge funds seeking to leverage their significant stakes in a given company to increase the value of their holdings, to “socially responsible” investors whose objectives go beyond share-price maximization and encompass other normative goals.<sup>14</sup>

The Manhattan Institute’s Proxy Monitor project looks at a specific type of shareholder activism—namely, that launched through the process of introducing shareholder proposals on corporate proxy ballots. Under regulations promulgated by the Securities and Exchange Commission (SEC), through authority vested in the agency by the federal securities laws, companies must include shareholders’ proposals on their proxy ballots—to be voted on by all shareholders at corporate annual meetings—if such proposals conform to certain procedural and substantive requirements.<sup>15</sup>

Because these requirements permit very small, short-term shareholders to sponsor proposals (under SEC rules, a shareholder need only own \$2,000 of stock for one year to introduce a proposal) and because these requirements allow proposals focusing on social or political issues unrelated to share value, there is reason for concern that special-interest shareholders could be utilizing this process to advance their own idiosyncratic objectives, to the average shareholder’s detriment.<sup>16</sup>

Empirical evidence gathered from the ProxyMonitor.org database generally supports this concern. During the last ten years, a small subset of investors has dominated the shareholder-proposal process. A plurality of all shareholder proposals have been introduced by three small individual shareholders and their family members—“corporate gadflies” who repeatedly file substantially similar proposals across a broad set of companies.<sup>17</sup> Most institutional investors almost never introduce shareholder proposals; in

recent years, a majority of all sponsoring institutions have had an express social-investing purpose or an affiliation with a religious or public-policy organization.

The third major class of shareholder-proposal sponsor, apart from corporate gadflies and social investors, is pension funds, particularly those affiliated with state and municipal workers. Most pension funds do not file shareholder proposals, but those that do argue that such engagement affords them an important corporate-governance mechanism to improve share value.<sup>18</sup> Others have worried that labor-affiliated and public-pension funds may be motivated, at least in part, by concerns other than share value.<sup>19</sup>

By far, the public-employee pension funds that have been most active in sponsoring shareholder proposals have been those affiliated with New York City and State. The New York State Common Retirement Fund, which holds assets in trust for the New York State & Local Retirement System (NYSLRS), began introducing shareholder proposals in 2010, under the leadership of the state’s publicly elected comptroller. Democrat Thomas P. DiNapoli, who serves as the fund’s sole trustee. The New York State fund’s proposals have been overwhelmingly oriented toward social and political concerns and have met with little shareholder support: a 2015 proposal at Staples concerning executive compensation was the first New York State proposal to garner majority support from shareholders, among 57 introduced since 2010.

The NYC pension funds—five financially independent vehicles for New York City retirees that have separate boards but are each administratively overseen by the city’s elected comptroller—have long been active in filing shareholder proposals: during the last ten years, the NYC funds have sponsored more shareholder proposals than any other shareholder, save the two most active corporate gadflies.

The city’s funds have historically focused on social or policy concerns; but in 2015, New York City Comptroller Scott Stringer—first elected in fall 2013—launched a broad campaign for a corporate “proxy-access” rule, which would grant shareholders, given ownership and holding-period requirements, the power to nominate board directors on the company’s proxy statement.<sup>20</sup> Comptroller Stringer’s campaign has been remarkably successful in terms of winning majority support from shareholders: among 22 Fortune

250 companies facing a NYC fund-sponsored proxy-access proposal in 2015, 18 received majority shareholder support.

This report examines these and other 2015 trends in shareholder-proposal activism and places those trends in historical context.

**Section I** offers an overview of shareholder proposals introduced on corporate proxy ballots in 2015, as compared with earlier years. In addition to looking at the proposals that actually made it on to proxies, Section I examines proposals that shareholders introduced but that companies excluded from their ballots after receiving a no-action letter from the SEC stating that the agency would not pursue an enforcement action, were the company to exclude them—a point of legal and regulatory contention this proxy season.

**Section II** examines, in greater detail, the sponsors of shareholder proposals, in 2015 and historically.

**Section III** looks at the types of proposals that shareholders introduced in 2015, relative to historical trends.

**Section IV** assesses voting results for shareholder proposals, in 2015 and historically.

**Section V** scrutinizes shareholder activism by public-employee pension funds, historically and in 2015, with particular attention paid to the NYC pension funds' proxy-access campaign.

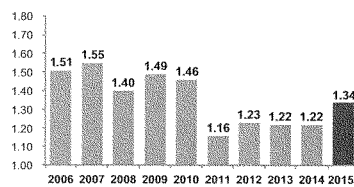
**Appendix** considers executive-compensation advisory-vote data for Fortune 250 companies, in 2015 and in each of the years holding such votes subsequent to such votes' mandate in Dodd-Frank (2011–15).

## I. SHAREHOLDER-PROPOSAL INCIDENCE

In 2015, the average Fortune 250 company faced 1.34 shareholder proposals on its proxy statement, the highest level since 2010 (**Figure 1**). The increase in shareholder-proposal incidence was driven almost entirely by the proxy-access campaign: 36 shareholder proposals seeking proxy access were introduced in 2015, up from only ten in 2014. Notwithstanding this increase, the number of shareholder proposals introduced remains below that witnessed before 2011, when the average Fortune 250 company faced 1.40–1.55 proposals.

Much as the uptick in 2015 shareholder-proposal activity is explained by the proxy-access campaign, the higher level of activity during 2006–10 is largely explained by shareholder proposals seeking shareholder advisory votes on executive compensation, which constituted 10 percent of all shareholder proposals introduced in that period. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>21</sup> required such shareholder advisory votes on executive compensation beginning in 2011,<sup>22</sup> which obviated any need for further shareholder proposals on that topic.

**Figure 1. Shareholder Proposals per Company, Fortune 250, 2006–15\***



\*In 2015, based on 235 companies filing proxy statements by August 31  
Source: ProxyMonitor.org

## SPECIAL FOCUS: SHAREHOLDER-PROPOSAL EXCLUSIONS

We have consistently observed that “the universe of shareholder proposals actually listed on corporate proxy ballots paints an incomplete picture of shareholder-proposal activism”<sup>23</sup> because many shareholder proposals introduced never make it on to corporate proxy ballots. In part, this is because proposals are withdrawn—either because a shareholder neglects to follow up on the proposal or because the corporate leadership negotiates with the proposal’s sponsor and sufficiently assuages their concerns.

Proposals are commonly excluded from the proxy ballot by the corporations themselves—typically after receiving assurances from the SEC that the agency will take “no action” if the proposal is excluded because the proposal fails to comply with the agency’s rules.<sup>24</sup> In a limited number of cases, a company has filed suit and successfully persuaded a federal court to permit it to exclude a shareholder proposal.<sup>25</sup> A 2013 survey of Proxy Monitor companies conducted by the Society of Corporate Secretaries and Governance Professionals<sup>26</sup> suggested that, on average, large companies face 77 percent more shareholder proposals than actually appear on proxy ballots<sup>27</sup> (though this figure may vary from year to year).

The SEC issues no-action letters to petitioning companies if the agency’s staff determines that a shareholder proposal does not comply with SEC rules. Procedurally, the shareholder must establish his ownership in the company and meet filing deadlines.<sup>28</sup> Substantively—at least under the rules at the end of the 2014 proxy season—a company would be permitted to exclude a shareholder proposal that was too vague or indefinite to implement, that asked the company to do something that it had already done or lacks the power to implement, that conflicted with state law, that duplicated or conflicted with another ballot proposal, or that involved the company’s “ordinary business operations.” Companies are also permitted to exclude repeat proposals that failed to gain minimal shareholder support in earlier years.<sup>29</sup>

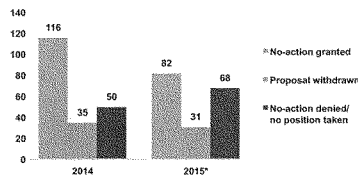
For the 2015 proxy season, the SEC suspended its “conflicting proposals” rule on the order of chairman Mary Jo White, who, on January 16, 2015, asked the staff to report back on the proper scope and application of the rule and had the agency’s Division of Corporation Finance announce that it would not be expressing any views on the

appropriateness of excluding conflicting proposals from proxy ballots in the interim.<sup>30</sup> Chairman White’s order was precipitated by investor outcry over a December 1, 2014, SEC staff no-action letter that had advised Whole Foods that the agency would take no action were the company to exclude a proxy-access proposal introduced by corporate gadfly James McRitchie, given the company’s stated intention to introduce its own proposal for proxy access with higher ownership and holding-period thresholds than those sought by McRitchie.<sup>31</sup> McRitchie had appealed to the SEC commissioners to reverse this decision,<sup>32</sup> prior to White’s announcement.

In addition to the conflicting-proposals rule, the SEC’s “ordinary business” exception was placed in considerable doubt up to the eve of the 2015 proxy season, after a November 26, 2014, order by Judge Leonard P. Stark of the federal district court in Delaware, which reversed the SEC’s determination that Wal-Mart could properly exclude a shareholder proposal by Trinity Wall Street church.<sup>33</sup> The church’s proposal had asked the board to amend the company’s charter and charge its board committees with new duties overseeing the company’s sale of certain products that “especially endanger . . . public safety and well-being.” Specifically, the proposal asked for a report on “whether or not the company should sell guns equipped with magazines holding more than ten rounds of ammunition.”<sup>34</sup> Judge Stark concluded that Trinity’s proposal involved matters of “significant social concern,” which the SEC has viewed as an exception to the ordinary-business-operations rule;<sup>35</sup> but on April 14, 2015, the Third Circuit Court of Appeals reversed<sup>36</sup>—though the court’s ultimate decision, issued after the proxy season on July 6,<sup>37</sup> is hardly a matter of lucidity resolving such issues going forward.<sup>38</sup>

In this environment of challenges to shareholder-proposal exclusion rules, the SEC staff was significantly less likely to issue no-action letters in the 2015 proxy season than in 2014. In 2015, the SEC issued 82 no-action letters to petitioning companies and denied or refused to take a position on 68; in 2014, the agency issued 116 no-action letters and denied only 50 (Figure 2). Twelve of the petitions that failed to receive a no-action letter in 2015 involved the agency not issuing an opinion on conflicting proposals. In 31 cases in 2015 and 35 cases in 2014, a proposal sponsor withdrew the proposal after the company petitioned the SEC.

**Figure 2. SEC Responses to No-Action Petitions, Number of Decisions, Fortune 250, 2014–15\***



\*For 2015, based on 235 companies filing proxy statements by August 31  
Source: Proxy Monitor data

The SEC's changed response to no-action petitions in 2015 materially changes the overall shareholder-proposal picture. Including proposals excluded pursuant to a no-action letter in 2015, the average Fortune 250 company faced 1.82 proposals per company having filed—which is actually down from 1.88 proposals per company in 2014, notwithstanding this proxy season's substantial increase in proposals seeking proxy access.

## II. SHAREHOLDER-PROPOSAL SPONSORS

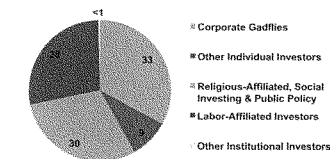
A small group of shareholders has dominated the process of introducing shareholder proposals for each of the last ten years tracked in the ProxyMonitor.org database. The year 2015 is no exception. These shareholder-proposal activists can roughly be divided into three groups:

1. **Labor-Affiliated Investors.** Labor-affiliated pension funds—including corporate-specific pension plans, “multiemployer” plans affiliated with labor unions, and state and municipal pension plans—sponsored 28 percent of shareholder proposals introduced at Fortune 250 companies in 2015 (Figure 3). The percentage of shareholder proposals with labor-affiliated sponsors is up from 25 percent in 2014 (Figure 4), owing largely to the NYC funds’ proxy-access campaign; but it still remains below that seen over the broader period dating to 2006 (Figure 5)—32 percent—owing principally to less activity among private multiemployer pension plans affiliated with labor unions, such as the American Federation of Labor–Congress of Industrial Organizations (AFL-CIO) or American Federation of State, County, and Municipal Employees (AFSCME).

2. **Corporate Gadflies.** Three individual investors and their family members—John Chevedden, William Steiner (and son Kenneth), and James McRitchie (and wife, Myra K. Young)—sponsored one-third of shareholder proposals in 2015, up from 31 percent in 2014 and 28 percent (including formerly active corporate gadflies Evelyn Davis and Emil Rossi and his family) across the broader ten-year period.
3. **Social Investors.** Institutional investors, focusing on “socially responsible” investing,<sup>39</sup> as well as various retirement and investment vehicles associated with religious or public-policy organizations,<sup>40</sup> sponsored 30 percent of shareholder proposals in 2015, up from 29 percent in 2014 and 27 percent across the broader ten-year period.

Aside from the three principal corporate gadflies, individual investors sponsored only 9 percent of shareholder proposals introduced in 2015, down from 14 percent in 2014, and 12 percent in the 2006–14 period. (One-third of these “other” individual-sponsored shareholder proposals were introduced by two other individuals who might best be deemed gadflies, Gerald Armstrong and John Harrington.) Apart from labor-affiliated and social investors, only one institutional investor sponsored a shareholder proposal in 2015: Trian Fund Management—a hedge fund led by activist investor Nathan Peltz—introduced a proposal at DuPont related to the fund’s ultimately unsuccessful effort to take four board seats and break up the company.<sup>41</sup>

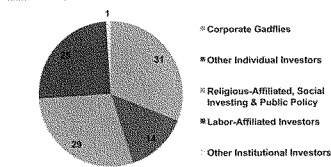
**Figure 3. Percentage of Shareholder Proposals by Proponent Type, Fortune 250, 2015\***



\*Based on 235 companies filing proxy statements by August 31  
Source: ProxyMonitor.org

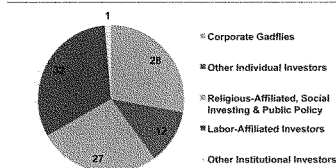


**Figure 4. Percentage of Shareholder Proposals by Proponent Type, Fortune 250, 2014**



Source: ProxyMonitor.org

**Figure 5. Percentage of Shareholder Proposals by Proponent Type, Fortune 250, 2006–14**



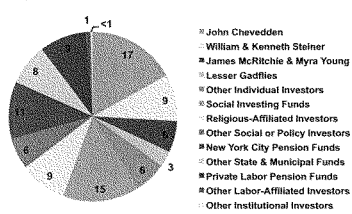
Source: ProxyMonitor.org

Examining the sponsors of shareholder proposals more granularly, the outsized role played by the most active corporate gadflies, as well as the NYC pension funds, becomes clearer. In 2015, corporate gadfly John Chevedden sponsored one in six shareholder proposals, the NYC funds sponsored one in nine, gadflies William and Kenneth Steiner sponsored one in 11, and gadflies McRitchie and Young sponsored one in 15 (Figure 6). Apart from these principal gadflies and the NYC funds, not a single shareholder sponsored more than eight shareholder proposals in 2015 (Figure 7).

Nevertheless, a large number of social-investing funds were active, such that, overall, these vehicles sponsored 15 percent of all shareholder proposals in 2015. (Social-investing funds As You Sow, Trillium Asset Management, and Walden Asset Management each sponsored five or more shareholder proposals, as did the policy-oriented Investor Voice and the Catholic-affiliated Mercy Investment Program.) Labor-affiliated funds—other than the NYC funds—sponsored

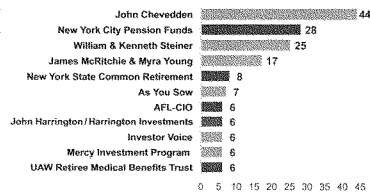
18 percent of all proposals, led by the New York State Common Retirement Fund (eight proposals), AFL-CIO (six proposals), United Autoworkers Retiree Medical Benefits Trust (six proposals), and International Brotherhood of Electrical Workers (five proposals).

**Figure 6. Percentage of Shareholder Proposals by Proponent Subtype, Fortune 250, 2015\***



\*Based on 235 companies filing proxy statements by August 31  
Source: ProxyMonitor.org

**Figure 7. Number of Shareholder Proposals by Sponsor, Fortune 250, 2015\***



\*Based on 235 companies filing proxy statements by August 31  
Source: ProxyMonitor.org

### III. SHAREHOLDER PROPOSALS BY SUBJECT

Shareholder proposals can be broadly divided into three categories:

**1. Corporate Governance.** Process-based proposals that seek to modify the rules governing board structure or shareholder-board interactions. Proposals commonly seek to:

- Modify **voting rules** for director elections or shareholder actions
- Modify the periods during which investors are elected (e.g., through “**board declassification**” proposals that seek to elect all directors annually rather than over staggered terms)<sup>42</sup>
- Empower shareholders to call **special meetings** or to act outside annual meetings by **written consent**
- Separate the company’s **chairman and chief executive** roles
- Grant shareholders the right to nominate their own directors on corporate proxy ballots (i.e., **proxy access**)

**2. Executive Compensation.** Substance-based proposals that seek to better align management’s incentives with shareholders’ interests through executive-compensation plans. Proposals commonly seek to:

- Modify the terms or vesting periods of **equity-compensation plans**
- Limit or change **accelerated payments** or other payouts to executives in the event of a change-of-control transaction, the executive’s entry into government service, or death (called “golden parachutes” and “golden coffins” by critics)
- **Claw back** previously paid executive compensation in the event that the company has faced an adverse criminal or civil government action

**3. Social Policy.** Substance-based proposals that seek to reorient a company’s approach to align with a social or policy goal that may not be related—or at least has an attenuated relationship—to share value. Proposals commonly address:

- **Animal rights** concerns
- **Human rights** issues
- **Employment rights**, including corporate discrimination policies and diversity
- **Environmental** issues, including sustainability and greenhouse-gas emissions
- **Lobbying and political spending**, including calls for increased disclosure, increased shareholder input on corporate political engagement, and outright limits on corporate political spending or lobbying

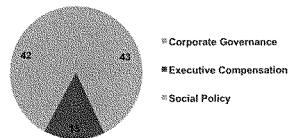
In 2015, 43 percent of shareholder proposals involved corporate-governance concerns, up from 36 percent in 2014 and 39 percent during the broader 2006–14 period (**Figure 8, Figure 9, and Figure 10**). This increase was principally due to the NYC pension funds’ proxy-access campaign: overall, proxy-access proposals constituted 11 percent of 2015 shareholder proposals, versus only 4 percent in 2014 and just 1 percent in the entire 2006–14 period (**Figure 11, Figure 12, and Figure 13**). Proposals to separate a company’s chairman and CEO positions and to empower shareholders to call special meetings or act through written consent were also up marginally from previous years.

In 2015, 42 percent of shareholder proposals involved social or policy concerns, down from 47 percent in 2014 but up from 39 percent during the 2006–14 period. Although the percentage of environmental proposals was marginally higher—19 percent in 2015, up from 18 percent in 2014 and 11 percent since 2006—the percentage of proposals involving corporate spending or lobbying dropped five percentage points, year over year, from 22 percent to 17 percent. Other social or policy concerns, apart from the environment and political spending, were less likely to be introduced than in earlier years.

Proposals related to executive compensation were somewhat less common in 2015 (15 percent of proposals introduced) than in 2014 (17 percent). Executive-compensation-related proposals remain less frequently introduced than in the 2006–10 period, when a significant percentage of shareholder proposals sought shareholder advisory votes on executive compensation (now mandatory for all publicly traded companies under the 2010 Dodd-Frank financial reform law). The year 2015 did see an increase in the percentage of proposals (8 percent, up from 4 percent in

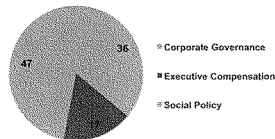
2014) seeking to limit change-of-control or other accelerated benefits to executives (e.g., upon taking a government job). The year 2015 also saw a substantially higher number of proposals seeking to claw back executive pay following an adverse criminal or civil action by the government against the company.

**Figure 8. Percentage of Shareholder Proposals by Type, Fortune 250, 2015\***



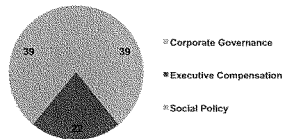
\*Based on 235 companies filing 2015 proxy statements by August 31  
Source: ProxyMonitor.org

**Figure 9. Percentage of Shareholder Proposals by Type, Fortune 250, 2014**



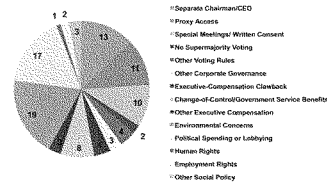
Source: ProxyMonitor.org

**Figure 10. Percentage of Shareholder Proposals by Type, Fortune 250, 2006-14**



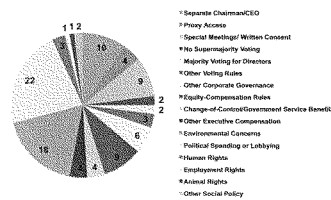
Source: ProxyMonitor.org

**Figure 11. Percentage of Shareholder Proposals by Subtype, Fortune 250, 2015\***



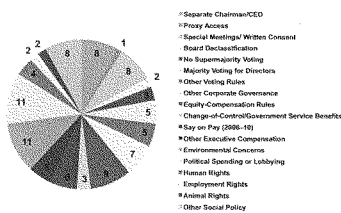
\*Based on 235 companies filing 2015 proxy statements by August 31  
Source: ProxyMonitor.org

**Figure 12. Percentage of Shareholder Proposals by Subtype, Fortune 250, 2014**



Source: ProxyMonitor.org

**Figure 13. Percentage of Shareholder Proposals by Subtype, Fortune 250, 2006-14**

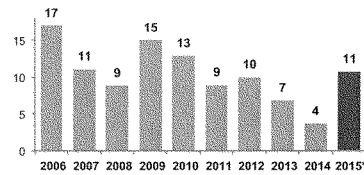


Source: ProxyMonitor.org

#### IV. SHAREHOLDER-PROPOSAL VOTING

In 2015, 11 percent of shareholder proposals received the support of a majority of shareholders—up markedly from 2014 (4 percent) and the highest percentage since 2010 (Figure 14).<sup>43</sup> This increase in support, however, is wholly attributable to support for the proxy-access campaign launched by the NYC pension funds. Almost two-thirds of 35 shareholder proposals seeking proxy access at Fortune 250 companies received majority shareholder support; but only 4 percent (ten proposals) of all other shareholder proposals, excluding proxy access, were supported by a majority of shareholders (Figure 15).

**Figure 14. Percentage of Shareholder Proposals Winning Majority Support, Fortune 250, 2006–15\***



\*In 2015, based on 229 companies holding annual meetings by August 31  
Source: ProxyMonitor.org

**Figure 15. Shareholder Support by Proposal Class, Fortune 250, 2015\***

Proposal Class	Number of Shareholder Proposals Introduced	Number Defeated	Number Winning Majority Support
<b>Corporate Governance</b>	<b>135</b>	<b>104</b>	<b>31</b>
Separate Chairman and CEO	40	39	1
Proxy Access	35	12	23
Shareholder Action by Written Consent	21	21	0
Shareholder Power to Call Special Meetings	11	8	3
Eliminate Supermajority Provisions in Bylaws	5	3	2
Change Stock Classes or Voting Rights	5	5	0
Change Vote-Counting Standard	5	5	0
Other	13	11	2
<b>Executive Compensation</b>	<b>47</b>	<b>45</b>	<b>2</b>
Change-of-Control/Government Service Benefits	25	23	2
Executive Compensation Clawbacks	12	12	0
Other	10	10	0
<b>Social Policy</b>	<b>133</b>	<b>133</b>	<b>0</b>
Environmental Issues	59	59	0
Political Spending or Lobbying	51	51	0
Employment Rights	7	7	0
Human Rights	5	5	0
Health Care	3	3	0
Other	8	3	0

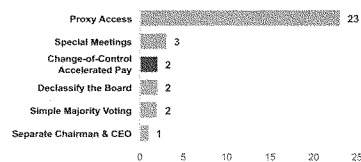
\*Based on 229 companies holding annual meetings by August 31  
Source: ProxyMonitor.org

In 2015, the ten shareholder proposals, apart from proxy access, that received majority shareholder support to date all involved corporate-governance questions (eight proposals) or executive compensation (two) (Figure 16). As has been the case in each of the last ten years,<sup>44</sup> not a single shareholder proposal involving social or policy concerns was supported by a majority of shareholders at a Fortune 250 company. In addition, as Figure 15 indicates, apart from proxy access, most shareholders rejected most shareholder proposals even among those classes of proposal that received majority support on occasion:

- Eight of 11 proposals seeking shareholder rights to call special meetings failed to receive majority support
- 23 of 25 proposals seeking to limit accelerated payments to executives in the event of a corporate change in control or other special situation were voted down
- Three of five proposals seeking to eliminate supermajority voting provisions from corporate bylaws failed to pass
- 39 of 40 proposals seeking to separate the company's chairman and CEO position were defeated

The one category of proposal to buck that trend, other than proxy access, comprised those that sought to declassify boards (i.e., to elect all directors annually rather than in staggered terms): two of two board-declassification proposals received majority support, in keeping with historical norms.<sup>45</sup>

**Figure 16. Number of Shareholder Proposals Receiving Majority Shareholder Support by Subtype, Fortune 250, 2015\***



\*In 2015, based on 229 companies holding annual meetings by August 31  
Source: ProxyMonitor.org

As noted in earlier reports,<sup>46</sup> the percentage of shareholder proposals to win majority support tends to be highly

dependent on the number of likely-to-pass proposals that are introduced. Certain proposals usually receive majority shareholder support (e.g., board declassification, proxy access), and a small number of others do with some regularity (e.g., eliminating supermajority provisions in bylaws, requiring directors to win a majority rather than plurality of votes to be elected).

Overall voting trends can reflect the fact that many of these more popular proposals have been adopted at many large companies and are therefore less commonly introduced than in earlier years.<sup>47</sup> Companies tend to adapt as they better come to understand the likelihood of proposals' passage and shareholder sentiment on contested issues; when a company determines that a shareholder proposal is likely to garner majority voting support, it is "more likely to negotiate with the shareholder activists proposing them—either by voluntarily adopting the activists' preferred rules on their own or by taking other actions convincing the activists to withdraw their proposal."<sup>48</sup>

Investor sentiment on certain types of proposals may also change over time, after further research, analysis, and communication among stakeholders. When corporate gadflies first introduced proposals to permit shareholder action by written consent in 2010, ten of 14 proposals of that type won majority shareholder support; in 2014 and 2015, in contrast, a total of 41 such proposals have been introduced, and none has passed.

The SEC's decision not to enforce its competing-proposals rule during the 2015 proxy season created an interesting wrinkle in this year's proxy voting: some companies introduced management proposals that covered the same issue, while offering different particulars from similar shareholder proposals on the ballot. Among those in the Fortune 250:

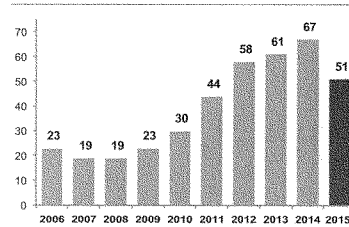
- On April 13, Goodyear's proxy ballot included a shareholder proposal introduced by John Chevedden that called on the company to eliminate all supermajority provisions from its bylaws, as well as a management proposal to require only majority shareholder support for change-of-control transactions (as opposed to the two-thirds default requirement under Ohio law). A total of 56 percent of shareholders voted against Chevedden's proposal, while management's competing proposal passed overwhelmingly.

- On April 23, shareholders of AES Corp. faced two competing proposals on their ballot. Competing with the NYC pension funds' proxy-access proposal, the AES board introduced its own proxy-access proposal that raised the ownership threshold for nominating directors on the corporate proxy ballot to 5 percent (compared with 3 percent on the NYC pension fund proposal), reduced the percentage of the board that could be nominated to 20 percent (compared with 25 percent on the NYC pension fund proposal), and required that all shares be "long" rather than borrowed "short" (short-sellers were not necessarily excluded in the NYC pension fund proposal and would have interests adverse to other shareholders).
- Further, to compete with a shareholder proposal introduced by John Chevedden concerning shareholder rights to call special meetings, AES proposed its own proposal with higher threshold requirements. AES received a split decision: 66 percent of shareholders supported the NYC pension fund proposal, and only 36 percent supported the management proposal regarding proxy access; but 70 percent of shareholders backed the AES board's proposal on special meetings, while only 36 percent supported Chevedden's.
- On April 28, Exelon introduced its own proxy-access proposal competing with that of the NYC pension funds. Although the particulars of Exelon's proposal were substantially the same as those in AES's, the shareholder vote came out differently: only 43 percent of shareholders supported the NYC pension fund's proposal, while 52 percent supported the management proposal. In its proxy response to the NYC proposal, the Exelon board emphasized its other corporate-governance rules and emphasized that it had consulted with shareholders (holding 39 percent of outstanding shares) in reaching its recommendation, which represented a compromise among competing concerns.<sup>49</sup>
- On April 30, Capital One introduced its own special-meeting proposal with a higher voting threshold than that included in a shareholder proposal sponsored by John Chevedden. Management's proposal passed, while Chevedden's—with 49 percent support—narrowly missed a majority.

### SPECIAL FOCUS: PROPOSALS RELATED TO POLITICAL SPENDING OR LOBBYING

The incidence of shareholder proposals involving corporate political spending or lobbying declined in 2015 (Figure 17). Shareholder proposals on this subject have been common in each of the last ten years, but the number of such proposals started to increase after the Supreme Court's 2010 decision in *Citizens United v. Federal Election Commission*,<sup>50</sup> which determined that independent political expenditures were speech protected by the First Amendment to the United States Constitution—regardless of whether such speech was funded by for-profit corporations. The number of shareholder proposals introduced at Fortune 250 companies that involved corporate political spending or lobbying peaked at 67 in 2014, before falling 24 percent in 2015.

**Figure 17. Number of Shareholder Proposals Relating to Political Spending or Lobbying, Fortune 250, 2006–15\***



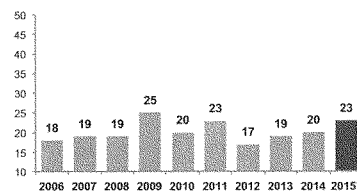
\*For 2015, based on 235 companies filing proxy statements by August 31. Source: ProxyMonitor.org

Shareholder proposals related to a company's political spending or lobbying are no exception to the rule that proposals related to social or political concerns essentially never receive majority shareholder support over board opposition.<sup>51</sup> Shareholder support for these proposals has vacillated between 18 percent and 25 percent, on average, during the last ten years (Figure 18). Though no shareholder proposals have won majority support in 2015, the average shareholder vote for such proposals is up marginally, compared with the last three years.

This variation, however, is largely attributable to a different mix of proposal types and sponsors and does not signify an overall shift in shareholder support. Certain proposals were commonly introduced in recent years that received low-single-digit support—such as those seeking a 75 percent shareholder vote to authorize corporate political spending or to prohibit such spending outright, which constituted six of 67 political-spending-related shareholder proposals in 2014—but were not in the mix of proposals in 2015, presumably because they failed to meet minimum shareholder support thresholds or because their sponsors moved on to other ideas.

Also, there have been no individual-backed shareholder proposals relating to political spending or lobbying introduced at a Fortune 250 company in 2015, compared with seven in 2014: because individuals are less equipped than institutional investors to solicit support for their proposals, the change in sponsor mix can be expected to affect voting results.<sup>52</sup>

**Figure 18. Average Shareholder Vote per Shareholder Proposal Related to Political Spending or Lobbying, Fortune 250, 2006–15\***



\*For 2015, based on 229 companies holding annual meetings by August 31  
Source: ProxyMonitor.org

## V. ASSESSING PUBLIC-PENSION FUND SHAREHOLDER ACTIVISM

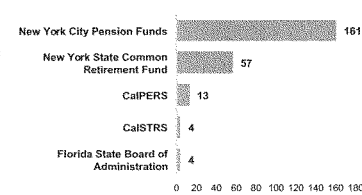
In 2015, almost one-fifth of all shareholder proposals were sponsored by pension plans for public employees. Overall, public-employee pension funds dominate the space for defined-benefit retirement assets<sup>53</sup> in the United States: these

plans hold two-thirds of the 200 largest such plans' total assets (\$3.2 trillion of \$4.8 trillion).<sup>54</sup> The largest public-employee fund—the Federal Retirement Thrift Savings Plan, which serves federal government employees<sup>55</sup>—has not been involved in shareholder-proposal activism, but the next five largest public-employee pension plans have been involved:

- California Public Employees' Retirement System (CalPERS), with \$297 billion in assets
- California State Teachers' Retirement System (CalSTRS) (\$187 billion)
- New York State Common Retirement Fund (\$178 billion)
- New York City Retirement Systems (\$159 billion)
- Florida State Board of Administration (\$155 billion)<sup>56</sup>

Although each of these large public-pension funds has sponsored shareholder proposals, their level of activity—as well as their approaches to shareholder activism more broadly<sup>57</sup>—varies markedly (Figure 19). The pension funds for New York City and State sponsor, far and away, the most shareholder proposals. Most public-employee pension funds file no shareholder proposals, but six other state-employee funds filed at least one shareholder proposal at a Fortune 250 company in the last ten years,<sup>58</sup> in addition to three other municipal funds.<sup>59</sup>

**Figure 19. Number of Shareholder Proposals Introduced by Five Large Pension Funds, Fortune 250, 2006–15\***



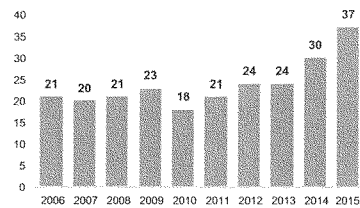
\*For 2015, based on 235 companies filing proxy statements by August 31  
Source: ProxyMonitor.org

Although public-employee pension funds have sponsored shareholder proposals throughout the past decade—led by the New York funds—their activity has increased notably in 2014 and 2015 (Figure 20). The increase was led by the New York State and City funds, respectively, in each year (Figure 21).

The New York State Common Retirement Fund sponsored no shareholder proposals at Fortune 250 companies during 2006–09 but, following Thomas DiNapoli's initial appointment as state comptroller in 2007, initiated a shareholder-proposal campaign: the number of proposals sponsored by the fund increased each year through 2014, when it sponsored 20 proposals.

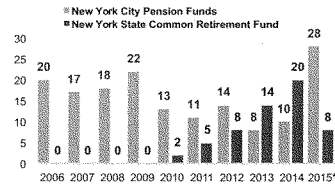
In 2015, the fund was less active—it has sponsored only eight proposals at Fortune 250 companies to date—but the NYC funds picked up the slack: in 2015, Comptroller Stringer's first full proxy season since assuming office, the NYC funds sponsored 28 shareholder proposals at Fortune 250 companies, a record high for an institutional investor dating to 2006. Of the 28 proposals, 22 sought proxy access (of 75 such proposals that the NYC funds sponsored at companies across the broader stock market).<sup>60</sup>

**Figure 20. Number of Shareholder Proposals Introduced by Five Large Pension Funds, By Year, Fortune 250**



\*For 2015, based on 235 companies filing proxy statements by August 31  
Source: ProxyMonitor.org

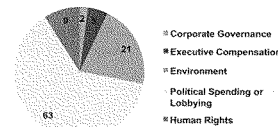
**Figure 21. Number of Shareholder Proposals Introduced by New York Pension Funds, By Year, Fortune 250**



\*For 2015, based on 235 companies filing proxy statements by August 31  
Source: ProxyMonitor.org

Comptroller DiNapoli's shareholder-proposal activism has focused on social and policy concerns: 63 percent of the New York State Common Retirement Fund's shareholder proposals have involved corporate political spending or lobbying, 21 percent have involved environmental issues, and 9 percent have involved employment rights, such as sexual orientation and gender-identity discrimination (Figure 22). Conversely, the NYC pension funds' shareholder-proposal activism—which, during the ten years in the ProxyMonitor.org database, spans the tenures of three comptrollers, Bill Thompson, John Liu, and Stringer—has involved a broader panoply of concerns, though 62 percent involved various social or policy issues (Figure 23), a figure that would be higher but for Comptroller Stringer's proxy-access push in 2015.

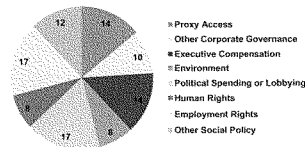
**Figure 22. Subject Matters of Shareholder Proposals Sponsored by New York State Common Retirement Fund, Fortune 250, 2006–15\***



\*For 2015, based on 235 companies filing proxy statements by August 31  
Source: ProxyMonitor.org



**Figure 23. Subject Matters of Shareholder Proposals Sponsored by New York City Pension Funds, Fortune 250, 2006–15\*, Percent**

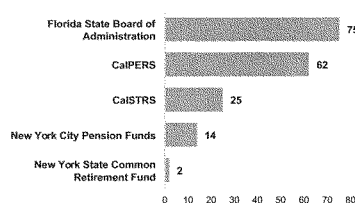


\*For 2015, based on 235 companies filing proxy statements by August 31  
Source: ProxyMonitor.org

Among less active public-employee funds, the focus of shareholder activism has varied. Some funds, such as CalSTRS, have focused their limited shareholder-proposal activism on social issues. Others have focused broadly on corporate-governance concerns in sponsoring shareholder proposals, even if they engage in a social-investing approach using other tactics: 11 of the 13 shareholder proposals introduced by CalPERS have involved corporate-governance issues—most frequently, voting rules; and several state-employee pension funds, among them the Florida State Board of Administration, participated in a coordinated campaign seeking to declassify corporate boards (an effort spearheaded by Harvard law professor Lucian Bebchuk).<sup>61</sup>

Unsurprisingly, the pension funds that have focused on corporate-governance issues have been far more successful at winning majority support for their proposals than those that have focused on social or policy issues (Figure 24). Only one of the 57 shareholder proposals sponsored by the New York State Common Retirement Fund received majority support (a 2015 proposal at Staples requiring boards to seek shareholder approval when executives' severance agreements exceeded a certain threshold). Twenty-three of the 161 proposals sponsored by the NYC pension funds received majority support, but 18 of these sought proxy access.

**Figure 24. Percentage of Shareholder Proposals Receiving Majority Support, By Fund, Fortune 250, 2006–15\***



\*In 2015, based on 229 companies holding annual meetings by August 31  
Source: ProxyMonitor.org

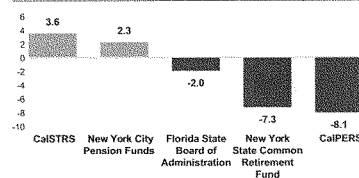
### Share-Value Analysis of Public-Pension Funds' Shareholder-Proposal Campaigns, 2006–14

The ultimate test of whether shareholder proposals are an effective tool—at least from the standpoint of the average diversified investor—is not whether they win majority shareholder support but whether they enhance share value.<sup>62</sup> Individual investors might, of course, have different priorities, and certain institutional investors are designed to have different priorities. But precisely because most investors inherently disagree about many issues of public concern, corporate governance has tended to assume that shareholder value is the orienting concern for equity investors; such concerns are implicit in the fiduciary duties that pension funds owe to retirees or taxpayers.<sup>63</sup>

To test the relationship between public-pension funds' shareholder-proposal activism and share value, we initially compared the share-price reactions of the Fortune 250 companies targeted by shareholder proposals by the five largest state and municipal pension funds during 2006–14. On average, these companies saw their share price underperform the broader S&P 500 index by 0.9 percent in the year following the shareholder vote.<sup>64</sup> Because pension funds' strategies and levels of activity varied so broadly, we disaggregated by pension fund (Figure 25).

The sample sizes for CalSTRS, CalPERS, and the Florida fund are probably too small to be meaningful, but the stock-price reactions of the companies targeted by the New York State Common Retirement Fund and NYC pension funds have opposite effects: the companies targeted by the state fund saw their share price drop by 7.3 percent, relative to the broader market, in the year following a proposal's introduction; the companies targeted by the city funds saw their share price outperform the market by 2.3 percent.<sup>65</sup>

**Figure 25. Average Percentage Stock Price Change Relative to S&P 500, Year After Shareholder Proposal Introduced, By Fund, Fortune 250, 2006–14**



Source: ProxyMonitor.org

The overall observed negative relationship between public-pension funds' shareholder proposals and share value could be explained by several factors not accounted for by this basic analysis, including broad variations in company or industry unrelated to shareholder-proposal activism. To study this question in greater detail, the Manhattan Institute's Center for Legal Policy and its Proxy Monitor team commissioned an econometric study by Tracie Woidtke, a professor at the Haslam College of Business at the University of Tennessee.<sup>66</sup>

Building on a research methodology initially developed for her doctoral dissertation, Woidtke examined the valuation effects associated with pension fund influence, measured through ownership, on Fortune 250 companies, during 2001–13.<sup>67</sup> Firm value was assessed through industry-adjusted Tobin's Q, with various controls added to the analysis, including firm leverage, research and development expenses, advertising expenses, index membership, assets, positive income, stock transaction costs, insider ownership, and year fixed effects.

Woidtke's results, formally released in conjunction with this report, broadly confirm the baseline stock-price story. Woidtke finds that firm value "is negatively related to public pension fund ownership and positively related to private pension fund ownership during 2001–13."<sup>68</sup> As with our basic analysis, however, this overall relationship does not hold true for each public-pension fund, and "interesting differences arise when we examine different activist strategies and how these strategies vary over time."<sup>69</sup> Specifically:

The negative valuation effect in the more recent period (2008–13) is driven by ownership of public funds who sponsor social issue funds, especially the New York State Common Retirement System (NYSCR), and coincides with active sponsoring of social issue proposals during this time period. Ownership by these funds is not associated with negative valuation effects during the earlier period (2001–07) when they were not sponsoring social issue proposals. Consistent with social issue activism having negative valuation effects, Tobin's Q is 22 percent lower (1.42 versus 1.83) and industry-adjusted Tobin's Q is 141 percent lower (-0.12 versus 0.29) for companies targeted by NYSCR with a social issue proposal than for other companies in our sample.<sup>70</sup>

Although alternative explanations could be advanced to explain Woidtke's results, her analysis suggests strongly that some types of shareholder-proposal activism on the part of public-employee pension funds are associated with lower share value—and that the New York State Common Retirement Fund's campaigns under Comptroller Thomas DiNapoli may not have enhanced share value for the respective securities held by the fund.

#### 2015 Proxy-Access Campaign: Assessment

In terms of shareholder voting results, NYC comptroller Scott Stringer's campaign for proxy access in 2015 was an unqualified success: 18 of 22 proxy-access proposals sponsored by the NYC pension funds at Fortune 250 companies received majority shareholder support, and none of the other four proposals received less than 42 percent shareholder backing. Comptroller Stringer's proxy-access effort notably reorients the city funds' traditional social-policy focus in shareholder-proposal activism toward a corporate-governance focus with significant shareholder support.

Will the proxy-access campaign's shareholder-voting success translate into share value? Comptroller Stringer's press release touting the effort claims that the proposed rule could "raise the market cap of publicly held companies in the United States by up to \$140 billion, or 1.1 percent,"<sup>71</sup> citing research by the CFA Institute.<sup>72</sup> Others assessing the proposed proxy-access rule have been skeptical. Even as a majority of shareholders at most companies have lined up with Stringer's effort, a substantial fraction of shareholders (25 percent–68 percent) have opposed each of these proposals, unless supported by the companies' boards of directors. Included among the investors not supporting the proxy-access proposals are the large mutual-fund groups Fidelity and Vanguard.<sup>73</sup>

Because no one knows precisely how the proxy-access rules will be utilized in practice, it is impossible to know whether they will enhance share value. In theory, lowering the barriers to entry for large, diversified shareholders to nominate directors competing with those tapped by board nominating committees could enhance share value, assuming that those shareholders have expertise in director selection or corporate management that boards lack. On the other hand, when the U.S. Court of Appeals for the D.C. Circuit threw out the SEC's promulgated mandatory proxy-access rule in 2011, it worried that "unions and state and local governments whose interests in jobs may well be greater than their interest in share value, can be expected to pursue self-interested objectives rather than the goal of maximizing shareholder value."<sup>74</sup>

In that regard, the NYC funds' express methodology in determining which companies to target suggests concerns other than share value. The funds expressly targeted companies based on three criteria: "climate change, board diversity and excessive CEO pay."<sup>75</sup> Though executive pay is plausibly related to share value (excessive pay may dilute share ownership and otherwise serve as a proxy for agency costs—the costs of ownership that prevent alignment of management and shareholder interests),<sup>76</sup> climate change and board diversity have attenuated, if any, connections to share value.<sup>77</sup>

The NYC pension funds' campaign does, however, have the virtues of clearly defined criteria and transparency, and there is no evidence that Comptroller Stringer was targeting particular companies with self-interested objectives beyond the three priority issues that the campaign publicly identified.

In contrast, other labor-affiliated investors sponsoring proxy-access proposals in 2015 have targeted specific companies that have been in the crosshairs of ongoing wage and union-organizing campaigns:

- Community Health Systems faced a proxy-access shareholder proposal sponsored by the Connecticut Retirement Plans and Trust Funds. The largest non-urban provider of hospital health care, Community Health has been involved in contentious litigation with labor over efforts to unionize registered nurses.<sup>78</sup>
- Retailer Kohl's, targeted by CalPERS with a proxy-access proposal, has been facing specific union agitation over wages and labor conditions, including at the company's annual meeting.<sup>79</sup> In addition, CalPERS is the principal creditor in the bankruptcy of Golden State municipality San Bernardino,<sup>80</sup> and Kohl's is San Bernardino's largest outside creditor, owed \$29.4 million at the time of the city's bankruptcy.<sup>81</sup> In litigation over that bankruptcy, CalPERS has been aggressively pursuing its interests at the expense of other bondholders.<sup>82</sup>
- McDonald's, targeted by the UAW Retiree Medical Benefits Trust, has been the principal target of union organizers' "Fight for 15" campaign, aimed at substantially increasing fast-food workers' wages.<sup>83</sup>
- Walgreens Boots Alliance was targeted with a proxy-access proposal by the labor-affiliated group Change to Win. The nation's largest drug retailer, Walgreens has emerged as a principal target of labor wage campaigns, which were previously successful in pressuring retailers like Wal-Mart and Target to increase pay scales.<sup>84</sup>

These four labor-affiliated funds may have targeted these four particular companies for objectively neutral reasons, but the fact that targeted companies were so central to union campaigns—and, in CalPERS's case, the sponsor's own self-interest—at least raises a red flag.

### Proxy Access: Share-Price Analysis

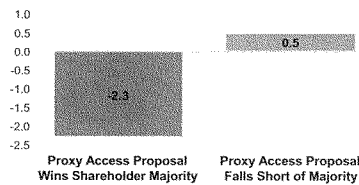
Although majority shareholder support is a gauge of median shareholder sentiment—assuming that voting mechanisms accurately capture shareholder sentiment, an assumption that may not be borne out in practice<sup>85</sup>—it does not necessarily reflect accurately the expected share-value effects of a given course of action. In contrast, share-price effects—which are driven by marginal buyers and sellers of security—are

broadly regarded as implicitly assessing market expectations about share value.<sup>86</sup>

To assess the market's reaction to proxy-access proposals in the 2015 proxy season, we measured the share-price effects of the release of information about shareholder votes on proxy-access shareholder proposals introduced at Fortune 250 companies. From a baseline date of one business day before a company's annual meeting, we measured the change in stock price—relative to the S&P 500 index—until a date five business days after the annual meeting.<sup>87</sup> We separated results into two groups: companies in which a majority of shareholders voted against the proxy-access proposal (12 total companies); and companies in which a majority of shareholders voted for the proxy-access proposal over board opposition (21 total companies).<sup>88</sup>

The results of this analysis suggest that the market may have negatively assessed proxy access in terms of share value. Among companies in which shareholders rejected the proposal, the corporate stock price increased by 0.5 percent relative to the broader market (Figure 26). Six companies outperformed the market, and six underperformed. In contrast, among companies in which shareholders voted for proxy access, the corporate stock price declined by 2.3 percent. Four companies outperformed the market, and 17 underperformed.

**Figure 26. Average Percentage Stock Price Change Relative to S&P 500, After Shareholder Proxy Access Vote, Fortune 250, 2015\***



\*In 2015, based on 229 companies holding annual meetings by August 31  
Source: ProxyMonitor.org

The negative stock-price effect—if it represents an actual relationship and not merely statistical noise—is probably less pronounced than these data initially suggest. The biggest downward mover among the pool of companies passing proxy access, Kohl's, undoubtedly saw its stock price pummeled, primarily owing to missing earnings expectations. The concentration of energy companies in the sample—a necessary consequence of the NYC pension funds' focus on climate change in identifying its pool of target companies—undoubtedly introduces confounding industry effects.

Nevertheless, the results hold when Kohl's is excluded from the sample and when oil and gas companies are indexed against an energy exchange-traded fund<sup>89</sup> rather than the S&P. (The observed negative share-price effect is -1.7 percent, excluding Kohl's; and -1.5 percent, indexing oil and gas companies by sector. Combining both of these adjustments, the negative price effect is -0.9 percent—and 15 of the remaining 20 companies continue to underperform in the days after their annual meetings.)

These preliminary results should be retested with a broader data set and the types of controls that Woitke uses in her broader public-pension study; but as a preliminary analysis, they tend to run opposite the findings synthesized by CFA that examined stock-price effects of the proxy-access rule when the SEC was advancing the idea.<sup>90</sup> Although the observed stock-price effects may be subject to alternative explanations or flow from confounding, unexplained variables, these preliminary observations at least throw into question the assumption that profit-maximizing investors see the proposed proxy-access rule as enhancing share value. Whether such a market assessment is accurate depends on whether and how shareholders choose to utilize the new rules, assuming that they are adopted.

## CONCLUSION

The 2015 proxy season was marked by legal and regulatory uncertainty, an increase in shareholder-proposal sponsorship, and a broad, successful campaign by the NYC pension funds pushing publicly traded companies to establish proxy-access rules for director elections. The SEC chairman's January 2015 decision<sup>91</sup> not to enforce its conflicting-proposals rule led to several companies facing competing management and shareholder proposals.

Overall, the agency's staff was significantly less likely to issue companies no-action letters, which led to an increase in the number of shareholder proposals on proxy ballots. Though the Third Circuit Court of Appeals reversed a lower-court decision that would have significantly eroded the SEC's ordinary business-operations rule for excluding shareholder proposals, its decision<sup>92</sup> generated significant ambiguity about how that rule should be properly applied.

After the close of the proxy season, other legal and regulatory decisions highlighted the changing landscape that companies and investors face. On August 18, the D.C. Circuit Court of Appeals vacated the SEC's "conflict minerals" disclosure rule on First Amendment grounds<sup>93</sup>—the latest legal rebuff to an agency increasingly given to requiring disclosures that seem far afield from its statutory mission to promote "efficiency, competition, and capital formation."<sup>94</sup>

On August 5, in the most recent example of this agency trend, the SEC formally adopted its proposed rule requiring companies to disclose the ratio of their chief executive's pay to that of their median worker.<sup>95</sup> Although this agency action, like the conflict-minerals rule, was prompted by Congress,<sup>96</sup> it is in significant tension with the agency's increased deference paid to the shareholder-proposal process: over the last decade, Fortune 250 companies have faced 11 shareholder proposals regarding the CEO-worker pay ratio, and shareholder opposition to those proposals ranged from 88 percent to 97 percent.

Against this legal and regulatory backdrop, the NYC pension funds' successful campaign for proxy access in 2015 highlights the role that shareholders are increasingly playing in reshaping corporate governance. Although a majority of shareholders supported most proxy-access proposals, whether these rules will achieve their stated objective of increasing share value remains in doubt.

During the nine years through 2014, public-employee pension funds' shareholder activism is associated with abnormally low share-price performance. Econometric analysis confirms a negative relationship between public-pension fund firm ownership and firm value and confirms that this overall relationship is significantly explained by social-issue shareholder-proposal activism. The NYC pension funds' proxy-access campaign is notable, however, in that it is centered on a corporate-governance rule, not a social or policy concern, even if screening criteria used to select which companies to target are social-policy-oriented.

Short-term share-price effects in the wake of shareholder votes supporting or rejecting a proxy-access rule in 2015 suggest market skepticism of the claim that the proposed rule will enhance share value, though fuller analysis is necessary to confirm those results and to assess whether the campaign will meet its stated goal to improve share value over the longer term.

Overall, the finding that public-pension funds' shareholder-proposal activism does not add to share value for the average diversified investor—and is actually associated with lower value—suggests that states should reexamine their public-employee pension funds' approaches to this issue. Unlike private pension plans, public-pension funds are exempt from the federal Employee Retirement Income Security Act (ERISA)<sup>97</sup> and bound only by state law obligations. Yet these funds collectively hold trillions of dollars in assets, providing for trillions of dollars of pension obligations for workers and retirees, with trillions of dollars of potential taxpayer liabilities. State policymakers should consider adopting appropriate guidelines to mitigate risks.

### APPENDIX: Shareholder Advisory Votes on Executive Compensation

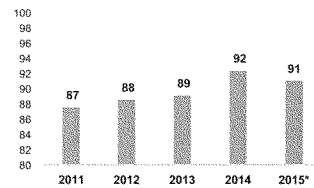
The ProxyMonitor.org database tracks not only shareholder proposals but also shareholder advisory votes on executive compensation, which have been mandatory under federal law—annually, biennially, or triennially—since 2011. Shareholders at most companies have opted to hold such votes annually. In 2015, 216 companies in the Fortune 250 have held such votes to date, among 229 to hold annual meetings.

The likelihood that shareholders vote against management's executive-compensation packages remains low. Indeed, in 2015, a majority of the shareholders of only one Fortune 250 company, Bed Bath & Beyond, have voted against executive pay—fewer than in any previous year since votes were mandated under Dodd-Frank. (A total of 35 percent of Bed Bath & Beyond shareholders voted for the company's compensation package.)

After rising marginally each year since 2011, average shareholder support for executive compensation fell slightly in 2015, to 91 percent from 92 percent last year—a level still above that in 2011, 2012, or 2013 (Figure 27). The percentage of companies getting the support of 90 percent or more of shareholders also fell slightly, from 79 percent in 2014 to 74 percent in 2015; again, 2015 support is higher than any other year since say-on-pay became mandatory (Figure 28). Likewise, the percentage of companies failing to get 70 percent support for their executive compensation—the threshold level deemed significant by the proxy advisory firm ISS<sup>SM</sup>—rose marginally, from 4 percent in 2014 to 5 percent in 2015, though again falling below that witnessed in any earlier year (Figure 29).

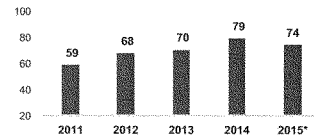
It will be worth watching to see if the modest drop in support for executive compensation, year-over-year, represents a trend or whether 2014 was an outlier. Overall, companies continue to win very broad support for their executive-compensation packages and seem more likely than ever to win majority shareholder support.

**Figure 27. Average Shareholder Advisory Vote on Executive Compensation, %, Fortune 250, 2011–15\***



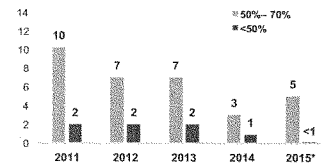
\*For 2015, based on 216 companies holding shareholder advisory votes on executive compensation by August 31  
Source: ProxyMonitor.org

**Figure 28. Percentage of Fortune 250 Companies with at Least 90+% of Shareholders Supporting Executive Compensation, 2011–15\***



Source: ProxyMonitor.org

**Figure 29. Percentage of Fortune 250 Companies Receiving 50%–70%, or Below 50%, Shareholder Support for Executive Compensation, 2011–15\***



Source: ProxyMonitor.org

## ENDNOTES

- <sup>1</sup> Stockholders of publicly traded companies who have held shares valued at \$2,000 or more for at least one year can introduce proposals for shareholders' consideration at corporate annual meetings. See 17 C.F.R. § 240.14a-8 (2007) [hereinafter 14a-8]. The federal Securities and Exchange Commission determines the procedural appropriateness of a shareholder proposal for inclusion on a corporation's proxy ballot, pursuant to the Securities Exchange Act of 1934, Pub. L. No. 73-291, Ch. 404, 48 Stat. 881 (1934) (codified at 15 U.S.C. §§ 78a-78oo (2006 & Supp. II 2009)), at §§ 78m, 78n & 78u; 15 U.S.C. §§ 80a-1 to 80a-64 (2000) (pursuant to Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 841 (1940)); but the substantive rights governing such measures and how they can force boards to act remain largely a question of state corporate law; cf. Del. Code Ann., tit. 8, § 211(b) (2009) (noting that in addition to the election of directors, "any other proper business may be transacted at the annual meeting").
- <sup>2</sup> Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, publicly traded companies must hold shareholder advisory votes on executive compensation annually, biennially, or triennially, at shareholders' discretion. See Pub. L. No. 111-203, 124 Stat. 1376, §951 (2010) [hereinafter Dodd-Frank].
- <sup>3</sup> See Proxy Monitor, Reports and Findings, [http://proxymonitor.org/Forms/reports\\_findings.aspx](http://proxymonitor.org/Forms/reports_findings.aspx) (last visited Aug. 30, 2015).
- <sup>4</sup> The following companies are listed in the 2014 Fortune 250 but are not independent publicly traded corporations in 2015: Fannie Mae, Freddie Mac, State Farm Insurance, Energy Transfer Equity, Enterprise Products Partners, CHS, Plains GP Holdings, Liberty Mutual Holding Company, HCA Holdings, New York Life Insurance, Nationwide Mutual Insurance, TIAA-CREF, Massachusetts Mutual Life Insurance, Publix Super Markets, Northwestern Mutual Life Insurance, U.S. Foods, United States Automobile Association, Icahn Enterprises, Global Partners, Land O'Lakes, Aramark Holdings, Smithfield Foods, Toys "R" Us, Peter Kiewit Sons', H.J. Heinz, and Guardian Life Insurance Company of America.
- <sup>5</sup> Those companies are: Applied Materials, Ashland, Coca-Cola Enterprises, GameStop, ITT, KBR, Motorola Solutions, Oshkosh, Principal Financial Group, Public Service Enterprise Group, and the Williams Companies.
- <sup>6</sup> Those companies are: AbbVie, Bed Bath & Beyond, CDW, Centene, CST Brands, DaVita HealthCare Partners, Family Dollar Stores, Gilead Sciences, Hertz Global Holdings, NRG Energy, and Ross Stores.
- <sup>7</sup> Those companies are: AMR, Aon, Constellation Energy, Coventry Health Care, Dell, Eaton, Hillshire Brands, H.J. Heinz, Medco, Smithfield Foods, Sunoco, URS, and US Airways.
- <sup>8</sup> The adjustments noted in endnotes 5 and 6 mean that the dataset of companies compared between 2014 and 2015 is marginally different. Nevertheless, because the companies added and deleted are among the smallest in the Fortune 250, they are generally less likely to receive shareholder proposals than others, so overall filing and voting results should not differ materially. Among the nine new companies in the dataset for 2015, which appeared in the 2014 but not 2013 Fortune 250, seven faced no shareholder proposals. Gilead Sciences faced four proposals (two from corporate gadflies John Chevedden and James McRitchie, and one each from social-investing and labor funds), while DaVita HealthCare received a proxy access proposal from the United Autoworkers Retiree Medical Trust.
- <sup>9</sup> See Heidi Welsh, Accuracy in Proxy Monitoring, HLS Forum on Corporate Governance and Financial Regulation (Sept. 16, 2013), <https://blogs.law.harvard.edu/corpgov/2013/09/16/accuracy-in-proxy-monitoring-2/> (critiquing Proxy Monitor dataset).
- <sup>10</sup> See, e.g., Paul Rose, Common Agency and the Public Corporation, 63 Vand. L. Rev. 1355, 1356 (2010) (observing that "general trends have supported increased shareholder power and influence within public companies in recent years").
- <sup>11</sup> See Barry Burr, Institutional Investors Increase Ownership of U.S. Companies to All-Time High, Pensions & Investments (Sept. 5, 2008, 12:01 AM), <http://www.pionline.com/article/20080905/ONLINE/809049969/institutional-investors-increase-ownership-of-us-companies-to-all-time-high#>; see also Carolyn Kay Brancato & Stephan Rabinov, The 2008 Institutional Investment Report: Trends in Institutional Investor Assets and Equity Ownership of U.S. Corporations (Sept. 2008).
- <sup>12</sup> In particular, two major federal laws have altered the balance: the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002), enacted in the wake of the collapse of Enron and the bursting Internet stock bubble; and the 2010 Dodd-Frank Act, *supra* note 2, enacted in the wake of the 2008 financial crisis. In addition, the SEC has reinforced these trends through a series of new rules, including one that limits brokers' ability to vote individual stockholders' shares. See SEC Rel. No. 34-60215 (July 1, 2009), <http://www.sec.gov/rules/sro/nysc/2009/34-60215.pdf>.
- <sup>13</sup> Shareholder Activist Definition, Investopedia.com, <http://www.investopedia.com/terms/s/shareholderactivist.asp> (last visited Sept. 10, 2015) ("A person who attempts to use his or her rights as a shareholder of a publicly-traded corporation to bring about social change. Some of the issues most often addressed by shareholder activists are related to the environment, investments in politically sensitive parts of the world and workers' rights (sweatshops). The term can also refer to investors who believe that a company's management is doing a bad job and who attempt to gain control of the company and replace management for the good of the shareholders.").
- <sup>14</sup> See Michael Chamberlain, Socially Responsible Investing: What You Need to Know, *Forbes* (Apr. 24, 2013), [http://www.forbes.com/sites/feenonlyplanner/2013/04/24/socially-responsible-investing-what-you-](http://www.forbes.com/sites/feenonlyplanner/2013/04/24/socially-responsible-investing-what-you-need-to-know/)

need-to-know ("In general, socially responsible investors are looking to promote concepts and ideals that they feel strongly about").

<sup>15</sup> See 14a-8, supra note 1.

<sup>16</sup> See, e.g., *Bus. Roundtable v. S.E.C.*, 647 F.3d 1144, 1152 (D.C. Cir. 2011) (citing proposition that "investors with a special interest, such as unions and state and local governments whose interests in jobs may well be greater than their interest in share value, can be expected to pursue self-interested objectives rather than the goal of maximizing shareholder value"); see also Dep't of Labor, Office of the Inspector General, *Proxy-Voting May Not Be Solely for the Economic Benefit of Retirement Plans* (Mar. 31, 2011), <http://www.oig.dol.gov/public/reports/oa/2011-09-11-001-12-121.pdf> (questioning whether labor pension funds are using "plan assets to support or pursue proxy proposals for personal, social, legislative, regulatory, or public policy agendas"); James R. Copland & Margaret M. O'Keefe, *Proxy Monitor 2014: A Report on Corporate Governance and Shareholder Activism 14* (Manhattan Inst. for Pol'y Res., Fall 2014), [http://www.proxymonitor.org/forms/pmr\\_09.aspx#notes](http://www.proxymonitor.org/forms/pmr_09.aspx#notes) (showing linkage between labor-affiliated shareholder activism and corporate political spending) [hereinafter Copland & O'Keefe Fall 2014].

<sup>17</sup> "Corporate gadflies," as commonly used in Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 *Colum. L. Rev.* 1867, 1895 (1992); and Jessica Holzer, *Firms Try New Tack against Gadflies*, *Wall St. J.* (June 6, 2011), <http://online.wsj.com/article/SB10001424052702304906004576367133865305262.html>.

<sup>18</sup> See New York City Comptroller, *Boardroom Accountability Project*, <http://comptroller.nyc.gov/boardroom-accountability/> (last visited Sept. 11, 2015) [hereinafter *Boardroom Accountability Project*] (citing objective "to ensure that companies are truly managed for the long-term" and contrasting "short-term investors" that allegedly may "manipulate corporate governance at the expense of those seeking long-term value").

<sup>19</sup> See, e.g., *Bus. Roundtable*, 647 F.3d at 1152 ("[I]nvestors with a special interest, such as unions and state and local governments whose interests in jobs may well be greater than their interest in share value, can be expected to pursue self-interested objectives rather than the goal of maximizing shareholder value"); Dep't of Labor, supra note 16; Copland & O'Keefe Fall 2014, supra note 16, at 14.

<sup>20</sup> See *Boardroom Accountability Project*, supra note 18; see also Press Release, *Comptroller Stringer, NYC Pensions Funds Launch National Campaign To Give Shareowners A True Voice In How Corporate Boards Are Elected: New York City Pension Funds File 75 Proxy Access Shareowner Proposals To Kick Off the Boardroom Accountability Project*, <http://comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-pension-funds-launch-national-campaign-to-give-shareowners-a-true-voice-in-how-corporate-boards-are-elected/> [hereinafter *Stringer Press Release*].

<sup>21</sup> See Dodd-Frank Act, supra note 2.

<sup>22</sup> See id.

<sup>23</sup> Copland & O'Keefe Fall 2014, supra note 16, at 6 (citing Copland, *Proxy Monitor 2013: Political Spending, Say on Pay, and Other Key Issues to Watch in the 2013 Proxy Season* (Manhattan Inst. for Pol'y Res., Winter 2013), [http://proxymonitor.org/forms/pmr\\_05.aspx](http://proxymonitor.org/forms/pmr_05.aspx) [hereinafter Copland Winter 2013]; see also Copland & O'Keefe, *Proxy Monitor 2013: Corporate Governance and Shareholder Activism* (Manhattan Inst. for Pol'y Res., Fall 2013), available at [http://proxymonitor.org/forms/pmr\\_06.aspx](http://proxymonitor.org/forms/pmr_06.aspx) [hereinafter Copland & O'Keefe Fall 2013]; Copland, *Proxy Monitor 2014: Companies Fight Back Against Chevedden; Unions and Social Investors Ramp Up Push on Corporate Political Spending* (Manhattan Inst. for Pol'y Res., Winter 2014), [http://proxymonitor.org/forms/pmr\\_07.aspx](http://proxymonitor.org/forms/pmr_07.aspx) [hereinafter Copland Winter 2014].

<sup>24</sup> See No-Action Letters, SEC, <http://www.sec.gov/answers/noaction.htm> (last visited Sept. 11, 2015).

<sup>25</sup> See, e.g., Andrew Ackerman, *Corporations Take Swats at a Gadfly*, *Wall St. J.* (Mar. 12, 2014), <http://online.wsj.com/news/articles/SB100014240527023035462045794355123805615267mod=vocus>; Ning Chiu, *Fifth Circuit Upholds Decision Against Chevedden as More Companies Seek 14a-8 Relief from Courts*, *Davis Polk & Wardwell LLP* (Feb. 18, 2014), <http://www.davispolk.com/briefing/corporategovernance/fifth-circuit-upholds-decision-against-chevedden-more-companies-seek>; *Waste Connections, Inc. v. Chevedden*, No. 4:13-cv-00176 (S.D. Tex. June 3, 2013), *aff'd*, No. 13-20336, 2014 WL 554566 (5th Cir. Feb. 13, 2014), <http://www.gpo.gov/fdsys/pkg/USCOURTS-ca5-13-20336/pdf/USCOURTS-ca5-13-20336-0.pdf>.

<sup>26</sup> Society of Corporate Secretaries and Governance Professionals, <http://www.scs.org> (last visited Sept. 11, 2015).

<sup>27</sup> See Copland Winter 2013, supra note 23.

<sup>28</sup> See 14a-8, supra note 1.

<sup>29</sup> See id.

<sup>30</sup> See Statement from Chair White Directing Staff to Review Commission Rule for Excluding Conflicting Proxy Proposals, SEC (Jan. 16, 2015), [http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html#VST9b\\_rf\\_Wt](http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html#VST9b_rf_Wt) [hereinafter *White Statement*].

<sup>31</sup> See No-Action Letter Re: Wal-Mart Stores, Inc., SEC, <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2014/trinitychurch032014-14a8.pdf> [hereinafter "Wal-Mart No-Action Letter"] (stating "[W]e will not recommend enforcement action to the Commission if Wal-Mart omits the proposal from its proxy materials in reliance on rule 14a-8(i)(7).") (last visited Sept. 11, 2015); see also 14a-8, supra note 1 at subsection (i)(7) (indicating that when a "proposal deals with a matter relating to the company's ordinary business operations," a company may rely on that as a basis for excluding the proposal).

<sup>32</sup> Letter from James McRitchie to Office of Chief Counsel, Division



of Corporation Finance, SEC (Dec. 23, 2014), available at <http://corpgov.net/wp-content/uploads/2014/12/McRitchieAppealNo-action12-23-2014.pdf> (last visited Sept. 11, 2015).

<sup>41</sup> *Trinity Wall Street v. Wal-Mart Stores, Inc.*, 75 F. Supp. 3d 617 (D. Del. 2014), rev'd sub nom. *Trinity Wall St. v. Wal-Mart Stores, Inc.*, No. 14-4764, 2015 WL 1905766 (3d Cir., Apr. 14, 2015) (available online at <http://law.justia.com/cases/federal/district-courts/delaware/delcve/1:2014cv00405/54554/65/>).

<sup>42</sup> *Id.* at 622.

<sup>43</sup> *Id.* at 630.

<sup>44</sup> See *Trinity Wall Street v. Wal-Mart Stores, Inc.*, No. 14-4764, 2015 WL 1905766 (3d Cir., Apr. 14, 2015) (available online at <http://www.arkansasbusiness.com/public/wmt-trinity.pdf>).

<sup>45</sup> *Trinity Wall St. v. Wal-Mart Stores, Inc.*, 792 F.3d 323 (3d Cir. 2015).

<sup>46</sup> See Stephen M. Bainbridge, *Two Cheers for Trinity Wall Street v. Wal-Mart: The Awkward New Test for Ordinary Business Exclusion*, Legal Backgrounder, Washington Legal Foundation, available at [http://www.wlf.org/upload/legalstudies/legalbackgrounder/08211SLB\\_Bainbridge2.pdf](http://www.wlf.org/upload/legalstudies/legalbackgrounder/08211SLB_Bainbridge2.pdf) (last visited Sept. 11, 2015).

<sup>47</sup> See Chamberlain, *supra* note 14 (defining "socially responsible investing").

<sup>48</sup> Pension plans are generally bound as fiduciaries under the Employee Retirement Income Security Act (ERISA) to maximize share value in their pension management. See 29 C.F.R. § 2509.08-2(1) (2008). However, those affiliated with religious organizations are exempt from this requirement. See 29 U.S.C. § 1003(b).

<sup>49</sup> See Liz Hoffman & Timothy W. Martin, *Largest U.S. Pensions Divided on Activism*, Wall St. J., May 19, 2015, <http://www.wsj.com/articles/largest-u-s-pensions-divided-on-activism-1432075445>.

<sup>50</sup> Board-declassification proposals were introduced at many publicly traded companies from 2012 through 2014 by various public-employee pension funds affiliated with Harvard's Shareholder Rights Project, see *The President and Fellows of Harvard College, Shareholder Rights Project*, <http://srp.law.harvard.edu/>.

<sup>51</sup> In determining shareholder support for shareholder proposals, the Manhattan Institute counts votes consistent with the practice dictated in a company's bylaws, consistent with state law. Some companies measure shareholder support by dividing the number of votes for a proposal by the total number of shares present and voting, ignoring abstentions. Other companies measure shareholder support by dividing the number of favorable votes by the number of shares present and entitled to vote—thus including abstentions in the denominator of the tally. Neither practice necessarily skews shareholder votes in management's favor; whereas the latter method makes it relatively more difficult for shareholder resolutions to obtain majority support, it also makes it more difficult for management to win shareholder backing for its own proposals, such as equity compensation plans.

Although shareholder-proposal activists prefer to exclude abstentions consistently in tabulating vote totals, without regard to corporate bylaws—which necessarily inflates apparent support for their proposals—such a methodology is inconsistent with federal law. The SEC's Schedule 14A specifies that for "each matter which is to be submitted to a vote of security holders," corporate proxy statements must "[d]isclose the method by which votes will be counted, including the treatment and effect of abstentions and broker non-votes under applicable state law as well as registrant charter and bylaw provisions"—clearly indicating that corporations can adopt varying counting methodologies in assessing shareholder votes and that state substantive law governs the parameters of vote calculation. See Item 21, *Voting Procedures*, 17 C.F.R. § 240.14a-101, available at <http://www.sec.gov/about/sched14a.pdf> (last visited Sept. 11, 2015).

Under the state law of Delaware, in which most large public corporations are chartered, "the certificate of incorporation or bylaws of any corporation authorized to issue stock may specify the number of shares and/or the amount of other securities having voting power the holders of which shall be present or represented by proxy at any meeting in order to constitute a quorum for, and the votes that shall be necessary for, the transaction of any business." Del. Gen. Corp. L. § 216, available at <http://delcode.delaware.gov/title8/c001sc07/> (last visited Sept. 11, 2015). As a default rule, absent a bylaw specification, Delaware law specifies that "in all matters other than the election of directors," companies should count "the affirmative vote of the majority of shares of such class or series or classes or series present in person or represented by proxy at the meeting," *id.* at 216(4)—the precise inverse of shareholder-proposal activists' preferred counting rule.

The SEC staff has adopted a rule that for the very limited purpose of determining whether a proposal has met the "resubmission threshold" to qualify for inclusion on the next year's corporate ballot—a permissive standard requiring merely a minimum 3 percent, 6 percent, or 10 percent vote, respectively, in successive years, see *Amendments to Rules on Shareholder Proposals*, Exchange Act Release No. 40,018; 63 Fed. Reg. 29,106, 29,108 (May 28, 1998) (codified at 17 C.F.R. pt. 240)—"only votes for and against a proposal are included in the calculation of the shareholder vote of that proposal," ignoring abstentions. SEC Staff Legal Bulletin No. 14, F.4., July 13, 2001, <http://www.sec.gov/interp/legal/cslb14.htm> (last visited Sept. 11, 2015). Because this is a staff rule not voted on by the Commission, because it exists for a limited purpose (with multiple rationales, including reducing workload in processing 14a-8 no-action petitions and adopting a permissive standard for ballot inclusion); and because it contravenes clear and longstanding deference to substantive state law in the field of corporate governance, the notion that this limited SEC staff vote-counting rule should dictate counting methodology, irrespective of state law and governing corporate bylaws, is untenable. Indeed, in 2014 and 2015, various shareholder proponents have introduced proposals seeking to modify companies' bylaws to treat abstentions as non-votes; such proposals have received less than 10 percent shareholder support.

- <sup>44</sup> See Copland & O'Keefe Fall 2014, *supra* note 16, at 2 ("From 2006 through 2014, among 1,141 shareholder proposals at Fortune 250 companies that involved social or policy concerns, not a single proposal has won the support of a majority of shareholders over board opposition."); James R. Copland, *Getting the Politics Out of Proxy Season*, *Wall St. J.*, Apr. 23, 2015, available at <http://www.wsj.com/articles/getting-the-politics-out-of-proxy-season-1429744795>. Note that this statement holds true for the current Fortune 250, but a shareholder proposal at KBR, Inc. did receive 55 percent shareholder support over board opposition in 2011, when the company was in the Fortune 250 list. That proposal, sponsored by the New York City pension funds, encouraged the board to amend the company's equal-employment opportunity policy to prohibit discrimination based on sexual orientation.
- <sup>45</sup> Although there were only two shareholder proposals at Fortune 250 companies in 2015 that sought to declassify corporate boards, the year did involve a significant dispute about the empirical data justifying the idea. As discussed in earlier Proxy Monitor reports, see Copland Winter 2014, *supra* note 23, text accompanying notes 12–15, early academic studies showed that staggered boards reduced share value, see, e.g., Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, *Staggered Boards and the Wealth of Shareholders: Evidence from Two Natural Experiments* (Nat'l Bureau of Econ. Research, Working Paper No. 17127, June 2011), available at <http://www.nber.org/papers/w17127>; but subsequent research has thrown these findings into question, see, e.g., Martijn Cremers, Lubomir P. Litov, and Simone M. Sepe, *Staggered Boards and Firm Value, Revisited*, *Social Science Research Network*, Dec. 19, 2013, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2364165](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2364165). In December 2014, SEC Commissioner Daniel Gallagher and Stanford professor Joseph Grundfest released a provocative paper summarizing this dispute, Daniel M. Gallagher & Joseph Grundfest, *Did Harvard Violate Federal Securities Law? The Campaign against Classified Boards of Directors*, *Social Science Research Network*, Dec. 10, 2014, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2536586](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2536586). Gallagher and Grundfest's paper asserted that the Harvard Shareholder Rights Project, see *supra* note 42, violated federal securities law by inadequately characterizing the current state of the research in shareholder proposals it helped funds to introduce, which prompted an aggressive pushback from academics, see, e.g., *Statement of Thirty-Four Senior Corporate and Securities Law Professors Urging Commissioner Gallagher and Professor Grundfest to Withdraw Their Allegations against Harvard and the SRP*, HLS Forum on Corporate Governance and Financial Regulation (Jan. 15, 2015), <http://corpgov.law.harvard.edu/2015/01/15/statement-of-thirty-four-senior-corporate-and-securities-law-professors-urging-commissioner-gallagher-and-professor-grundfest-to-withdraw-their-allegations-against-harvard-and-the-srp/>, though this furious academic response did not challenge the paper's characterization of the academic evidence but rather objected to its allegations against Harvard University and its academic-led clinical law program.
- <sup>46</sup> See, e.g., Copland & O'Keefe Fall 2014, *supra* note 16, at 9 & tbl.1.
- <sup>47</sup> For example, according to the Harvard Shareholder Rights Project, a clinical program that advocated for the proposal to declassify staggered boards, two-thirds of the S&P 500 companies that had classified boards as of 2012 had changed their practice by 2014. See Harvard Shareholder Rights Project, *121 Companies Agreeing to Move toward Annual Director Elections*, <http://srp.law.harvard.edu/companies-entering-into-agreements.shtml> (last visited Sept. 11, 2015).
- <sup>48</sup> See Copland & O'Keefe Fall 2014, *supra* note 16, at 5. (For example, among companies facing board-declassification proposals introduced through efforts of the Harvard Shareholder Rights Project, 56 percent agreed to declassify their boards in 2012, 68 percent in 2013, and 76 percent in 2014. See Harvard Shareholder Rights Project, *supra* note 47.)
- <sup>49</sup> See Exelon Corp., *Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934*, proposals no. 5, 6 (Mar. 19, 2015), [http://www.sec.gov/Archives/edgar/data/1109357/000119312515098237/d876808ddef14a.htm#from876808\\_18](http://www.sec.gov/Archives/edgar/data/1109357/000119312515098237/d876808ddef14a.htm#from876808_18).
- <sup>50</sup> *Citizens United v. Fed. Election Comm'n*, 558 U.S. 310 (2010).
- <sup>51</sup> A 2006 spending-disclosure proposal introduced at Amgen did receive majority-shareholder support (67 percent) after the proposal was supported by management. Also, as noted in footnote 44, *supra*, KBR, Inc. did receive 55 percent shareholder support for a shareholder proposal related to sexual-orientation employee discrimination, over board opposition, in 2011, when the company was in the Fortune 250 list.
- <sup>52</sup> See James R. Copland et al., *Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism 20–22 & tech. app.* (Manhattan Inst. for Pol'y Res., Fall 2012), [http://proxymonitor.org/Forms/pmr\\_04.aspx](http://proxymonitor.org/Forms/pmr_04.aspx) (showing significant variation in shareholder votes based on proposal type).
- <sup>53</sup> Defined-benefit pension plans have a fixed payment at retirement, paid by a guarantor, typically one's employer. See *Choosing a Retirement Plan: Defined Benefit Plans*, Internal Revenue Service, available at <http://www.irs.gov/Retirement-Plans/Choosing-a-Retirement-Plan:-Defined-Benefit-Plan> (last visited Sept. 11, 2015). In contrast, defined-contribution plans, such as those under section 401(k) of the Internal Revenue Code, are portable retirement plans with variable outlays, and investments under the control of the retiree.
- <sup>54</sup> Rob Kozlowski, *Retirement Plan Assets Rise 8.5%, Pass \$9 Trillion, Pensions & Investments* (Feb. 9, 2015), <http://www.pionline.com/article/20150209/PRINT/302099984/retirement-plan-assets-rise-85-pass-9-trillion>.
- <sup>55</sup> The Thrift Savings Plan (TSP) is a tax-deferred retirement savings and investment plan that offers federal employees the same type of savings and tax benefits that many private corporations offer their employees under 401(k) plans. By participating in the TSP, federal employees have the opportunity to save part of their income for retirement, receive

matching agency contributions, and reduce their current taxes. See Thrift Savings Plan, <https://www.tsp.gov/index.shtml> (last visited Sept. 11, 2015).

<sup>36</sup> See Kozlowski, *supra* note 54.

<sup>37</sup> For example, the two large California public-employee pension funds, CalPERS and CalSTRS, differ dramatically on how they respond to activist hedge funds' efforts to influence corporate management, as witnessed by their being on opposite sides of Trian Fund Management's effort to break up DuPont. See Hoffman & Martin, *supra* note 41.

<sup>38</sup> States whose funds were involved in at least some shareholder-proposal activism since 2006 are Connecticut (eight proposals), Indiana (two proposals), Illinois (two proposals), Massachusetts (four proposals), Minnesota (one proposal), and North Carolina (nine proposals).

<sup>39</sup> These funds are the Philadelphia Public Employee Retirement System (14 proposals) and the firefighters' pensions for Kansas City (15 proposals) and Miami (six proposals).

<sup>40</sup> See Press Release, Comptroller Stringer, NYC Pensions Funds Launch National Campaign To Give Shareowners A True Voice In How Corporate Boards Are Elected: New York City Pension Funds File 75 Proxy Access Shareowner Proposals to Kick Off the Boardroom Accountability Project, <https://comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-pension-funds-launch-national-campaign-to-give-shareowners-a-true-voice-in-how-corporate-boards-are-elected/> [hereinafter "Stringer Press Release"] (last visited Sept. 11, 2015).

<sup>41</sup> See Shareholder Rights Project, Investors Working with the SRP Clinic, available at <http://srp.law.harvard.edu/clients.shtml> (last visited Sept. 11, 2015).

<sup>42</sup> Traditionally, corporate law has oriented corporate boards and managers' fiduciary duties around a single variable, share value, see *Dodge v. Ford Motor Company*, 170 N.W. 668 (Mich. 1919) (holding that corporate fiduciary duties flowed to shareholders, not employees or other interests), which avoids the ownership costs—chiefly conflicts of interest that arise among various owners—that are inherent in non-corporate ownership forms. See generally Henry Hansmann, The Ownership of Enterprise 35–49 (1996) (arguing that the costs of collective decision-making best explain the predominance of the corporate equity-ownership form in large-scale for-profit enterprise); see also Stephen M. Bainbridge, The Case for Limited Shareholder Voting Rights, 53 UCLA L. Rev. 601 (2006) (arguing that increasing shareholder power imposes significant costs in reduced managerial authority). Since shortly after *Dodge v. Ford* was decided, an academic debate has proliferated between those arguing for a social responsibility for corporations, see E. Merrick Dodd, Jr., For Whom are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145, 1148 (1932) (arguing for the view that "the business corporation as an economic institution which has a social service as well as a profit-making function"), and those supporting the traditional rule centered on share value, see Adolf A. Berle, Jr., For Whom Corporate Managers Are Trustees: A Note, 45

Harv. L. Rev. 1365, 1367 (1932). The modern push for "corporate social responsibility" generally traces to a pair of 1970s books, *Where the Law Ends*, by Christopher Stone (1975), and *Taming the Giant Corporation*, by Ralph Nader, Mark Green, and Joel Seligman (1976). For a critique of the early concept of corporate social responsibility advocated by these authors, see David L. Engel, An Approach to Corporate Social Responsibility, 32 Stan. L. Rev. 1, 1 (1979) ("Any mandatory governance reforms intended to spur more corporate altruism are almost sure to have general institutional costs within the corporate system itself. . . . But the proponents of 'more' corporate social responsibility have never bothered to analyze or examine, from any clearly defined starting point, even just the benefits they anticipate from reform . . .").

<sup>43</sup> See Employee Retirement Income Security Act (ERISA), Pub. L. No. 93-406, § 514, 88 Stat. 829, 897 (1974) (codified at 29 U.S.C. §§ 1001-1461 (2006)); 29 C.F.R. § 2509.08-2(1) (2008) (requiring pension plan managers to "consider only those factors that relate to the economic value of the plan's investment" and not to "subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives"); These fiduciary duties under ERISA do not apply to pension plans for state and municipal employees or for those affiliated with religious institutions. See 29 U.S.C. § 1003(b).

<sup>44</sup> Sample size was 193 proposals, which includes all shareholder proposals available in the Proxy Monitor database from the five largest public-employee pension funds, excluding 2015 proposals and 2014 proposals with a record date after May 2014, and excluding any company that underwent a significant change of control within one year of the record date for the proposal at issue. Share prices were adjusted for stock splits.

<sup>45</sup> For further discussion of these findings, see James R. Copland, Special Report: Public Pension Funds' Shareholder-Proposal Activism (Manhattan Inst. for Pol'y Res., Finding 3 2015), <http://proxymonitor.org/forms/2015Finding3.aspx>.

<sup>46</sup> See The University of Tennessee Knoxville: Tracie Woidtke, <http://finance.bus.utk.edu/faculty/Woidtke.asp>.

<sup>47</sup> See Tracie Woidtke, Pension Fund Activism and Firm Value (forthcoming 2015) (on file with author).

<sup>48</sup> *Id.* at 3.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at 3–4.

<sup>51</sup> See Stringer Press Release, *supra* note 60.

<sup>52</sup> See CFA Institute, Proxy Access in the United States: Revisiting the Proposed SEC Rule (Aug. 2014), available at <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2014.n9.1> (last visited Sept. 11, 2015). The CFA Institute is a global association of chartered financial analysts. See generally CFA Institute, <https://www.cfainstitute.org/pages/index.aspx> (last visited Sept. 11, 2015).

- <sup>71</sup> See Gretchen Morgenson, *Mutual Fund Giants Vote to Keep the Insiders In*, N.Y. Times, May 31, 2015, at BU1, available at <http://www.nytimes.com/2015/05/31/business/fund-giants-resist-proxy-access-board-shake-ups.html> (last visited Sept. 11, 2015).
- <sup>72</sup> *Bus. Roundtable v. S.E.C.*, 647 F.3d 1144, 1152 (D.C. Cir. 2011).
- <sup>73</sup> See Stringer Press Release, *supra* note 60.
- <sup>74</sup> See generally Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. Chi. L. Rev. 751, 788–89 (2002) (discussing the “camouflaging” of managerial rent extraction); Lucian A. Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J.L. Econ. & Org. 487, 501 (1999) (showing that “within the standard principal-agent framework, permitting value-diversion imposes a cost on shareholders that may reduce ex ante share value”).
- <sup>75</sup> Board diversity has become a hot topic in academic corporate-governance circles, see, e.g., The Faulty Lounge, <http://www.thefaultylounge.org/board-diversity/> (last visited July 8, 2015), but empirical scholarship supporting the notion that board diversity matters for shareholder value is mixed at best, with several studies showing that gender diversity is negatively associated with share value, particularly when required or pressed by government mandate, see Kimberly D. Krawiec, *What Does Corporate Boardroom Diversity Accomplish?*, N.Y. Times (Room for Debate, Apr. 1, 2015), <http://www.nytimes.com/roomfordebate/2015/04/01/the-effect-of-women-on-corporate-boards/what-does-corporate-boardroom-diversity-accomplish> (citing studies); Stephen Bainbridge, *Professorbainbridge.com* (May 14, 2015), <http://www.professorbainbridge.com/professorbainbridge.com/2015/05/gender-diversity-in-the-boardroom.html> (citing studies). Although energy companies may face peculiar regulatory risks from government action to tackle climate change, such risks are rather obvious for energy and utility companies and their investors—and already disclosed, see Commission Guidance Regarding Disclosure Related to Climate Change, Exchange Act Release No. 34-61469, 75 Fed. Reg. 6290, 6291, 6296; John M. Broder, S.E.C. Adds Climate Risk to Disclosure List, N.Y. Times, Jan. 27, 2010, at B1. The risks that climate change itself may place on such companies’ business models are too far in the future—and thus too discounted to present—to concern shareholders focused solely on share price.
- <sup>76</sup> See Press Release, National Nurses United, U.S. Court of Appeals Issues Scathing Judgment against Big Hospital Chain, Ordering CHS to Repay Union Costs for “Willful” Failure to Bargain with RNs, <http://www.commondreams.org/newswire/2015/05/11/us-court-appeals-issues-scathing-judgment-against-big-hospital-chain-ordering> (last visited Sept. 11, 2015).
- <sup>77</sup> See Kohl’s Refuses to Hear from Workers Who Keep Its Stores Clean, Union Advocate (May 14, 2015), <http://advocate.stpaulunions.org/2015/05/14/kohls-refuses-to-hear-from-workers-who-keep-its-stores-clean/> (last visited Sept. 11, 2015).
- <sup>78</sup> See Andrew Edwards, *Pension Costs Lead San Bernardino’s Debt*, [San Bernardino] Sun News (Aug. 10, 2012), available at <http://www.sbsun.com/general-news/20120810/pension-costs-lead-san-bernardinoss-debts> (last visited Sept. 11, 2015).
- <sup>79</sup> See *id.*
- <sup>80</sup> See Steven Church & Romy Varghese, *Calpers’ Pension Hammer Forces “Unfair” Bond Ruling by Judge*, Bloomberg Business (May 12, 2015), available at <http://www.bloomberg.com/news/articles/2015-05-12/calpers-pension-hammer-forces-unfair-bond-ruling-by-judge> (last visited Sept. 11, 2015).
- <sup>81</sup> See Fight for \$15, <http://fightfor15.org/latest-news/> (last visited Sept. 11, 2015).
- <sup>82</sup> See Nandita Bose, *After Target Wage Hike, Labor Groups Turn to Drugstore Chains, Philly Voice* (Mar. 21, 2015), available at <http://www.phillyvoice.com/after-target-wage-hike-labor-groups-eye-drugstores/> (last visited Sept. 11, 2015).
- <sup>83</sup> See Copland & O’Keefe Fall 2014, *supra* note 16, at 17–19 (discussing inefficiencies in shareholder-proposal voting market in context of proxy advisory firms’ influence).
- <sup>84</sup> Although markets are not perfectly efficient, they are sufficiently so that the Supreme Court has relied on the “efficient market hypothesis” in handling class action standards in federal securities litigation. See *Basic v. Levinson*, 485 U.S. 224 (1988).
- <sup>85</sup> We selected a five-day window because some companies announce voting results on shareholder proposals on the date of their annual meeting, and others wait until they have filed a Form 8-K with the SEC days later.
- <sup>86</sup> Two companies—Apache and Citigroup—were excluded from the analysis because their boards of directors recommended a vote for the proxy access shareholder proposal, thus eliminating any element of surprise at the annual meeting.
- <sup>87</sup> The iShares Global Equity ETF, see <https://www.ishares.com/us/products/239741/ishares-global-energy-etf> (last visited Sept. 11, 2015).
- <sup>88</sup> See CFA Institute, *supra* note 72.
- <sup>89</sup> See White Statement, *supra* note 30.
- <sup>90</sup> See *Trinity Wall St.*, 792 F.3d 323.
- <sup>91</sup> See Jonathan H. Adler, D.C. Circuit Voids SEC “Conflict Minerals” Policy on First Amendment Grounds (Again), Washington Post (Aug. 18, 2015), available at [www.washingtonpost.com/news/voikh-conspiracy/wp/2015/08/18/d-c-circuit-voids-sec-conflict-minerals-policy-on-first-amendment-grounds-again/](http://www.washingtonpost.com/news/voikh-conspiracy/wp/2015/08/18/d-c-circuit-voids-sec-conflict-minerals-policy-on-first-amendment-grounds-again/) (last visited Sept. 11, 2015).
- <sup>92</sup> See Securities Exchange Act of 1934, *supra* note 1 at § 78c(f) (“Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to

the protection of investors, whether the action will promote efficiency, competition, and capital formation.”).

<sup>41</sup> See SEC Press Release, SEC Adopts Rule for Pay Ratio Disclosure: Rule Implements Dodd-Frank Mandate While Providing Companies with Flexibility to Calculate Pay Ratio, <http://www.sec.gov/news/pressrelease/2015-160.html> (last visited Sept. 11, 2015).

<sup>42</sup> See Dodd-Frank, *supra* note 2, Section 1502.

<sup>43</sup> Under the Employee Retirement Income Security Act of 1974 (ERISA), fiduciary duties governing employee benefit plan investment portfolios require that “in voting proxies . . . the responsible fiduciary shall consider only those factors that relate to the economic value of the plan’s investment and shall not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives.” 29 C.F.R. § 2509.08-2(1) (2008). State and municipal public employee plans are exempt from this requirement. See 29 U.S.C. § 1003(b).

<sup>44</sup> If a company falls below 70 percent support, then ISS expects its board to respond to investors’ concerns and, if insufficiently satisfied, the proxy advisor will punish the company in future say-on-pay vote recommendations as well as, potentially, by withholding support for the company’s nominees for director. See ISS, 2015 U.S. Proxy Voting Summary Guidelines 13 (Mar. 5, 2015), [http://www.issgovernance.com/file/policy/1\\_2015-us-summary-voting-guidelines-updated.pdf](http://www.issgovernance.com/file/policy/1_2015-us-summary-voting-guidelines-updated.pdf).

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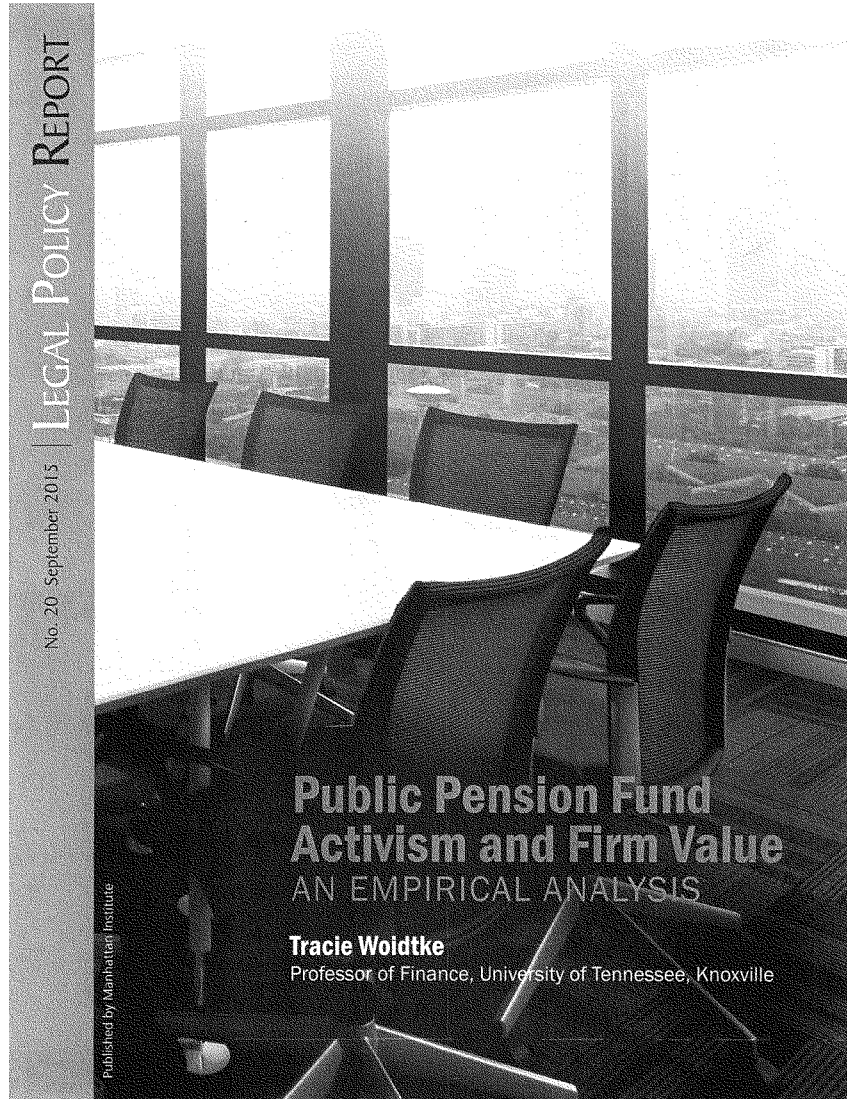
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She won the University of Tennessee, Knoxville's 2007 Allen H. Keally Outstanding Teacher Award and the university's 2008 Southern-Peters Outstanding Research Award. Woidtke holds a B.A. in math and computer science and an MBA, all from Millsaps College, and a Ph.D. in finance from Tulane University. As a Rotary Scholar, she attended Queen's University in Canada.

## Public Pension Fund Activism and Firm Value

### AN EMPIRICAL ANALYSIS

#### EXECUTIVE SUMMARY

This paper examines the relationship between public pension funds engaged in shareholder activism—specifically, that involving corporate-governance rules or social/policy concerns—and firm value during 2001–13; consistent with the author's previous research, the paper finds that public pension fund ownership is associated with lower firm value, as measured by Tobin's Q and industry-adjusted Q.

The paper further explores this relationship across two time subsets, 2001–07 and 2008–13; it examines two data samples, the Fortune 250 and S&P 500; and looks separately at the major state pension funds engaged in such activism—principally the California Public Employees Retirement System (CalPERS), California State Teachers Retirement System (CalSTRS), New York State Common Retirement System (NYSCR), and Florida State Board of Administration (FSBA). Key findings include:

1. **Ownership by public pension funds engaged in social-issue shareholder-proposal activism is negatively related to firm value.** This relationship is significant for the 2008–13 period—when the two large funds focused on social-issue activism, CalSTRS and the NYSCR, were engaged in shareholder-proposal activism—in both the Fortune 250 and S&P 500 samples.
2. **Ownership by NYSCR is negatively related to firm value during the period in which the fund was actively engaged in sponsoring shareholder proposals related to social issues.** This relationship is significant for 2008–13, at the 1 percent level, for both the Fortune 250 and S&P 500 firm samples, as well as for the overall 2001–13 period for the broader S&P 500 sample. There is no statistically significant relationship between NYSCR ownership and firm value in the earlier 2001–07 period, when the fund was not as active in sponsoring shareholder proposals. Overall, S&P 500 firms targeted by NYSCR with social-issue shareholder proposals subsequently had a 21 percent lower Tobin's Q and a 91 percent lower industry-adjusted Q than all other firm-years in the sample.

3. **There is no significant relationship between public pension fund ownership and firm value for funds engaging in shareholder-proposal activism focused on corporate governance rules.** For the full 2001–13 period, 2001–07 period, and 2008–13 period, there is no statistically significant relationship between firm value and ownership by public pension funds engaged in corporate-governance-related shareholder-proposal activism, in either the Fortune 250 or S&P 500 sample. Certain funds engaged in such activism—notably the FSBA and the Ohio pension funds—show significant positive relationships between their ownership and firm value for certain periods or samples.

These findings suggest that public pension funds' shareholder activism influences companies but that such influence is not generally associated with positive valuation effects; when influence is associated with social-issue activism, valuation effects tend to be negative. In contrast, private pension fund ownership—driven by the Teachers Insurance and Annuity Association—College Retirement Equities Fund (TIAA-CREF), which engages in strategies designed to influence corporate behavior in its portfolio—is associated with higher firm value, at least in some sample study periods.

These findings are also consistent with the hypothesis that performance-based compensation for administrators of private pension funds generally results in a convergence of their interests with other shareholders', whereas public pension fund administrators' actions may be motivated more by political or social influences than by firm performance, leading to a conflict of interest. Policymakers overseeing state and municipal pension plans need to consider carefully the shareholder-activism strategies employed by their funds.

## INTRODUCTION

Many credit the increase in institutional shareholder activism during the 1990s, at least in part, to intense lobbying efforts by institutional investors to allow greater shareholder involvement in the proxy voting process (e.g., Eisenhofer and Bany 2013). For example, the U.S. Securities and Exchange Commission (SEC) initiated a comprehensive reexamination of the federal proxy regulations, which culminated in the 1992 proxy-rule amendments, after receiving a series of letters from some of the most activist institutional investors, spearheaded by the California Public Employees Retirement System (CalPERS) (Fisch 1994).

The aim of the expansive reforms was to increase the ability of investors to communicate with one another on how to respond to a proxy-issue proposal. Among others, the 1992 proxy reforms enabled activist investors to broadcast their voting positions on a website (CalPERS began to broadcast its voting positions on a new website), potentially enhancing their influence over shareholder voting and company management.

Several pension funds continue to be among the most active institutional investors by broadcasting their stance on proxy voting for certain issues, publishing focus lists, sponsoring proxy proposals, and supporting reforms that increase shareholders' power to influence company management (e.g., proxy access and say on pay). Even though public pension funds do not tend to face the same potential conflicts of interests stemming from either short-term investment horizons or business ties with their portfolio companies as other types of institutions do, they are frequently criticized for being influenced more by social and political issues than by shareholder wealth.

In its July 22, 2011 decision invalidating the SEC's proposed mandatory proxy-access rule, the U.S. Court of Appeals declared: "By ducking serious evaluation of the costs that could be imposed upon companies from use of the [proxy access] rule by shareholders representing special interests, particularly union and government pension funds, we think the [Securities and Exchange] Commission acted arbitrarily."

In an earlier study (Woidtke 2002), this author examined the potential influence that different institutional investors' incentive structures had over their portfolio companies during the early onset of institutional-investor activism (1989–93)

by studying the valuation effects associated with the different incentive structures of public and private pension funds for a sample of Fortune 500 firms. In particular, the author tested whether other shareholders in a firm benefit from the relationship between a firm's management and certain institutional investors, when ownership in a firm by the group of institutions is used as a proxy for the institutions' influence with management.

The author found that firm value is positively related to ownership by private pension funds and negatively related to ownership by activist public pension funds after controlling for other determinants of ownership. However, the results suggested that not all public pension fund activism is associated with negative valuation effects. Instead, the results suggested that the actions of public pension funds that focus on social or "poor" corporate governance issues were associated with negative valuation effects during 1989–93.

The author concluded that the positive effect associated with private pension fund ownership is consistent with the larger, more performance-based compensation for administrators of private pension funds, resulting in a convergence of interests with other shareholders. The negative effect associated with the ownership of public pension funds that focus on social or "poor" corporate governance issues is consistent with the argument that these administrators' actions may be motivated more by political or social influences than by firm performance, leading to a conflict of interest.

This paper examines the valuation effects associated with the different incentive structures of public and private pension funds for a sample of firms, in both the Fortune 250 and S&P 500 Index, during a more recent period (2001–13). The study aims to see if the valuation effects associated with pension fund influence, measured through ownership, have altered as the regulatory environment has changed and institutional investor activism has evolved. This paper also takes a more granular look at specific shareholder-proposal activist strategies, drawn from the Manhattan Institute's ProxyMonitor.org database and other available information, as associated with sponsoring public pension funds.

Following Woidtke (2002), the paper uses a firm's industry-adjusted Tobin's Q—the ratio of the market value of a firm's assets to the book value of its assets—to measure the expected valuation effects from observable and unobservable

aspects of the relationships between pension funds and their portfolio firms. As with Woidtke (2002), the paper finds that industry-adjusted Q is negatively related to public pension fund ownership and positively related to private pension fund ownership during 2001–13.

However, interesting differences arise when different activist strategies—and how such strategies vary over time—are examined. The positive valuation effect for private pension fund ownership is driven by the ownership of TIAA-CREF, the most well-known private pension fund activist throughout the sample period. In contrast, the valuation effect for public pension fund ownership is not confined to a particular public pension fund during the entire period. Instead, the relation varies with public pension fund strategy over time.

The negative valuation effect in the more recent period (2008–13) is driven by ownership of public funds that sponsor social-issue proposals, especially the New York State Common Retirement System (NYSCR), and coincides with active sponsoring of social-issue proposals during this period. Ownership by these funds is not associated with negative valuation effects during the earlier period (2001–07) when they were not as active in sponsoring social-issue proposals.

Consistent with social-issue activism having negative valuation effects, Tobin's Q is 22 percent lower (1.42 vs. 1.83) and industry-adjusted Tobin's Q is 141 percent lower (-0.12 vs. 0.29) for companies targeted by NYSCR with a social-issue proposal than for other companies in the Fortune 250. These results are robust for companies in a larger dataset, the S&P 500, for which Tobin's Q is 21 percent lower (1.59 vs. 2.02) and industry-adjusted Tobin's Q is 91 percent lower (0.04 vs. 0.45) for companies targeted by NYSCR with a social-issue proposal than for other companies.

The negative valuation effect for public-pension fund ownership during the earlier period (2001–07) is less clear. Across the narrower Fortune 250 sample, the effect appears to be driven by the State of Wisconsin Investor Board (SWIB), which, despite being considered among the most active public pension funds in earlier studies, did not sponsor proxy proposals during this paper's sample period. However, SWIB's negative valuation effect is not statistically significant in the broader S&P 500 sample.

Conversely, the California State Teachers Retirement System (CalSTRS), which focuses its shareholder-proposal activism

on social issues, has a directionally negative but statistically insignificant relationship with firm value in the narrower Fortune 250 sample—but a negative, significant relationship with firm value for the entire period of the broader S&P 500 sample. That negative relationship is only significant for the earlier period, when the fund was not sponsoring shareholder proposals.

There is no significant evidence of a negative valuation effect overall for ownership by public pension funds that sponsor corporate governance proposals (CalPERS and the Florida State Board of Administration (FSBA)). Overall, the results suggest that pension funds continue to influence companies, but pension fund influence is not always associated with positive valuation effects. In particular, negative valuation effects are found when influence is associated with social-issue activism.

## I. RELATIVE FIRM VALUE

Assuming that financial markets are efficient and that a firm's market value is an unbiased estimate of the present value of its future cash flows, Tobin's Q is a measure of the contribution of the firm's intangible assets to its market value. Management's actions directly affect the value of intangible assets. Tobin's Q should therefore include any adjustments that the market has made to incorporate expected valuation effects associated with the relationship between institutional shareholders and their portfolio firms.<sup>1</sup>

In particular, a positive valuation effect would be incorporated if the market perceives that the objective function of an institution's administrator will result in a relationship that aligns management's incentives with those of other shareholders. On the other hand, if the objective function of an institution's administrator is perceived to result in a relationship that does not align incentives between managers and other shareholders, a negative valuation effect would be incorporated. Thus, a firm's Q less the median Q for its industry (industry-adjusted Q) provides a measure of the influence of private and public pension funds on the shareholder wealth of a firm, relative to its industry.

This measure avoids the problems of pinpointing when new information is released and of introducing a possible sample-selection bias from studying only firms that have been publicly targeted. Industry-adjusted Q will capture all valuation effects that are expected to result when pension funds are present in a firm's ownership structure. Industry-

adjusted  $Q$  is calculated as a firm's  $Q$ , less the median  $Q$  for firms with the same two-digit SIC code. Financial data are obtained from Compustat.

## II. PENSION FUND OWNERSHIP

To measure the influence of pension fund ownership on industry-adjusted  $Q$ , this paper uses lagged pension fund ownership—calculated as the number of shares held by a pension fund, as a proportion of shares outstanding at the end of the quarter before industry-adjusted  $Q$  is calculated. The numbers of shares owned in a firm by pension funds are collected from Thomson 13f ownership data.<sup>2</sup>

One data limitation is that ownership data are not available for all pension funds. For example, pension funds managing less than \$100 million in assets and pension funds delegating investment decisions to outside money managers are not required to disclose their holdings. However, to the extent that pension funds with 13f filings are the largest pension funds that are most likely to monitor corporate behavior, most of the pension funds most likely to affect shareholder value are included in this paper.

Likewise, ownership data are available for most of the pension funds that have been documented as having relations with portfolio firms' valuations in earlier studies on pension fund activism—public (CalPERS, CalSTRS, FSBA, NYSCR, and SWIB) and private (CREF).<sup>3</sup> One notable group of public pension funds not included in this paper are those associated with New York City public employees, which are among the most-active sponsors of shareholder proposals and collectively among the five-largest state or municipal pension plans. Because these funds do not file 13f reports, their ownership data are unavailable.

Average ownership in this paper's sample by the group of pension funds with 13f filings is 3.75 percent for the Fortune 250 and 3.98 percent for the S&P 500. When classifying pension fund ownership according to whether funds are private or public, average ownership is 1.27 percent for private pension funds and 2.48 percent for public pension funds for the Fortune 250; and 1.45 percent for private pension funds and 2.53 percent for public pension funds for the S&P 500. Average ownership by TIAA-CREF represents approximately 60 percent of private pension fund ownership for the Fortune 250 and 53 percent of private pension fund ownership for the S&P 500.

Average ownership by public pension funds that sponsor proxy proposals during this paper's sample period is approximately 44 percent of public pension fund ownership for the Fortune 250 and 43 percent of private pension fund ownership for the S&P 500. CalPERS (average ownership: 0.35 percent for the Fortune 250 sample; 0.34 percent for the S&P 500 sample) was the only public fund to actively sponsor corporate-governance proxy proposals throughout the 2001–13 period.

FSBA (average ownership: 0.23 percent for both the Fortune 250 and S&P 500 samples) also sponsored corporate-governance proxy proposals, but their sponsorship was confined to the latter half of the 2001–13 period. CalSTRS (average ownership: 0.12 percent for the Fortune 250 sample; 0.11 percent for the S&P 500 sample) and NYSCR (average ownership: 0.38 percent for the Fortune 250 sample; 0.40 percent for the S&P 500 sample) were not active sponsors during the first half of the 2001–13 period, but became active sponsoring social issue proposals during the second half of the period.

SWIB (average ownership: 0.09 percent for the Fortune 250 sample; 0.10 percent for the S&P 500 sample) was not active sponsoring proxy proposals at any point during the 2001–13 period, though it was during earlier periods. Finally, Ohio only sponsored a corporate governance proposal during the latter part of the period, and only for the S&P 500 sample.

## III. EMPIRICAL ANALYSIS

To measure the valuation effects of pension fund influence, this paper regresses Tobin's  $Q$  and industry-adjusted  $Q$  on lagged ownership by public pension funds and private pension funds, controlling for other factors found to influence industry-adjusted  $Q$  in Woidtke (2002). The paper uses robust standard errors clustered at the firm level to compute statistical significance. Specifications (1) and (4) present results for the full sample period; specifications (2) and (5) present results for the 2001–07 early period; and specifications (3) and (6) present results for the 2008–13 later period (Figure 1 and Figure 2).

**Figure 1. Pooled Regression Analysis of Tobin's Q and Industry-Adjusted Q on Lagged Ownership by U.S. Public Pension Funds and Private Pension Funds: Fortune 250\***

Sample Period:	2001–2013	2001–2007	2008–2013	2001–13	2001–07	2008–13
	Tobin's Q	Tobin's Q	Tobin's Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q
Constant	6.16*** (0.000)	7.06*** (0.000)	4.96*** (0.000)	3.97*** (0.000)	4.65*** (0.000)	3.03*** (0.000)
Lagged Ownership by U.S. Public Pension Funds	-13.51*** (0.009)	-13.13* (0.061)	-13.12** (0.015)	-12.91** (0.025)	-14.66** (0.046)	-8.73 (0.193)
Lagged Ownership by Private Pension Funds	19.77*** (0.001)	16.90** (0.012)	20.38*** (0.004)	12.40** (0.026)	11.31* (0.063)	11.34 (0.112)
Lagged Ownership by Other Institutions	-1.41*** (0.000)	-1.76*** (0.000)	-1.23*** (0.000)	-1.03*** (0.003)	-1.15*** (0.009)	-0.86*** (0.006)
Leverage	-0.98*** (0.004)	-1.62*** (0.000)	-0.34 (0.388)	-1.40*** (0.000)	-1.90*** (0.000)	-0.97** (0.014)
R&D Expense Scaled by Assets	11.32*** (0.000)	13.47*** (0.000)	7.19*** (0.000)	7.20*** (0.000)	9.62*** (0.000)	2.26 (0.310)
Missing R&D Indicator Variable	-0.07 (0.353)	-0.14 (0.113)	-0.03 (0.782)	0.19** (0.033)	0.14 (0.146)	0.19* (0.061)
Advertising Expense Scaled by Assets	8.10*** (0.001)	9.59*** (0.002)	6.10** (0.034)	6.27*** (0.005)	8.33*** (0.007)	3.80 (0.120)
Missing Advertising Indicator Variable	-0.20* (0.060)	-0.19 (0.157)	-0.23** (0.029)	-0.23** (0.050)	-0.22 (0.141)	-0.24** (0.026)
Member of S&P 500 Index	0.16 (0.234)	0.10 (0.387)	0.29* (0.053)	0.18 (0.297)	0.07 (0.744)	0.39** (0.034)
Natural Log of Assets	-0.31*** (0.000)	-0.37*** (0.000)	-0.27*** (0.000)	-0.25*** (0.000)	-0.29*** (0.000)	-0.22*** (0.000)
Prior Year Positive Income Indicator Variable	0.04 (0.606)	0.00 (0.990)	0.09 (0.142)	0.03 (0.748)	-0.02 (0.909)	0.09 (0.221)
Estimated Stock Transaction Costs	-0.71*** (0.000)	-1.01*** (0.000)	-0.57*** (0.000)	-0.47*** (0.000)	-0.65*** (0.009)	-0.38*** (0.001)
Insider Ownership	0.03* (0.091)	0.04* (0.086)	0.02 (0.243)	0.03** (0.037)	0.05** (0.037)	-0.03 (0.130)
Insider Ownership Squared	-0.00** (0.026)	-0.00** (0.041)	-0.00* (0.082)	-0.00** (0.013)	-0.00** (0.016)	-0.00* (0.070)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2326	1153	1173	2326	1153	1173
Adjusted R-squared	0.50	0.54	0.44	0.33	0.40	0.25

\*The sample contains 2,326 observations for a sample of Fortune 250 firms during 2001–13. Tobin's Q proxies for firm value and is equal to a firm's market value of assets scaled by its book value of assets, where market value of assets equals book value of assets plus market value of equity. Book values are taken at fiscal year-end and market values are taken at calendar year-end. Industry-adjusted Q controls for relative firm value in a given year and is equal to a firm's Tobin's Q less the median Tobin's Q for all firms in the same two-digit SIC code. Lagged ownership by U.S. public pension funds equals the aggregate number of shares held by U.S. public pension funds, which file 13F reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Lagged ownership by private pension funds equals the aggregate number of shares held by CREF and corporate pension funds, which file 13F reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Robust standard errors are clustered at the firm level. The corresponding p-values are given in parentheses. Statistical significance at the 1 percent, 5 percent, and 10 percent levels is indicated by \*\*\*, \*\*, and \*, respectively.

A negative valuation effect is found for public pension fund ownership and a positive valuation effect is found for private pension fund ownership. The negative valuation effect for public pension fund ownership is statistically significant for the entire sample period and early sample period, for Tobin's Q and industry-adjusted Q—and for both the Fortune 250 and the S&P 500 samples. However, the results are only

statistically significant for Tobin's Q in the later period. The positive valuation for private pension fund ownership is only statistically significant for both samples for the 2001–07 early period.

The paper next measures valuation effects associated with public pension fund ownership based on whether the public

**Figure 2. Pooled Regression Analysis of Tobin's Q and Industry-Adjusted Q on Lagged Ownership by U.S. Public Pension Funds and Private Pension Funds: S&P 500\***

Sample Period:	2001-2013	2001-2007	2008-2013	2001-13	2001-07	2008-13
	Tobin's Q	Tobin's Q	Tobin's Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q
Constant	6.59*** (0.000)	8.02*** (0.000)	5.23*** (0.000)	4.30*** (0.000)	5.64*** (0.000)	3.23*** (0.000)
Lagged Ownership by U.S. Public Pension Funds	-16.02*** (0.005)	-18.93*** (0.006)	-15.38** (0.024)	-10.10* (0.072)	-13.24* (0.053)	-9.62 (0.162)
Lagged Ownership by Private Pension Funds	1.03 (0.548)	9.83** (0.021)	-0.01 (0.987)	1.62 (0.421)	10.03*** (0.010)	0.69 (0.548)
Lagged Ownership by Other Institutions	-0.30 (0.199)	-0.77** (0.011)	-0.02 (0.944)	-0.22 (0.330)	-0.76** (0.013)	0.13 (0.590)
Leverage	-0.85*** (0.003)	-1.66*** (0.000)	-0.37 (0.253)	-0.93*** (0.001)	-1.62*** (0.000)	-0.53* (0.086)
R&D Expense Scaled by Assets	7.87*** (0.000)	9.76*** (0.000)	5.93*** (0.000)	5.13*** (0.000)	6.75*** (0.000)	3.45** (0.013)
Missing R&D Indicator Variable	-0.02 (0.850)	0.01 (0.944)	-0.02 (0.774)	0.23*** (0.006)	0.28** (0.041)	0.21*** (0.009)
Advertising Expense Scaled by Assets	5.67*** (0.002)	4.23** (0.021)	6.99*** (0.001)	3.33* (0.057)	2.01 (0.239)	4.57** (0.038)
Missing Advertising Indicator Variable	-0.20** (0.016)	-0.17* (0.077)	-0.20** (0.027)	-0.27*** (0.001)	-0.28*** (0.005)	-0.25*** (0.005)
Natural Log of Assets	-0.40*** (0.000)	-0.49*** (0.000)	-0.34*** (0.000)	-0.33*** (0.000)	-0.42*** (0.000)	-0.28*** (0.000)
Prior Year Positive Income Indicator Variable	0.24*** (0.000)	0.19* (0.079)	0.21*** (0.003)	0.21*** (0.001)	0.20** (0.042)	0.15** (0.021)
Estimated Stock Transaction Costs	-0.65*** (0.000)	-1.09*** (0.000)	-0.50*** (0.000)	-0.49*** (0.000)	-0.85*** (0.000)	-0.36*** (0.001)
Insider Ownership	-0.34 (0.624)	-0.80 (0.380)	-0.28 (0.737)	0.28 (0.699)	-0.29 (0.738)	0.47 (0.608)
Insider Ownership Squared	0.16 (0.763)	0.53 (0.392)	0.18 (0.799)	-0.36 (0.535)	-0.01 (0.984)	-0.39 (0.633)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	4672	2045	2627	4672	2045	2627
Adjusted R-squared	0.40	0.42	0.41	0.28	0.31	0.27

\*The sample contains 4,672 observations for a sample of S&P 500 firms during 2001-13. Tobin's Q proxies for firm value and is equal to a firm's market value of assets scaled by its book value of assets, where market value of assets equal book value of assets less book value of equity plus market value of equity. Book values are taken at fiscal year-end and market values are taken at calendar year-end. Industry-adjusted Q controls proxies for relative firm value in a given year and is equal to a firm's Tobin's Q less the median Tobin's Q for all firms in the same two-digit SIC code. Lagged ownership by U.S. public pension funds equal the aggregate number of shares held by U.S. public pension funds who file 13F reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Lagged ownership by private pension funds equal the aggregate number of shares held by CREF and corporate pension funds who file 13F reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Robust standard errors are clustered at the firm level. The corresponding p-values are given in parentheses. Statistical significance at the 1 percent, 5 percent, and 10 percent level is indicated by \*\*\*, \*\*, and \*, respectively.

pension fund sponsors a proxy proposal during 2001-13 and whether it tends to sponsor proposals on corporate governance or social issues. CalPERS and FSBA sponsor proposals principally or only on corporate governance issues. CalSTRS and NYSCR sponsor proposals mostly on social issues.

The first three specifications in Figure 3 and Figure 4 present results for ownership by public funds, based on corporate

governance proposal sponsorship; the last three specifications present results for ownership by public funds based on social issue proposal sponsorship—for the Fortune 250 and S&P 500. No significant valuation effect is found for ownership by public pension funds that sponsor corporate governance proposals during any period.

**Figure 3. Pooled Regression Analysis of Industry-Adjusted Q on Lagged Ownership by U.S. Public Pension Funds According to Focus of Proxy Proposal Sponsorship and Private Pension Funds: Fortune 250\***

Sample Period:	Corporate Governance Focus			Social Issues Focus		
	2001-2013	2001-2007	2008-2013	2001-13	2001-07	2008-13
	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q
Constant	3.87*** (0.000)	4.52*** (0.000)	3.04*** (0.000)	3.99*** (0.000)	4.77*** (0.000)	3.14*** (0.000)
Lagged Ownership By Public Pension Fund Corporate Governance Proposal Sponsors	22.79 (0.351)	26.84 (0.346)	-13.30 (0.738)			
Lagged Ownership by Public Pension Fund Non-Corporate Governance Proposal Sponsors	-16.54** (0.012)	-18.73** (0.023)	-8.18 (0.303)			
Lagged Ownership by Public Pension Fund Social Issue Proposal Sponsors				-0.24 (0.982)	20.86 (0.104)	-80.79** (0.010)
Lagged Ownership by Public Pension Fund Non-Social Issue Sponsors				-16.72** (0.017)	-28.13*** (0.003)	1.09 (0.888)
Lagged Ownership by Private Pension Funds	11.82** (0.035)	10.37* (0.030)	11.33 (0.112)	12.76** (0.029)	12.41** (0.045)	10.72 (0.129)
Lagged Ownership by Other Institutions	-1.05*** (0.002)	-1.16*** (0.008)	-0.86*** (0.007)	-1.05*** (0.002)	-1.19*** (0.007)	-0.78** (0.012)
Leverage	-1.39*** (0.000)	-1.88*** (0.000)	-0.98** (0.014)	-1.41*** (0.000)	-1.94*** (0.000)	-0.97** (0.014)
R&D Expense Scaled by Assets	7.21*** (0.000)	9.60*** (0.000)	2.25 (0.312)	7.23*** (0.000)	9.76*** (0.000)	2.24 (0.314)
Missing R&D Indicator Variable	0.18** (0.036)	0.13 (0.159)	0.19* (0.060)	0.19** (0.033)	0.14 (0.119)	0.20** (0.047)
Advertising Expense Scaled by Assets	6.11*** (0.007)	8.11*** (0.009)	3.81 (0.120)	6.33*** (0.005)	8.41*** (0.006)	3.55 (0.153)
Missing Advertising Indicator Variable	-0.23* (0.051)	-0.21 (0.154)	-0.24** (0.026)	-0.23* (0.050)	-0.22 (0.140)	-0.24** (0.024)
Member of S&P 500 Index	0.15 (0.384)	0.03 (0.897)	0.39** (0.032)	0.18 (0.292)	0.06 (0.758)	0.38** (0.032)
Natural Log of Assets	-0.26*** (0.000)	-0.29*** (0.000)	-0.22*** (0.000)	-0.25*** (0.000)	-0.29*** (0.000)	-0.22*** (0.000)
Prior Year Positive Income Indicator Variable	0.02 (0.774)	-0.02 (0.865)	0.09 (0.224)	0.02 (0.766)	-0.02 (0.881)	0.10 (0.165)
Estimated Stock Transaction Costs	-0.49*** (0.000)	-0.66*** (0.009)	-0.37*** (0.001)	-0.47*** (0.000)	-0.70*** (0.006)	-0.37*** (0.001)
Insider Ownership	0.04** (0.032)	0.05** (0.031)	0.03 (0.130)	0.03** (0.036)	0.05** (0.034)	0.03 (0.140)
Insider Ownership Squared	-0.00** (0.011)	-0.00** (0.013)	-0.00* (0.070)	-0.00** (0.013)	-0.00** (0.014)	-0.00* (0.068)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2326	1153	1173	2326	1153	1173
Adjusted R-squared	0.33	0.40	0.25	0.33	0.40	0.25

\*The sample contains 2,326 observations for a sample of Fortune 250 firms during 2001-13. Tobin's Q proxies for firm value and is equal to a firm's market value of assets scaled by its book value of assets, where market value of assets equal book value of assets plus market value of equity. Book values are taken at fiscal year-end and market values are taken at calendar year-end. Industry-adjusted Q controls for relative firm value in a given year and is equal to a firm's Tobin's Q less the median Tobin's Q for all firms in the same two-digit SIC code. Lagged ownership by U.S. public pension funds equal the aggregate number of shares held by U.S. public pension funds which file 13F reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Public pension fund Corporate Governance proposal sponsors are defined as public funds that only sponsor corporate governance proposals at a sample firm during 2001-13 and include CalPERS and FSA. Public pension fund Social Issue proposal sponsors are defined as public funds that primarily sponsor social issue proposals at a sample firm during 2001-13 and include CalSTRS and HPS&R. Lagged ownership by private pension funds equal the aggregate number of shares held by CREF and corporate pension funds which file 13F reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Robust standard errors are clustered at the firm level. The corresponding p-values are given in parentheses. Statistical significance at the 1 percent, 5 percent, and 10 percent level is indicated by \*\*\*, \*\*, and \*, respectively.



**Figure 4. Pooled Regression Analysis of Industry-Adjusted Q on Lagged Ownership by U.S. Public Pension Funds According to Focus of Proxy Proposal Sponsorship and Private Pension Funds: S&P 500\***

Sample Period:	Corporate Governance Focus			Social Issues Focus		
	2001-2013	2001-2007	2008-2013	2001-13	2001-07	2008-13
	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q
Constant	4.19*** (0.000)	5.42*** (0.000)	3.30*** (0.000)	4.32*** (0.000)	5.63*** (0.000)	3.32*** (0.000)
Lagged Ownership By Public Pension Fund Corporate Governance Proposal Sponsors	16.62 (0.399)	32.40 (0.186)	-39.17 (0.210)			
Lagged Ownership by Public Pension Fund Non-Corporate Governance Proposal Sponsors	-13.83** (0.033)	-20.82** (0.015)	-6.47 (0.369)			
Lagged Ownership by Public Pension Fund Social Issue Proposal Sponsors				-45.51*** (0.005)	-18.27 (0.310)	-92.05*** (0.000)
Lagged Ownership by Public Pension Fund Non-Social Issue Sponsors				-4.03 (0.468)	-12.07 (0.105)	-0.38 (0.957)
Lagged Ownership by Private Pension Funds	1.74 (0.399)	10.85*** (0.005)	0.61 (0.594)	1.49 (0.437)	9.99** (0.010)	0.43 (0.664)
Lagged Ownership by Other Institutions	-0.23 (0.314)	-0.74** (0.015)	0.16 (0.524)	-0.17 (0.476)	-0.75** (0.016)	0.27 (0.282)
Leverage	-0.92*** (0.001)	-1.55*** (0.000)	-0.53* (0.082)	-0.96*** (0.000)	-1.62*** (0.000)	-0.57* (0.061)
R&D Expense Scaled by Assets	5.13*** (0.000)	6.69*** (0.000)	3.41** (0.014)	5.17*** (0.000)	6.76*** (0.000)	3.50*** (0.011)
Missing R&D Indicator Variable	0.23*** (0.007)	0.27** (0.044)	0.21*** (0.009)	0.24*** (0.005)	0.28** (0.041)	0.23*** (0.005)
Advertising Expense Scaled by Assets	3.17* (0.075)	1.51 (0.407)	4.66** (0.032)	3.26* (0.053)	2.01 (0.238)	4.60** (0.031)
Missing Advertising Indicator Variable	-0.27*** (0.001)	-0.28*** (0.005)	-0.25*** (0.005)	-0.27*** (0.001)	-0.28*** (0.005)	-0.25*** (0.004)
Natural Log of Assets	-0.33*** (0.000)	-0.42*** (0.000)	-0.28*** (0.000)	-0.34*** (0.000)	-0.42*** (0.000)	-0.28*** (0.000)
Prior Year Positive Income Indicator Variable	0.21*** (0.001)	0.19** (0.050)	0.15** (0.023)	0.21*** (0.000)	0.20** (0.042)	0.17*** (0.010)
Estimated Stock Transaction Costs	-0.49*** (0.000)	-0.84*** (0.000)	-0.36*** (0.001)	-0.47*** (0.000)	-0.84*** (0.000)	-0.35*** (0.001)
Insider Ownership	0.32 (0.658)	-0.18 (0.831)	0.43 (0.638)	0.20 (0.779)	-0.30 (0.734)	0.20 (0.833)
Insider Ownership Squared	-0.38 (0.518)	-0.07 (0.910)	-0.38 (0.647)	-0.33 (0.581)	-0.02 (0.978)	-0.18 (0.825)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	4672	2045	2627	4672	2045	2627
Adjusted R-squared	0.28	0.31	0.27	0.28	0.31	0.27

\*The sample contains 4,672 observations for a sample of S&P 500 firms during 2001-13. Tobin's Q proxies for firm value and is equal to a firm's market value of assets scaled by its book value of assets, where market value of assets equals book value of assets less book value of equity plus market value of equity. Book values are taken at fiscal year-end and market values are taken at calendar year-end. Industry-adjusted Q controls proxies for relative firm value in a given year and is equal to a firm's Tobin's Q less the median Tobin's Q for all firms in the same two-digit SIC code. Lagged ownership by U.S. public pension funds equal the aggregate number of shares held by U.S. public pension funds who file 13f reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Public pension fund Corporate Governance proposal sponsors are defined as public funds that only sponsor corporate governance proposals at a sample firm during 2001-13 and include CalPERS and NIRA. Public pension fund Social Issue proposal sponsors are defined as public funds that primarily sponsor social issue proposals at a sample firm during 2001-13 and include CalSTRS and NYSCRL. Lagged ownership by private pension funds equal the aggregate number of shares held by CREF and corporate pension funds who file 13f reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Robust standard errors are clustered at the firm level. The corresponding p-values are given in parentheses. Statistical significance at the 1 percent, 5 percent, and 10 percent level is indicated by \*\*\*, \*\*, and \*, respectively.

For the narrower Fortune 250 sample, ownership by public pension funds that sponsor social-issue proposals has a negative valuation effect only during the later sample period (2008–13), when CalSTRS and NYSCR actively engaged in sponsoring social issue proposals. In the broader S&P 500 sample, ownership by public pension funds that sponsor social-issue proposals has a negative valuation effect during the entire sample period and the later period—significant at the 1 percent level.

No significant valuation effect is found for aggregate ownership by these funds during the early period when they are not actively engaged in sponsoring social issue proposals. The insignificant valuation effects for ownership by public pension funds that sponsor corporate governance or social issue proposals during the early period indicates that the significant negative valuation effect during this period is driven by ownership of public pension funds that do not sponsor a proxy proposal.

The paper further breaks down ownership for individual pension funds that have been classified as activist funds, whether through sponsoring proxy proposals or some other form of activism, in previous research (Figure 5 and Figure 6). When examining ownership at the individual fund level, the paper continues to find no significant valuation effect for ownership by CalPERS, but finds some evidence of a positive valuation effect for ownership by FSBA. The paper finds no significant effect for ownership by CalSTRS in the Fortune 250 sample, but a significant negative valuation for CalSTRS in the broader S&P 500 sample—for the overall sample period and for the earlier period when CalSTRS did not actively sponsor shareholder proposals.

**Figure 5. Pooled Regression Analysis of Industry-Adjusted Q on Lagged Ownership by Individual Activist U.S. Pension Funds and Corporate Pension Funds: Fortune 250\***

Sample Period:	2001–2013	2001–2007	2008–2013
	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q
Constant	3.69*** (0.000)	4.35*** (0.000)	2.87*** (0.000)
<b>Public Funds – Corporate Governance Focus</b>			
Lagged Ownership by CalPERS	-13.38 (0.628)	-25.84 (0.424)	-4.70 (0.905)
Lagged Ownership by FSBA	145.39* (0.080)	144.96* (0.097)	171.90 (0.247)
<b>Public Funds – Social Issues Focus</b>			
Lagged Ownership by CalSTRS	-10.21 (0.432)	-6.39 (0.631)	-221.16 (0.307)
Lagged Ownership by NYSCR	-18.99 (0.307)	10.83 (0.614)	-104.28*** (0.007)
<b>Public Funds – Other Focus</b>			
Lagged Ownership by SWIB	-48.71** (0.027)	-70.36*** (0.005)	-5.61 (0.912)
<b>Private Funds</b>			
Lagged Ownership by CREF	16.82** (0.021)	13.58 (0.130)	21.95** (0.014)
Lagged Ownership by Corporate Pension Funds	3.67 (0.653)	3.66 (0.701)	-0.57 (0.954)
Lagged Ownership by Other Institutions	-1.15*** (0.002)	-1.41*** (0.003)	-0.78** (0.011)
Leverage	-1.41*** (0.000)	-1.90*** (0.000)	-0.99** (0.012)
R&D Expense Scaled by Assets	7.23*** (0.000)	9.80*** (0.000)	2.30 (0.300)
Missing R&D Indicator Variable	0.17* (0.052)	0.11 (0.230)	0.20** (0.045)
Advertising Expense Scaled by Assets	6.37*** (0.006)	8.86*** (0.006)	3.67 (0.132)
Missing Advertising Indicator Variable	-0.22* (0.056)	-0.19 (0.195)	-0.23** (0.029)
Member of S&P 500 Index	0.19 (0.267)	0.11 (0.572)	0.33** (0.046)
Natural Log of Assets	-0.26*** (0.000)	-0.30*** (0.000)	-0.22*** (0.000)
Prior Year Positive Income Indicator Variable	0.03 (0.695)	-0.01 (0.971)	0.10 (0.141)
Estimated Stock Transaction Costs	-0.46*** (0.001)	-0.67*** (0.009)	-0.36*** (0.002)
Insider Ownership	0.04** (0.028)	0.05** (0.024)	0.03 (0.127)
Insider Ownership Squared	-0.00** (0.014)	-0.00*** (0.010)	-0.00* (0.080)
Year Fixed Effects	Yes	Yes	Yes
Observations	2326	1153	1173
Adjusted R-squared	0.33	0.40	0.26

**Figure 6. Pooled Regression Analysis of Industry-Adjusted Q on Lagged Ownership by Individual Activist U.S. Pension Funds and Corporate Pension Funds: S&P 500\***

Sample Period:	2001-2013	2001-2007	2008-2013	2001-13	2001-07	2008-13
	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q	Industry-Adjusted Q
Constant	4.22*** (0.000)	5.45*** (0.000)	3.24*** (0.000)	4.22*** (0.000)	5.42*** (0.000)	3.28*** (0.000)
<b>Public Funds – Corporate Governance Focus</b>						
Lagged Ownership by CalPERS	-7.48 (0.733)	-16.39 (0.562)	-49.69 (0.116)	-5.73 (0.794)	-11.58 (0.683)	-51.92 (0.101)
Lagged Ownership by FSBA	108.98** (0.030)	98.10** (0.042)	157.71 (0.116)	90.72* (0.072)	78.48 (0.114)	141.02 (0.160)
Lagged Ownership by Ohio				25.10** (0.043)	27.32 (0.258)	24.18** (0.046)
<b>Public Funds – Social Issues Focus</b>						
Lagged Ownership by CalSTRS	-57.96*** (0.004)	-49.01** (0.017)	-60.75 (0.662)	-55.43*** (0.003)	-52.08** (0.013)	-55.38 (0.693)
Lagged Ownership by NYSCR	-68.07*** (0.003)	-26.15 (0.381)	109.51*** (0.000)	-71.71*** (0.002)	-29.62 (0.318)	-113.96*** (0.000)
<b>Public Funds – Other Focus</b>						
Lagged Ownership by SWIB	-22.24 (0.304)	-31.72 (0.382)	-8.22 (0.752)	-22.21 (0.305)	-31.84 (0.379)	-7.97 (0.760)
<b>Private Funds</b>						
Lagged Ownership by CREF	20.03*** (0.001)	30.23*** (0.001)	10.36 (0.156)	19.06*** (0.002)	29.62*** (0.001)	9.17 (0.203)
Lagged Ownership by Corporate Pension Funds	0.43 (0.689)	2.28 (0.552)	0.20 (0.782)	0.12 (0.895)	1.12 (0.776)	-0.04 (0.941)
Lagged Ownership by Other Institutions	-0.34 (0.145)	-0.93*** (0.003)	0.15 (0.559)	-0.37 (0.116)	-0.96*** (0.002)	0.12 (0.642)
Leverage	-0.97*** (0.000)	-1.56*** (0.000)	-0.60** (0.046)	-0.98*** (0.000)	-1.56*** (0.000)	-0.61** (0.043)
R&D Expense Scaled by Assets	5.02*** (0.000)	6.57*** (0.000)	3.29** (0.018)	5.05*** (0.000)	6.54*** (0.000)	3.35** (0.016)
Missing R&D Indicator Variable	0.25*** (0.004)	0.28* (0.051)	0.22*** (0.004)	0.26*** (0.003)	0.28** (0.050)	0.24*** (0.002)
Advertising Expense Scaled by Assets	3.04* (0.096)	1.66 (0.370)	4.40** (0.043)	3.09* (0.089)	1.64 (0.377)	4.46** (0.038)
Missing Advertising Indicator Variable	-0.27*** (0.001)	-0.27*** (0.006)	-0.25*** (0.004)	-0.27*** (0.001)	-0.27*** (0.006)	-0.25*** (0.003)
Natural Log of Assets	-0.35*** (0.000)	-0.44*** (0.000)	-0.29*** (0.000)	-0.35*** (0.000)	-0.44*** (0.000)	-0.29*** (0.000)
Prior Year Positive Income Indicator Variable	0.20*** (0.001)	0.19** (0.048)	0.16** (0.016)	0.20*** (0.001)	0.19* (0.051)	0.16** (0.015)
Estimated Stock Transaction Costs	-0.48*** (0.000)	-0.85*** (0.000)	-0.34*** (0.001)	-0.48*** (0.000)	-0.85*** (0.000)	-0.34*** (0.001)
Insider Ownership	0.44 (0.533)	0.02 (0.978)	0.44 (0.634)	0.37 (0.600)	0.01 (0.994)	0.34 (0.712)
Insider Ownership Squared	-0.54 (0.365)	-0.38 (0.531)	-0.35 (0.667)	-0.49 (0.415)	-0.36 (0.554)	-0.28 (0.733)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	4672	2045	2627	4672	2045	2627
Adjusted R-squared	0.28	0.31	0.28	0.28	0.31	0.28

Public Pension Fund Activism and Firm Value

Figure 5. Footnote

\* The sample contains 7,326 observations for a sample of Fortune 250 firms during 2001–13 period. Tobin's Q proxies for firm value and is equal to a firm's market value of assets scaled by its book value of assets, where market value of assets equal book value of assets less book value of equity plus market value of equity. Book values are taken at fiscal year-end and market values are taken at calendar year-end. Industry-adjusted Q controls proxies for relative firm value in a given year and is equal to a firm's Tobin's Q less the median Tobin's Q for all firms in the same two-digit SIC code. Lagged ownership by U.S. public pension funds equal the aggregate number of shares held by U.S. public pension funds which file 13f reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Lagged ownership by private pension funds equal the aggregate number of shares held by CRSP and corporate pension funds which file 13f reports divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Robust standard errors are clustered at the firm level. The corresponding p-values are given in parentheses. Statistical significance at the 1 percent, 5 percent, and 10 percent level is indicated by \*\*\*, \*\*, and \*, respectively.

Figure 6. Footnote

\* The sample contains 4,672 observations for a sample of S&P 500 firms during 2001–13 period. Tobin's Q proxies for firm value and is equal to a firm's market value of assets scaled by its book value of assets, where market value of assets equal book value of assets less book value of equity plus market value of equity. Book values are taken at fiscal year-end and market values are taken at calendar year-end. Industry-adjusted Q controls proxies for relative firm value in a given year and is equal to a firm's Tobin's Q less the median Tobin's Q for all firms in the same two-digit SIC code. Lagged ownership by U.S. public pension funds equal the aggregate number of shares held by U.S. public pension funds which file 13f reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Lagged ownership by private pension funds equal the aggregate number of shares held by CRSP and corporate pension funds which file 13f reports, divided by the total number of shares outstanding—all measured for the most recent quarter with data available prior to the calendar year-end. Robust standard errors are clustered at the firm level. The corresponding p-values are given in parentheses. Statistical significance at the 1 percent, 5 percent, and 10 percent level is indicated by \*\*\*, \*\*, and \*, respectively.

Ownership by NYSCR had a significantly negative valuation effect only in the later period for the Fortune 250 sample, a significantly negative effect overall, and for the later period in the broader S&P 500 sample. We find a negative valuation effect for ownership by SWIB during the early period, but only in the narrower Fortune 250 sample (this result is not confirmed in the broader S&P 500 sample). SWIB does not sponsor proxy proposals in our sample. However, according to its website, SWIB actively administers its own proxy votes on corporate governance and social issues. The website also discusses guidelines used by SWIB to consider other actions, such as sponsoring a proposal or participating in shareholder litigation.

In the broader S&P 500 sample, the Ohio pension funds, which are relatively new in sponsoring shareholder proposals oriented around corporate governance, are associated with higher firm valuations—overall and for the latter period, when those funds sponsored proposals. When examining ownership separately for TIAA-CREF, which is known to hold private communications with portfolio firms and sponsor shareholder proposals when necessary, the paper finds a significantly positive valuation effect for TIAA-CREF ownership. There is no observed significant effect for ownership by corporate pension funds.

Next, this paper compares proxies for firm value and relative firm value—between sample firms at the end of the year in which they are targeted by a public pension fund in the paper's sample—with a corporate governance (social issue) proposal and all firm-year observations in which a firm is not targeted by a public pension fund in the paper's sample with a corporate governance (social issue) proposal. Next, the paper presents a comparison of ownership, in

terms of percentage of outstanding shares and market value of the ownership stake by the public pension fund sponsor.

Figure 7 and Figure 8 show that CalPERS targets ten firms in the Fortune 250 sample with a corporate-governance proposal, and 14 firms in the S&P 500 sample. FSBA targets three sample firms in the Fortune 250 sample and 6 sample firms in the S&P 500 sample. CalSTRS targets four firms in the Fortune 250 sample and 11 firms in the S&P 500 sample. NYSCR targets 27 firms and 42 firms in the S&P 500 sample.

Firms targeted by CalPERS do not vary consistently from other firms: in the Fortune 250 sample, such firms have a *higher* Tobin's Q (industry-adjusted Q)—2.04 (0.44), compared with 1.82 (0.29) for all other firm-year observations. But CalPERS-targeted firms have *lower* Q's in the broader S&P 500 sample—1.78 (0.23)—compared with 2.02 (0.45) for all other firm-year observations. However, FSBA-targeted firms have higher Tobin's Q in both samples—2.00 for the Fortune 250 and 2.16 for the S&P 500—and higher industry-adjusted Q in the Fortune 250 sample (0.47). (For the S&P 500 sample, industry-adjusted Q for firms targeted by FSBA is the same as for other firm-year observations.)

In contrast, for the Fortune 250 sample, Tobin's Q (industry-adjusted Q) averages 1.17 (–0.34) for firms after being targeted by CalSTRS and 1.42 (–0.12) for firms after being targeted by NYSCR with a social issue proposal—much lower when compared with 1.83 (0.29) for all other firm-year observations. These results hold true for the broader S&P 500 sample, when firms targeted by CalSTRS have Tobin's Q (industry-adjusted Q) averaging

**Figure 7. Summary Statistics According to Types of Public Pension Fund Activism: Fortune 250**

**Panel A. Comparison Between Firms Targeted with a Corporate Governance Proposal Sponsored by and Those Not Targeted by CalPERS or FSBA**

	Targeted by CalPERS	Not Targeted by CalPERS	Targeted by FSBA	Not Targeted by FSBA
	Mean (N=10)	Mean (N=2571)	Mean (N=3)	Mean (N=2578)
<b>Value measures</b>				
Tobin's Q	2.04	1.82	2.00	1.82
Industry-Adjusted Tobin's Q	0.44	0.29	0.47	0.29
<b>% Shares Owned by</b>				
U.S. Public Pension Funds	2.40	2.49	2.12	2.49
CalPERS	0.33	0.36	0.32	0.36
FSBA	0.22	0.24	0.18	0.24
CalSTRS	0.00	0.14	0.00	0.14
NYSCR	0.40	0.38	0.37	0.38
<b>Market Value of Shares Owned by (\$M)</b>				
CalPERS	313.42	140.12	120.83	140.81
FSBA	214.87	95.52	77.62	96.01

**Panel B. Comparison Between Firms Targeted with a Social Issue Proposal Sponsored by and Those Not Targeted by CalSTRS or NYSCR**

	Targeted by CalSTRS	Not Targeted by CalSTRS	Targeted by NYSCR	Not Targeted by NYSCR
	Mean (N=4)	Mean (N=2577)	Mean (N=27)	Mean (N=2554)
<b>Value measures</b>				
Tobin's Q	1.17	1.82	1.42	1.83
Industry-Adjusted Tobin's Q	-0.34	0.29	-0.12	0.29
<b>% Shares Owned by</b>				
U.S. Public Pension Funds	2.39	2.49	1.72	2.50
CalPERS	0.30	0.36	0.29	0.36
FSBA	0.22	0.24	0.16	0.24
CalSTRS	0.05	0.13	0.08	0.14
NYSCR	0.48	0.38	0.31	0.38
<b>Market Value of Shares Owned by (\$M)</b>				
CalSTRS	17.84	45.00	51.45	44.89
NYSCR	143.94	145.76	287.66	144.26

**Figure 8. Summary Statistics According to Types of Public Pension Fund Activism: S&P 500**

**Panel A. Comparison Between Firms Targeted with a Corporate Governance Proposal Sponsored by and Those Not Targeted by CalPERS or FSBA**

	Targeted by CalPERS Mean (N=14)	Not Targeted by CalPERS Mean (N=4669)	Targeted by Florida Mean (N=6)	Not Targeted by Florida Mean (N=4677)
<b>Value measures</b>				
Tobin's Q	1.78	2.02	2.16	2.02
Industry-Adjusted Tobin's Q	0.23	0.45	0.45	0.45
<b>% Shares Owned by</b>				
U.S. Public Pension Funds	2.39	2.45	2.03	2.45
CalPERS	0.35	0.35	0.28	0.35
FSBA	0.23	0.24	0.18	0.24
CalSTRS	0.06	0.12	0.00	0.12
NYSCR	0.38	0.39	0.39	0.39
<b>Market Value of Shares Owned by (\$M)</b>				
CalPERS	348.93	91.16	74.40	91.96
FSBA	247.05	63.10	49.49	63.67

**Panel B. Comparison Between Firms Targeted with a Social Issue Proposal Sponsored by and Those Not Targeted by CalSTRS or NYSCR**

	Targeted by CalSTRS Mean (N=11)	Not Targeted by CalSTRS Mean (N=4672)	Targeted by NYSCR Mean (N=42)	Not Targeted by NYSCR Mean (N=4641)
<b>Value measures</b>				
Tobin's Q	1.86	2.02	1.59	2.02
Industry-Adjusted Tobin's Q	0.26	0.45	0.04	0.45
<b>% Shares Owned by</b>				
U.S. Public Pension Funds	1.93	2.45	1.99	2.46
CalPERS	0.26	0.35	0.31	0.35
FSBA	0.18	0.24	0.19	0.24
CalSTRS	0.04	0.12	0.15	0.12
NYSCR	0.39	0.39	0.35	0.39
<b>Market Value of Shares Owned by (\$M)</b>				
CalSTRS	10.12	30.67	66.53	30.30
NYSCR	76.40	98.43	211.54	97.36

1.86 (0.26) and firms targeted by NYSCR average 1.59 (0.04)—compared with 2.02 (0.45) for all other firm-year observations. The comparison is similar when the comparison sample is restricted to the same period when the shareholder proposals are filed.

When comparing ownership stakes across groups, the average percentage ownership by sponsor funds in target firms tends to be slightly lower; but the market value of the ownership stake by the public pension fund sponsor tends to be much higher in firms they target for CalPERS (\$313.42M vs. \$140.12M) and NYSCR (\$287.66M vs. \$144.26M).

For the less active sponsors FSBA and CalSTRS, average percentage ownership in the firm and average market value of their ownership stake are lower. For example, the market value of the ownership stake by CalSTRS averages \$17.84M in targets, compared with \$45M in non-targets. The market value of the ownership stake by FSBA averages \$77.62M in targets, compared with \$96.01M in non-targets.

## CONCLUSION

This paper, consistent with earlier research, finds that public pension funds' ownership is associated with lower firm value, as measured by Tobin's Q and industry-adjusted Q. The negative valuation effect for public pension fund ownership is not, however, confined to a particular public pension fund during the entire period scrutinized. Instead, this effect varies, depending on whether funds are engaged in shareholder activism and on whether their activism is focused on corporate-governance concerns or social issues.

Social-issue shareholder-proposal activism appears to be negatively related to firm value. In this paper, the negative relationship between public pension fund ownership and firm value is significant for firms targeted by public pension funds engaging in social-issue activism—across two different firm samples—in 2008–13, when the two large funds focused on social-issue activism, CalSTRS and the NYSCR, were engaged in shareholder-proposal activism. For S&P 500 firms, the negative relationship between pension-fund ownership and firm value is significant at the 1 percent level, both for ownership by all social-issue shareholder-proposal sponsoring pension funds and for the NYSCR in particular—in the full 2001–13 period and in the more recent period, but not for the earlier 2001–07 period, when neither CalSTRS nor NYSCR actively sponsored shareholder proposals.

State and municipal pension plans are among the largest institutional owners in the U.S. stock market. The largest such plans manage more than \$3 trillion in assets, and the four public pension funds principally studied in this paper—CalPERS, CalSTRS, NYSCR, and FSBA—collectively manage more than \$800 billion (Kozlowski 2015). Such plans' management, and shareholder activism, is thus of significant public-policy relevance.

## ENDNOTES

- <sup>1</sup> Several studies use Tobin's Q as a proxy for firm value. For example, Woidtke (2002) uses industry-adjusted Q to measure the relationship between relative firm value and pension fund ownership. Morck, Shleifer, and Vishny (1988) use Q to measure the relationship between firm value and insider ownership. McConnell and Servaes (1990) use Q to measure the relationship between firm value and institutional ownership. Lang and Stulz (1994) use Q to measure the relation between firm value and corporate diversification.
- <sup>2</sup> Institutions managing at least \$100 million in investments must disclose their holdings through 13f filings.
- <sup>3</sup> See, for example, Carlton, Nelson, and Weisbach (1998), Del Guercio and Hawkins (1999), Wahal (1996), and Woidtke (2002).

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STATEMENT OF  
JOHN ENGLER  
PRESIDENT OF BUSINESS ROUNDTABLE

BEFORE THE  
SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES

HEARING ON

**"CORPORATE GOVERNANCE: FOSTERING A SYSTEM THAT PROMOTES CAPITAL FORMATION AND  
MAXIMIZES SHAREHOLDER VALUE"**

SEPTEMBER 21, 2016

Good morning, and thank you, Chairman Garrett, Ranking Member Maloney and members of the Subcommittee.

I am John Engler, and I serve as President of Business Roundtable, an association of CEOs of major U.S. companies operating in every sector of the American economy.

Business Roundtable CEOs lead companies that produce \$7 trillion in annual revenues and employ nearly 16 million workers. Business Roundtable member companies comprise nearly one-fifth of the total market capitalization of U.S. stock markets and invest \$129 billion annually in research and development – equal to nearly 40 percent of U.S. private R&D spending. Our companies pay more than \$222 billion in dividends to shareholders and generate more than \$495 billion in sales for small and medium-sized businesses annually. Business Roundtable companies also donate more than \$8 billion a year in charitable contributions.

We appreciate the opportunity today to provide the perspective of U.S. business leaders on improving the regulatory environment that governs America's capital markets and helps companies support stronger, long-term economic growth.

We also appreciate the efforts led by Chairman Hensarling already under way in this Committee. As we wrote in a recent letter to the Committee, the Chairman's *Financial CHOICE Act* would reform a series of provisions in the *Dodd-Frank Wall Street Reform*

*and Consumer Protection Act* that Business Roundtable CEOs have long identified as detrimental to their ability to invest, hire and expand their business activities.<sup>1</sup>

In particular, Business Roundtable CEOs strongly support the legislation's increased oversight of, and accountability for, proxy advisory firms. We also strongly support the bill's repeal of the Securities and Exchange Commission's (SEC's) authority over proxy access; the SEC's authority over chairman and CEO structure disclosures; provisions related to executive compensation; the Volcker Rule; and specialized public company disclosure.

These smart reforms would foster a more modern, competitive business environment that would promote long-term value creation. We look forward to working with all of you on this legislation in the weeks ahead.

Also top of mind for CEOs are two issues that I want to focus on today: the current U.S. public company disclosure regime and the shareholder proposal process.

Business Roundtable CEOs agree that modernizing both would enhance communications between companies and shareholders, improve the quality of information made available to investors and help companies, in turn, advance the economic interests of shareholders, employees and consumers over the long term.

Let me explain why and briefly provide our recommendations.

#### **Materiality Standard for Public Company Disclosure**

As Business Roundtable detailed in its [white paper on materiality and public disclosure](#), the concept of materiality has been the bedrock principle for U.S. securities laws since 1933.<sup>2</sup> It is intended to ensure that required disclosures – new and existing – provide investors with the useful information that is essential to making effective investing and proxy voting decisions.<sup>3</sup> The concept is sufficiently flexible to address new developments in the business environment and takes into account the facts and circumstances unique to each company.

#### *Erosion of the Standard Over Time*

Unfortunately, adherence to the bedrock principle of materiality has diminished over time. Congress and the SEC are increasingly turning to the disclosure system to address social, political and environmental issues that are irrelevant to reasonable investors' investment and proxy voting decisions and – while important – are more efficiently and effectively addressed through other means. As a result, investors today receive voluminous, complex information that is often immaterial to their investment or voting decisions.

In addition, with an increase in the volume and complexity of information included in annual and periodic disclosures – along with other burdensome regulations – comes an increase in compliance costs and complexity for public companies. These increased costs and administrative burdens directly lower the investment returns to shareholders and reduce the number of companies entering the public markets. As a result, the number of publicly traded companies has dropped from more than 6,000 in the year 2000, to fewer than 4,500 companies today. Fewer publicly traded companies means a decrease in the depth and quality of U.S. capital markets, which ultimately hurts every American seeking to save for retirement, buy a house or fund a child's education.

#### *Adherence to the Materiality Standard*

America's business leaders strongly urge Congress to abstain from enacting new mandates and review earlier actions that are contrary to the materiality standard. Such action would reduce the cost to registrants, and the investing public will benefit from useful, clear disclosures. The *Financial CHOICE Act* provides one avenue for such a review.

A disclosure regime firmly rooted in the principle of materiality will encourage more companies to go public, enabling America's public capital markets to better deliver increased value for the economy and the American public.

#### **U.S. Shareholder Proposal Process**

Responsible shareholder engagement is essential for a company to perform at a high level. The current shareholder proposal process under Rule 14a-8 remains key to the interaction between companies and investors. However, the current process is outdated and is being abused. This abuse imposes significant costs on companies and limits the ability of companies to focus their resources on long-term value creation.

#### *Modernization Is Needed*

The current shareholder proposal process has been hijacked by corporate gadflies and political activist investors.<sup>4</sup>

These individuals often have insignificant economic stakes in target companies, owning only the minimal amount of shares that it takes to file shareholder proposals. Not surprisingly, many of their proposals seek not to promote shareholder value, but to pursue idiosyncratic, social or political agendas that are immaterial to, or in direct conflict with, the interests of the shareholders as a whole. It has become enormously expensive for corporations to manage and respond to these types of shareholder proposals, and these costs may be passed along to ordinary investors.

Two factors are driving this negative trend:

1. *The threshold for submitting a proposal is too low.* Set decades ago, the threshold has fallen out of step with stock prices in the current market. To be qualified to submit a proposal, a shareholder must own only \$2,000 in market value, or 1 percent – whichever is less – of a company's outstanding stock for at least one year. The \$2,000 threshold, in particular, falls well short of any reasonable material ownership standard for public companies. For example, this year, JPMorgan Chase received a shareholder proposal requesting that the company amend its executive compensation policy to include various social factors. At the time of filing, the proponent held just 40 of JPMorgan's roughly 1 billion shares outstanding.

2. *It is difficult for a company to exclude proposals relating to general social issues.* For several decades, the SEC permitted corporate managers to exclude proposals submitted "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes." In 1970, however, the D.C. Circuit Court of Appeals ruled against the SEC and found that shareholder proposals are not excludable when they raise issues of corporate social responsibility or question the "political and moral predilections" of management. In response, the SEC narrowed the "general economic, political, racial, religious, social or similar causes" exclusion to proposals that are "not significantly related to the business of the issuer nor within its control." This court-driven change in SEC policy has facilitated an influx of proposals on social issues. Last year, activist shareholders filed 479 social, environmental and political proposals, and this stream of proposals remains steady with more than 400 such proposals submitted for 2016 meetings. Most social, environmental and political proposals, which rarely garner meaningful shareholder support, have little connection to shareholder value and are not issues material to a company's business. Yet they are resubmitted year after year.

#### *Options for Modernizing the Shareholder Proposal Process*

To address the greatest concerns with the current shareholder proposal process, Business Roundtable CEOs recommend the following reforms:

- ***Replace the \$2,000 holding requirement.*** The \$2,000 monetary holding requirement – implemented in 1983 and last updated in 1998 to adjust for inflation – is no longer a reasonable standard for ownership. The SEC should employ a holding requirement based on the percentage of stock owned by a shareholder proponent.
- ***Increase the length of the holding requirement.*** The current holding period encourages a focus on short-term goals at the cost of long-term investing. Requiring a longer holding period would better align the interests of the shareholders making the proposals with the long-term success of the company.

- **Enhance proponent disclosure requirements.** While companies must include in the proxy the proponent's name, address and number of voting securities the proponent owns or an undertaking to provide the same upon request, proponents are not required to state their economic ownership in the company, the period of time of their investments or the breadth of their advocacy on the issue at hand. Congress and the SEC should amend the rules to require proponents owning less than a specified percentage of the company – and proponents by proxy – to disclose their motivations, economic interests and holdings in the company's securities. We also suggest amending the rules to require proponents to divulge their overall shareholder activity, including voting results. These changes would allow shareholders to make informed decisions about the proponent's proposal, its mission and the impact.
- **Increase requirements for proposals by proxy.** At times, a proponent has no material ownership of the company, but rather receives permission to act on behalf of a shareholder that meets the shareholder proposal eligibility threshold. As such, the true proponent of the proposal may have no significant economic ownership in, or material relationship to, the company. The rule should be revised so that when a proponent is relying on a proxy to submit a proposal, the shareholder giving the proxy must meet a higher eligibility threshold.
- **Strengthen the resubmission thresholds.** The current resubmission threshold allows a company to exclude a proposal focusing on substantially the same subject matter for a three-year period. To avoid possible exclusion, a proposal must have received at least 3 percent of the vote on its first submission, 6 percent on the second and 10 percent on the third. A proposal that is opposed by 90 percent of a company's shareholders can be resubmitted indefinitely, leading to a "tyranny of the minority." While a cost-benefit analysis is needed to determine what parameters should be used to update the thresholds, the thresholds should, at the very least, be updated.
- **Better define the criteria for applying the ordinary business exclusion.** No clear definition of "ordinary business" exists when a company seeks no-action relief under the "ordinary business" exclusion. Further, the SEC has indicated that in applying the "ordinary business" exclusion to proposals that raise social policy, it "applies the most well-reasoned standards possible, given the complexity of the task," but that, "from time to time, in light of the experience in dealing with proposals in particular subject areas, it adjusts its approach." Expanded review and oversight procedures, implemented with input from issuers and investors, should be implemented to prevent arbitrary changes in direction.
- **Reinstate the conflicting proposal exclusion.** In 2015, the SEC revised its approach to the conflicting proposal exclusion, materially departing from decades of guidance. The SEC's new interpretation limits issuers' abilities to

exclude a shareholder proposal that conflicts with a company proposal unless “a reasonable shareholder could not logically vote in favor of both proposals, i.e., a vote for one proposal is tantamount to a vote against the other proposal.” This new standard risks confusing shareholders, resulting in a lack of clear guidance from shareholders, and intrudes upon the fiduciary duties of directors.

- **Reevaluate the standard for excluding proposals that are contrary to proxy rules.** Rule 14a-8(i)(3) permits the exclusion of proposals that are contrary to the SEC’s proxy rules, including proposals that are materially false or misleading or that are overly vague. In 2004, the staff significantly curtailed the ability of companies to use this exclusion when it took the position that it will not allow a company to exclude a supporting statement or proposal – even if it contains unsupported factual assertions, is disputed or countered, impugns the company or management or relies upon unidentified sources – unless the company “demonstrates objectively that a factual statement is materially false or misleading.” The staff should reevaluate the deferential standard it is using to exclude proposals contrary to proxy rules and place the burden back on shareholders to demonstrate that their proposals are consistent with SEC rules.
- **Revise the “no-action” letter process.** The current no-action letter process is administered at the staff level at the SEC, and presidentially appointed SEC Commissioners who bear ultimate accountability for SEC actions have little authority to reconsider a staff decision. This decentralized, issue-by-issue review, especially over the course of time, leads to inconsistent guidance and interpretation of the rules.

These recommendations are not intended to be an exclusive list. Rather, they are a starting point to address the legitimate concerns America’s leading CEOs have with a current system that fails to contribute positively to the creation of shareholder value.

### Conclusion

In summary, Business Roundtable companies are committed to promoting an environment for U.S. capital markets that facilitates greater long-term value growth for shareholders, employees and consumers.

We appreciate the Committee’s attention to these important issues and stand ready to work with Congress and other stakeholders to strengthen U.S. capital markets and the economy today and over the long run.

Thank you for the opportunity to testify before you today.

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<sup>1</sup> See *Business Roundtable Letter Supporting Key Provisions of Financial CHOICE Act* (September 2016), available at: <http://businessroundtable.org/resources/brt-letter-supporting-key-provisions-financial-choice-act>.

<sup>2</sup> See *The Materiality Standard for Public Company Disclosure: Maintain What Works*, Business Roundtable (October 2015), available at: <http://businessroundtable.org/sites/default/files/reports/Materiality%20White%20Paper%20FINAL%2009-29-15.pdf>.

<sup>3</sup> See *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (“An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”); *Basic Inc. v. Levinson*, 485 U.S. 224, 983 (1988) (adopting the materiality standard set forth in TSC Industries in the Section 10(b) and Rule 10b-5 context).

<sup>4</sup> Hedge funds, mutual funds and other institutional investors without ties to organizational labor or social purposes unrelated to shareholder return account for only 2 percent of all shareholder proposals. See James R. Copeland, *Proxy Monitor 2011: A Report on Corporate Governance and Shareholder Activism*, Manhattan Institute (September 2011), available at: [http://proxymonitor.org/forms/pmr\\_02.aspx](http://proxymonitor.org/forms/pmr_02.aspx).

Testimony of

**Anne Simpson**  
**Investment Director, Sustainability**  
**California Public Employees' Retirement System**

**Before the**  
**United States House of Representatives**  
**Committee on Financial Services**  
**Subcommittee on Capital Markets and Government Sponsored Enterprises**

**Hearing on**  
**“Corporate Governance: Fostering a System that Promotes Capital Formation and**  
**Maximizes Shareholder Value”**

**September 21, 2016**



Chairman Garrett, Ranking Member Maloney, and other Members of the Subcommittee:

Thank you for the opportunity to testify at today's hearing. I am Anne Simpson, Investment Director, Sustainability at the California Public Employees' Retirement System ("CalPERS"). I am pleased to appear before you today on behalf of CalPERS and appreciate the Subcommittee's focus on corporate governance and on ways to foster a system that promotes capital formation and maximizes shareowner value.

CalPERS is the largest public pension fund in the United States with approximately \$301 billion in global assets, as of market close on September 16, 2016, and equity holdings in over 10,000 companies. In addition, CalPERS is a fiduciary that in Fiscal Year (FY) 2015 paid out \$19.4 billion in retirement benefits to more than 1.8 million public employees, retirees, their families, and beneficiaries. For every dollar that we pay in benefits to our members, 65 cents are generated by investment returns, which is why the topic of today's hearing is so important. The CalPERS Global Governance Principles, which is included in the appendix to this testimony, are the framework by which we execute our shareowner proxy voting responsibilities, engage portfolio companies to achieve long-term returns, and request internal and external managers of CalPERS' capital to take into consideration when making investment decisions.

#### **Overview of Testimony**

My testimony discusses how CalPERS benefits from a system that operates with accountable and transparent corporate governance, while at the same time promoting capital formation with the objective of achieving the best returns and value for shareowners over the long-term. Although my testimony does not capture all of our corporate governance and financial market regulatory concerns, I would like to highlight CalPERS' views about a number of key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")<sup>1</sup> and related Securities and Exchange Commission ("SEC") rulemaking activity. Among the issues I will discuss are executive compensation, corporate governance, and transparency, which we believe are crucial to strengthening the U.S. financial system for the benefit of long-term investors like CalPERS and the hundreds of thousands of retirees and employees that we serve.

The U.S. is home to the world's most dynamic and robust capital markets, and access to capital is critical to the effective functioning of these markets. Moreover, access to capital is crucially important to business and productivity growth, job and wealth creation, innovation, and sustainable community and economic development. CalPERS provides this much-needed capital by investing in public companies primarily as a long-term investor, without betting on market fluctuations. The benefits of access to capital accrue to the direct recipients of investments, and to the geographic areas in which they are located. As such, we have long supported efforts to promote capital formation and more liquid financial markets to spur sustainable growth in the real economy.

Although the U.S. economy has improved substantially since the 2008 financial crisis, another significant financial downturn could undermine the economic gains and retirement security of millions of hard-working Americans. Like many investors, CalPERS was hit hard by the crisis,

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<sup>1</sup> Pub. L. No. 111-203 (July 21, 2010).

as \$70 billion were wiped from our assets. We, therefore, strongly support the work of the SEC to implement reform in the wake of the crisis. With Dodd-Frank not yet fully implemented, there is unfinished business that is critical to protecting and strengthening shareowner rights and investor confidence in the financial markets. As reflected in my testimony of July 10, 2012 before this Subcommittee and my testimony of July 12, 2011 before the U.S. Senate Committee on Banking, Housing and Urban Affairs, CalPERS has strongly emphasized the need to complete the important work of ensuring smart regulation to protect both investors and the markets on which we and the broader public rely. Smart regulation promotes economic growth and is not duplicative, burdensome or designed without appropriate consideration of economic impact. Because we are a significant institutional investor with a long-term investment horizon, we fundamentally depend on the integrity and efficiency of our financial markets to provide the long-term sustainable, risk-adjusted returns that allow us to meet our liabilities. As such, my testimony also addresses the goal of ensuring that the SEC has the resources that it needs to carry out these responsibilities and to regulate our capital markets in a smart manner.

I will now address each of these issues in greater detail. First, we advocate executive compensation which is fully disclosed and aligns interests between executive management and shareowners. Accordingly, we strongly support SEC rulemakings related to “say-on-pay votes,” executive compensation “clawbacks,” and “pay ratio” disclosures.

Second, we firmly embrace accountable corporate governance. That is why we support renewal of an SEC rulemaking for proxy access. We are also in favor of the SEC clarifying the interpretation of Rule 14a-8(i)(9) to allow for the submission of alternate shareowner and management proposals. These positions are consistent with the underlying tenet of our Global Governance Principles: fully accountable corporate governance produces, over the long-term, the best returns to shareowners.

CalPERS also supports ensuring that proxy advisory firms are well-regulated and transparent but opposes efforts to create an unduly burdensome regulatory regime. Such firms and other data providers play a useful role in efficiently providing CalPERS and other institutional investors independent research and analysis to help inform voting decisions.

Third, corporate financial reporting plays a key role in capital markets by providing transparent and relevant information about the economic performance and condition of businesses. Because we believe that operating, financial, and governance information must be transparent, we strongly support a review of the effectiveness of SEC disclosures, but such review should have a strong focus on the needs of investors. We encourage the SEC to consider improvements to its disclosure regime that acknowledge advancements in technology and enhance the capacity of issuers to be more transparent. We also encourage rules that would provide investors more useful information about climate risks and other sustainability issues for the long-term benefit of shareowners.

Fourth, to address these pressing issues, we also urge that the SEC be fully funded and be provided predictable funding levels. We are concerned about provisions of H.R. 5485, the “Financial Services and General Government Appropriations Act, 2017” (the “FSGG Appropriations Bill”) because the bill would fund the SEC at \$226 million below the SEC’s

request and it includes a number of problematic “policy riders.”

### **Executive Compensation**

#### *Say-on-pay*

CalPERS believes that executive compensation is a critical and visible aspect of a company's governance and that pay decisions are one of the most direct ways for shareowners to assess the performance of the board.

Consequently, we support Section 951 of Dodd-Frank relating to shareowner approval of executive compensation and “golden parachute” compensation arrangements. We submitted comments to the SEC urging the adoption of rules to specify that “say-on-pay votes” must occur at least once every three years and that companies are required to hold a “frequency” vote at least once every six years in order to allow shareowners to decide how often they would like to be presented with the say-on-pay vote. We are pleased that the SEC adopted final say-on-pay rules.

We believe that Section 951 provides shareowners the necessary disclosures to allow for a more informed vote as it relates to executive compensation and golden parachute compensation plans. CalPERS’ Global Governance Principles address this as a critical right of shareowners and state that shareowners should be provided the opportunity to vote on executive compensation plans and have appropriate disclosures on which to base their decisions annually.

#### *Claw backs*

CalPERS submitted comments in support of the SEC’s proposed rule to implement Section 954 of Dodd-Frank, which added Section 10D to the Securities Exchange Act of 1934. Section 10D requires the SEC to adopt rules that direct the national securities exchanges and national securities associations to establish listing standards that require issuers to develop and implement a policy for the recovery of incentive-based compensation based on revised financial information. The objective of Section 954 is an important one and is consistent with our Global Governance Principles, which request portfolio companies to develop executive compensation plans with a robust clawback policy. CalPERS believes that the proposed rule contains this crucial element.<sup>2</sup>

The premise of the SEC’s proposed rule on clawbacks is supported by research. For example, a 2012 Harvard Law School study found that most firms lack a robust clawback policy – one that requires firms to recover extra pay by executives as a result of errors in performance measures. Notably, the study stated that “the absence of such a policy is likely to reduce firm value by leading to the systematic overpayment of executives and, more important, by weakening and distorting executives’ incentives.”<sup>3</sup>

<sup>2</sup> Listing Standards for Recovery of Erroneously Awarded Compensation, Securities Act Release No. 9861, exchange Act Release No. 75,342, Investment Company Act Release NO. 31,702, 80 Fed. Reg. 41,144 (proposed July 14, 2015), available at <https://www.sec.gov/rules/proposed/2015/33-9861.pdf>.

<sup>3</sup> Jesse M. Fried, Professor of Law at Harvard Law School and Nitzan Shilon, S.J.D. candidate at Harvard Law School, “The Dodd-Frank Clawback and the Problem of Excess Pay,” The Corporate Board, January/February 2012. <http://www.law.harvard.edu/faculty/jfried/1201FriedShilon.pdf>.

CalPERS believes that returning unearned compensation to shareowners clearly serves the interest of shareowners and better aligns the interests of executive officers and shareowners. We urge you to support implementation of Section 954 because it would address a deficiency in existing practice by providing a mechanism to finally compel executive officers to return unearned compensation. The SEC's proposed rule goes a long way in correcting this fundamental problem. It is not enough to require that only certain executives return unearned income. Recent reports about compensation awarded to a retiring Wells Fargo executive provide an example of why clawbacks should be more expansive.

#### *Pay Ratio*

We submitted comments to the SEC on its proposal to require public companies to disclose the ratio of the compensation of their chief executive officer to the median compensation of the company's employees ("pay ratio"), pursuant to Section 953(b) of Dodd-Frank. We are pleased that the SEC has adopted a final pay ratio rule and urge opposition to the amendment to the FSGG Appropriations Bill that recently passed the House to prohibit the SEC from finalizing, implementing, administering or enforcing pay ratio disclosures.

### **Corporate Governance**

#### *Proxy Access*

We have been a long-time proponent of good corporate governance and believe proxy voting rights not only provide shareowners with the ability to hold accountable the stewards of their capital but also enhance the efficiency of global capital markets. In this regard, we have written the SEC urging renewal of an SEC rulemaking for proxy access by addressing the issues raised in the D.C. Circuit Court decision. We believe that proxy access is important to ensure that shareowners are able to nominate director candidates who can be considered on a level playing field with board or management candidates. CalPERS has been actively involved in the campaign to win proxy access at companies in the S&P 500 through private ordering. Voting tallies on proxy access proposals show that the majority of shareowners favor proxy access. Prohibiting the SEC from revisiting a rule favored by a majority of shareowners does not appear to benefit the interests of shareowners.

#### *Universal Proxy Ballots*

CalPERS believes that shareowners should have the ability to vote for any combination of director candidates in contested elections. As stated in our Global Governance Principles, "To facilitate the shareowner voting process in contested elections - opposing sides engaged in the contest should utilize a proxy card naming all management nominees and all dissident nominees, providing each nominee equal prominence on the proxy card." Unfortunately, the current proxy voting process does not provide shareowners with an efficient and cost-effective way to exercise this right.

We believe that achieving this ideal requires the SEC to adopt the necessary technical fixes to the bona fide nominee rule and to adopt a mandatory universal proxy card. Shareowners need a

proxy voting system that works without the need of physical presence to vote for the full slate of director candidates. Universal proxy ballots would “level the playing field” and ensure shareowners voting by proxy have the same rights as if they had physically attended the meeting. We are confident that the SEC can address this issue without creating undue burden on companies.

To remain an effective fiduciary for our beneficiaries, we strongly encourage the SEC to move forward with adopting universal proxy ballots and making any technical fixes necessary to ensure efficient voting. We urge opposition to the amendment to the FSGG Appropriations Bill that recently passed the House to prohibit the SEC from proposing or implementing a rule that mandates the use of universal proxy ballots during proxy contests.

*Alternative Management and Shareowner Proposals - SEC Rule 14a-8(i)(9)*

Because we view matters of corporate governance as critical elements of our investment strategy, we urged the SEC to clarify the interpretation of SEC Rule 14a-8(i)(9) to allow for the submission of alternative shareowner and management proposals, unless neither alternative is precatory. CalPERS favors providing this clarification for all types of shareowner proposals and does not believe that it should be limited to proxy access proposals. We believe that it is essential that the SEC considers real world examples of alternative proxy access proposals recently presented to shareowners rather than the theoretical arguments presented by opponents of proxy access. Additionally, the SEC should evaluate the actual proxies and vote results consistent with its long-standing advice that Rule 14a-8(i)(9) be applied where multiple proposals “could provide inconsistent and ambiguous results.”<sup>4</sup>

We believe that precatory proposals do not directly conflict with other proposals on the same subject since, even if passed, the precatory proposal does not prevent the company from implementing a binding proposal or considering another precatory proposal. Much has changed since the exclusion currently reflected in Rule 14a-8(i)(9) was adopted by the SEC in 1967. Shareowners now have access to more information and can intelligently provide input on a broad variety of matters that impact the corporations they own. Just as the SEC has been willing to evolve its view on other exclusions, most notably Rule 14a-8(i)(7) related to ordinary business, the SEC should recognize the increasing complexity of today’s markets and shareowners’ ability to keep pace with that complexity. Should the SEC adopt the logic of some in the corporate community, companies may continue to circumvent responsible shareowner requests on a variety of topics, not just proxy access. We joined with the California State Teachers’ Retirement System in sending a letter to the SEC to convey these concerns.

*Shareowner Proposals*

There is no need to further restrict shareowner proposals, thus making it more difficult for shareowners to file proposals and have them appear in proxies. In 2016, there were fewer than 1,000 total proposals filed at all reporting companies in the U.S. The average company receives less than one shareowner proposal in a five year period. Only half of the proposals submitted by

<sup>4</sup> Letter from SEC, Div. of Enforcement, to Susan I. Permut, Senior Vice President, EMC Corp. (Feb. 24, 2009), available at <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2009/steinerchevedden022409-14a8.pdf>.

shareowners appear in companies' proxies, therefore, very few companies (fewer than 500 in 2016) held votes on shareowner submitted issues. Given the small number of shareowner proposals, there is no crisis that needs to be addressed. In fact, the current rules restrict shareowners and limit participation. Furthermore, small shareowners initiated many of the campaigns for enhancements that were eventually adopted as best corporate practices. Therefore, we oppose efforts to prevent such shareowners from filing proposals, which would deny the market the benefits of their input.

#### *Proxy Advisory Legislation*

We also have concerns about H.R. 5311, the "Corporate Governance Reform and Transparency Act," which recently passed the full House Financial Services Committee and was included in H.R. 5983, the "Financial CHOICE Act." We believe that H.R. 5311 would establish an unduly burdensome regulatory regime for proxy advisory firms. H.R. 5311 would also grant issuers undue influence over the proxy recommendation process through the ombudsman and draft recommendations requirements. Additionally, the conflicts of interest management requirement is duplicative of existing SEC authority in this area. The proposed regulatory regime will also create additional barriers to entry for new proxy advisory firms rather than enhance competition. Furthermore, H.R. 5311 would regulate the consultants on only one side of a transaction. Corporations also hire firms as consultants on proxies, yet such firms would evidently continue to be unregulated. Finally, the definition included in legislation makes it unclear whether the intent is to regulate the thousands of entities that provide advice to institutional investors or only the three or so that would actually be considered proxy advisory firms by the market. As an institutional investor that relies on proxy advisory services, we would welcome the opportunity to work with the Committee on these provisions.

#### **Transparency**

##### *Disclosure Effectiveness*

We support the SEC's decision to undertake a comprehensive review of its disclosure regime through the Disclosure Effectiveness Initiative, and recently provided comments to on the SEC's Concept Releases, Effectiveness of Financial Disclosures About Entities Other Than the Registrant – Regulation S-X and Business and Financial Disclosure Required by Regulation S-K. As long-term shareowners, effective disclosures are essential to enhancing the efficiency of global capital markets, to supporting informed decision-making as to how we vote our interests and allocate capital to achieve sustainable returns and to deliver promised retirement and health benefits. In support of these efforts, our Global Governance Principles outline areas which strengthen effective disclosures.

We strongly believe that all investors, whether large institutions or private individuals, should have access to financial reporting disclosures to allow providers of capital the ability to judge for themselves whether to buy, sell or hold a security. Further, we believe that financial reporting disclosures need to be meaningful, understandable, timely, comparable, and consistent to enable open and honest dialogue as well as informed decision-making. Without consistent, comparable disclosures, CalPERS and other investors are disadvantaged in their capital allocation decisions and in their decisions as asset owners in assessing corporate boards and management teams.

Although we strongly support the SEC's work to comprehensively review the disclosure requirements of Regulation S-X and Regulation S-K, we also support the consideration of all potential improvements to the current disclosure regime for the benefit of investors, such as clarifying the definition of materiality to reflect long-term investor needs, and including more decision-useful information in disclosures. In addition, we support the consideration of enhancements to the SEC's disclosure regime that would make better use of technological advances to efficiently provide greater and more precise disclosures on sustainability, including more robust reporting of board diversity information.<sup>5</sup> CalPERS also supports disclosures on corporate political spending. In short, disclosure effectiveness is the key to clear, concise financial reporting for investors, and we would like the investor voice to be heard and considered during the Disclosure Effectiveness Initiative.

#### *Climate Change*

We note that another key aspect of the SEC's work to provide more meaningful disclosures to investors is ensuring that investors have more detailed corporate disclosures regarding climate change. Embedded in our Global Governance Principles is the expectation that corporate boards disclose fair, accurate, and material information relevant to investment decisions enabling shareowners to evaluate risks, past and present performance, and to draw inferences regarding future performance relating to climate change.

Comprehensive disclosure of risk factors related to climate change should clearly reveal how registrants identify and manage risks, in order to generate sustainable economic returns. For this reason, both a detailed explanation about how each risk affects the registrant, as well as disclosure of exactly how the registrant is addressing the risk are needed to provide greater context to shareowners' assessment of risk and risk management. For stakeholders and investors, as the providers of the capital, knowing what measures boards take in managing and mitigating risks allows a growing sense of trust and confidence to be developed regarding their investments. These views are reflected in our recent comments to the SEC on the Regulation S-K concept release. We urge opposition to the amendment to the FSGG Appropriations Bill that recently passed the House to prohibit the SEC from implementing, administering, enforcing, or codifying into regulation the SEC's guidance related to "Commission Guidance Regarding Disclosure Related to Climate Change."

#### **SEC Funding**

Just as importantly, for any of these critical initiatives to be effective, the SEC must be well-managed and well-staffed. We urge that the SEC be fully funded at the FY 2017 requested level of \$1.781 billion, which reflects the importance of the SEC's fundamental role of regulating the U.S. capital markets, and core mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. Accordingly, we are concerned about provisions of the FSGG Appropriations Bill that would fund the SEC at \$1.5 billion, which is \$226 million below the SEC's FY 2017 Budget Request and \$50 million lower than the FY 2016 enacted level.

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<sup>5</sup> Petition for Amendment of Proxy Rule Regarding Board Nominee Disclosure - Chart/Matrix Approach, March 31, 2015 <https://www.sec.gov/rules/petitions/2015/petn4-682.pdf>.

As our capital markets grow increasingly fast and complex, it continues to be imperative that the SEC has the resources it needs to address emerging challenges and to promote investor confidence while also spurring capital formation and economic growth. It is important to note that the SEC's funding is deficit neutral because funds appropriated to the agency are offset by industry transaction fees and thereby do not impact the federal deficit or the availability of funding for other regulatory agencies. In addition, the SEC's appropriation does not count against the FY 2016 and FY 2017 caps established under the Bipartisan Budget Act of 2015. For these reasons, we urge your support of the SEC's FY 2017 funding request, without the problematic policy riders considered in the House.

In conclusion, accountable and transparent corporate governance serves to mitigate investment risk and also plays a vitally important role in promoting long-term capital formation, which can ensure a growing and vibrant economy. Thank you, Chairman Garrett and Ranking Member Maloney for inviting me to participate in this hearing. I look forward to the opportunity to respond to any questions.



THE CALIFORNIA PUBLIC EMPLOYEES'  
RETIREMENT SYSTEM



**GLOBAL GOVERNANCE PRINCIPLES**

California Public Employees' Retirement System  
Lincoln Plaza - 400 Q Street - Sacramento, CA 95811

*Updated: March 16, 2015*

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## I. INTRODUCTION

The California Public Employees' Retirement System (CalPERS, System) is the largest U.S. public pension fund, with assets totaling approximately \$300 billion spanning domestic and international markets as of June 30, 2014. Our mission is to provide responsible and efficient stewardship of the System to deliver promised retirement and health benefits, while promoting wellness and retirement security for members and beneficiaries. This mission was adopted by the CalPERS Board of Administration to guide us in serving our more than 1.6 million members and retirees.

The CalPERS Board of Administration is guided by the CalPERS Board's Investment Committee, Investment Beliefs<sup>1</sup> and Core Values: Quality, Respect, Accountability, Integrity, Openness, and Balance. CalPERS management and more than 380 Investment Office staff carry out the daily activities of the investment program. Our goal is to efficiently and effectively manage investments to achieve the highest possible return at an acceptable level of risk. In doing so, CalPERS has generated strong long-term returns.

CalPERS Global Governance Program has evolved since the mid-80's when it was solely reactionary: reacting to the anti-takeover actions of corporate managers that struck a dissonant chord with owners of the corporate entity concerned with accountability and fair play. The late 1980s and early 1990s represented a period in which CalPERS learned a great deal about the "rules of the game" – how to influence corporate managers, what issues were likely to elicit fellow shareowner support, and where the traditional modes of shareowner/corporation communication were at odds with current reality. Beginning in 1993, CalPERS turned its focus toward companies considered by virtually every measure to be "poor" financial performers. By centering its attention and resources in this way, CalPERS could demonstrate very specific and tangible results to those who questioned the value of corporate governance.

Over the years, we've learned that shareowners can be instrumental in encouraging responsible corporate citizenship. CalPERS believes that environmental, social, and corporate governance issues can affect the performance<sup>2</sup> of investment portfolios (to varying degrees across companies, sectors, regions, and asset classes through time.) In 2005, CalPERS joined 19 other institutional investors from 12 countries to develop and become a signatory to the United Nations supported Principles for Responsible Investment (Appendix A).

<sup>1</sup> In October 2013, CalPERS adopted a set of ten Investment Beliefs intended to guide decision-making, facilitate the management of a complex portfolio, and enhance consistency. The Investment Beliefs can be found at [www.calpers-governance.org](http://www.calpers-governance.org)

<sup>2</sup> CalPERS launched the Sustainable Investment Research Initiative (SIRI) in 2013. SIRI was designed to promote innovative thought leadership that would advance and inform CalPERS understanding of environmental, social and governance factors and the impact they may have on companies, markets, and investment intermediaries. SIRI produced the Review of Evidence: Bibliography of Academic Studies – an online searchable database of more than 700 studies on sustainability factors and investment spanning four decades. More information on SIRI can be found at [www.calpers-governance.org](http://www.calpers-governance.org).

In 2011, CalPERS Global Governance Program transitioned into an Investment Office-wide role to support the Total Fund; and, the CalPERS Board approved the adoption of a Total Fund process for integrating environmental, social, and governance (ESG) issues across the investment portfolio as a strategic priority. This transition recognizes CalPERS' ongoing effort<sup>3</sup> to integrate ESG factors into investment decision making across asset classes, grounded in the three forms of economic capital – financial, human, and physical – that are needed for long-term value creation. This work has also been integrated into CalPERS Investment Beliefs which address sustainable investment, risk management, and CalPERS engagement with companies, regulators, managers, and stakeholders.

What have we learned over the years? We have learned that (a) company managers want to perform well, in both an absolute sense and as compared to their peers; (b) company managers want to adopt long-term strategies and visions, but often do not feel that their shareowners are patient enough; and (c) all companies – whether governed under a structure of full accountability or not – will inevitably experience both ascents and descents along the path of profitability.

We have also learned, and firmly embrace the belief that good corporate governance – that is, accountable corporate governance – means the difference between wallowing for long periods in the depths of the performance cycle, and responding quickly to correct the corporate course.

*“Long-term value creation requires effective management of three forms of capital: financial, physical and human – CalPERS Investment Belief 4.”  
(October, 2013)*

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<sup>3</sup> CalPERS discloses its progress of the System's efforts, sustainability work, and goals towards sustainable decision making in its publicly available report, *Towards Sustainable Investment & Operations*, which can be found at [www.calpers-governance.org](http://www.calpers-governance.org).

## II. PURPOSE

The CalPERS Board, through its Investment Committee, has adopted the Global Governance Principles (Global Principles). The Global Principles create the framework by which CalPERS:

1. Executes its shareowner<sup>4</sup> proxy voting responsibilities.
2. Engages investee companies to achieve long-term sustainable risk-adjusted returns.
3. Requests internal and external managers of CalPERS capital to take into consideration when making investment decisions.

Inherent within the concept of prudence is the duty to monitor investment performance<sup>5</sup>. The U.S. Department of Labor (DOL), entrusted with oversight of the Employee Retirement Income and Security Act of 1974 (ERISA), has warned private pension fiduciaries that they may be held accountable for screening the performance of holdings, even those held under passive strategies<sup>6</sup>. In 1988, the DOL issued its so-called Avon Letter, putting private pension plan trustees on notice that proxy voting rights must be diligently exercised as an aspect of fiduciary duty<sup>7</sup>. In 1994 the DOL updated its Avon Letter in a bulletin that consolidates the voting requirements of ERISA fiduciaries. The DOL now advocates a corporate activist role for pension plan trustees, to include "... activities intended to monitor or influence corporate management."<sup>8</sup>

CalPERS implements its proxy voting responsibility and global governance initiatives in a manner that is consistent with the Global Principles unless such action may result in long-term harm to the company that outweighs all reasonably likely long-term benefit; or, unless such a vote is contrary to the interests of the beneficiaries of the System.

The execution of proxies and voting instructions is an important mechanism by which shareowners can influence a company's operations and corporate governance. It is therefore important for shareowners to exercise their right to participate and make their voting decisions based on a full understanding of the information and legal documentation presented to them. CalPERS will vote in favor of, or "For", an individual or slate of director nominees up for election that the System believes will effectively oversee CalPERS interests as a shareowner consistent with the Global Principles. CalPERS will withhold its vote from, or vote "Against", an individual or slate of director nominees at companies that do not effectively oversee CalPERS interests as a shareowner consistent with the Global Principles. CalPERS will also withhold its vote in limited circumstances where a company has consistently demonstrated long-term economic underperformance.

<sup>4</sup> Throughout this document, CalPERS has chosen to adopt the term "shareowner" rather than "shareholder." This is to reflect a view that equity ownership carries with it active responsibilities and is not merely passively "holding" shares. "For corporate governance structures to work effectively, Shareowners must be active and prudent in the use of their rights. In this way, Shareowners must act like owners and continue to exercise the rights available to them." (2005 CFA Institute: Centre for Financial Market Integrity, The Corporate Governance of Listed Companies: A Manual for Investors) CalPERS also has other rights via other forms of capital and investment vehicles with the Global Principles adapted accordingly.

<sup>5</sup> Richard H. Koppes and Maureen L. Reilly, An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor and Index Fund, The J. Of Corp. Law, Univ. of Iowa (Summer 1995).

<sup>6</sup> See 29 C.F.R. sec. 2550.404a-1, DOL preamble to proposed regulations for the investment of plan assets, at fn. 7.

<sup>7</sup> DOL Op. Ltr. To Helmut Fandl, Avon Products, Inc. (Feb. 29, 1988).

<sup>8</sup> DOL Interp. Bulletin 94-1 (July 1994).



CalPERS has a long history of constructively engaging companies that fail to meet CalPERS standards of conduct as defined by the Global Principles. CalPERS prefers constructive engagement to divesting as a means of affecting the conduct of entities in which it invests. Investors that divest lose their ability as shareowners to influence the company to act responsibly.

The Global Principles are broken down into three areas – Core, Domestic, and International Principles. Adopting the Global Principles in its entirety may not be appropriate for every company in the global capital marketplace due to differing developmental stages, competitive environment, regulatory or legal constraints. However, CalPERS does believe the criteria contained in the Core Principles should be adopted by companies across all markets - from developed to emerging – in order to establish the foundation for achieving long-term sustainable investment returns through accountable corporate governance structures.

For companies in the United States or listed on U.S. stock exchanges, CalPERS advocates the expansion of the Core Principles into the Domestic Principles. For companies outside the United States or listed on non-U.S. stock exchanges, CalPERS advocates the expansion of the Core Principles into the International Principles.

CalPERS expects all internal and external managers of CalPERS capital to integrate the Global Principles into investment decision making including proxy voting, consistent with fiduciary duty. CalPERS recognizes that countries and companies are in different developmental stages and that CalPERS investment managers will need to exercise their best judgment after taking all relevant factors, principles, and trends into account. CalPERS requires internal and external managers across the total fund to consider these Global Principles among the decision factors employed in the investment process.

### III. GLOBAL GOVERNANCE PRINCIPLES

#### A. Core Principles

There are many features that are important considerations in the continuing evolution of corporate governance best practices. However, the underlying tenet for CalPERS Core Principles is that fully accountable governance structures produce, over the long term, the best returns to shareowners. CalPERS believes the following Core Principles should be adopted by companies and markets – from developed to emerging – in order to establish the foundation for achieving long-term sustainable investment returns through accountable corporate governance structures.

1. **Sustainability:** Companies and external managers in which CalPERS invests are expected to optimize operating performance, profitability and investment returns in a risk-aware manner while conducting themselves with propriety and with a view toward responsible conduct. Anchored by CalPERS Investment Beliefs, CalPERS believes long-term value creation requires the effective management of three forms of capital described as follows:
  - a. **Financial Capital (Governance):** Governance is the primary tool to align interests between CalPERS and the managers of our financial capital – including companies and external managers. Good governance enhances a company's long-term value and protects investor interests.
  - b. **Physical Capital (Environment):** Encouraging external managers, portfolio companies, and policy makers to engage in responsible environmental practices is important to identifying opportunities and risk management. This means making wise use of scarce resources, considering impact, and addressing systemic risks, such as climate change.
  - c. **Human Capital (Social):** The success and long-term value of the companies we invest in will be impacted by their management of human capital. This includes fair labor practices, responsible contracting, workplace and board diversity, and protecting the safety of employees directly and through the supply chain.
2. **Director Accountability:** Directors should be accountable to shareowners, and management accountable to directors. To ensure this accountability, directors must be accessible to shareowner inquiry concerning their key decisions affecting the company's strategic direction.
3. **Transparency:** Operating, financial, and governance information about companies must be readily transparent to permit accurate market comparisons; this includes disclosure and transparency of objective globally accepted minimum accounting standards, such as the International Financial Reporting Standards ("IFRS").
4. **One-share/One-vote:** All investors must be treated equitably and upon the principle of one-share/one-vote.
5. **Proxy Materials:** Proxy materials should be written in a manner designed to provide shareowners with the information necessary to make informed voting decisions. Similarly, proxy materials should be distributed in a manner designed to encourage

shareowner participation. All shareowner votes, whether cast in person or by proxy, should be formally counted with vote outcomes formally announced.

6. **Code of Best Practices:** Each capital market in which shares are issued and traded should adopt its own Code of Best Practices to promote transparency of information, prevention of harmful labor practices, investor protection, and corporate social responsibility. Where such a code is adopted, companies should disclose to their shareowners whether they are in compliance.
7. **Long-term Vision:** Corporate directors and management should have a long-term strategic vision that, at its core, emphasizes sustained shareowner value and effective management of both risk and opportunities in the oversight of financial, physical, and human capital. In turn, despite differing investment strategies and tactics, shareowners should encourage corporate management to resist short-term behavior by supporting and rewarding long-term superior returns.
8. **Access to Director Nominations:** Shareowners should have effective access to the director nomination process.
9. **Political Stability:** Progress toward the development of basic democratic institutions and principles, including such things as: a strong and impartial legal system; and, respect and enforcement of property and shareowner rights.

Political stability encompasses:

- a. **Political risk:** internal and external conflict; corruption; the military and religion in politics; law and order; ethnic tensions; democratic accountability; bureaucratic quality.
- b. **Civil liberties:** freedom of expression, association and organization rights; rule of law and human rights; free trade unions and effective collective bargaining; personal autonomy and economic rights.
- c. **Independent judiciary and legal protection:** an absence of irregular payments made to the judiciary; the extent to which there is a trusted legal framework that honors contracts, clearly delineates ownership and protects financial assets.

10. **Transparency:** Financial transparency, including elements of a free press, is necessary for investors to have truthful, accurate and relevant information.

Transparency encompasses:

- a. **Freedom of the press:** structure of the news delivery system in a country; laws and their promulgation with respect to the influence of the news; the degree of political influence and control; economic influences on the news; the degree to which there are violations against the media with respect to physical violations and censorship.
- b. **Monetary and fiscal transparency:** the extent to which governmental monetary and fiscal policies and implementation are publicly available in a clear and timely manner, in accordance with international standards.
- c. **Stock exchange listing requirements:** stringency of stock exchange listing requirements with respect to frequency of financial reporting, the requirement of annual independent audits, and minimal financial viability.

- d. **Accounting standards:** the extent to which U.S. Generally Accepted Accounting Principles, or International Accounting Standards is used in financial reporting; whether the country is a member of the International Accounting Standards Council.

**11. Productive Labor Practices:** No harmful labor practices or use of child labor. In compliance, or moving toward compliance, with the International Labor Organization (ILO) Declaration on the Fundamental Principles and Rights at Work.

Productive Labor Practices encompasses:

- a. **ILO ratification:** whether the convention is ratified, not ratified, pending ratification or denounced.
- b. **Quality of enabling legislation:** the extent to which the rights described in the ILO convention are protected by law.
- c. **Institutional capacity:** the extent to which governmental administrative bodies with labor law enforcement responsibility exist at the national, regional and local level.
- d. **Effectiveness of implementation:** evidence that enforcement procedures exist and are working effectively; evidence of a clear grievance process that is utilized and provides penalties that have deterrence value.

**12. Corporate Social Responsibility – Eliminating Human Rights Violations:**

Corporations should adopt maximum progressive practices toward the elimination of human rights violations in all countries or environments in which the company operates. Additionally, these practices should emphasize and focus on preventing discrimination and/or violence based on race, color, religion, national origin, age, disability, sexual orientation, gender identity, marital status, or any other status protected by laws or regulations in areas of a company's operation.

Companies should operate in compliance, or moving toward compliance, with the Global Sullivan Principles (Appendix B), or the human rights and labor standards principles exemplified by the United Nations Global Compact Principles (Appendix C).

**13. Market Regulation and Liquidity:** Little to no repatriation risk. Potential market and currency volatility are adequately rewarded.

Market regulation and liquidity encompasses:

- a. Market capitalization
- b. Change in market capitalization
- c. Average monthly trading volume
- d. Growth in listed securities
- e. Market volatility as measured by standard deviation
- f. Return/risk ratio

**14. Capital Market Openness:** Free market policies, openness to foreign investors, and legal protection for foreign investors.

Capital market openness encompasses:

- a. **Foreign investment:** degree to which there are restrictions on foreign ownership of local assets, repatriation restrictions or un-equal treatment of foreigners and locals under the law.
- b. **Trade policy:** degree to which there are deterrents to free trade such as trade barriers and punitive tariffs.
- c. **Banking and finance:** degree of government ownership of banks and allocation of credit; freedom financial institutions have to offer all types of financial services; protectionist banking regulations against foreigners.

**15. Settlement Proficiency/Transaction Costs:** Reasonable trading and settlement proficiency and reasonable transaction costs.

Settlement proficiency/transaction costs encompass:

- a. **Trading and settlement proficiency:** degree to which a country's trading and settlement is automated; success of the market in settling transactions in a timely, efficient manner.
- b. **Transaction costs:** the costs associated with trading in a particular market, including stamp taxes and duties; amount of dividends and income taxes; capital gains taxes.

**16. Disclosure:** Companies should adopt corporate reporting guidelines in order to measure, disclose, and be accountable to internal and external stakeholders for organizational performance.

Disclosure reporting guidelines should include:

- a. The effect of environmental, social and governance impacts, risks and opportunities related to the company's stakeholders.
- b. Activities the company is undertaking to protect shareholder rights and investment capital.

**17. Financial Markets:** Policy makers and standards setters which impact investment portfolio risk and return should promote fair, orderly, and effectively regulated financial markets through the following:

- a. **Transparency:** To promote full disclosure so that the financial markets provide incentives that price risk and opportunity.
- b. **Governance:** To foster alignment of interest, protect investor rights and independence of regulators.
- c. **Systemic Risk:** For earlier identification by regulators of issues that give rise to overall market risk that threaten global markets and foster action that mitigates those risks.

## B. Domestic Principles (United States)

CalPERS advocates the expansion of the Core Principles by companies domiciled in the United States or that list shares on U.S. stock exchanges into the Domestic Principles. CalPERS Domestic Principles embrace the Council of Institutional Investors Corporate Governance Policies (Appendix D) and represent an evolving framework for accountable corporate governance to be applied to the U.S. capital market.

In addition to encouraging portfolio companies to adopt the Core Principles, CalPERS implements its U.S. corporate governance initiatives and proxy voting responsibilities in a manner that is consistent with the following:

### 1. Board Independence & Leadership

Independence is the cornerstone of accountability. It is now widely recognized throughout the U.S. that independent boards are essential to a sound governance structure. Nearly all corporate governance commentators agree that boards should be comprised of at least a majority of "independent directors." But the definitional independence of a majority of the board may not be enough in some instances. The leadership of the board must embrace independence, and it must ultimately change the way in which directors interact with management. Independence also requires a lack of conflict between the director's personal, financial, or professional interests, and the interests of shareowners.

Accordingly, to instill board independence and leadership, CalPERS recommends:

- 1.1 Majority of Independent Directors:** At a minimum, a majority of the board consists of directors who are independent. Boards should strive to obtain board composition made up of a substantial<sup>9</sup> majority of independent directors.
- 1.2 Independent Executive Session:** Independent directors meet periodically (at least once a year) alone in an executive session, without the CEO. The independent board chair or lead (or presiding) independent director should preside over this meeting.
- 1.3 Independent Director Definition:** Each company should disclose in its annual proxy statement the definition of "independence" relied upon by its board. The board's definition of "independence" should address, at a minimum, those provisions set forth in Appendix E.
- 1.4 Independent Board Chairperson:** The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board should provide a written statement in the proxy materials discussing why the combined role is in the best interest of

<sup>9</sup> The National Association of Corporate Directors' (NACD's) Blue Ribbon Commission on Director Professionalism released its report in November 1996. (Hereafter "NACD Report") The NACD Report calls for a "substantial majority" of a board's directors to be independent. The Business Roundtable's Principles of Corporate Governance (November 2005, hereafter "BRT Principles") is in general accord that a "substantial majority" of directors should be independent, both in fact and appearance, as determined by the board. (BRT Principles, p.14) Neither the NACD, nor BRT, define "substantial."

shareowners, and it should name a lead independent director to fulfill duties that are consistent with those provided in Appendix F.

- 1.5 Board Member Tenure:** Boards should consider all relevant facts and circumstances to determine whether a director should be considered independent. These considerations include the director's years of service on the board – extended periods of service may adversely impact a director's ability to bring an objective perspective to the boardroom. Additionally, there should be routine discussions surrounding director refreshment to ensure boards maintain the necessary mix of skills and experience to meet strategic objectives.
- 1.6 Examine Separate Chair/CEO Positions:** When selecting a new CEO, boards should re-examine the traditional combination of the "chief executive" and "chair" positions.
- 1.7 Board Role of Retiring CEO:** Generally, a company's retiring CEO should not continue to serve as a director on the board and at the very least be prohibited from sitting on any of the board committees.
- 1.8 Board Access to Management:** The board should have a process in place by which all directors can have access to senior management.
- 1.9 Independent Board Committees:** Committees who perform the audit, director nomination and executive compensation functions should consist entirely of independent directors.
- 1.10 Board Oversight:** The full board is responsible for the oversight function on behalf of shareowners. Should the board decide to have other committees (e.g. executive committee) in addition to those required by law, the duties and membership of such committees should be fully disclosed.
- 1.11 Board Resources:** The board, through its committees, should have access to adequate resources to provide independent counsel advice, or other tools that allow the board to effectively perform its duties on behalf of shareowners.
- 1.12 Board Responsibilities:** The Board should be responsible for reviewing, approving and guiding corporate strategy, capital discipline and allocation, major plans of action, risk policies, business plans, setting performance objectives, monitoring implementation and corporate performance, overseeing major capital expenditures, and acquisitions/divestitures. Further, shareowner approval should be required for any major transactions, issuance of additional shares, or any changes to the company's governing documents such as the bylaws and charter that would limit or reduce shareowner rights.

## 2. Board, Director, and CEO Evaluation

As a fiduciary, a director owes a duty of loyalty to the corporation and its shareowners and must exercise reasonable care in relation to his or her duties as a director. No board can truly perform its function of overseeing a company's strategic direction and monitoring management's success without a system of evaluating itself. CalPERS may seek director candidates for nomination to the board of a publicly traded corporation in which it invests where the board does not effectively oversee shareowner interests by failing to perform in accordance with the Global Principles or in circumstances where a company has consistently demonstrated long-term economic underperformance.

In CalPERS view, each director should fit within the skill sets identified by the board as necessary to focus board attention on optimizing company operating performance and returns to shareowners. No director can fulfill his or her potential as an effective board member without a personal dedication of time and energy. Boards should therefore have an effective means of evaluating itself and individual director performance.

With this in mind, CalPERS recommends that:

**2.1 Corporate Governance Principles:** The board adopts and discloses a written statement of its own governance principles, and re-evaluates them on at least an annual basis.

**2.2 Board Talent Assessment and Diversity:** The board should facilitate a process that ensures a thorough understanding of the diverse characteristics necessary to effectively oversee management's execution of a long-term business strategy. Board diversity should be thought of in terms of skill sets, gender, age, nationality, race, sexual orientation, gender identity, and historically under-represented groups.

Consideration should go beyond the traditional notion of diversity to include a more broad range of experience, thoughts, perspectives, and competencies to help enable effective board leadership. A robust process for how diversity is considered when assessing board talent and diversity should be adequately disclosed and entail:

- a. **Director Talent Evaluation:** To focus on the evolving global capital markets, a board should disclose its process for evaluating the diverse talent and skills needed on the board and its key committees.
- b. **Director Attributes:** Board attributes should include a range of skills and experience which provide a diverse and dynamic team to oversee business strategy, risk mitigation and senior management performance. The board should establish and disclose a diverse mix of director attributes, experiences, perspectives and skill sets that are most appropriate for the company. At a minimum, director attributes should include expertise in accounting or finance, international markets, business or management, industry knowledge, governance, customer-base experience or perspective, crisis response, risk assessment, leadership and strategic planning. Additionally, existing directors should receive continuing education surrounding a company's activities and operations to ensure they maintain the necessary skill sets and knowledge to meet their fiduciary responsibilities.



- c. **Director Nominations:** With each qualified director nomination recommendation, the board should consider the issue of competence, independence, continuing director tenure, as well as board diversity, and take steps as necessary to ensure that the board maintains openness to new ideas, a willingness to re-examine the status quo, and able to exercise judgment in the best interests of the corporation free of any external influence that may attempt to be or may appear to be exerted upon them.
- 2.3 Board, Committee, and Director Expectations:** The board establishes preparation, participation and performance expectations for itself (acting as a collective body), for the key committees and each of the individual directors. A process by which these established board, key committee and individual director expectations are evaluated on an annual basis should be disclosed to shareowners. Directors must satisfactorily perform based on the established expectations with re-nomination based on any other basis being neither expected nor guaranteed.
- 2.4 Director Time Commitment:** The board adopts and discloses guidelines<sup>10</sup> in the company's proxy statement to address competing time commitments that are faced when directors, especially acting CEOs<sup>11</sup>, serve on multiple boards.
- 2.5 Director Attendance:** Directors should be expected to attend at least 75% of the board and key committee meetings on which they sit.
- 2.6 Board Size:** The board periodically reviews its own size, and determines the size that is most effective toward future operations.
- 2.7 CEO Performance:** Independent directors establish CEO performance criteria focused on optimizing operating performance, profitability and shareowner value creation; and regularly review the CEO's performance against those criteria.
- 2.8 CEO Succession Plan:** The board should proactively lead and be accountable for the development, implementation, and continual review of a CEO succession plan. Board members should be required to have a thorough understanding of the characteristics necessary for a CEO to execute on a long-term strategy that optimizes operating performance, profitability and shareowner value creation.

At a minimum, the CEO succession planning process should:

- a. Become a routine topic of discussion by the board.
- b. Extend down throughout the company emphasizing the development of internal CEO candidates and senior managers while remaining open to external recruitment.

<sup>10</sup> See NACD Report (p. 10-12) recommends that candidates who are CEOs or senior executives of public corporations be "preferred" if they hold no more than 1-2 public company directorships; other candidates who hold full-time positions be preferred if they hold no more than 3-4 public company directorships; and all other candidates be preferred if they hold no more than 5-6 other public company directorships.

<sup>11</sup> "The job of being the CEO of a major corporation is one of the most challenging in the world today. Only extraordinary people are capable of performing it adequately; a small portion of these will appropriately be able to commit some energy to directorship of one other enterprise. No CEO has time for more than that." (Robert A.G. Monks, "Shareholders and Director Section", DIRECTORS & BOARDS (Autumn 1996 p.158)

- c. Require all board members be given exposure to internal candidates.
- d. Encompass both a long-term perspective to address expected CEO transition periods and a short-term perspective to address crisis management in the event of death, disability or untimely departure of the CEO.
- e. Provide for open and ongoing dialogue between the CEO and board while incorporating an opportunity for the board to discuss CEO succession planning without the CEO present.
- f. Be disclosed to shareowners on an annual basis and in a manner that would not jeopardize the implementation of an effective and timely CEO succession plan.

**2.9 Director Succession Plan:** The board should proactively lead and be accountable for the development, implementation, and continual review of a director succession plan. Board members should be required to have a thorough understanding of the characteristics necessary to effectively oversee management's execution of a long-term strategy that optimizes operating performance, profitability, and shareowner value creation.

At a minimum, the director succession planning process should:

- a. Become a routine topic of discussion by the board.
- b. Encompass how expected future board retirements or the occurrence of unexpected director turnover as a result of death, disability or untimely departure is addressed in a timely manner.
- c. Encompass how director turnover either through transitioning off the board or as a result of rotating committee assignments and leadership is addressed in a timely manner.
- d. Provide for a mechanism to solicit shareowner input.
- e. Be disclosed to shareowners on an annual basis and in a manner that would not jeopardize the implementation of an effective and timely director succession plan.

### **3. Executive & Director Compensation**

Compensation programs are one of the most powerful tools available to the company to attract, retain, and motivate key employees to optimize operating performance, profitability and sustainable long-term shareowner return. CalPERS considers long-term to be five or more years for mature companies and at least three years for other companies. Well-designed compensation programs will be adequately disclosed and align management with the long-term economic interests of shareowners.

CalPERS believes shareowners should have an effective mechanism by which to periodically promote substantive dialogue, encourage independent thinking by the board, and stimulate healthy debate for the purpose of holding management accountable for performance through executive compensation programs. However, CalPERS does not generally believe that it is optimal for shareowners to approve individual contracts at the company specific level.

Implicit in CalPERS Domestic Principles related to executive compensation, is the belief that the philosophy and practice of executive compensation needs to be performance-based. Through its efforts to advocate executive compensation reform, CalPERS emphasizes improved disclosure, the alignment of interests between executive management and shareowners, and enhanced compensation committee accountability for executive compensation.

With this in mind, CalPERS recommends the following:

### **Executive Compensation**

#### **3.1 Structure and Components of Total Compensation**

- a. **Board Designed, Implemented, and Disclosed to Shareowners:** To ensure the alignment of interest with long-term shareowners, executive compensation programs are to be designed, implemented, and disclosed to shareowners by the board, through an independent compensation committee. Executive compensation programs should not restrict the company's ability to attract and retain competent executives.
- b. **Mix of Cash and Equity:** Executive compensation be comprised of a combination of cash and equity based compensation.
- c. **Shareowner Advisory Vote on Executive Compensation:** Companies submit executive compensation policies to shareowners for non-binding approval on an annual basis.
- d. **Executive Contract Disclosure:** Executive contracts be fully disclosed, with adequate information to judge the "drivers" of incentive components of compensation packages.
- e. **Targeting Total Compensation Components:** Overall target ranges of total compensation and components therein including base salary, short-term incentive and long-term incentive components should be disclosed.
- f. **Peer Relative Analysis:** Disclosure should include how much of total compensation is based on peer relative analysis and how much is based on other criteria.
- g. **Executive Compensation Alignment with Business Strategy:** Compensation committees should have a well articulated philosophy that links compensation to long-term business strategy.
- h. **Sustainability Objectives and Executive Compensation:** Executive compensation plans should be designed to support sustainability performance objectives particularly with regard to risk management, environmental, health, and safety standards. Sustainability objectives that trigger payouts should be disclosed.

### 3.2 Incentive Compensation

- a. **Performance Link:** A significant portion of executive compensation should be comprised of “at risk” pay linked to optimizing the company’s operating performance and profitability that results in sustainable long-term shareowner value creation.
- b. **Types of Incentive Compensation:** The types of incentive compensation to be awarded should be disclosed such as the company’s use of options, restricted stock, performance shares or other types.
- c. **Establishing Performance Metrics:** Performance metrics such as total stock return, return on capital, return on equity and return on assets, should be set before the start of a compensation period while the previous years’ metrics which triggered incentive payouts should be disclosed.
- d. **Multiple Performance Metrics:** Plan design should utilize multiple performance metrics when linking pay to performance.
- e. **Performance Hurdles:** Performance hurdles<sup>12</sup> that align the interests of management with long-term shareowners should be established with incentive compensation being directly tied to the attainment and/or out-performance of such hurdles. Provisions by which compensation will not be paid if performance hurdles are not obtained should be disclosed to shareowners.
- f. **Retesting Incentive Compensation:** Provisions for the resetting of performance hurdles in the event that incentive compensation is retested<sup>13</sup> should be disclosed.
- g. **Clawback Policy:** Companies should recapture incentive payments that were made to executives on the basis of having met or exceeded performance targets during a period of fraudulent activity or a material negative restatement of financial results for which executives are found personally responsible.

### 3.3 Equity Compensation

- a. **Equity Ownership:** Executive equity ownership should be required through the attainment and continuous ownership of a significant equity investment in the company. Executive stock ownership guidelines and holding requirements should be disclosed to shareowners on an annual basis. In addition to equity ownership, a company should make full disclosure of any pledging policies. Further, stock subject to the ownership requirements should not be pledged or otherwise encumbered.
- b. **Hedging:** The use of derivatives or other structures to hedge director or executive stock ownership undermines the alignment of interest that equity compensation is intended to provide. Companies should therefore prohibit the activity and provide full disclosure of any hedging policies.

<sup>12</sup> Executive compensation should directly link the interests of senior management, both individually and as a team, to the long-term interests of shareholders. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk. (BRT Principles pg. 24)

<sup>13</sup> “Retested” means extending a performance period to enable initial performance hurdles to be achieved.

- c. **Equity Grants Linked to Performance:** Equity based compensation plans should incorporate performance based equity grant vesting requirements tied to achieving performance metrics. The issuance of discounted equity grants or accelerated vesting are not desirable performance based methodologies.
- d. **Unvested Equity Acceleration upon a Change-in-Control:** In the event of a merger, acquisition, or change-in-control, unvested equity should not accelerate but should instead convert into the equity of the newly formed company.
- e. **Recapturing Dividend Equivalent Payouts:** Companies should develop and disclose a policy for recapturing dividend equivalent payouts on equity that does not vest. In addition, companies should ensure voting rights are not permitted on unvested equity.
- f. **Equity Grant Vesting Period:** Equity grants should vest over a period of at least three years.
- g. **Board Approval of Stock Options:** The board's methodology and corresponding details for approving stock options for both company directors and employees should be highly transparent and include disclosure of: 1) quantity, 2) grant date, 3) strike price, and 4) the underlying stock's market price as of grant date. The approval and granting of stock options for both directors and employees should preferably occur on a date when all corporate actions are taken by the board. The board should also require a report from the CEO stating specifically how the board's delegated authority to issue stock options to employees was used during the prior year.
- h. **Equity Grant Repricing:** Equity grant repricing without shareowner approval should be prohibited.
- i. **Evergreen or Reload Provisions:** "Evergreen"<sup>14</sup> or "Reload"<sup>15</sup> provisions should be prohibited.
- j. **Distribution of Equity Compensation:** How equity-based compensation will be distributed within various levels of the company should be disclosed.
- k. **Equity Dilution and Run Rate Provisions:** Provisions for addressing the issue of equity dilution, the intended life of an equity plan, and the expected yearly run rate of the equity plan should be disclosed.
- l. **Equity Repurchase Plans:** If the company intends to repurchase equity in response to the issue of dilution, the equity plan should clearly articulate how the repurchase decision is made in relation to other capital allocation alternatives.
- m. **Shareowner Approval:** All equity based compensation plans or material changes to existing equity based compensation plans should be shareowner approved.
- n. **Cost of Equity Based Compensation:** Reasonable ranges which the board will target the total cost of new or material changes to existing equity based

<sup>14</sup> Evergreen provisions provide a feature that automatically increases the shares available for grant on an annual basis. Evergreen provisions include provisions for a set number of shares to be added to the plan each year, or a set percentage of outstanding shares.

<sup>15</sup> Reload provisions allow an optionee who exercises a stock option using stock already owned to receive a new option for the number of shares used to exercise. The intent of reload options is to make the optionee whole in cases where they use existing shares they own to pay the cost of exercising options.

compensation plans should be disclosed. The cost of new or material changes to existing equity based compensation plans should not exceed that of the company's peers unless the company has demonstrated consistent long-term economic out-performance on a peer relative basis.

### 3.4 Use and Disclosure of Severance Agreements

- a. **Severance Agreement Disclosure:** In cases where the company will consider severance agreements<sup>16</sup>, the policy should contain the overall parameters of how such agreements will be used including the specific detail regarding the positions within the company that may receive severance agreements; the maximum periods covered by the agreements; provisions by which the agreements will be reviewed and renewed; any hurdles or triggers that will affect the agreements; a clear description of what would and would not constitute termination for cause; and disclosure of where investors can view the entire text of severance agreements.
- b. **Severance Agreement Amendments:** Material amendments to severance agreements should be disclosed to shareowners.
- c. **Shareowner Approval of Severance Payments:** Severance payments that provide benefits<sup>17</sup> with a total present value exceeding market standards<sup>18</sup> should be ratified by shareowners.

**3.5 Use of "Other" Forms of Compensation:** Compensation policies should include guidelines by which the company will use alternative forms<sup>19</sup> of compensation ("perquisites"), and the relative weight in relation to total compensation if perquisites will be utilized. To the degree that the company will provide perquisites, it should clearly articulate how shareowners should expect to realize value from these other forms of compensation.

**3.6 Use of Retirement Plans, Defined Contribution/Benefit Plans:** Defined contribution and defined benefit retirement plans should be clearly disclosed in tabular format showing all benefits available whether from qualified or non-qualified plans and net of any offsets.

<sup>16</sup> Severance agreement means any agreement that dictates what an executive will be compensated when the company terminates employment without cause or when there is a termination of employment following a finally approved and implemented change in control.

<sup>17</sup> Severance benefits mean the value of all cash and non-cash benefits, including, but not limited to, the following: (i) cash benefits; (ii) perquisites; (iii) consulting fees; (iv) equity and the accelerated vesting of equity, (v) the value of "gross-up" payments; and (vi) the value of additional service credit or other special additional benefits under the company's retirement system. Severance benefits do not include already accrued pension benefits.

<sup>18</sup> The disclosed threshold in the United States should not exceed 2.99 times the sum of the executive's base salary plus target bonus.

<sup>19</sup> "Other" forms of compensation include, but are not limited to, pension benefits including terms of deferred pay, perquisites and loans.

### 3.7 Director Compensation

- a. **Combination of Cash and Equity:** Director compensation should be a combination of cash and stock in the company.
- b. **Equity Ownership:** Director equity ownership should be required through the attainment and continuous ownership of an equity investment in the company. Director stock ownership guidelines and holding requirements should be disclosed to shareowners on an annual basis.

### 4. Integrity of Financial Reporting

Financial reporting plays an integral role in the capital markets by providing transparent and relevant information about the economic performance and condition of businesses. Effective financial reporting depends on high quality accounting standards, as well as consistent application, rigorous independent audit and enforcement of those standards. CalPERS is a strong advocate of reform that ensures the continual improvement and integrity of financial reporting.

**4.1 Integrated Reporting:** Companies should provide for the integrated representation of operational, financial, environmental, social, and governance performance in terms of both financial and non-financial results in order to offer investors a better information set for assessing risk.

**4.2 Global Accounting Standards:** Convergence to one set of high quality global accounting standards to ensure integrity of financial reporting without compromising quality is critical.

**4.3 Role of the Auditor:** Auditors should provide independent assurance and attestation to the quality of financial statements to instill confidence in the providers of capital.

**4.4 Auditor Ratification by Shareowners:** The selection of the independent external auditor should be ratified by shareowners annually.

**4.5 Audit Opinion:** Auditors should bring integrity, independence, objectivity, and professional competence to the financial reporting process. The audit opinion should state whether the financial statements and disclosures are complete, materially accurate, and free of material misstatement, whether caused by error or fraud.

**4.6 Auditor's Enhanced Reporting to Investors:** Auditors should provide a reasonable and balanced assurance on financial reporting matters to investors in narrative reports such as an Auditor's Discussion and Analysis (AD&A) or a Letter to the Shareowners. Enhanced reporting should include:

- a. Business, operational and risks believed to exist and considered;
- b. Assumptions used in judgments that materially affect the financial statements, and whether those assumptions are at the low or high end of the range of possible outcomes;
- c. Appropriateness of the accounting policies adopted by the company;

- d. Changes to accounting policies that have a significant impact on the financial statements;
- e. Methods and judgements made in valuing assets and liabilities;
- f. Unusual transactions;
- g. Accounting applications and practices that are uncommon to the industry;
- h. Identification of any matters in the Annual Report that the auditors believe are incorrect or inconsistent, with the information contained in the financial statements or obtained in the course of their audit;
- i. Audit issues and their resolution which the audit partner documents in a final audit memo to the Audit Committee;
- j. Quality and effectiveness of the governance structure and risk management;
- k. Completeness and reasonableness of the Audit Committee report.

**4.7 Non-Audit Fees:** Non-audit, consulting services can impair the objectivity of the auditor. The board, through its independent Audit Committee, should ensure that excessive non-audit fees are prohibited. The Audit Committee should explain why individual non-audit service engagements were provided by the company's independent auditor rather than by another party and how the auditor's independence is safeguarded. To limit the risk of possible conflicts of interest and independence of the auditor, non-audit services and fees paid to auditors for non-audit services should both be approved in advance by the Audit Committee and disclosed in the proxy statement on an annual basis.

**4.8 Auditor Independence:** The Audit Committee should assess the independence of the external auditing firm on an annual basis. Prior to acceptance of an external auditor engagement, the Audit Committee should require written disclosure from the external auditor of:

- a. all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit clients or persons in a financial reporting oversight role that may have a bearing on independence;
- b. the potential effects of these relationships on the independence in both appearance and fact of the registered public accounting firm;
- c. the substance of the registered accounting firm's discussion with the audit committee.

**4.9 Assertion of Internal Financial Controls:** The Audit Committee should require the auditor's opinion to include commentary on any management assertion that the system of internal financial controls is operating effectively and efficiently, that assets are safeguarded, and that financial information is reliable as of a specific date, based on a specific integrated framework of internal controls.

**4.10 Audit Committee Oversight:** To ensure the integrity of audited financial statements, the corporation's interaction with the external auditor should be overseen by the audit committee on behalf of shareowners.



- 4.11 Audit Committee Expertise:** Audit committee financial expertise at a minimum should include skill-sets as outlined by Section 407(d)(5)(i) of Regulation S-K and the Exchange listing requirements. Boards should consider the effectiveness of the audit committee and designated financial expert(s) in its annual assessment. Firms may be able to reduce their cost of capital as related to the quality of its financial reporting. The quality of financial reporting can be increased by appropriately structuring the audit committee with effective financial expertise.
- 4.12 Auditor Liability:** To strengthen the auditor's objective and unbiased audit of financial reporting, audit committees should ensure that contracts with the auditor do not contain specific limits to the auditor's liability to the company for consequential damages or require the corporation to use alternative dispute resolution.
- 4.13 Auditor Selection:** Audit committees should promote expanding the pool of auditors considered for the annual audit to help improve market competition and thereby minimize the concentration of only a small number of audit firms from which to engage for audit services. To allow audit committees a robust foundation to determine audit firm independence, auditors should provide 3 prior years of activities, relationships, and services (including tax services) with the company, affiliates of the company and persons in financial reporting oversight roles that may impact the independence of the audit firm.
- 4.14 Auditor Rotation:** Audit committees should promote rotation of the auditor to ensure a fresh perspective and review of the financial reporting framework.
- 4.15 Audit Committee Disclosures:** Disclosure regarding the content of Audit Committee discussions with external auditors provide better transparency, enhance audit quality and benefits investors. On an annual basis, the Audit Committee should be responsible for disclosing:
- a. Assessment of the independence and objectivity of the external auditor to assure the auditors and their staff have no financial, business, employment or family and other personal relationships with the company;
  - b. Assessment of the appropriateness of total fees charged by the auditors;
  - c. Assessment of non-audit services and fees charged including limitations or restrictions tied to the provision of non-audit services;
  - d. Explanation of why non-audit services were provided by the auditor rather than by another party and how the auditor's independence has been safeguarded;
  - e. Rationale for recommending the appointment, reappointment or removal of the external auditor including information on tendering frequency, tenure, and any contractual obligations that acted to restrict the choice of external auditors;
  - f. Auditor rotation period;
  - g. Assessment of issues which resulted in auditor resignation.

**4.16 Audit Committee Communication with Auditor:** The auditor should articulate to the Audit Committee, risks and other matters arising from the audit that are significant to the oversight of the financial reporting process, including situations where the auditor is aware of disputes or concerns raised regarding accounting or auditing matters. The Audit Committee should consider providing to investors a summary document of its discussions with auditors to enhance investor confidence in the audit process.

## **5. Risk Oversight**

In response to the turmoil in the financial markets and economic uncertainties, CalPERS has elevated the importance of risk oversight and management. The primary goal is to ensure companies adopt policies, operating procedures, reporting, and decision-making protocols to effectively manage, evaluate, and mitigate risk. The ultimate outcome is to ensure that companies function as "risk intelligent" organizations. CalPERS recommends the following:

- 5.1** The board is ultimately responsible for a company's risk management philosophy, organizational risk framework and oversight. The board should be comprised of skilled directors with a balance of broad business experience and extensive industry expertise to understand and question the breadth of risks faced by the company. Risk management should be considered a priority and sufficient time should be devoted to oversight.
- 5.2** The company should promote a risk-focused culture and a common risk management framework should be used across the entire organization. Frequent and meaningful communication should be considered the "cornerstone" for an effective risk framework. A robust risk framework will facilitate communication across business units, up the command chain and to the board.
- 5.3** The board should set out specific risk tolerances and implement a dynamic process that continuously evaluates and prioritizes risks. An effective risk oversight process considers both internal company related risks such as operational, financial, credit, liquidity, corporate governance, cyber-security, environmental, reputational, social, and external risks such as industry related, systemic, and macro economic.
- 5.4** Executive compensation practices should be evaluated to ensure alignment with the company's risk tolerances and that compensation structures do not encourage excessive risk taking.
- 5.5** At least annually, the board should approve a documented risk management plan and disclose sufficient information to enable shareowners to assess whether the board is carrying out its risk oversight responsibilities. Disclosure should also include the role of external parties such as third-party consultants in the risk management process.

**5.6** While the board is ultimately responsible for risk oversight, executive management should be charged with designing, implementing and maintaining an effective risk program. Roles and reporting lines related to risk management should be clearly defined. At a minimum, the roles and reporting lines should be explicitly set out for the board, board risk committees, chief executive officer, chief financial officer, the chief risk officer, and business unit heads. The board and risk related committees should have appropriate transparency and visibility into the organization's risk management practices to carry out their responsibilities.

## **6. Corporate Responsibility**

CalPERS believes that boards that strive for active cooperation between corporations and stakeholders<sup>20</sup> will be most likely to create wealth, employment and sustainable economies. With adequate, accurate and timely data disclosure of environmental, social, and governance practices, shareowners are able to more effectively make investment decisions by taking into account those practices of the companies in which the System invests. Therefore, CalPERS recommends the following:

**6.1 Environmental Disclosure:** To ensure sustainable long-term returns, companies should provide accurate and timely disclosure of environmental risks and opportunities through adoption of policies or objectives, such as those associated with climate change. Companies should apply the Global Framework for Climate Risk Disclosure<sup>21</sup> (Appendix G) when providing such disclosure. The 14 point Ceres Climate Change Governance Checklist (Appendix H) is recommended as a tool by companies to assist in the application of the Global Framework for Climate Risk Disclosure.

**6.2 Sustainable Corporate Development:** Corporations strive to measure, disclose, and be accountable to internal and external stakeholders for organizational performance towards the goal of sustainable development. It is recommended that corporations adopt the Global Reporting Initiative Sustainability Reporting Guidelines<sup>22</sup> to disclose economic, environmental, and social impacts.

**6.3 Reincorporation:** When considering reincorporation, corporations should analyze shareowner protections, company economic, capital market, macro economic, and corporate governance considerations.

**6.4 Charitable and Political Contributions:** Robust board oversight and disclosure of corporate charitable and political activity is needed to ensure alignment with business

<sup>20</sup> In accordance with the Global Reporting Initiative: Stakeholders are defined broadly as those groups or individuals: (a) that can reasonably be expected to be significantly affected by the organization's activities, products, and/or services; or (b) whose actions can reasonably be expected to affect the ability of the organization to successfully implement its strategies and achieve its objectives.

<sup>21</sup> Additional information on the Framework and a Guide for Using the Global Framework for Climate Risk Disclosure is available on the CalPERS website: [www.calpers-governance.org](http://www.calpers-governance.org).

<sup>22</sup> Adoption of the Guidelines will provide companies with a reporting mechanism through which to disclose, at a minimum, implementation of the Global Sullivan Principles and the Global Framework for Climate Risk Disclosure. The Guidelines along with additional information on GRI can be found at [www.globalreporting.org](http://www.globalreporting.org).

strategy and to protect assets on behalf of shareowners. We recommend the following:

- a. **Policy:** The board should develop and disclose a policy that outlines the board's role in overseeing corporate charitable and political contributions, the terms and conditions under which charitable and political contributions are permissible, and the process for disclosing charitable and political contributions annually.
- b. **Board Monitoring, Assessment and Approval:** The board of directors should monitor charitable and political contributions (including trade association contributions directed for lobbying purposes) made by the company. The board should ensure that only contributions consistent with and aligned to the interests of the company and its shareowners are approved.
- c. **Disclosure:** The board should disclose on an annual basis the amounts and recipients of monetary and non-monetary contributions made by the company during the prior fiscal year. If any expenditure earmarked or used for political or charitable activities were provided to or through a third-party to influence elections of candidates or ballot measures or governmental action, then those expenditures should be included in the report.

## 7. Shareowner Rights

Shareowner rights<sup>23</sup> – or those structural devices that define the formal relationship between shareowners and the directors to whom they delegate corporate control – should be featured in the governance principles adopted by corporate boards. Therefore, CalPERS recommends that corporations adopt the following shareowner rights:

**7.1 Majority Vote Requirements:** Shareowner voting rights should not be subject to supermajority voting requirements. A majority of proxies cast should be able to:

- a. Amend the company's governing documents such as the Bylaws and Charter by shareowner resolution.
- b. Remove a director with or without cause.

**7.2 Majority Vote Standard for Director Elections:** In an uncontested director election, a majority of proxies cast should be required to elect a director. In a contested election, a plurality of proxies cast should be required to elect a director. Resignation for any director that receives a withhold vote greater than 50% of the votes cast should be required. Unless the incumbent director receiving less than a majority of the votes cast has earlier resigned, the term of the incumbent director should not exceed 90 days after the date on which the voting results are determined.

<sup>23</sup> Lucian Bebchuk, Alma Cohen, and Allen Ferrell, "What matters in Corporate Governance," (2004), The John M. Olin Center for Law, Economics and Business of Harvard University: Found that portfolios of companies with strong shareowner-rights protections outperformed portfolios of companies with weaker protections by 8.5% per year.

- 7.3 Universal Proxy:** To facilitate the shareowner voting process in contested elections – opposing sides engaged in the contest should utilize a proxy card naming all management nominees and all dissident nominees, providing every nominee equal prominence on the proxy card.
- 7.4 Special Meetings and Written Consent:** Shareowners should be able to call special meetings or act by written consent.
- 7.5 Sponsoring and Implementation of Shareowner Resolutions:** Shareowners should have the right to sponsor resolutions. A shareowner resolution that is approved by a majority of proxies cast should be implemented by the board.
- 7.6 Prohibit Greenmail:** Every company should prohibit greenmail.
- 7.7 Poison Pill Approval:** No board should enact nor amend a poison pill except with shareowner approval.
- 7.8 Annual Director Elections:** Every director should be elected annually.
- 7.9 Proxy Confidentiality:** Proxies should be kept confidential from the company, except at the express request of shareowners.
- 7.10 Broker Non-Votes:** Broker non-votes should be counted for quorum purposes only.
- 7.11 Cumulative Voting Rights:** Shareowners should have the right to cumulate<sup>24</sup> votes in a contested election of directors.

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<sup>24</sup> Such a right gives shareowners the ability to aggregate their votes for directors and either cast all of those votes for one candidate or distribute those votes for any number of candidates.

## C. International Principles

For companies not domiciled in the United States nor trade on U.S. stock exchanges, CalPERS advocates the expansion of the Core Principles into the International Principles, as adopted by the International Corporate Governance Network ("ICGN"). As a founding member of ICGN, CalPERS believes the ICGN Global Principles represent an evolving framework for accountable corporate governance to be applied outside of the United States. In addition to encouraging portfolio companies to adopt these principles, CalPERS implements its international corporate governance initiatives and proxy voting responsibilities in a manner that is consistent with the ICGN Global Principles.

The ICGN Global Principles<sup>25</sup> are as follows:

### Section A: Board

#### 1. Responsibilities

- 1.1 **Duties:** The board should act on an informed basis and in the best long term interests of the company with good faith, care and diligence, for the benefit of shareholders, while having regard to relevant stakeholders.
- 1.2 **Responsibilities:** The board is accountable to shareholders and relevant stakeholders and responsible for protecting and generating sustainable value over the long term. In fulfilling their role effectively, board members should:
  - a. guide, review and approve corporate strategy and financial planning, including major capital expenditures, acquisitions and divestments;
  - b. monitor the effectiveness of the company's governance practices, environmental practices, and social practices, and adhere to applicable laws;
  - c. embody high standards of business ethics and oversee the implementation of codes of conduct that engender a corporate culture of integrity;
  - d. oversee the management of potential conflicts of interest, such as those which may arise around related party transactions;
  - e. oversee the integrity of the company's accounting and reporting systems, its compliance with internationally accepted standards, the effectiveness of its systems of internal control, and the independence of the external audit process;
  - f. oversee the implementation of effective risk management and proactively review the risk management approach and policies annually or with any significant business change;
  - g. ensure a formal, fair and transparent process for nomination, election and evaluation of directors;
  - h. appoint and, if necessary, remove the chief executive officer (CEO) and develop succession plans;
  - i. align CEO and senior management remuneration with the longer term interests of the company and its shareholders; and
  - j. conduct an objective board evaluation on a regular basis, consistently seeking to

<sup>25</sup> The ICGN Global Governance Principles were revised and ratified by membership in 2014. The Principles along with additional information on ICGN can be found at [www.icgn.org](http://www.icgn.org).

enhance board effectiveness.

- 1.3 **Dialogue:** The board should make available communication channels for periodic dialogue on governance matters with shareholders and stakeholders as appropriate. Boards should clearly explain such procedures to shareholders including guidance relating to compliance with disclosure and other relevant market rules.
- 1.4 **Commitment:** The board should meet regularly to discharge its duties and directors should allocate adequate time to board meeting preparation and attendance. Board members should know the business, its operations and senior management well enough to contribute effectively to board discussions and decisions.
- 1.5 **Directorships:** The number, and nature, of board appointments an individual director holds (particularly the chair and executive directors) should be carefully considered and reviewed on a regular basis and the degree to which each individual director has the capacity to undertake multiple directorships should be clearly disclosed.
- 1.6 **Induction:** The board should have in place a formal process of induction for all new directors so that they are well-informed about the company as soon as possible after their appointment. Directors should also be enabled to regularly refresh their skills and knowledge to discharge their responsibilities.
- 1.7 **Committees:** The board should establish committees to deliberate on issues such as audit, remuneration and nomination. Where the board chooses not to establish such committees, the board should disclose the fact and the procedures it employs to discharge its duties and responsibilities effectively.
- 1.8 **Advice:** The board should receive advice on its responsibilities under relevant law and regulation, usually from the company secretary or an in-house general counsel. In addition, the board should have access to independent advice as appropriate and at the company's expense.

## **2. Leadership and Independence**

- 2.1 **Chair and CEO:** The board should have independent leadership. There should be a clear division of responsibilities between the chairmanship of the board and the executive management of the company's business.
- 2.2 **Lead Independent Director:** The chair should be independent on the date of appointment. If the chair is not independent, the company should adopt an appropriate structure to mitigate any potential challenges arising from this, such as the appointment of a lead independent director. The board should explain the reasons why this leadership structure is appropriate and keep the structure under review. A lead independent director also provides shareholders and directors with a valuable channel of communication should they wish to discuss concerns relating to the chair.

- 2.3 Succession:** If, exceptionally, the board decides that a CEO should succeed to become chair, the board should communicate appropriately with shareholders in advance setting out a convincing rationale and provide detailed explanation in the annual report. Unless extraordinary circumstances exist there should be a break in service between the roles, (e.g. a period of two years).
- 2.4 Effectiveness:** The chair is responsible for leadership of the board and ensuring its effectiveness. The chair should ensure a culture of openness and constructive debate that allows a range of views to be expressed. This includes setting an appropriate board agenda and ensuring adequate time is available for discussion of all agenda items. There should also be opportunities for the board to hear from an appropriate range of senior management.
- 2.5 Independence:** The board should identify in the annual report the names of the directors considered by the board to be independent and who are able to exercise independent judgement free from any external influence. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:
- a. is or has been employed in an executive capacity by the company or a subsidiary and there has not been an appropriate period between ceasing such employment and serving on the board;
  - b. is or has within an appropriate period been a partner, director or senior employee of a provider of material professional or contractual services to the company or any of its subsidiaries;
  - c. receives or has received additional remuneration from the company apart from a director's fee, participates in the company's share option plan or a performance-related pay scheme, or is a member of the company's pension scheme;
  - d. has or had close family ties with any of the company's advisers, directors or senior management;
  - e. holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
  - f. is a significant shareholder of the company, or an officer of, or otherwise associated with, a significant shareholder of the company;
  - g. is or has been a nominee director as a representative of minority shareholders or the state;
  - h. has been a director of the company for such a period that his or her independence may have become compromised.
- 2.6 Independent Meetings:** The chair should regularly hold meetings with the non-executive directors without executive directors present. In addition, the non-executive directors (led by the lead independent director) should meet as appropriate, and at least annually, without the chair present.



### **3. Composition and Appointment**

- 3.1 Composition:** The board should comprise a majority of non-executive directors, the majority of whom are independent, noting that practice may legitimately vary from this standard in controlled companies where a critical mass of the board is preferred to be independent. There should be a sufficient mix of individuals with relevant knowledge, independence, competence, industry experience and diversity of perspectives to generate effective challenge, discussion and objective decision-making.
- 3.2 Diversity:** The board should disclose the company's policy on diversity which should include measurable targets for achieving appropriate diversity within its senior management and board (both executive and non-executive) and report on progress made in achieving such targets.
- 3.3 Tenure:** Non-executive directors should serve for an appropriate length of time to properly serve the board without compromising the independence of the board. The length of tenure of each director should be reviewed regularly by the nomination committee to allow for board refreshment and diversity.
- 3.4 Appointment Process:** The board should disclose the process for director nomination and election / re-election along with information about board candidates which includes:
- a. board member identities and rationale for appointment;
  - b. core competencies, qualifications, and professional background;
  - c. recent and current board and management mandates at other companies, as well as significant roles on non-profit/ charitable organisations;
  - d. factors affecting independence, including relationship/s with controlling shareholders;
  - e. length of tenure;
  - f. board and committee meeting attendance; and
  - g. any shareholdings in the company.
- 3.5 Nominations:** The board should ensure that shareholders are able to nominate candidates for board appointment. Such candidacies should be proposed to the appropriate board committee and, subject to an appropriate nomination threshold, be nominated directly on the company's proxy.
- 3.6 Elections:** Board members should be conscious of their accountability to shareholders. Accountability mechanisms may require directors to stand for election on an annual basis or to stand for election at least once every three years. Shareholders should have a separate vote on the election of each director, with each candidate approved by a simple majority of shares voted.
- 3.7 Evaluation:** The nomination committee should evaluate the process for a rigorous review of the performance of the board, the company secretary (where such a position exists), the board's committees and individual directors prior to being proposed for re-election. The board should also periodically (preferably every three years) engage an independent outside consultant to undertake the evaluation. The

non-executive directors, led by the lead independent director, should be responsible for performance evaluation of the chair, taking into account the views of executive officers. The board should disclose the process for evaluation and, as far as reasonably possible, any material issues of relevance arising from the conclusions and any action taken as a consequence.

**3.8 Nomination Committee:** The board should establish a nomination committee comprised of non-executive directors, the majority of whom are independent. The main role and responsibilities of the nomination committee should be described in the committee's terms of reference. This includes:

- a. developing a skills matrix, by preparing a description of the desired roles, experience and capabilities required for each appointment, and then evaluating the composition of the board.
- b. leading the process for board appointments and putting forward recommendations to shareholders on directors to be elected and re-elected;
- c. upholding the principle of director independence by addressing conflicts of interest (and potential conflicts of interest) among committee members and between the committee and its advisors during the nomination process;
- d. considering and being responsible for the appointment of independent consultants for recruitment or evaluation including their selection and terms of engagement and publically disclosing their identity and consulting fees; and
- e. entering into dialogue with shareholders on the subject of board nominations either directly or via the board; and
- f. board succession planning.

#### **4. Corporate Culture**

**4.1 Codes of Conduct/Ethics:** The board should adopt high standards of business ethics through codes of conduct/ethics (or similar instrument) and oversee a culture of integrity, notwithstanding differing ethical norms and legal standards in various countries. This should permeate all aspects of the company's operations, ensuring that its vision, mission and objectives are ethically sound and demonstrative of its values. Codes should be effectively communicated and integrated into the company's strategy and operations, including risk management systems and remuneration structures.

**4.2 Bribery and Corruption:** The board should ensure that management has implemented appropriately stringent policies and procedures to mitigate the risk of bribery and corruption or other malfeasance. Such policies and procedures should be communicated to shareholders and other interested parties.

**4.3 Whistleblowing:** The board should ensure that the company has in place an independent, confidential mechanism whereby an employee, supplier or other stakeholder can (without fear of retribution) raise issues of particular concern with regard to potential or suspected breaches of a company's code of ethics or local law.

- 4.4 Political Lobbying:** The board should have a policy on political engagement, covering lobbying and donations to political causes or candidates where allowed under law, and ensure that the benefits and risks of the approach taken are understood, monitored, transparent and regularly reviewed.
- 4.5 Employee Share Dealing:** The board should develop clear rules regarding any trading by directors and employees in the company's own securities. Individuals should not benefit directly or indirectly from knowledge which is not generally available to the market.
- 4.6 Behavior and Conduct:** The board should foster a corporate culture which ensures that employees understand their responsibility for appropriate behavior. There should be appropriate board level and staff training in all aspects relating to corporate culture and ethics. Due diligence and monitoring programs should be in place to enable staff to understand relevant codes of conduct and apply them effectively to avoid company involvement in inappropriate behavior.

## **5. Risk Oversight**

- 5.1 Proactive Oversight:** The board should proactively oversee, review and approve the approach to risk management regularly or with any significant business change and satisfy itself that the approach is functioning effectively. Strategy and risk are inseparable and should permeate all board discussions and, as such, the board should consider a range of plausible outcomes that could result from its decision-making and actions needed to manage those outcomes.
- 5.2 Comprehensive Approach:** The board should adopt a comprehensive approach to the oversight of risk which includes all material aspects of risk including financial, strategic, operational, environmental, and social risks (including political and legal ramifications of such risks), as well as any reputational consequences.
- 5.3 Risk Culture:** The board should lead by example and foster an effective risk culture that encourages openness and constructive challenge of judgements and assumptions. The company's culture with regard to risk and the process by which issues are escalated and de-escalated within the company should be evaluated at intervals as appropriate to the situation.
- 5.4 Dynamic Process:** The board should ensure that risk is appropriately reflected in the company's strategy and capital allocation. Risk should be managed accordingly in a rational, appropriately independent, dynamic and forward-looking way. This process of managing risks should be continual and include consideration of a range of plausible impacts.
- 5.5 Risk Committee:** While ultimate responsibility for a company's risk management approach rests with the full board, having a risk committee (be it a stand-alone risk committee, a combined risk committee with nomination and governance, strategy, audit or other) can be an effective mechanism to bring the transparency, focus and independent judgment needed to oversee the company's risk management approach.

## **6. Remuneration**

- 6.1 **Alignment:** Remuneration should be designed to effectively align the interests of the CEO and executive officers with those of the company and its shareholders. Remuneration should be reasonable and equitable and the quantum should be determined within the context of the company as a whole.
- 6.2 **Performance:** Performance measurement should integrate risk considerations so that there are no rewards for taking inappropriate risks at the expense of the company and its shareholders. Performance related elements should be rigorous and measured over timescales, and with methodologies, which help ensure that performance pay is directly correlated with sustained value creation. Companies should include provisions in their incentive plans that enable the company to with-hold the payment of any sum, or recover sums paid ('clawback'), in the event of serious misconduct or a material misstatement in the company's financial statements.
- 6.3 **Disclosure:** The board should disclose a clear, understandable and comprehensive remuneration policy which is aligned with the company's long-term strategic objectives. The remuneration report should also describe how awards granted to individual directors and the CEO were determined and deemed appropriate in the context of the company's underlying performance in any given year. This extends to non-cash items such as director and officer insurance, fringe benefits and terms of severance packages if any.
- 6.4 **Share Ownership:** The board should disclose the company policy concerning ownership of shares by the CEO and executive officers. This should include the company policy as to how share ownership requirements are to be achieved and for how long they are to be retained. The use of derivatives or other structures that enable the hedging of an individual's exposure to the company's shares should be discouraged.
- 6.5 **Shareholder Approval:** Shareholders should have an opportunity to vote on the remuneration policies, particularly where significant change to remuneration structures is proposed or where significant numbers of shareholders have opposed a remuneration resolution. In particular, share-based remuneration plans should be subject to shareholder approval before being implemented.
- 6.6 **Employee Incentives:** The board should ensure that the development of remuneration structures for company employees reinforce, and do not undermine, sustained value creation. Performance-based remuneration for staff should incorporate risk, including measuring risk-adjusted returns, to help ensure that no inappropriate or unintended risks are being incentivized. While a major component of most employee incentive remuneration is likely to be cash-based, these programs should be designed and implemented in a manner consistent with the company's long-term performance drivers.
- 6.7 **Non-Executive Director Pay:** The board should ensure that pay for a non-executive director and/or a non-executive chair is structured in a way which ensures

independence, objectivity, and alignment with shareholders' interests. Performance-based pay should not be granted to non-executive directors and non-executive chairs.

**6.8 Remuneration Committee:** The board should establish a remuneration committee comprised of non-executive directors, the majority of whom are independent. The main role and responsibilities of the remuneration committee should be described in the committee terms of reference. This includes:

- a. determining and recommending to the board the remuneration philosophy and policy of the company;
- b. designing, implementing, monitoring and evaluating short-term and long-term share-based incentives and other benefits schemes including pension arrangements, for all executive officers;
- c. ensuring that conflicts of interest among committee members and between the committee and its advisors are avoided;
- d. appointing any independent remuneration consultant including their selection and terms of engagement and disclosing their identity and consulting fees; and
- e. maintaining appropriate communication with shareholders on the subject of remuneration either directly or via the board.

## **7. Reporting and Audit**

**7.1 Comprehensive Disclosure:** The board should present a balanced and understandable assessment of the company's position and prospects in the annual report and accounts in order for shareholders to be able to assess the company's performance, business model, strategy and long-term prospects.

**7.2 Materiality:** The board should disclose relevant and material information on a timely basis so as to allow shareholders to take into account information which assists in identifying risks and sources of wealth creation. Issues material to shareholders should be set out succinctly in the annual report, or equivalent disclosures, and approved by the board itself.

**7.3 Affirmation:** The board should affirm that the company's annual report and accounts present a true and fair view of the company's position and prospects. As appropriate, taking into account statutory and regulatory obligations in each jurisdiction, the information provided in the annual report and accounts should:

- a. be relevant to investment decisions, enabling shareholders to evaluate risks, past and present performance, and to draw inferences regarding future performance;
- b. enable shareholders, who put up the risk capital, to fulfil their responsibilities as owners to assess company management and the strategies adopted;
- c. be a faithful representation of the events it purports to represent;
- d. generally be neutral and report activity in a fair and unbiased way except where there is uncertainty. Prudence should prevail such that assets and income are not overstated and liabilities and expenses are not understated. There should be substance over form. Any off-balance sheet items should be appropriately disclosed;
- e. be verifiable so that when a systematic approach and methodology is used the

- same conclusion is reached;
- f. be presented in a way that enables comparisons to be drawn of both the entity's performance over time and against other entities; and
  - g. recognize the 'matching principle' which requires that expenses are matched with revenues.
- 7.4 Solvency Risk:** The board should confirm in the annual report that it has carried out a robust assessment of the state of affairs of the company and any material risks, including to its solvency and liquidity that would threaten its viability. The board should state whether, in its opinion, the company will be able to meet its liabilities as they fall due and continue in operation for the foreseeable future, explaining any supporting assumptions and risks or uncertainties relevant to that and how they are being managed. In particular, disclosure on risk should include a description of:
- a. risk in the context of the company's strategy;
  - b. risk to returns expected by shareholders with a focus on key consequences;
  - c. risk oversight approach and processes;
  - d. how lessons learnt have been applied to improve future outcomes; and
  - e. the principal risks to the company's business model and the achievement of its strategic objectives, including risks that could threaten its viability.
- 7.5 Non-Financial Information:** The board should provide an integrated report that puts historical performance into context, and portrays the risks, opportunities and prospects for the company in the future, helping shareholders understand a company's strategic objectives and its progress towards meeting them. Such disclosures should:
- a. be linked to the company's business model;
  - b. be genuinely informative and include forward-looking elements where this will enhance understanding;
  - c. describe the company's strategy, and associated risks and opportunities, and explain the board's role in assessing and overseeing strategy and the management of risks and opportunities;
  - d. be accessible and appropriately integrated with other information that enables shareholders to obtain a picture of the whole company;
  - e. use key performance indicators that are linked to strategy and facilitate comparisons;
  - f. use objective metrics where they apply and evidence-based estimates where they do not; and
  - g. be strengthened where possible by independent assurance that is carried out annually having regard to established disclosure standards.
- 7.6 Internal Controls:** The board should oversee the establishment and maintenance of an effective system of internal control which should be measured against internationally accepted standards of internal audit and tested periodically for its adequacy. Where an internal audit function has not been established, full reasons for this should be disclosed in the annual report, as well as an explanation of how adequate assurance of the effectiveness of the system of internal controls has been obtained.

- 7.7 Independent External Audit:** The board should publish the report from the external auditor which should provide an independent and objective opinion whether the accounts give a true and fair view of the financial position and performance of the company. The engagement partner should be named in the audit report and the company should publish its policy on audit firm rotation. If the auditor resigns then the reasons for the resignation should be publicly disclosed by the resigning auditor.
- 7.8 Non-Audit Fees:** The audit committee should, as far as practicable, approve any non-audit services provided by the external auditor and related fees to ensure that they do not compromise auditor independence. The non-audit fees should be disclosed in the annual report with explanations where appropriate. Non-audit fees should normally be less than the audit fee and, if not, there should be a clear explanation as to why it was necessary for the auditor to provide these services and how the independence and objectivity of the audit was assured.
- 7.9 Audit Committee:** The board should establish an audit committee comprised of non-executive directors, the majority of whom are independent. At least one member of the audit committee should have recent and relevant financial experience. The chair of the board should not be the chair of the audit committee, other than in exceptional circumstances which should be explained in the annual report. The main role and responsibilities of the audit committee should be described in the committee's terms of reference. This includes:
- a. monitoring the integrity of the accounts and any formal announcements relating to the company's financial performance, and reviewing significant financial reporting judgments contained in them;
  - b. maintaining oversight of key accounting policies and accounting judgments which should be in accordance with generally accepted international accounting standards, and disclosing such policies in the notes to the company's accounts;
  - c. agreeing the minimum scope of the audit as prescribed by applicable law and any further assurance that the company needs. Shareholders (who satisfy a reasonable threshold shareholding) should have the opportunity to expand the scope of the forthcoming audit or discuss the results of the completed audit should they wish to;
  - d. assuring itself of the quality of the audit carried out by the external auditors and assessing the effectiveness and independence of the auditor each year. This includes overseeing the appointment, reappointment and, if necessary, the removal of the external auditor and the remuneration of the auditor. There should be transparency in advance when the audit is to be tendered so that shareholders can engage with the company in relation to the process should they so wish;
  - e. having appropriate dialogue with the external auditor without management present and overseeing the interaction between management and the external auditor, including reviewing the management letter provided by the external auditors and overseeing management's response; and
  - f. reporting on its work and conclusions in the annual report.

## **8. General meetings**

- 8.1 Shareholder Identification:** The board should ensure that the company maintains a record of the registered owners of its shares or those holding voting rights over its shares. Registered shareholders, or their agents, should provide the company (where anonymity rules do not preclude this) with the identity of beneficial owners or holders of voting rights when requested in a timely manner. Shareholders should be able to review this record of registered owners of shares or those holding voting rights over shares.
- 8.2 Notice:** The board should ensure that the general meeting agenda is posted on the company's website at least one month prior to the meeting taking place. The agenda should be clear and properly itemized and include the date and location of the meeting as well as information regarding the issues to be decided at the meeting.
- 8.3 Vote Deadline:** The board should clearly publicize a date by which shareholders should cast their voting instructions. The practice of share blocking or requirements for lengthy share holdings should be discontinued.
- 8.4 Vote Mechanisms:** The board should promote efficient and accessible voting mechanisms that allow shareholders to participate in general meetings either in person or remotely, preferably by electronic means or by post, and should not impose unnecessary hurdles.
- 8.5 Vote Disclosure:** The board should ensure that equal effect is given to votes whether cast in person or in absentia and all votes should be properly counted and recorded via ballot. The outcome of the vote, the vote instruction (reported separately for, against or abstain) and voting levels for each resolution should be published promptly after the meeting on the company website. If a board-endorsed resolution has been opposed by a significant proportion of votes, the company should explain subsequently what actions were taken to understand and respond to the concerns that led shareholders to vote against the board's recommendation.

## **9. Shareholder rights**

- 9.1 Share Classes:** The board should disclose sufficient information about the material attributes of all of the company's classes and series of shares on a timely basis. Ordinary or common shares should feature one vote for each share. Divergence from a 'one-share, one-vote' standard which gives certain shareholders power disproportionate to their economic interests should be disclosed and explained. Dual class share structures should be kept under review and should be accompanied by commensurate extra protections for minority shareholders, particularly in the event of a takeover bid.
- 9.2 Major decisions:** The board should ensure that shareholders have the right to vote on major decisions which may change the nature of the company in which they have invested. Such rights should be clearly described in the company's governing documents and include:



- a. amendments to governing documents of the company such as articles or by-laws;
- b. company share repurchases (buy-backs);
- c. any new share issues. The board should be mindful of dilution of existing shareholders and provide full explanations where pre-emption rights are not offered;
- d. shareholder rights plans ('poison pills') or other structures that act as anti-takeover mechanisms. Only non-conflicted shareholders should be entitled to vote on such plans and the vote should be binding. Plans should be time limited and put periodically to shareholders for re-approval;
- e. proposals to change the voting rights of different series and classes of shares;
- f. material and extraordinary transactions such as mergers and acquisitions.

**9.3 Conflicts of Interest:** The board should ensure that policies and procedures on conflicts of interest are established, understood and implemented by directors, management, employees and other relevant parties. If a director has an interest in a matter under consideration by the board, then the director should promptly declare such an interest and be precluded from voting on the subject or exerting influence.

**9.4 Related party transactions:** The board should disclose the process for reviewing and monitoring related party transactions which, for significant transactions, includes establishing a committee of independent directors. This can be a separate committee or an existing committee comprised of independent directors, for example the audit committee. The committee should review significant related party transactions to determine whether they are in the best interests of the company and, if so, to determine what terms are fair and reasonable. The conclusion of committee deliberations on significant related party transactions should be disclosed in the company's annual report to shareholders.

**9.5 Shareholder Approval:** Shareholders should have the right to approve significant related party transactions and this should be based on the approval of a majority of disinterested shareholders. The board should submit the transaction for shareholder approval and disclose (both before concluding the transaction and in the company's annual report):

- a. the identity of the ultimate beneficiaries including, any controlling owner and any party affiliated with the controlling owner with any direct / indirect ownership interest in the company;
- b. other businesses in which the controlling shareholder has a significant interest; and
- c. shareholder agreements (e.g. commitments to related party payments such as license fees, service agreements and loans).

**9.6 Shareholder Questions:** The board should allow a reasonable opportunity for the shareholders as a whole at a general meeting to ask questions about or make comments on the management of the company, and to ask the external auditor questions related to the audit.

- 9.7 Shareholder Resolutions:** The board should ensure that shareholders have the right to place items on the agenda of general meetings, and to propose resolutions subject to reasonable limitations. Shareholders should be enabled to work together to make such a proposal.
- 9.8 Shareholder Meetings:** The board should ensure that shareholders, of a specified portion of its outstanding shares or a specified number of shareholders, have the right to call a meeting of shareholders for the purpose of transacting the legitimate business of the company.
- 9.9 Thresholds:** Any threshold associated with shareholder resolutions, shareholder proposals or other such participation, should balance the need to ensure the matter under consideration is likely to be of importance to all shareholders and not only a small minority.
- 9.10 Equality and Redress:** The board should ensure that shareholders of the same series or class are treated equally and afforded protection against abusive or oppressive conduct by the company or its management, including market manipulation, false or misleading information, material omissions and insider trading. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress. Proper remedies and procedural rules should be put in place to make the protection effective and affordable. Where national legal remedies are not afforded the board is encouraged to ensure that sufficient shareholder protections are provided in the company's bylaws.

## **Section B: Institutional Investors**

### **1. Responsibilities**

#### **1.1 Duties:**

- a. Institutional investors should focus on delivering value by promoting and safeguarding the interests of beneficiaries or clients over an appropriate time-horizon. This is often expressed as a fiduciary duty, requiring prudence, care and loyalty on the part of all agents which are subject to such obligations.
- b. Asset owners should actively consider which of their agents should be subject to the strictures of fiduciary duty and if such requirements are not applied what lower standards of behavior are appropriate. Asset owners cannot delegate their underlying fiduciary duties. Even when they employ agents to act on their behalf, asset owners need to ensure through contracts or by other means that the responsibilities of ownership are appropriately and fully delivered in their interests and on their behalf by those agents, who are to be held to account for doing so.
- c. While different agents in the investment chain play different roles, each should focus on the needs of its beneficiaries or clients such that it is always seeking to deliver value over their required time-horizon. Benchmarks for measuring success should be tailored to the needs and risk exposures of beneficiaries or clients, with reporting designed to provide them with an understanding of success toward meeting those needs and managing related risks, in addition (as relevant) to providing applicable market-relative performance numbers.

**1.2 Responsibilities:** Asset owners should fully align the interests of their fund managers with their own obligations to beneficiaries by setting out their expectations in fund management contracts (or similar instruments) to ensure that the responsibilities of ownership are appropriately and fully delivered in their interests. This should include:

- a. ensuring that the timescales over which investment risk and opportunity are considered match those of the client;
- b. setting out an appropriate internal risk management approach so that material risks are managed effectively;
- c. effectively integrating relevant environmental, social and governance factors into investment decision-making and ongoing management;
- d. aligning interests effectively through appropriate fees and pay structures;
- e. where engagement is delegated to the fund manager, ensuring adherence to the highest standards of stewardship recognising a spectrum of acceptable stewardship approaches;
- f. ensuring commission processes and payments reward relevant and high quality research;
- g. ensuring that portfolio turnover is appropriate, in line with expectations and managed effectively; and
- h. providing appropriate transparency such that clients can gain confidence about all these issues.

**1.3 Reporting:** Institutional investors should adopt and disclose clearly stated, understandable and consistent policies to guide their approaches to stewardship and voting. Asset owners should report at least annually to those to whom they are accountable on their stewardship policy and its execution. Fund managers and other agents should seek a clear set of objectives and expectations from their clients and beneficiaries, in particular with regard to their investment time-horizon.

**1.4 Public Policy:** Institutional investors should engage as appropriate in the development of relevant public policy and good practice standards and be willing to encourage change where this is deemed helpful by beneficiaries or clients to the delivery of value over appropriate time horizons.

## **2. Leadership and independence**

**2.1 Oversight:** Institutional investors should be led by boards or other governance structures that act independently and without bias, advancing beneficiary or client interests as their primary obligation. Governing bodies, and where relevant, individuals in a fiduciary position of responsibility for ultimate investors, such as pension fund trustees and representative boards, should be aware of their primary oversight role.

**2.2 Constitution:** All decisions should be taken in the interests of the beneficiaries or clients. The governing bodies of investment institutions should therefore have a structure and constitution that reflects this and should be disclosed to beneficiaries and clients, together with explanations as to how such arrangements address

alignment with beneficiary interests. They should have mechanisms in place to solicit and receive ongoing feedback from beneficiaries and respond to their concerns.

**2.3 Review:** Institutional investors should also make use of regular independent reviews of their internal governance structures, and respond to any recommendations arising from them, to ensure that they meet expectations of accountability.

**2.4 Time horizons:** Governing bodies should clearly understand the objectives of their beneficiaries or clients, communicate such objectives to fund managers and other agents employed, and ensure they are being met. They should oversee the management of risk and the work of all their agents such that they deliver fully in the interests of the beneficiaries or clients over appropriate time-horizons. In considering what time-horizons are appropriate, institutional investors will need to consider the best interests of their clients and beneficiaries, and any issues of intergenerational fairness between them as well as where the ultimate risk-bearing lies. They should make clear which, if any, public or regulatory authorities have responsibility to monitor and enforce their fiduciary functioning.

**2.5 Appointments:** The way in which individuals are appointed to serve on the governing body should be disclosed to beneficiaries as well as the criteria that are applied to such appointments. Such criteria should always take account of the need for expertise and understanding of the matters for which the governing body is responsible. Governing bodies, particularly of institutional investors where the beneficiaries or clients face the underlying investment risk, should also include representatives of those beneficiaries or clients to build confidence in the collegiality of interests between them. They should reflect the diversity of interests of those whom they represent.

### **3. Capacity**

**3.1 Experience:** Institutional investors should be led by governing bodies and staff with the appropriate capacity and experience to oversee effectively and manage all relevant activities in the interests of beneficiaries or clients. Decision-makers along all parts of the investment chain should be appropriately resourced and meet relevant standards of experience and skill in matters subject to deliberation. All should have appropriate training and induction processes made available to them, and should be able to allocate sufficient time both to that training and induction and to ongoing decision-making.

**3.2 Advice:** Governing bodies should have the right to outside advice, independent from any received by the sponsoring body; they need to have the capacity critically and prudently to evaluate any advice received and to take appropriate decisions themselves, not simply defer to that advice. Fund managers and others in a similar agency position should deploy sufficient, qualified resources properly to deliver on clients' expectations. Institutional investors should be able to justify to beneficiaries or clients specific actions taken on their behalf whether by themselves or by their agents. Institutional investors remain accountable for the delivery of actions even where they have delegated the day-to-day responsibility for carrying them out.

- 3.3 **Collaboration:** Where an investment institution is not of sufficient scale to have governance structures or internal resources to deliver effective oversight on behalf of beneficiaries or clients, it should consider ways to consolidate, collaborate or build scale such that it is capable of this necessary oversight. This may require dialogue with policymakers and government authorities to facilitate such developments.

#### **4. Conflicts of interest**

- 4.1 **Policies:** Institutional investors should have robust policies to clarify, minimize and help manage conflicts of interest to help ensure that they maintain focus on advancing beneficiary or client interests. In particular, policies should address how matters are handled when the interests of clients or beneficiaries diverge from each other. Any conflict should be promptly disclosed to those to whom the party is immediately accountable in the investment chain.
- 4.2 **Compliance:** Institutional investors should have effective programmes for dealing with compliance matters and should also consider their obligations to beneficiaries or clients in terms of broader ethical considerations. For example, they should manage appropriately and effectively the risks of bribery and corruption, money laundering and other like risks. They should have effective policies to deal with inside information, avoid market manipulation, and foster transparency and fairness in share trade execution and reporting.

#### **5. Remuneration**

- 5.1 **Alignment:** Institutional investors should reinforce their obligations to act fully in the interests of beneficiaries or clients by setting fee and remuneration structures that provide appropriate alignment over relevant time-horizons, and communicate this to beneficiaries or clients. In large part this will require the structure for fees paid to parties in the investment chain to be more associated with the long-term perspectives which will generate returns over the time-horizon that beneficiaries or clients are seeking. Collective investment vehicles may also seek transparency of the remuneration structures for individuals within the agents that they hire, in particular to gain assurance that these provide appropriate incentives to those individuals. In particular, they may wish to assure themselves that pay structures for individuals do not inappropriately incentivise risk-taking behaviours.
- 5.2 **Performance:** Consideration should be given to including a long-term performance incentive that reflects long-term investment results or is in the form of an interest in the fund that extends through the period of responsibility for the investments. Good practice is for institutional investors to disclose to their beneficiaries or clients an explanation of how their remuneration structures and performance horizons for individual staff members advance alignment with the interests of beneficiaries or clients. Asset owners may wish to ensure that remuneration frameworks do not unduly constrain their ability to attract and retain well-qualified personnel.
- 5.3 **Culture:** Remuneration plays a crucial role in establishing and maintaining an appropriate culture or 'investment behaviour' within an organisation. As such, institutional investors should consider whether pay is adequately aligned with

performance, whether there is an appropriate balance between base pay and incentives, and whether the period over which performance is measured is both short term and longer term. . Having greater proportions of variable rewards deferred for longer periods of time and subject to performance adjustment mechanisms such as claw-back structures, particularly if the deferred awards are invested alongside beneficiaries or clients, is likely to help instil the right mind-set and culture. These measures are an appropriate context for the delivery of value over time for beneficiaries and clients.

## **6. Monitoring**

**6.1 Monitoring Approach:** Institutional investors should regularly monitor investee companies in order to assess their individual circumstances, performance and long-term potential, and to consider whether there is value in intervening to encourage change. Investors should be clear what standards they are applying, and how they monitor investee companies. Monitoring should include:

- a. maintaining awareness of the company's ongoing performance, as well as developments within and external to the company that might affect its value and the risks it faces;
- b. all relevant factors including the company's approach to environmental and social matters;
- c. assessing the effectiveness of the company's governance and leadership;
- d. considering the quality of the company's reporting;
- e. attending relevant meetings with senior company officers and board directors when appropriate; and
- f. where practicable, attendance at general meetings.

**6.2 Company Dialogue:** Institutional investors should seek to identify, as early as possible, any problems that may put significant investment value at risk. If they have concerns they should seek to ensure that the appropriate members of the investee company's board or management are made aware of them as soon as possible. Institutional investors should carefully consider explanations given for any departure from relevant corporate governance codes and make reasoned judgements in each case. Where this could lead to a negative vote or an abstention at a general meeting, the investee company's board should, at least in respect of significant holdings, be contacted to discuss the issue and, if it remains unresolved, notified in writing of the reasons for the decision.

**6.3 Review:** Institutional investors should periodically measure and review the effectiveness of their monitoring and ownership activities and communicate the results to their clients or beneficiaries. Asset owners should monitor the activities and effectiveness of their fund managers and other agents, holding them to account for delivery of value over time according to relevant mandates.

## **7. Engagement**

- 7.1 Proactive Engagement:** Institutional investors should engage intelligently and proactively as appropriate with investee companies with the aim of preserving or enhancing value on behalf of beneficiaries or clients. This is particularly constructive in advance of general meetings, to work together to identify agreeable positions and enhance understanding around company strategy, financial performance, risk to long term performance, governance, operations and with respect to social and environmental matters. Engagement is most effective when investors have the adequate knowledge and skills to encourage and effect necessary change.
- 7.2 Market Abuse:** Institutional investors should respect market abuse rules and not seek trading advantage through possession of price-sensitive information when engaging with companies. Where appropriate and feasible, investors should consider formally becoming insiders in order to support a process of longer term change, and the intention whether or not to become insiders should be made clear at the outset of the engagement. Companies should ensure that all sensitive information and decisions resulting from engagement are made public for the benefit of all shareholders at the appropriate time.
- 7.3 Engagement Approach:** Institutional investors should have a clear approach to engagement which should be communicated to companies as part of an engagement policy. The spectrum of engagement activities may vary, for example depending on the nature of the investment or the size of shareholding, and this will affect the appropriateness of the engagement approach taken with investee companies. In situations where dialogue is not producing the desired result, additional engagement steps that may be taken by investors include:
- a. expressing concerns to corporate representatives or non-executive directors, either directly or in a shareholders' meeting;
  - b. expressing their concern collectively with other investors;
  - c. making a public statement;
  - d. submitting shareholder resolutions;
  - e. speaking at general meetings;
  - f. submitting one or more nominations for election to the board as appropriate and convening a shareholders' meeting;
  - g. seeking governance improvements and/or damages through legal remedies or arbitration; and
  - h. exit or threat of exit from the investment as a last resort.
- 7.4 Collective Engagement:** Institutional investors should act collectively as appropriate when engaging with investee companies where this would assist in advancing beneficiary or client interest, taking account of relevant law and regulation. Institutional investors should disclose their policy on collective engagement. Shareholders should not face regulatory barriers to discussions between themselves regarding forthcoming voting decisions or concerning other governance matters. Concert party rules and/or takeover regulations should not prevent shareholders from sharing perspectives about companies in which they have mutual interests and/or concerns.

## 8. Voting

**8.1 Informed Voting:** Institutional investors should seek to vote shares held and make informed and independent voting decisions at investee companies, applying due care, diligence and judgment. They should have a clear policy on voting made available to investee companies and beneficiaries or clients.

**8.2 Proxy voting:** Institutional investors should disclose the extent to which they use proxy research and voting services, including the identity of the service provider and the degree to which any recommendations are followed. Investors should clearly specify how they wish votes to be cast, noting that they cannot delegate their ownership responsibilities, and should ensure that votes cast by intermediaries are carried out in a manner consistent with their own voting policies.

**8.3 Vote Decisions:** Institutional investors should seek to reach a clear decision either for or against each resolution or, in specific cases, may wish to abstain. Voting decisions and the rationale taken should be made publicly available in due course and, where a vote is contrary to the company board's recommended position, should be communicated to the company in advance of the general meeting. Where an institutional investor chooses not to vote in specific circumstances, or in particular markets or where holdings are below a certain scale threshold, this should be disclosed to clients or beneficiaries in a clear policy.

**8.4 Voting Records:** Institutional investors should regularly disclose (e.g. quarterly or annually) a summary of their voting activity on a website or other appropriate means and, where possible, their full voting records. Voting records should include an indication of whether the votes were cast for or against the recommendations of the company's board.

**8.5 Stock Lending:** Institutional investors should disclose their approach to stock lending and voting in a clear policy which should clarify the types of circumstances when shares would be recalled to vote. The policy should be communicated to relevant agents in the chain of the vote execution, and, in respect of shares out on loan, to the agent lender.

Institutional investors should recognize that if shares are lent out, they temporarily lose their voting rights for the duration of the loan because they are no longer the legal owner of those shares (unless contractual arrangements to the contrary are made). In order for the votes to be cast, lent stock must be recalled before the record date declared by the company. In order to preserve the integrity of the shareholders' meeting it is important that the shares never be borrowed or received as collateral for the primary purpose of voting them.

The results of stock lending should be transparent to the beneficial owners of shares. The portion of the return from a position due to lending activity should be made known in the regular reports. Similarly, the percentage and number of shares of a given security which were not voted due to stock lending should also be reported to beneficiaries.



#### D. Joint Venture Governance

Shareowners have a direct interest in the returns, risks, and governance of all wholly- and partly-owned assets that make up public companies. To date, the focus of CalPERS efforts on governance, and that of regulators and investors, has been on wholly-owned business units, subsidiaries, and affiliates of public companies. CalPERS believes that ensuring the effective governance of material equity joint ventures – a key asset class with well-documented and unique performance challenges where there has been historically less transparency than for similar-sized wholly owned businesses – is also an essential part of effective corporate governance.

To enhance investor confidence and to raise performance, CalPERS believes that companies need to raise the level of transparency, accountability, and discipline in the governance of their material joint ventures. As a minimum, any joint venture accounting for 10 percent or more of a publicly-traded parent company's total assets, invested capital, costs or revenues – or that is expected to account for 10 percent of the profit and loss of the corporation – should be viewed as material, as should smaller joint ventures that are strategically important, or that carry disproportionate risks. We believe that companies may wish to adopt a more inclusive standard for materiality, and, for instance, draw the line at joint ventures at or above \$500 million in annual revenues or invested capital.

For this class of joint ventures, CalPERS believes that the Company Board – i.e., the Board of parent companies that have ownership interests in joint ventures – should ensure the adoption of certain practices related to these joint ventures:

1. **Corporate-Level Joint Venture Governance Practices.** For any publicly-held company with one or more material joint ventures, that parent company should:
  - 1.1 Require that the Audit Committee of the Company Board annually review the governance integrity and compliance policies of the company's material joint ventures<sup>26</sup>
  - 1.2 Designate a Corporate Board member to be responsible for ensuring that the Company's corporate-level strategic business review process includes the Company's material joint ventures, and this review process holds joint ventures to similar performance standards to one another and to similar-sized business units<sup>27</sup>
  - 1.3 Adopt and make available to the public a set of Joint Venture Governance Guidelines for the Company's material joint ventures (such as those in Appendix I, co-authored by CalPERS and Water Street Partners) which define a set of minimum expectations for overseeing such ventures

<sup>26</sup> Such a review would likely include: i) corporate audit processes, ii) financial reporting, iii) training and compliance programs, and iv) (potentially) Sarbanes Oxley compliance issues for large joint ventures. Note: this Audit Committee review is not intended as a broad-based strategic performance review of individual ventures, but a fact-based conversation about the corporate-level policies and implementation status of various controls related to joint ventures.

<sup>27</sup> It is the experience of the authors that joint ventures – even billion-dollar joint ventures – are routinely left outside the regular corporate-level review process, and are therefore not subject to the same "challenge process" or "restructuring conversations" as wholly-owned business units, which, in turn, drives financial underperformance.

- 1.4 Designate a Corporate Board member to be responsible for ensuring, on an annual basis, that the Company's material joint ventures are subject to a review of their adherence to these Joint Venture Governance Guidelines, and that the results of the review are discussed and approved by the Corporate Board<sup>28</sup>
2. **Public Disclosure and Transparency.** For any material joint venture that has at least one public company shareholder, that parent company should disclose to its public investors<sup>29</sup>:
  - 2.1 The name, business scope and objectives, and current financial impact of each material joint venture of the Company
  - 2.2 A list of the Lead Director of the Joint Venture Board of Directors of each material joint venture
  - 2.3 Whether each material joint venture is complying with the guidelines outlined in Appendix I; to the extent that the venture is not meeting any of these governance standards, provide an explanation for why such governance standards are not being met<sup>30</sup>

#### IV. CONCLUSION

By adopting the Global Principles, CalPERS strives to advance corporate governance best practices for the purpose of creating sustainable long-term investment returns and protecting the System's rights as a shareowner. CalPERS encourages other investors to incorporate these Global Principles into ownership policies and practices as a basis for advancing a foundation for accountability between a corporation's board of directors, management and its owners. With continued experience and communication between the board, corporate managers and owners, the issue of accountability can become – if not resolved – more clear.

<sup>28</sup> This Board member may be the Chair of the Audit Committee (and thus link the JV Governance Guidelines into the broader JV compliance and financial integrity review process as described in 1.1), or the same individual as named in 1.2 above.

<sup>29</sup> This applies irrespective of the parent company's equity ownership interest in the venture, or whether the parent company consolidates to joint ventures on its financial statements

<sup>30</sup> Such a "comply and explain" approach - i.e., require that public companies disclose whether they are complying with a set of minimums and, if not, why - has been used in a number of corporate governance situations. For instance, in adopting the Cadbury Code (UK corporate governance guidelines similar to CalPERS guidelines in the US), the London Stock Exchange asked that listed companies reveal in their annual reports whether they were complying with it - and if not, why. We believe that this is a powerful alternative to a "corporate requirement" in JV situations, creating better governance behaviors while also allowing for flexibility across different ventures operating under different circumstances.

## APPENDIX A

**Principles for Responsible Investment**

Launched in April 2006, The Principles for Responsible Investment (PRI) provides the framework for investors to give appropriate consideration to environment, social and corporate governance (ESG) issues. The PRI was an initiative of the UN Secretary-General and coordinated by UNEP Finance Initiative and the UN Global Compact. An international working group of 20 institutional investors was supported by a 70-person multi-stakeholder group of experts from the investment industry, intergovernmental and governmental organizations, civil society and academia. CalPERS is one of the original signatories.

**The Principles**

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

In signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.

We encourage other investors to adopt the Principles.

Additional information can be found at [www.unpri.org](http://www.unpri.org).

**The Global Sullivan Principles  
The Preamble**

The Objectives of the Global Sullivan Principles are to support economic, social and political justice by companies where they do business, to support human rights and to encourage equal opportunity at all levels of employment, including racial and gender diversity on decision making committees and Boards; to train and advance disadvantaged workers for technical, supervisory and management opportunities; and to assist with greater tolerance and understanding among peoples, thereby, helping to improve the quality of life for communities, workers and children with dignity and equality.

I urge companies large and small in every part of the world to support and follow the Global Sullivan Principles of corporate social responsibility wherever they have operations.

The Reverend Leon H. Sullivan

**The Principles**

As a company which endorses the Global Sullivan Principles we will respect the law, and as a responsible member of society we will apply these Principles with integrity consistent with the legitimate role of business. We will develop and implement company policies, procedures, training and internal reporting structures to ensure commitment to these principles throughout our organization. We believe the application of these Principles will achieve greater tolerance and better understanding among peoples, and advance the culture of peace.

Accordingly, we will:

- Express our support for universal human rights and, particularly, those of our employees, the communities within which we operate, and parties with whom we do business.
- Promote equal opportunity for our employees at all levels of the company with respect to issues such as color, race, gender, age, ethnicity or religious beliefs, and operate without unacceptable worker treatment such as the exploitation of children, physical punishment, female abuse, involuntary servitude, or other forms of abuse.
- Respect our employees' voluntary freedom of association.
- Compensate our employees to enable them to meet at least their basic needs and provide the opportunity to improve their skill and capability in order to raise their social and economic opportunities.
- Provide a safe and healthy workplace; protect human health and the environment; and promote sustainable development.
- Promote fair competition including respect for intellectual and other property rights, and not offer, pay or accept bribes.
- Work with governments and communities in which we do business to improve the quality of life in those communities – their educational, cultural, economic and social well-being – and seek to provide training and opportunities for workers from disadvantaged backgrounds.
- Promote the application of these principles by those with whom we do business.

We will be transparent in our implementation of these principles and provide information which demonstrates, publicly, our commitment to them.

### United Nations Global Compact Principles

The UN Global Compact's ten principles in the areas of human rights, labor, the environment and anti-corruption enjoy universal consensus and are derived from:

The Universal Declaration of Human Rights

The International Labor Organization's Declaration on Fundamental Principles and Rights at Work

The Rio Declaration on Environment and Development

The United Nations Convention against Corruption

The Global Compact asks companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labor standards, the environment, and anti-corruption:

#### Human Rights

Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and

Principle 2: make sure that they are not complicit in human rights abuses.

#### Labor Standards

Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;

Principle 4: the elimination of all forms of forced and compulsory labor;

Principle 5: the effective abolition of child labor; and

Principle 6: the elimination of discrimination in respect of employment and occupation.

#### Environment

Principle 7: Businesses should support a precautionary approach to environmental challenges;

Principle 8: undertake initiatives to promote greater environmental responsibility; and

Principle 9: encourage the development and diffusion of environmentally friendly technologies.

#### Anti-Corruption

Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.



### **Corporate Governance Policies (October 1, 2014)**

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2. The Board of Directors
3. Shareowner Voting Rights
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#### 1. Introduction

- 1.1 Nature and Purpose of the Council's Corporate Governance Policies
- 1.2 Federal and State Law Compliance
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- 1.4 Accountability to Shareowners
- 1.5 Shareowner Participation
- 1.6 Business Practices and Corporate Citizenship
- 1.7 Governance Practices at Public and Private Companies
- 1.8 Reincorporation
- 1.9 Judicial Forum

**1.1 Nature and Purpose of the Council's Corporate Governance Policies:** Council policies are designed to provide guidelines that the Council has found to be appropriate in most situations. They bind neither members nor corporations.

**1.2 Federal and State Law Compliance:** The Council expects that corporations will comply with all applicable federal and state laws and regulations and stock exchange listing standards.

**1.3 Disclosed Governance Policies and Ethics Code:** The Council believes every company should have written, disclosed governance procedures and policies, an ethics code that applies to all employees and directors, and provisions for its strict enforcement. The Council posts its corporate governance policies on its Web site ([www.cii.org](http://www.cii.org)); it hopes corporate boards will meet

or exceed these standards and adopt similarly appropriate additional policies to best protect shareowners' interests.

**1.4 Accountability to Shareowners:** Corporate governance structures and practices should protect and enhance a company's accountability to its shareowners, and ensure that they are treated equally. An action should not be taken if its purpose is to reduce accountability to shareowners.

**1.5 Shareowner Participation:** Shareowners should have meaningful ability to participate in the major fundamental decisions that affect corporate viability, and meaningful opportunities to suggest or nominate director candidates and to suggest processes and criteria for director selection and evaluation.

**1.6 Business Practices and Corporate Citizenship:** The Council believes companies should adhere to responsible business practices and practice good corporate citizenship. Promotion, adoption and effective implementation of guidelines for the responsible conduct of business and business relationships are consistent with the fiduciary responsibility of protecting long-term investment interests.

**1.7 Governance Practices at Public and Private Companies:** Publicly traded companies, private companies and companies in the process of going public should practice good governance. General members of venture capital, buyout and other private equity funds should encourage companies in which they invest to adopt long-term corporate governance provisions that are consistent with the Council's policies.

**1.8 Reincorporation:** U.S. companies should not reincorporate to offshore locations where corporate governance structures are weaker, which reduces management accountability to shareowners.

**1.9 Judicial Forum:** Companies should not attempt to restrict the venue for shareowner claims by adopting charter or bylaw provisions that seek to establish an exclusive forum. Nor should companies attempt to bar shareowners from the courts through the introduction of forced arbitration clauses.

## **2. The Board of Directors**

- 2.1 Annual Election of Directors**
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- 2.10 "Continuing Directors"**
- 2.11 Board Size and Service**
- 2.12 Board Operations**

**2.13 Auditor Independence****2.14 Charitable and Political Contributions****2.15 Directors with Conflicts**

**2.1 Annual Election of Directors:** All directors should be elected annually. Boards should not be classified (staggered).

**2.2 Director Elections:** Directors in uncontested elections should be elected by a majority of the votes cast. In contested elections, plurality voting should apply. An election is contested when there are more director candidates than there are available board seats. To facilitate the shareholder voting franchise, the opposing sides engaged in a contested election should utilize a proxy card naming all management-nominees and all shareholder-proponent nominees, providing every nominee equal prominence on the proxy card.

Directors who fail to receive the support of a majority of votes cast should step down from the board and not be reappointed. A modest transition period may be appropriate under certain circumstances, such as for directors keeping the company in compliance with legal or listing standards. But any director who does not receive the majority of votes cast should leave the board as soon as practicable.

**2.3 Independent Board:** At least two-thirds of the directors should be independent; their seat on the board should be their only non-trivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer. The company should disclose information necessary for shareowners to determine whether directors qualify as independent. This information should include all of the company's financial or business relationships with and payments to directors and their families and all significant payments to companies, non-profits, foundations and other organizations where company directors serve as employees, officers or directors (see *Council definition of independent director, Section 7, below*).

**2.4 Independent Chair/Lead Director:** The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board should provide a written statement in the proxy materials discussing why the combined role is in the best interests of shareowners, and it should name a lead independent director who should have approval over information flow to the board, meeting agendas and meeting schedules to ensure a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.

Other roles of the lead independent director should include chairing meetings of non-management directors and of independent directors, presiding over board meetings in the absence of the chair, serving as the principle liaison between the independent directors and the chair and leading the board/director evaluation process. Given these additional responsibilities, the lead independent director should expect to devote a greater amount of time to board service than the other directors.

**2.5 All-independent Board Committees:** Companies should have audit, nominating and compensation committees, and all members of these committees should be independent. The board (not the CEO) should appoint the committee chairs and members. Committees should be able to select their own service providers. Some regularly scheduled committee meetings should be held with only the committee members (and, if appropriate, the committee's



independent consultants) present. The process by which committee members and chairs are selected should be disclosed to shareowners.

## 2.6 Board Accountability to Shareowners

- a. **Majority Shareowner Votes:** Boards should take actions recommended in shareowner proposals that receive a majority of votes cast for and against. If shareowner approval is required for the action, the board should seek a binding vote on the action at the next shareowner meeting.
- b. **Interaction with Shareowners:** Directors should respond to communications from shareowners and should seek shareowner views on important governance, management and performance matters. To accomplish this goal, all companies should establish board-shareowner communications policies. Such policies should disclose the ground rules by which directors will meet with shareowners. The policies should also include detailed contact information for at least one independent director (but preferably for the independent board chair and/or the independent lead director and the independent chairs of the audit, compensation and nominating committees). Companies should also establish mechanisms by which shareowners with non-trivial concerns can communicate directly with all directors. Policies requiring that all director communication go through a member of the management team should be avoided unless they are for record-keeping purposes. In such cases, procedures documenting receipt and delivery of the request to the board and its response must be maintained and made available to shareowners upon request. Directors should have access to all communications. Boards should determine whether outside counsel should be present at meetings with shareowners to monitor compliance with disclosure rules.

All directors should attend the annual shareowners' meetings and be available, when requested by the chair, to answer shareowner questions. During the annual general meeting, shareowners should have the right to ask questions, both orally and in writing. Directors should provide answers or discuss the matters raised, regardless of whether the questions were submitted in advance. While reasonable time limits for questions are acceptable, the board should not ignore a question because it comes from a shareowner who holds a smaller number of shares or who has not held those shares for a certain length of time.

**2.7 Board's Role in Risk Oversight:** The board has ultimate responsibility for risk oversight. The board should (1) establish a company's risk management philosophy and risk appetite; (2) understand and ensure risk management practices for the company; (3) regularly review risks in relation to the risk appetite; and (4) evaluate how management responds to the most significant risks. In determining the risk profile, the board should consider the dynamics of the company, its industry and any systemic risks. Council policies on other critical corporate governance matters, such as executive compensation (*see 5.1, the Council's policy on executive compensation, below*), reinforce the importance of the board's consideration of risk factors. Effective risk oversight requires regular, meaningful communication between the board and management, among board members and committees, and between the board and any outside advisers it consults, about the company's material risks and risk management processes. The board should disclose to shareowners, at least annually, sufficient information to enable them to assess whether the board is carrying out its oversight responsibilities effectively.

## 2.7 Board/Director Succession Planning and Evaluation

- a. **Board Succession Planning:** The board should implement and disclose a board succession plan that involves preparing for future board retirements, committee assignment rotations, committee chair nominations and overall implementation of the company's long-term business plan. Boards should establish clear procedures to encourage and consider board nomination suggestions from long-term shareowners. The board should respond positively to shareowner requests seeking to discuss incumbent and potential directors.
- b. **Board Diversity:** The Council supports a diverse board. The Council believes a diverse board has benefits that can enhance corporate financial performance, particularly in today's global market place. Nominating committee charters, or equivalent, ought to reflect that boards should be diverse, including such considerations as background, experience, age, race, gender, ethnicity, and culture.
- c. **Evaluation of Directors:** Boards should review their own performance periodically. That evaluation should include a review of the performance and qualifications of any director who received "against" votes from a significant number of shareowners or for whom a significant number of shareowners withheld votes.
- d. **Board and Committee Meeting Attendance:** Absent compelling and stated reasons, directors who attend fewer than 75 percent of board and board-committee meetings for two consecutive years should not be re-nominated. Companies should disclose individual director attendance figures for board and committee meetings. Disclosure should distinguish between in-person and telephonic attendance. Excused absences should not be categorized as attendance.

**2.9 CEO Succession Planning:** The board should approve and maintain a detailed CEO succession plan and publicly disclose the essential features. An integral facet of management succession planning involves collaboration between the board and the current chief executive to develop the next generation of leaders from within the company's ranks. Boards therefore should: (1) make sure that broad leadership development programs are in place generally; and (2) carefully identify multiple candidates for the CEO role specifically, well before the position needs to be filled.

**2.10 Continuing Directors:** Corporations should not adopt so-called "continuing director" provisions (also known as "dead-hand" or "no-hand" provisions, which are most commonly seen in connection with a potential change in control of the company) that allow board actions to be taken only by: (1) those continuing directors who were also in office when a specified event took place or (2) a combination of continuing directors plus new directors who are approved by such continuing directors.

**2.11 Board Size and Service:** Absent compelling, unusual circumstances, a board should have no fewer than five and no more than 15 members (not too small to maintain the needed expertise and independence, and not too large to function efficiently). Shareowners should be allowed to vote on any major change in board size.

Companies should establish and publish guidelines specifying on how many other boards their directors may serve. Absent unusual, specified circumstances, directors with full-time jobs should not serve on more than two other boards. Currently serving CEOs should not serve as a director of more than one other company, and then only if the CEO's own company is in the top half of its peer group. No other director should serve on more than five for-profit company boards.

## 2.12 Board Operations

- a. **Informed Directors:** Directors should receive training from independent sources on their fiduciary responsibilities and liabilities. Directors have an affirmative obligation to become and remain independently familiar with company operations; they should not rely exclusively on information provided to them by the CEO to do their jobs. Directors should be provided meaningful information in a timely manner prior to board meetings and should be allowed reasonable access to management to discuss board issues.
- b. **Director Rights Regarding Board Agenda:** Any director should be allowed to place items on the board's agenda.
- c. **Executive Sessions:** The independent directors should hold regularly scheduled executive sessions without any of the management team or its staff present.

## 2.13 Auditor Independence

- a. **Audit Committee Responsibilities Regarding Outside Auditors:** The audit committee should have the responsibility to hire, oversee and, if necessary, fire the company's outside auditor.
- b. **Competitive Bids:** The audit committee should seek competitive bids for the external audit engagement at least every five years.
- c. **Non-audit Services:** A company's external auditor should not perform any non-audit services for the company, except those, such as attest services, that are required by statute or regulation to be performed by a company's external auditor.
- d. **Audit Committee Charters:** The proxy statement should include a copy of the audit committee charter and a statement by the audit committee that it has complied with the duties outlined in the charter.
- e. **Liability of Outside Auditors:** Companies should not agree to limit the liability of outside auditors.
- f. **Shareowner Votes on the Board's Choice of Outside Auditor:** Audit committee charters should provide for annual shareowner votes on the board's choice of independent, external auditor. Such provisions should state that if the board's selection fails to achieve the support of a majority of the for-and-against votes cast, the audit committee should: (1) take the shareowners' views into consideration and reconsider its choice of auditor and (2) solicit the views of major shareowners to determine why broad levels of shareowner support were not achieved.

- g. Disclosure of Reasons Behind Auditor Changes:** The audit committee should publicly provide to shareowners a plain-English explanation of the reasons for a change in the company's external auditors. At a minimum, this disclosure should be contained in the same Securities and Exchange Commission (SEC) filing that companies are required to submit within four days of an auditor change.

#### **2.14 Charitable and Political Contributions**

- a. Board Monitoring, Assessment and Approval:** The board of directors should monitor, assess and approve all charitable and political contributions (including trade association contributions) made by the company. The board should only approve contributions that are consistent with the interests of the company and its shareowners. The terms and conditions of such contributions should be clearly defined and approved by the board.
- b. Disclosure:** The board should develop and disclose publicly its guidelines for approving charitable and political contributions. The board should disclose on an annual basis the amounts and recipients of all monetary and non-monetary contributions made by the company during the prior fiscal year. Any expenditures earmarked for political or charitable activities that were provided to or through a third-party should be included in the report.

**2.15 Directors with Conflicts:** A director with a conflict of interest in a matter before the board should immediately communicate all facts about the conflict and abstain from voting on the matter. Deliberation on the matter should take place only among non-conflicted directors. The content of the deliberations, both verbal and written, should not be shared with the conflicted director. Prior to deliberation, the non-conflicted directors should have discretion to invite the conflicted director to share information that could help inform the vote. The conflicted director should comply if such communication is not prohibited by contract or law.

#### **3. Shareowner Voting Rights**

- 3.1 Right to Vote is Inviolable**
- 3.2 Access to the Proxy**
- 3.3 One Share, One Vote**
- 3.4 Advance Notice, Holding Requirements and Other Provisions**
- 3.5 Confidential Voting**
- 3.6 Voting Requirements**
- 3.7 Broker Votes**
- 3.8 Bundled Voting**

**3.1 Right to Vote is Inviolable:** A shareowners' right to vote is inviolable and should not be abridged.

**3.2 Access to the Proxy:** Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least three percent of a company's voting stock, to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least two years. Company proxy materials and

related mailings should provide equal space and equal treatment of nominations by qualifying investors.

To allow for informed voting decisions, it is essential that investors have full and accurate information about access mechanism users and their director nominees. Therefore, shareowners nominating director candidates under an access mechanism should adhere to the same SEC rules governing disclosure requirements and prohibitions on false and misleading statements that currently apply to proxy contests for board seats.

**3.3 One Share, One Vote:** Each share of common stock should have one vote. Corporations should not have classes of common stock with disparate voting rights. Authorized, unissued common shares that have voting rights to be set by the board should not be issued with unequal voting rights without shareowner approval.

**3.4 Advance Notice, Holding Requirements and Other Provisions:** Advance notice bylaws, holding requirements, disclosure rules and any other company imposed regulations on the ability of shareowners to solicit proxies beyond those required by law should not be so onerous as to deny sufficient time, limit the pool of eligible candidates, or otherwise make it impractical for shareowners to submit nominations or proposals and distribute supporting proxy materials.

**3.5 Confidential Voting:** All proxy votes should be confidential, with ballots counted by independent tabulators. Confidentiality should be automatic, permanent and apply to all ballot items. Rules and practices concerning the casting, counting and verifying of shareowner votes should be clearly disclosed.

**3.6 Voting Requirements:** A majority vote of common shares outstanding should be sufficient to amend company bylaws or take other action that requires or receives a shareowner vote. Supermajority votes should not be required. A majority vote of common shares outstanding should be required to approve:

- a. Major corporate decisions concerning the sale or pledge of corporate assets that would have a material effect on shareowner value. Such a transaction will automatically be deemed to have a material effect if the value of the assets exceeds 10 percent of the assets of the company and its subsidiaries on a consolidated basis;
- b. The corporation's acquisition of five percent or more of its common shares at above-market prices other than by tender offer to all shareowners;
- c. Poison pills;
- d. Abridging or limiting the rights of common shares to: (1) vote on the election or removal of directors or the timing or length of their term of office or (2) nominate directors or propose other action to be voted on by shareowners or (3) call special meetings of shareowners or take action by written consent or change the procedure for fixing the record date for such action; and
- e. Issuing debt to a degree that would excessively leverage the company and imperil its long-term viability.

**3.7 Broker Votes:** Uninstructed broker votes and abstentions should be counted only for purposes of a quorum.

**3.8 Bundled Voting:** Shareowners should be allowed to vote on unrelated issues separately. Individual voting issues (particularly those amending a company's charter), bylaws or anti-takeover provisions should not be bundled.

#### **4. Shareowner Meetings**

##### **4.1 Selection and Notification of Meeting Time and Location**

##### **4.2 Shareowner Rights to Call Special Meetings**

##### **4.3 Record Date and Ballot Item Disclosure**

##### **4.4 Timely Disclosure of Voting Results**

##### **4.5 Election Polls**

##### **4.6 Meeting Adjournment and Extension**

##### **4.7 Electronic Meetings**

##### **4.8 Director Attendance**

**4.1 Selection and Notification of Meeting Time and Location:** Corporations should make shareowners' expense and convenience primary criteria when selecting the time and location of shareowner meetings. Appropriate notice of shareowner meetings, including notice concerning any change in meeting date, time, place or shareowner action, should be given to shareowners in a manner and within time frames that will ensure that shareowners have a reasonable opportunity to exercise their franchise.

**4.2 Shareowner Rights to Call Special Meetings:** Shareowners should have the right to call special meetings.

**4.3 Record Date and Ballot Item Disclosure:** To promote the ability of shareowners to make informed decisions regarding whether to recall loaned shares: (1) shareowner meeting record dates should be disclosed as far in advance of the record date as possible, and (2) proxy statements should be disclosed before the record date passes whenever possible.

**4.4 Timely Disclosure of Voting Results:** A company should broadly and publicly disclose in a timely manner the final results of votes cast at annual and special meetings of shareowners. Whenever possible, preliminary results should be announced at the annual or special meeting of shareowners.

**4.5 Election Polls:** Polls should remain open at shareowner meetings until all agenda items have been discussed and shareowners have had an opportunity to ask and receive answers to questions concerning them.

**4.6 Meeting Adjournment and Extension:** Companies should not adjourn a meeting for the purpose of soliciting more votes to enable management to prevail on a voting item. A meeting should only be extended for compelling reasons such as vote fraud, problems with the voting process or lack of a quorum.

**4.7 Electronic Meetings:** Companies should hold shareowner meetings by remote communication (so-called “virtual” meetings) only as a supplement to traditional in-person shareowner meetings, not as a substitute.

Companies incorporating virtual technology into their shareowner meeting should use it as a tool for broadening, not limiting, shareowner meeting participation. With this objective in mind, a virtual option, if used, should facilitate the opportunity for remote attendees to participate in the meeting to the same degree as in-person attendees.

**4.8 Director Attendance:** As noted in Section 2, “The Board of Directors,” all directors should attend the annual shareowners’ meeting and be available, when requested by the chair, to respond directly to oral or written questions from shareowners.

## **5. Executive Compensation**

### **5.1 Introduction**

### **5.2 Advisory Shareowner Votes on Executive Pay**

### **5.3 Gross-ups**

### **5.4 Shareowner Approval of Equity-based Compensation Plans**

### **5.5 Role of Compensation Committee**

### **5.6 Salary**

### **5.7 Annual Incentive Compensation**

### **5.8 Long-term Incentive Compensation**

### **5.9 Dilution**

### **5.10 Stock Option Awards**

### **5.11 Stock Awards/Units**

### **5.12 Perquisites**

### **5.13 Employment Contracts, Severance and Change-of-control Payments**

### **5.14 Retirement Arrangements**

### **5.15 Stock Ownership**

**5.1 Introduction:** The Council believes that executive compensation is a critical and visible aspect of a company’s governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board. And they have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for employees, signaling the market and affecting employee morale.

The Council endorses reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the long-term, consistent with a company’s investment horizon. “Long-term” is generally considered to be five or more years for mature companies and at least three years for other companies. While the Council believes that executives should be well paid for superior performance, it also believes that executives should not be excessively paid. It is the job of the board of directors and the compensation committee specifically to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance, industry considerations, risk considerations and compensation paid to other employees.

It is also the job of the compensation committee to ensure that elements of compensation packages are appropriately structured to enhance the company's short- and long-term strategic goals and to retain and motivate executives to achieve those strategic goals. Compensation programs should not be driven by competitive surveys, which have become excessive and subject to abuse. It is shareowners, not executives, whose money is at risk.

Since executive compensation must be tailored to meet unique company needs and situations, compensation programs must always be structured on a company-by-company basis. However, certain principles should apply to all companies.

**5.2 Advisory Shareowner Votes on Executive Pay:** All companies should provide annually for advisory shareowner votes on the compensation of senior executives.

**5.3 Gross-ups:** Senior executives should not receive gross-ups beyond those provided to all the company's employees.

**5.4 Shareowner Approval of Equity-based Compensation Plans:** Current listing standards require shareowner approval of equity-based compensation plans and material amendments to plans (with limited exceptions). The Council strongly supports this concept and advocates that companies adopt conservative interpretations of approval requirements when confronted with choices. (For example, this may include material amendments to the plan.)

**5.5 Role of Compensation Committee:** The compensation committee is responsible for structuring executive pay and evaluating executive performance within the context of the pay structure of the entire company, subject to approval of the board of directors. To best handle this role, compensation committees should adopt the following principles and practices:

- a. **Committee Composition:** All members of the compensation committee should be independent. Committee membership should rotate periodically among the board's independent directors. Members should be or take responsibility to become knowledgeable about compensation and related issues. They should exercise due diligence and independent judgment in carrying out their committee responsibilities. They should represent diverse backgrounds and professional experiences.
- b. **Executive Pay Philosophy:** The compensation philosophy should be clearly disclosed to shareowners in annual proxy statements. In developing, approving and monitoring the executive pay philosophy, the compensation committee should consider the full range of pay components, including structure of programs, desired mix of cash and equity awards, goals for distribution of awards throughout the company, the relationship of executive pay to the pay of other employees, use of employment contracts and policy regarding dilution.
- c. **Oversight:** The compensation committee should vigorously oversee all aspects of executive compensation for a group composed of the CEO and other highly paid executives, as required by law, and any other highly paid employees, including executives of subsidiaries, special purpose entities and other affiliates, as determined by the compensation committee. The committee should ensure that the structure of employee compensation throughout the company is fair, non-discriminatory and forward-looking, and that it motivates, recruits and retains a workforce capable of meeting the company's strategic objectives. To perform its



oversight duties, the committee should approve, comply with and fully disclose a charter detailing its responsibilities.

- d. **Pay for Performance:** Compensation of the executive oversight group should be driven predominantly by performance. The compensation committee should establish performance measures for executive compensation that are agreed to ahead of time and publicly disclosed. Multiple performance measures should be used in an executive's incentive program, and the measures should be sufficiently diverse that they do not simply reward the executive multiple times for the same performance. The measures should be aligned with the company's short- and long-term strategic goals, and pay should incorporate company-wide performance metrics, not just business unit performance criteria.

Performance measures applicable to all performance-based awards (including annual and long-term incentive compensation) should reward superior performance—based predominantly on measures that drive long-term value creation—at minimum reasonable cost. Such measures should also reflect downside risk. The compensation committee should ensure that key performance metrics cannot be manipulated easily.

The compensation committee should ensure that sufficient and appropriate mechanisms and policies (for example, bonus banks and clawback policies) are in place to recover erroneous bonus and incentive awards paid out to executive officers, and to prevent such awards from being paid out in the first instance. Awards can be erroneous due to fraud, financial results that require restatement or some other cause that the committee believes warrants withholding or recovering incentive pay. The mechanisms and policies should be publicly disclosed.

- e. **Annual Approval and Review:** Each year, the compensation committee should review performance of individuals in the oversight group and approve any bonus, severance, equity-based award or extraordinary payment made to them. The committee should understand all components of executive compensation and annually review total compensation potentially payable to the oversight group under all possible scenarios, including death/disability, retirement, voluntary termination, termination with and without cause and changes of control. The committee should also ensure that the structure of pay at different levels (CEO and others in the oversight group, other executives and non-executive employees) is fair and appropriate in the context of broader company policies and goals and fully justified and explained.
- f. **Committee Accountability:** In addition to attending all annual and special shareowner meetings, committee members should be available to respond directly to questions about executive compensation; the chair of the committee should take the lead. In addition, the committee should regularly report on its activities to the independent directors of the board, who should review and ratify committee decisions. Committee members should take an active role in preparing the compensation committee report contained in the annual proxy materials, and be responsible for the contents of that report.
- g. **Outside Advice:** The compensation committee should retain and fire outside experts, including consultants, legal advisers and any other advisers when it deems appropriate, including when negotiating contracts with executives. Individual compensation advisers and their firms should be independent of the client company, its executives and directors and

should report solely to the compensation committee. The compensation committee should develop and disclose a formal policy on compensation adviser independence. In addition, the committee should annually disclose an assessment of its advisers' independence, along with a description of the nature and dollar amounts of services commissioned from the advisers and their firms by the client company's management. Companies should not agree to indemnify or limit the liability of compensation advisers or the advisers' firms.

- h. **Disclosure Practices:** The compensation committee is responsible for ensuring that all aspects of executive compensation are clearly, comprehensively and promptly disclosed, in plain English, in the annual proxy statement regardless of whether such disclosure is required by current rules and regulations. The compensation committee should disclose all information necessary for shareowners to understand how and how much executives are paid and how such pay fits within the overall pay structure of the company. It should provide annual proxy statement disclosure of the committee's compensation decisions with respect to salary, short-term incentive compensation, long-term incentive compensation and all other aspects of executive compensation, including the relative weights assigned to each component of total compensation.

The compensation committee should commit to provide full descriptions of the qualitative and quantitative performance measures and benchmarks used to determine compensation, including the weightings and rationale for each measure. At the beginning of a period, the compensation committee should calculate and disclose the maximum compensation payable if all performance-related targets are met. At the end of the performance cycle, the compensation committee should disclose actual targets and details on final payouts. Companies should provide forward-looking disclosure of performance targets whenever possible. Other recommended disclosures relevant to specific elements of executive compensation are detailed below.

- i. **Benchmarking:** Benchmarking at median or higher levels is a primary contributor to escalating executive compensation. Although benchmarking can be a constructive tool for formulating executive compensation packages, it should not be relied on exclusively. If benchmarking is used, compensation committees should commit to annual disclosure of the companies in peer groups used for benchmarking and/or other comparisons. If the peer group used for compensation purposes differs from that used to compare overall performance, such as the five-year stock return graph required in the annual proxy materials, the compensation committee should describe the differences between the groups and the rationale for choosing between them. In addition to disclosing names of companies used for benchmarking and comparisons, the compensation committee should disclose targets for each compensation element relative to the peer/benchmarking group and year-to-year changes in companies composing peer/benchmark groups.

## 5.6 Salary

- a. **Salary Level:** Since salary is one of the few components of executive compensation that is not "at risk," it should be set at a level that yields the highest value for the company at least cost. In general, salary should be set to reflect responsibilities, tenure and past performance, and to be tax efficient—meaning no more than \$1 million.

- b. **Above-median Salary:** The compensation committee should publicly disclose its rationale for paying salaries above the median of the peer group.

**5.7 Annual Incentive Compensation:** Cash incentive compensation plans should be structured to align executive interests with company goals and objectives. They should also reasonably reward superior performance that meets or exceeds well-defined and clearly disclosed performance targets that reinforce long-term strategic goals that were written and approved by the board in advance of the performance cycle.

- a. **Formula Plans:** The compensation committee should approve formulaic bonus plans containing specific qualitative and quantitative performance-based operational measures designed to reward executives for superior performance related to operational/strategic/other goals set by the board. Such awards should be capped at a reasonable maximum level. These caps should not be calculated as percentages of accounting or other financial measures (such as revenue, operating income or net profit), since these figures may change dramatically due to mergers, acquisitions and other non-performance-related strategic or accounting decisions.
- b. **Targets:** When setting performance goals for "target" bonuses, the compensation committee should set performance levels below which no bonuses would be paid and above which bonuses would be capped.
- c. **Changing Targets:** Except in extraordinary situations, the compensation committee should not "lower the bar" by changing performance targets in the middle of bonus cycles. If the committee decides that changes in performance targets are warranted in the middle of a performance cycle, it should disclose the reasons for the change and details of the initial targets and adjusted targets.

**5.8 Long-term Incentive Compensation:** Long-term incentive compensation, generally in the form of equity-based awards, can be structured to achieve a variety of long-term objectives, including retaining executives, aligning executives' financial interests with the interests of shareowners and rewarding the achievement of long-term specified strategic goals of the company and/or the superior performance of company stock.

But poorly structured awards permit excessive or abusive pay that is detrimental to the company and to shareowners. To maximize effectiveness and efficiency, compensation committees should carefully evaluate the costs and benefits of long-term incentive compensation, ensure that long-term compensation is appropriately structured and consider whether performance and incentive objectives would be enhanced if awards were distributed throughout the company, not simply to top executives.

Companies may rely on a myriad of long-term incentive vehicles to achieve a variety of long-term objectives, including performance-based restricted stock/units, phantom shares, stock units and stock options. While the technical underpinnings of long-term incentive awards may differ, the following principles and practices apply to all long-term incentive compensation awards. And, as detailed below, certain policies are relevant to specific types of long-term incentive awards.

- a. **Size of Awards:** Compensation committees should set appropriate limits on the size of long-term incentive awards granted to executives. So-called "mega-awards" or outsized awards should be avoided, except in extraordinary circumstances, because they can be disproportionate to performance.
  - b. **Vesting Requirements:** All long-term incentive awards should have meaningful performance periods and/or cliff vesting requirements that are consistent with the company's investment horizon but not less than three years, followed by pro rata vesting over at least two subsequent years for senior executives.
  - c. **Grant Timing:** Except in extraordinary circumstances, such as a permanent change in performance cycles, long-term incentive awards should be granted at the same time each year. Companies should not coordinate stock award grants with the release of material non-public information. The grants should occur whether recently publicized information is positive or negative, and stock options should never be backdated.
  - d. **Hedging:** Compensation committees should prohibit executives and directors from hedging (by buying puts and selling calls or employing other risk-minimizing techniques) equity-based awards granted as long-term incentive compensation or other stock holdings in the company. And they should strongly discourage other employees from hedging their holdings in company stock.
  - e. **Philosophy/Strategy:** Compensation committees should have a well-articulated philosophy and strategy for long-term incentive compensation that is fully and clearly disclosed in the annual proxy statement.
  - f. **Award Specifics:** Compensation committees should disclose the size, distribution, vesting requirements, other performance criteria and grant timing of each type of long-term incentive award granted to the executive oversight group. Compensation committees also should explain how each component contributes to the company's long-term performance objectives.
  - g. **Ownership Targets:** Compensation committees should disclose whether and how long-term incentive compensation may be used to satisfy meaningful stock ownership requirements. Disclosure should include any post-exercise holding periods or other requirements to ensure that long-term incentive compensation is used appropriately to meet ownership targets.
  - h. **Expiration Dates:** Compensation plans should have expiration dates and not be structured as "evergreen," rolling plans.
- 5.9 Dilution:** Dilution measures how much the additional issuance of stock may reduce existing shareowners' stake in a company. Dilution is particularly relevant for long-term incentive compensation plans since these programs essentially issue stock at below-market prices to the recipients. The potential dilution represented by long-term incentive compensation plans is a direct cost to shareowners.

Dilution from long-term incentive compensation plans may be evaluated using a variety of techniques including the reduction in earnings per share and voting power resulting from the increase in outstanding shares.

- a. **Philosophy/Strategy:** Compensation committees should develop and disclose the philosophy regarding dilution including definition(s) of dilution, peer group comparisons and specific targets for annual awards and total potential dilution represented by equity compensation programs for the current year and expected for the subsequent four years.
- b. **Stock Repurchase Programs:** Stock buyback decisions are a capital allocation decision and should not be driven solely for the purpose of minimizing dilution from equity-based compensation plans. The compensation committee should provide information about stock repurchase programs and the extent to which such programs are used to minimize the dilution of equity-based compensation plans.
- c. **Tabular Disclosure:** The annual proxy statement should include a table detailing the overhang represented by unexercised options and shares available for award and a discussion of the impact of the awards on earnings per share.

**5.10 Stock Option Awards:** Stock options give holders the right, but not the obligation, to buy stock in the future. Options may be structured in a variety of ways. Some structures and policies are preferable because they more effectively ensure that executives are compensated for superior performance. Other structures and policies are inappropriate and should be prohibited.

- a. **Performance Options:** Stock options should be: (1) indexed to peer groups or (2) premium-priced and/or (3) vest on achievement of specific performance targets that are based on challenging quantitative goals.
- b. **Dividend Equivalents:** To ensure that executives are neutral between dividends and stock price appreciation, dividend equivalents should be granted with stock options, but distributed only upon exercise of the option.
- c. **Discount Options:** Discount options should not be awarded.
- d. **Reload Options:** Reload options should be prohibited.
- e. **Option Repricing:** "Underwater" options should not be repriced or replaced (either with new options or other equity awards), unless approved by shareowners. Repricing programs, with shareowner approval, should exclude directors and executives, restart vesting periods and mandate value-for-value exchanges in which options are exchanged for a number of equivalently valued options/shares.

**5.11 Stock Awards/Units:** Stock awards/units and similar equity-based vehicles generally grant holders stock based on the attainment of performance goals and/or tenure requirements. These types of awards are more expensive to the company than options, since holders generally are not required to pay to receive the underlying stock, and therefore should be limited in size.

Stock awards should be linked to the attainment of specified performance goals and in some cases to additional time-vesting requirements. Stock awards should not be payable based solely on the attainment of tenure requirements.

**5.12 Perquisites:** Company perquisites blur the line between personal and business expenses. Executives, not companies, should be responsible for paying personal expenses—particularly those that average employees routinely shoulder, such as family and personal travel, financial planning, club memberships and other dues. The compensation committee should ensure that any perquisites are warranted and have a legitimate business purpose, and it should consider capping all perquisites at a *de minimis* level. Total perquisites should be described, disclosed and valued.

**5.13 Employment Contracts, Severance and Change-of-control Payments:** Various arrangements may be negotiated to outline terms and conditions for employment and to provide special payments following certain events, such as a termination of employment with/without cause and/or a change in control. The Council believes that these arrangements should be used on a limited basis.

- a. **Employment Contracts:** Companies should only provide employment contracts to executives in limited circumstances, such as to provide modest, short-term employment security to a newly hired or recently promoted executive. Such contracts should have a specified termination date (not to exceed three years); contracts should not be “rolling” on an open-ended basis.
- b. **Severance Payments:** Executives should not be entitled to severance payments in the event of termination for poor performance, resignation under pressure or failure to renew an employment contract. Company payments awarded upon death or disability should be limited to compensation already earned or vested.
- c. **Change-in-control Payments:** Any provisions providing for compensation following a change-in-control event should be “double-triggered.” That is, such provisions should stipulate that compensation is payable only: (1) after a control change actually takes place and (2) if a covered executive's job is terminated because of the control change.
- d. **Transparency:** The compensation committee should fully and clearly describe the terms and conditions of employment contracts and any other agreements/arrangements covering the executive oversight group and reasons why the compensation committee believes the agreements are in the best interests of shareowners.
- e. **Timely Disclosure:** New executive employment contracts or amendments to existing contracts should be immediately disclosed in 8-K filings and promptly disclosed in subsequent 10-Qs.
- f. **Shareowner Ratification:** Shareowners should ratify all employment contracts, side letters or other agreements providing for severance, change-in-control or other special payments to executives exceeding 2.99 times average annual salary plus annual bonus for the previous three years.

**5.14 Retirement Arrangements:** Deferred compensation plans, supplemental executive retirement plans, retirement packages and other retirement arrangements for highly paid executives can result in hidden and excessive benefits. Special retirement arrangements—including those structured to permit employees whose compensation exceeds Internal Revenue Service (IRS) limits to fully participate in similar plans covering other employees—should be consistent with programs offered to the general workforce, and they should be reasonable.

- a. **Supplemental Executive Retirement Plans (SERPs):** Supplemental plans should be an extension of the retirement program covering other employees. They should not include special provisions that are not offered under plans covering other employees, such as above-market interest rates and excess service credits. Payments such as stock and stock options, annual/long-term bonuses and other compensation not awarded to other employees and/or not considered in the determination of retirement benefits payable to other employees should not be considered in calculating benefits payable under SERPs.
- b. **Deferred Compensation Plans:** Investment alternatives offered under deferred compensation plans for executives should mirror those offered to employees in broad-based deferral plans. Above-market returns should not be applied to executive deferrals, nor should executives receive “sweeteners” for deferring cash payments into company stock.
- c. **Post-retirement Exercise Periods:** Executives should be limited to three-year post-retirement exercise periods for stock option grants.
- d. **Retirement Benefits:** Executives should not be entitled to special perquisites—such as apartments, automobiles, use of corporate aircraft, security, financial planning—and other benefits upon retirement. Executives are highly compensated employees who should be more than able to cover the costs of their retirement.

#### 5.15 Stock Ownership

- a. **Ownership Requirements:** Executives and directors should own, after a reasonable period of time, a meaningful position in the company’s common stock. Executives should be required to own stock—excluding unexercised options and unvested stock awards—equal to a multiple of salary. The stock subject to the ownership requirements should not be pledged or otherwise encumbered. The multiple should be scaled based on position, for example: two times salary for lower-level executives and up to six times salary for the CEO.
- b. **Stock Sales:** Executives should be required to sell stock through pre-announced 10b5-1 program sales or by providing a minimum 30-day advance notice of any stock sales. 10b5-1 program adoptions, amendments, terminations and transactions should be disclosed immediately, and boards of companies using 10b5-1 plans should: (1) adopt policies covering plan practices, (2) periodically monitor plan transactions and (3) ensure that company policies discuss plan use in the context of guidelines or requirements on equity hedging, holding and ownership.
- c. **Post-retirement Holdings:** Executives should be required to continue to satisfy the minimum stock holding requirements for at least six months after leaving the company.

- d. **Transparency:** Companies should disclose stock ownership requirements and whether any members of the executive oversight group are not in compliance.

## 6. Director Compensation

- 6.1 Introduction
- 6.2 Role of the Compensation Committee in Director Compensation
- 6.3 Retainer
- 6.4 Equity-based Compensation
- 6.5 Performance-based Compensation
- 6.6 Perquisites
- 6.7 Repricing and Exchange Programs
- 6.8 Employment Contracts, Severance and Change-of-control Payments
- 6.9 Retirement
- 6.10 Disgorgement

**6.1 Introduction:** Given the vital importance of their responsibilities, non-employee directors should expect to devote significant time to their boardroom duties.

Policy issues related to director compensation are fundamentally different from executive compensation. Director compensation policies should accomplish the following goals: (1) attract highly qualified candidates, (2) retain highly qualified directors, (3) align directors' interests with those of the long-term owners of the corporation and (4) provide complete disclosure to shareowners regarding all components of director compensation including the philosophy behind the program and all forms of compensation.

To accomplish these goals, director compensation should consist solely of a combination of cash retainer and equity-based compensation. The cornerstone of director compensation programs should be alignment of interests through the attainment of significant equity holdings in the company meaningful to each individual director. The Council believes that equity obtained with an individual's own capital provides the best alignment of interests with other shareowners. However, compensation plans can provide supplemental means of obtaining long-term equity holdings through equity compensation, long-term holding requirements and ownership requirements.

Companies should have flexibility within certain broad policy parameters to design and implement director compensation plans that suit their unique circumstances. To support this flexibility, investors must have complete and clear disclosure of both the philosophy behind the compensation plan as well as the actual compensation awarded under the plan. Without full disclosure, it is difficult to earn investors' confidence and support for director and executive compensation plans.

Although non-employee director compensation is generally immaterial to a company's bottom line and small relative to executive pay, director compensation is an important piece of a company's governance. Because director pay is set by the board and has inherent conflicts of interest, care must be taken to ensure there is no appearance of impropriety. Companies should pay particular attention to managing these conflicts.



**6.2 Role of the Compensation Committee in Director Compensation:** The compensation committee (or alternative committee comprised solely of independent directors) is responsible for structuring director pay, subject to approval of all the independent directors, so that it is aligned with the long-term interests of shareowners. Because directors set their own compensation, the following practices should be emphasized:

- a. **Total Compensation Review:** The compensation committee should understand and value each component of director compensation and annually review total compensation potentially payable to each director.
- b. **Outside Advice:** Committees should have the ability to hire a compensation consultant for assistance on director compensation plans. In cases where the compensation committee does use a consultant, it should always retain an independent compensation consultant or other advisers it deems appropriate to assist with the evaluation of the structure and value of director compensation. A summary of the pay consultant's advice should be provided in the annual proxy statement in plain English. The compensation committee should disclose all instances where the consultant is also retained by the committee to provide advice on executive compensation.
- c. **Compensation Committee Report:** The annual director compensation disclosure included in the proxy materials should include a discussion of the philosophy for director pay and the processes for setting director pay levels. Reasons for changes in director pay programs should be explained in plain English. Peer group(s) used to compare director pay packages should be fully disclosed, along with differences, if any, from the peer group(s) used for executive pay purposes. While peer analysis can be valuable, peer-relative justification should not dominate the rationale for (higher) pay levels. Rather, compensation programs should be appropriate for the circumstances of the company. The report should disclose how many committee meetings involved discussions of director pay.

### 6.3 Retainer

- a. **Amount of Annual Retainer:** The annual retainer should be the sole form of cash compensation paid to non-employee directors. Ideally, it should reflect an amount appropriate for a director's expected duties, including attending meetings, preparing for meetings/discussions and performing due diligence on sites/operations (which should include routine communications with a broad group of employees). In some combination, the retainer and the equity component also reflect the director's contribution from experience and leadership. Retainer amounts may be differentiated to recognize that certain non-employee directors—possibly including independent board chairs, independent lead directors, committee chairs or members of certain committees—are expected to spend more time on board duties than other directors.
- b. **Meeting Attendance Fees:** Directors should not receive any meeting attendance fees since attending meetings is the most basic duty of a non-employee director.
- c. **Director Attendance Policy:** The board should have a clearly defined attendance policy. If the committee imposes financial consequences (loss of a portion of the retainer or equity) for missing meetings as part of the director compensation program, this should be fully disclosed. Financial consequences for poor attendance, while perhaps appropriate in some

circumstances, should not be considered in lieu of examining the attendance record, commitment (time spent on director duties) and contribution in any review of director performance and in re-nomination decisions.

**6.4 Equity-based Compensation:** Equity-based compensation can be an important component of director compensation. These tools are perhaps best suited to instill optimal long-term perspective and alignment of interests with shareowners. To accomplish this objective, director compensation should contain an ownership requirement or incentive and minimum holding period requirements.

- a. **Vesting of Equity-based Awards:** To complement the annual retainer and align director-shareowner interests, non-employee directors should receive stock awards or stock-related awards such as phantom stock or share units. Equity-based compensation to non-employee directors should be fully vested on the grant date. This point is a marked difference to the Council's policy on executive compensation, which calls for performance-based vesting of equity-based awards. While views on this topic are mixed, the Council believes that the benefits of immediate vesting outweigh the complications. The main benefits are the immediate alignment of interests with shareowners and the fostering of independence and objectivity for the director.
- b. **Ownership Requirements:** Ownership requirements should be at least three to five times annual compensation. However, some qualified director candidates may not have financial means to meet immediate ownership thresholds. For this reason, companies may set either a minimum threshold for ownership or offer an incentive to build ownership. This concept should be an integral component of the committee's disclosure related to the philosophy of director pay. It is appropriate to provide a reasonable period of time for directors to meet ownership requirements or guidelines.
- c. **Holding Periods:** Separate from ownership requirements, the Council believes companies should adopt holding requirements for a significant majority of equity-based grants. Directors should be required to retain a significant portion (such as 80 percent) of equity grants until after they retire from the board. These policies should also prohibit the use of any transactions or arrangements that mitigate the risk or benefit of ownership to the director. Such transactions and arrangements inhibit the alignment of interests that equity compensation and ownership requirements provide.
- d. **Mix of Cash and Equity-based Compensation:** Companies should have the flexibility to set and adjust the split between equity-based and cash compensation as appropriate for their circumstances. The rationale for the ratio used is an important element of disclosures related to the overall philosophy of director compensation and should be disclosed.
- e. **Transparency:** The present value of equity awards paid to each director during the previous year and the philosophy and process used in determining director pay should be fully disclosed in the proxy statement.
- f. **Shareowner Approval:** Current listing standards require shareowner approval of equity-based compensation plans and material amendments to plans (with limited exceptions). Companies should adopt conservative interpretations of approval requirements when confronted with choices.

**6.5 Performance-based Compensation:** While the Council is a strong advocate of performance-based concepts in executive compensation, we do not support performance measures in director compensation. Performance-based compensation for directors creates potential conflicts with the director's primary role as an independent representative of shareowners.

**6.6 Perquisites:** Directors should not receive perquisites other than those that are meeting-related, such as air-fare, hotel accommodations and modest travel/accident insurance. Health, life and other forms of insurance; matching grants to charities; financial planning; automobile allowances and other similar perquisites cross the line as benefits offered to employees. Charitable awards programs are an unnecessary benefit; directors interested in posthumous donations can do so on their own via estate planning. Infrequent token gifts of modest value are not considered perquisites.

**6.7 Repricing and Exchange Programs:** Under no circumstances should directors participate in or be eligible for repricing or exchange programs.

**6.8 Employment Contracts, Severance and Change-of-control Payments:** Non-employee directors should not be eligible to receive any change-in-control payments or severance arrangements.

#### **6.9 Retirement Arrangements**

**a. Retirement Benefits:** Since non-employee directors are elected representatives of shareowners and not company employees, they should not be offered retirement benefits, such as defined benefit plans or deferred stock awards, nor should they be entitled to special post-retirement perquisites.

**b. Deferred Compensation Plans:** Directors may defer cash pay via a deferred compensation plan for directors. However, such investment alternatives offered under deferred compensation plans for directors should mirror those offered to employees in broad-based deferral plans. Non-employee directors should not receive "sweeteners" for deferring cash payments into company stock.

**6.10 Disgorgement:** Directors should be required to repay compensation to the company in the event of malfeasance or a breach of fiduciary duty involving the director.

### **7. Independent Director Definition**

#### **7.1 Introduction**

#### **7.2 Basic Definition of an Independent Director**

#### **7.3 Guidelines for Assessing Director Independence**

**7.1 Introduction:** A narrowly drawn definition of an independent director (coupled with a policy specifying that at least two-thirds of board members and all members of the audit, compensation and nominating committees should meet this standard) is in the corporation's and shareowners' financial interest because:

- a. Independence is critical to a properly functioning board;
- b. Certain clearly definable relationships pose a threat to a director's unqualified independence;
- c. The effect of a conflict of interest on an individual director is likely to be almost impossible to detect, either by shareowners or other board members; and
- d. While an across-the-board application of *any* definition to a large number of people will inevitably miscategorize a few of them, this risk is sufficiently small and is far outweighed by the significant benefits.

Independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. Consequently no clear rule can unerringly describe and distinguish independent directors. However, the independence of the director depends on all relationships the director has, including relationships between directors, that may compromise the director's objectivity and loyalty to shareowners. Directors have an obligation to consider all relevant facts and circumstances to determine whether a director should be considered independent.

Boards have an obligation to consider all relevant facts and circumstances to determine whether a director should be considered independent. These considerations include the director's years of service on the board. Extended periods of service may adversely impact a director's ability to bring an objective perspective to the boardroom.

**7.2 Basic Definition of an Independent Director:** An independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship. Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation.

**7.3 Guidelines for Assessing Director Independence:** The notes that follow are supplied to give added clarity and guidance in interpreting the specified relationships. A director will not be considered independent if he or she:

- a. Is, or in the past five years has been, or whose relative is, or in the past five years has been, employed by the corporation or employed by or a director of an affiliate;

*NOTES:* An "affiliate" relationship is established if one entity either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote more than 20 percent of the equity interest in another, unless some other person, either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote a greater percentage of the equity interest. For these purposes, joint venture partners and general partners meet the definition of an affiliate, and officers and employees of joint venture enterprises and general partners are considered affiliated. A subsidiary is an affiliate if it is at least 20 percent owned by the corporation.

Affiliates include predecessor companies. A "predecessor" is an entity that within the last five years was party to a "merger of equals" with the corporation or represented more than 50 percent of the corporation's sales or assets when such predecessor became part of the

corporation.

"Relatives" include spouses, parents, children, step-children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, aunts, uncles, nieces, nephews and first cousins, and anyone sharing the director's home.

- b. Is, or in the past five years has been, or whose relative is, or in the past five years has been, an employee, director or greater-than-20-percent owner of a firm that is one of the corporation's or its affiliate's paid advisers or consultants or that receives revenue of at least \$50,000 for being a paid adviser or consultant to an executive officer of the corporation;

*NOTES:* Advisers or consultants include, but are not limited to, law firms, auditors, accountants, insurance companies and commercial/investment banks. For purposes of this definition, an individual serving "of counsel" to a firm will be considered an employee of that firm.

The term "executive officer" includes the chief executive, operating, financial, legal and accounting officers of a company. This includes the president, treasurer, secretary, controller and any vice-president who is in charge of a principal business unit, division or function (such as sales, administration or finance) or performs a major policymaking function for the corporation.

- c. Is, or in the past five years has been, or whose relative is, or in the past five years has been, employed by or has had a five percent or greater ownership interest in a third-party that provides payments to or receives payments from the corporation and either: (i) such payments account for one percent of the third-party's or one percent of the corporation's consolidated gross revenues in any single fiscal year; or (ii) if the third-party is a debtor or creditor of the corporation and the amount owed exceeds one percent of the corporation's or third party's assets. Ownership means beneficial or record ownership, not custodial ownership;
- d. Has, or in the past five years has had, or whose relative has paid or received more than \$50,000 in the past five years under, a personal contract with the corporation, an executive officer or any affiliate of the corporation;

*NOTES:* Council members believe that even small personal contracts, no matter how formulated, can threaten a director's complete independence. This includes any arrangement under which the director borrows or lends money to the corporation at rates better (for the director) than those available to normal customers—even if no other services from the director are specified in connection with this relationship;

- e. Is, or in the past five years has been, or whose relative is, or in the past five years has been, an employee or director of a foundation, university or other non-profit organization that receives significant grants or endowments from the corporation, one of its affiliates or its executive officers or has been a *direct* beneficiary of any donations to such an organization;

*NOTES:* A "significant grant or endowment" is the lesser of \$100,000 or one percent of

total annual donations received by the organization.

- f. Is, or in the past five years has been, or whose relative is, or in the past five years has been, part of an interlocking directorate in which the CEO or other employee of the corporation serves on the board of a third-party entity (for-profit or not-for-profit) employing the director or such relative;
- g. Has a relative who is, or in the past five years has been, an employee, a director or a five percent or greater owner of a third-party entity that is a significant competitor of the corporation; or
- h. Is a party to a voting trust, agreement or proxy giving his/her decision making power as a director to management except to the extent there is a fully disclosed and narrow voting arrangement such as those which are customary between venture capitalists and management regarding the venture capitalists' board seats.

The foregoing describes relationships between directors and the corporation. The Council also believes that it is important to discuss relationships between directors on the same board which may threaten either director's independence. A director's objectivity as to the best interests of the shareowners is of utmost importance and connections between directors outside the corporation may threaten such objectivity and promote inappropriate voting blocks. As a result, directors must evaluate all of their relationships with each other to determine whether the director is deemed independent. The board of directors shall investigate and evaluate such relationships using the care, skill, prudence and diligence that a prudent person acting in a like capacity would use.

## DEFINITION OF INDEPENDENT DIRECTOR

"Independent director" means a director who:

1. Is not currently, or within the last five years<sup>31</sup> has not been, employed by the Company in an executive capacity.
2. Has not received more than \$50,000<sup>32</sup> in direct compensation from the Company during any 12-month period in the last three<sup>33</sup> years other than:
  - a. Director and committee fees including bona fide expense reimbursements.
  - b. Payments arising solely from investments in the company's securities.
3. Is not affiliated with a company that is an adviser or consultant to the Company or a member of the Company's senior management during any 12-month period in the last three years that has received more than \$50,000 from the Company.
4. Is not a current employee of a company (customer or supplier) that has made payments to, or received payments from the Company that exceed the greater of \$200,000<sup>34</sup> or 2%<sup>35</sup> of such other company's consolidated gross revenues.
5. Is not affiliated with a not-for-profit entity (including charitable organizations) that receives contributions from the Company that exceed the greater of \$200,000 or 2% of consolidated gross revenues of the recipient for that year.
6. Is not part of an interlocking directorate in which the CEO or other employee of the Company serves on the board of another company employing the director.
7. Has not had any of the relationships described above with any parent or subsidiary of the Company.
8. Is not a member of the immediate family<sup>36</sup> of any person described in Appendix E.

<sup>31</sup> 5-year look back periods are consistent the Council of Institutional Investors 2006 director independence standards.

<sup>32</sup> \$50,000 thresholds are consistent with the Council of Institutional Investors 2006 director independence standards.

<sup>33</sup> 3-year look back periods are consistent with the New York Stock Exchange and NASDAQ 2006 director independence standards.

<sup>34</sup> \$200,000 thresholds are consistent with NASDAQ 2006 director independence standards.

<sup>35</sup> 2% thresholds are consistent with New York Stock Exchange director independence standards.

<sup>36</sup> CalPERS defines immediate family consistent with the New York Stock Exchange: spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone who shares such person's home.

## APPENDIX F

**INDEPENDENT CHAIR/LEAD-DIRECTOR POSITION DUTY STATEMENT**

The independent chairperson is responsible for coordinating the activities of the board of directors including, but not limited to, those duties as follows:

1. Coordinate the scheduling of board meetings and preparation of agenda material for board meetings and executive sessions of the board's independent or non-management directors.
2. Lead board meetings in addition to executive sessions of the board's independent or non-management directors.
3. Define the scope, quality, quantity and timeliness of the flow of information between company management and the board that is necessary for the board to effectively and responsibly perform their duties.
4. Oversee the process of hiring, firing, evaluating, and compensating the CEO.
5. Approve the retention of consultants who report directly to the board.
6. Advise the independent board committee chairs in fulfilling their designated roles and responsibilities to the board.
7. Interview, along with the chair of the nominating committee, all board candidates, and make recommendations to the nominating committee and the board.
8. Assist the board and company officers in assuring compliance with and implementation of the company's Governance Principles.
9. Act as principal liaison between the independent directors and the CEO on sensitive issues.
10. Coordinate performance evaluations of the CEO, the board, and individual directors.
11. Recommend to the full board the membership of the various board committees, as well as selection of the committee chairs.
12. Be available for communication with shareowners.



### Global Framework for Climate Risk Disclosure

While each sector and company may differ in its approach to disclosure, the most successful corporate climate risk disclosure will be transparent and make clear the key assumptions and methods used to develop it. Companies should directly engage investors and securities analysts in disclosing climate risk through both written documents and discussions.

Investors expect climate risk disclosure to allow them to analyze a company's risks and opportunities and strongly encourage that the disclosure include the following elements:

1. **Emissions** – As an important first step in addressing climate risk, companies should disclose their total greenhouse gas emissions. Investors can use this emissions data to help approximate the risk companies may face from future climate change regulations.

Specifically, investors strongly encourage companies to disclose:

- a. Actual historical direct and indirect emissions since 1990;
- b. Current direct and indirect emissions; and
- c. Estimated future direct and indirect emissions of greenhouse gases from their operations, purchased electricity, and products/services.<sup>37</sup>

Investors strongly encourage companies to report absolute emissions using the most widely agreed upon international accounting standard – Corporate Accounting and Reporting Standard (revised edition) of the Greenhouse Gas Protocol, developed by the World Business Council for Sustainable Development and the World Resources Institute.<sup>38</sup> If companies use a different accounting standard, they should specify the standard and the rationale for using it.

2. **Strategic Analysis of Climate Risk and Emissions Management** – Investors are looking for analysis that identifies companies' future challenges and opportunities associated with climate change. Investors therefore seek management's strategic analysis of climate risk, including a clear and straightforward statement about implications for competitiveness. Where relevant, the following issues should also be addressed: access to resources, the timeframe that applies to the risk and the firm's plan for meeting any strategic challenges posed by climate risk.

Specifically, investors urge companies to disclose a strategic analysis that includes:

<sup>37</sup> These emissions disclosures correspond with the three "scopes" identified in the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard (revised edition) developed by the World Business Council for Sustainable Development and the World Resources Institute. Scope 1 includes a company's direct greenhouse gas emissions; Scope 2 includes emissions associated with the generation of electricity, heating/cooling, or steam purchased for a company's own consumption; and Scope 3 includes indirect emissions not covered by Scope 2. More information is available at <http://www.ghgprotocol.org>

<sup>38</sup> Available at <http://www.ghgprotocol.org>

- a. **Climate Change Statement** – A statement of the company's current position on climate change, its responsibility to address climate change, and its engagement with governments and advocacy organizations to affect climate change policy.
  - b. **Emissions Management** – Explanation of all significant actions the company is taking to minimize its climate risk and to identify opportunities. Specifically, this should include the actions the company is taking to reduce, offset, or limit greenhouse gas emissions. Actions could include establishment of emissions reduction targets, participation in emissions trading schemes, investment in clean energy technologies, and development and design of new products. Descriptions of greenhouse gas reduction activities and mitigation projects should include estimated emission reductions and timelines.
  - c. **Corporate Governance of Climate Change** – A description of the company's corporate governance actions, including whether the Board has been engaged on climate change and the executives in charge of addressing climate risk. In addition, companies should disclose whether executive compensation is tied to meeting corporate climate objectives, and if so, a description of how they are linked.
3. **Assessment of Physical Risks of Climate Change** – Climate change is beginning to cause an array of physical effects, many of which can have significant implications for companies and their investors. To help investors analyze these risks, investors encourage companies to analyze and disclose material, physical effects that climate change may have on the company's business and its operations, including their supply chain.
- Specifically, investors urge companies to begin by disclosing how climate and weather generally affect their business and its operations, including their supply chain. These effects may include the impact of changed weather patterns, such as increased number and intensity of storms; sea-level rise; water availability and other hydrological effects; changes in temperature; and impacts of health effects, such as heat-related illness or disease, on their workforce. After identifying these risk exposures, companies should describe how they could adapt to the physical risks of climate change and estimate the potential costs of adaptation.
4. **Analysis of Regulatory Risks** – As governments begin to address climate change by adopting new regulations that limit greenhouse gas emissions, companies with direct or indirect emissions may face regulatory risks that could have significant implications. Investors seek to understand these risks and to assess the potential financial impacts of climate change regulations on the company.

Specifically, investors strongly urge companies to disclose:

- a. Any known trends, events, demands, commitments, and uncertainties stemming from climate change that are reasonably likely to have a material effect on financial condition or operating performance. This analysis should include consideration of secondary effects of regulation such as increased energy and transportation costs. The analysis should incorporate the possibility that consumer demand may shift sharply due to changes in domestic and international energy markets.

- b. A list of all greenhouse gas regulations that have been imposed in the countries in which the company operates and an assessment of the potential financial impact of those rules.
- c. The company's expectations concerning the future cost of carbon resulting from emissions reductions of five, ten, and twenty percent below 2000 levels by 2015. Alternatively, companies could analyze and quantify the effect on the firm and shareowner value of a limited number of plausible greenhouse gas regulatory scenarios. These scenarios should include plausible greenhouse gas regulations that are under discussion by governments in countries where they operate. Companies should use the approach that provides the most meaningful disclosure, while also applying, where possible, a common analytic framework in order to facilitate comparative analyses across companies. Companies should clearly state the methods and assumptions used in their analyses for either alternative.

### **Ceres 14-Point Climate Change Governance Checklist**

#### **Board Oversight**

1. Board is actively engaged in climate change policy and has assigned oversight responsibility to board member, board committee or full board.

#### **Management Execution**

2. Chairman/CEO assumes leadership role in articulating and executing climate change policy.
3. Top executives and/or executive committees assigned to manage climate change response strategies.
4. Climate change initiatives are integrated into risk management and mainstream business activities.
5. Executive officers' compensation is linked to attainment of environmental goals and GHG targets.

#### **Public Disclosure**

6. Securities filings disclose material risks and opportunities posed by climate change.
7. Public communications offer comprehensive, transparent presentation of response measures.

#### **Emissions Accounting**

8. Company calculates and registers GHG emissions savings and offsets from operations.
9. Company conducts annual inventory of GHG emissions and publicly reports results.
10. Company has an emissions baseline by which to gauge future GHG emissions trends.
11. Company has third-party verification process for GHG emissions data.

#### **Strategic Planning**

12. Company sets absolute GHG emission reduction targets for facilities, energy use, business travel and other operations (including direct emissions.)
13. Company participates in GHG emissions trading programs – up to 30.
14. Company pursues business strategies to reduce GHG emissions, minimize exposure to regulatory and physical risks, and maximize opportunities from changing market forces and emerging controls.

### Joint Venture Governance Guidelines

*Businesses used to grow in one of two ways: from grassroots up or by acquisition. In both cases, the manager had control. **Today businesses grow through alliances, all kinds of dangerous liaisons and joint ventures, which, by the way, very few people understand.***

– Peter Drucker<sup>39</sup>

Good governance matters to joint ventures – and joint ventures matter to many public companies and, therefore, their public shareowners.

Today there are more than 1000 joint ventures (JVs) with more than \$1 billion in annual revenues or invested capital. The 8 largest publicly listed oil and gas companies and 6 metals and mining majors have more than \$500 billion in assets in major joint ventures. More broadly, many public companies hold a dozen or more material JVs in their portfolios, and depend on JVs for 10-20 percent of total corporate revenues, assets, or income, using joint ventures as a key tool to access technology and innovation, gain scale and reduce costs, share risk, and build new businesses. In such industries as conventional petroleum, alternative energy, chemicals, basic materials, and aerospace, joint ventures account for upwards of 30-50 percent of many company's economic activity. Likewise, joint ventures are widely used in China, India, Russia, Korea, Latin America, and the Middle East.

More than 10 years ago, CalPERS established a set of governance principles for public companies at the corporate level with the underlying tenet that fully accountable corporate governance structures produce, over the long term, the best returns to shareowners.

We believe a similar level of scrutiny and focus should be extended to the largest joint ventures of public companies, and that shareowners will benefit by the application of more consistent standards of governance. These JV Governance Guidelines, co-authored by CalPERS and Water Street Partners<sup>40</sup>, are an effort to promote such attention and, in time, drive improved performance and reduced risk within a large but relatively less-transparent asset class.

### INTRODUCTION: THE JV GOVERNANCE CHALLENGE

Any joint venture warrants good governance.<sup>41</sup> Our focus – and that of these Guidelines – is on joint ventures that are financially large or strategically significant, and entail some degree of joint managerial decision-making and operational interdependence between the shareowners and the venture.<sup>42</sup>

<sup>39</sup> The Post-Capitalist Executive: An Interview with Peter F. Drucker; Harvard Business Review; May-June 1993.

<sup>40</sup> Water Street Partners is an advisory firm based in Washington DC founded by David Ernst and James Bamford, widely-published experts on joint venture strategy and governance who founded and led the Alliance Practice at McKinsey & Company from 1990 to 2008.

<sup>41</sup> We define "joint venture" as a legal business entity owned by two or more separate corporate parents.

<sup>42</sup> To be clear, these guidelines are not aimed at certain types of joint ventures that do not demonstrate these characteristics – notably (1) joint ventures that are purely financial vehicles, such as are common in the real estate and other investment industries, or (2) joint ventures that are clearly operated by one partner and do not function as

The governance of these joint ventures introduces unique challenges. These challenges are an outgrowth of the way the corporate-parent shareholders inter-relate to the venture, most notably: shared oversight and control; significant economic and business flows between the shareholders and JV for various services, inputs or outputs; differing appetites for growth, investment, and cash returns from the shareholders (i.e., corporate parents); and changes in shareholder strategies and reactions to new market conditions that put pressure on the JV.

To understand why joint ventures are different, consider how the governance of joint ventures compare to that of public companies:

**Board composition and decision making:**

- ❖ Public Company Governance: Nonexecutive/independent Board members constitute a majority of the Board, and the Board is an agent for independent shareowners, who are aligned around the basic desire to maximize overall shareowner returns
- ❖ JV Governance: In JVs, there are typically no independent Board members from outside the JV and the parent companies; Board members represent parent companies which often have differing objectives, investment and risk preferences, and receive asymmetric benefits from the venture

**Resource flows from the shareholders:**

- ❖ Public Company Governance: The company does not depend on shareowners for operational inputs into the business -- or, if the company does, those transactions are conducted on a true arms-length basis, and subject to legal and governance protections against conflicts of interest
- ❖ JV Governance: Commercial relationships are not always easily conducted at arms-length market prices, and conflicts of interest cannot be completely avoided.

**Management team:**

- ❖ Public Company Governance: Members of the management team do not have past or future reporting relationships or employment opportunities with the companies of Board members
- ❖ JV Governance: The top JV executives are frequently current or former employees of one shareholder, and their future employment opportunities may be influenced by a parent-company executive who is a Board Director of the JV. In addition, especially for secondees, pension and other compensation elements may be tied to one shareholder *even while serving in the venture*.

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discreet organizational entities with a management team, board and assets, etc., such has been a hallmark structure of the classic upstream oil and gas joint venture.

While JVs hold some governance advantages to that of public companies,<sup>43</sup> on balance, joint venture governance is *pound for pound* more challenging than corporate governance, and is arguably just as important for public shareowners. CalPERS has long believed that good corporate governance represents “the grain in the balance” that “makes the difference between wallowing for long (and perhaps fatal) periods in the depths of the performance cycle, and responding quickly to correct the corporate course.” CalPERS and Water Street Partners believe that, in joint ventures, poor governance represents “an anvil at the end of the table” that can have enormous impact on the stability and performance of these ventures and, by extension, a meaningful impact to their public-company owner(s).

Consider some data. Despite some compelling reasons to enter into joint ventures, the historic performance of JVs has been mixed. Research has shown that roughly 50 percent of JVs fail to meet the financial and strategic goals of the corporate parents, while 46 percent of joint venture announcements have a negative impact on the parent’s share price.<sup>44</sup>

**Poor governance plays a role in this underperformance** – and indeed is preventing many already successful JVs from delivering even better returns to their corporate parents. For instance, an ex post assessment of 49 large joint ventures showed that some 50 percent of failures were the result of poor governance and management. Likewise, some 80 percent of participants of a JV CEO and Directors Roundtable<sup>45</sup> stated that their JV Boards have not been a source of real strength for the JV, and some 60 percent did not have financial management systems in their JVs that were as good as those in their parent businesses.<sup>46</sup> Other research showed a very high correlation between good outcome performance (e.g., financial, operational and strategic results) and good governance performance and health.<sup>47</sup> Similarly, in more than 100 situations involving the restructuring of major joint ventures, the ventures were routinely

<sup>43</sup> For example, because JV Board members almost always come from one of the parent companies, tend to be quite experienced in the relevant business area or market; and, as senior managers, are more than willing to assert their views in Board meetings when appropriate to protect shareholder interests. JV Board members also frequently are in a position to do more to help the JV management succeed, e.g. by accessing resources and skills from the parent company.

<sup>44</sup> For more details on joint venture and alliance performance, please see Joel Bleeke and David Ernst, *Collaborating to Compete*, John Wiley & Sons, 1993; David Ernst and Tammy Halevy, “When to Think Alliance,” *McKinsey Quarterly*, Q4 2000; James Bamford and David Ernst, “Managing an Alliance Portfolio,” *McKinsey Quarterly*, Q3, 2002; and James Bamford and David Ernst, “Getting a Grip on Alliances,” *Corporate Dealmaker*, December 2004.

<sup>45</sup> JV CEO and Directors Roundtable (sponsored by McKinsey and led by James Bamford and David Ernst) in New York on October 13, 2004 (participants ran or oversaw more than 100 major JVs across 10 industries).

<sup>46</sup> A McKinsey survey of 34 companies showed that 53 percent of companies do not regularly incorporate joint ventures into their standard corporate planning and review process, and that 44 percent claim that senior parent executives are not sufficiently focused on joint ventures and other major alliances. (McKinsey survey of Conference Board participants in the 2004 Strategic Alliances Conference, April 2004). Anecdotal, numerous cases where companies leave even their largest joint ventures outside the corporate challenge process. For further details, see James Bamford, David Ernst, and David Fubini, “Launching a Worldclass Joint Venture,” *Harvard Business Review*, February 2004.

<sup>47</sup> Results from McKinsey Benchmarking of JV governance (2008), authored by James Bamford, David Ernst and Lois D’Costa, and presented to the Association of Strategic Alliance Professionals in February 2008. This research evaluated the performance and rigorously calibrated a broad set of governance and talent practices of 25 major joint ventures in the oil and gas, basic materials, financial services and other industries in the US, Europe, Asia and the Middle East.

able to capture 10-30 percent increases in annual profitability by making changes to the governance, scope, and structure of the JV.<sup>48 49</sup>

Using the petroleum and basic materials industries as proxies, it is possible to estimate the amount of “value restoration” associated with improved JV good governance. For the top 8 petroleum companies and the top 6 basic and mining companies, material joint ventures today account for \$72 billion in annual earnings (on a \$503 billion asset base). Calculations by Water Street Partners indicate that, conservatively, there is \$5-13 billion in improved annual earnings available collectively to these 14 companies. At current trading multiples, this represents roughly \$50-130 billion in added market capitalization that could be created through better JV governance and enhanced performance in just these 14 companies. When we extrapolate to other companies in the petroleum and mining industries – and to other industries such as telecom, chemicals, aerospace and defense, industrial manufacturing, and high-tech – there is, at minimum, \$15-36 billion in value restoration available from the improved governance and shareholder relationship of material joint ventures.<sup>50</sup>

Despite the importance of JV governance, companies under-invest in governance design. The established body of JV governance case law and accepted good practice are underdeveloped,<sup>51</sup> with little systematic benchmarking of JV governance practices or JV performance. While certain important governance provisions do get included in most JV legal contracts (e.g., Board composition, veto rights, dispute resolution), these provisions address only a narrow set of issues, and tend to focus on establishing a rudimentary framework for governance, plus legal protections against “extreme” events (e.g., material breach, parent bankruptcy). The key legal documents of most major JVs do not come close to meeting the real needs of (i) putting in place an effective ongoing JV governance system; (ii) ensuring that each JV is appropriately monitored by the parent companies; and (iii) triggering interventions on a timely basis, based on appropriate transparency, accountability, and engaged Board members.

We believe that it is useful for corporate and JV Boards to adopt a set of JV governance guidelines – that is, a set of standards or “minimums” for JV governance – against which companies and their public shareholders can assess the governance of their largest JVs. In proposing these guidelines, our hope is to help improve the performance of these ventures that today serve as a vital – but often challenging – engine for corporate growth.

While our focus is on the material joint ventures of public companies, we believe many of these concepts are equally relevant to JVs that have private or government ownership, as well as smaller joint ventures and complex non-equity partnership structures. We encourage

<sup>48</sup> For further details on the value associated with restructuring large joint ventures, see David Ernst and James Bamford, “Your Alliances are Too Stable,” *Harvard Business Review*, June 2005.

<sup>49</sup> For other significant work on joint ventures, see: Stephen I. Glover and Craig M. Wasserman (editors and co-authors), *Partnerships, Joint Ventures and Strategic Alliances*, Law Journal Press (2007); Kathryn Rudie Harrigan, *Managing for Joint Venture Success*, Lexington Books (1986); Pierre Dussauge and Bernard Garrette, *Cooperative Strategy: Competing Successfully through Strategic Alliances*, John Wiley (1999); Benjamin Gomes-Casseres *The Alliance Revolution*, Harvard University Press (1996); John Child, David Faulkner and Stephen Tallman, *Strategies for Cooperation: Managing Alliances, Networks, and Joint Ventures*, Oxford University Press (2005).

<sup>50</sup> For details of this analysis, see Water Street Partners website, [waterstreetpartners.net](http://waterstreetpartners.net).

<sup>51</sup> A few groups in the oil and gas industry have developed guidelines for auditing certain types of JVs. See, for example, *Guidelines for Joint Venture Audit Standards*, Australian Petroleum Production & Exploration Association Limited, February 2000.



companies to have a discussion about where and how to apply these guidelines in their portfolio of equity joint ventures and non-equity partnerships.

#### DESIGN OBJECTIVES AND PRINCIPLES

The purpose of these guidelines is to improve the performance and reduce the risks associated with material joint ventures, and to do so by putting in place a set of governance practices that:

1. Raise the level of performance management discipline and accountability, which has often proven inconsistent in joint ventures
2. Improve decision making speed and the ability of joint ventures to respond rapidly to changes in the market
3. Increase transparency overall – within the venture and its board structures, within the corporate parents who own these ventures, and ultimately within the public shareowners of these parent companies
4. Promote alignment among the parent companies and put in place mechanisms to deal with the inherent tensions and conflicts that arise between joint venture parent companies
5. Create a mechanism for JV Boards to assess the health of governance on a regular basis, promoting proactive adjustments to avoid major issues that can build over time
6. Provide a set of guidelines that are *complementary* to existing requirements (e.g., financial disclosure, accounting, compliance, legal, etc.) to which joint ventures are already exposed

#### JV GOVERNANCE GUIDELINES

CalPERS and Water Street Partners recommend that the Boards of material joint ventures adopt the following guidelines, and put into place practices to support them<sup>62</sup>:

##### A. Board Mandate and Structure

1. The Joint Venture Board of Directors is the primary means for governing the joint venture, and the JV CEO reports directly and only to the JV Board. Shareholder input to the JV CEO and JV CFO should be channeled through the Board (and not communicated in an uncoordinated manner to JV management).
2. The JV Board has an explicit charter and delegation of authority framework that defines its role in relation to JV Management, JV Board Committees, and the Boards and Management of the Parent Companies. This charter and framework specifically spells out where venture management has the power to act on its own and where the parents

<sup>52</sup> These guidelines are aimed at financially large or strategically significant joint ventures that entail some degree of joint managerial decision-making and operational interdependence between the shareholders and the venture. As such, they are not aimed at joint ventures that are, for instance, purely financial vehicles, such as are common in the real estate and other investment industries, or joint ventures that are clearly operated by one partner and do not function as a discreet organizational entities with a management team, board and assets, etc.. Likewise, these guidelines relate to the governance of joint ventures – and not to other important aspects of these business structures, including ownership and financial arrangements, legal issues, including dispute resolution and exit provisions, and human resource and staffing policies.

(individually or through the JV Board) will have control, influence or close involvement.<sup>53</sup> The framework also identifies decisions that require separate approval by the Parent Company Boards or Parent Company Management – where approval by the JV Board is not sufficient. The scope of the framework should include matters to fiscal authority, operations, personnel decisions, and strategy (such as changes to the venture's product, pricing or market positioning). The Board periodically reassesses this delegation of authority framework, and takes measures to adjust approval levels based on JV performance and business conditions.

3. The JV Board is responsible for performing the roles of a traditional Corporate Board, including: (i) setting strategy and direction; (ii) approving major capital investments; (iii) ensuring strong performance management and managing financial risk; (iv) protecting shareholder and public interests, including legal, safety, ethics and environmental considerations; and (v) overseeing CEO and top-management hiring, evaluation, compensation and succession planning. In addition, the JV Board is responsible for JV-specific roles, including:
  - a. Securing needed resources and organizational commitments from the corporate parents, on a timely basis. This includes facilitating staff rotations as needed between the JV and parent companies
  - b. Overseeing the negotiation of major commercial agreements between JV and parent, and shielding the JV CEO and management team from negotiating with parent stakeholders on issues where parent interests are misaligned
  - c. Periodically assessing the need for major change in the venture strategy, scope, ownership/financial structure and operating model within the strategic confines defined by the parent company – much as a corporation would challenge the strategy, structure, and, if needed, continued corporate ownership of a business unit
4. The Board has established and maintains an active Audit Committee, which meets more than once a year, and is responsible for reporting and oversight of compliance, financial statement integrity, and overall risk management.<sup>54</sup> At least one Board member has significant financial expertise and is the chair of the Audit Committee.

<sup>53</sup> Areas where the Board could comment on its level of ongoing involvement include: second-level staffing decisions and performance reviews, product pricing decisions, negotiation of commercial and service agreements between the venture and one of the parents, and development of new growth opportunities. This level of clarity will almost certainly go beyond what is written in the joint venture legal agreement, which typically only spell out matters that require super-majority or unanimous approval, or where one shareholder has veto rights (e.g., hiring of a new CEO or CFO, approval of capital investments above \$20M, settlements of litigation against the company, dissolution of the business). While there is some early evidence that less operational involvement by the shareholders / Board is linked to stronger outcome performance, the above governance guideline only aims for the Board to clarify its posture toward the venture, rather than recommend what that posture should be.

<sup>54</sup> One US company that is a highly-experienced user of joint ventures has taken this practice one step further: As a way to promote good financial disciplines and controls, it requires its major JVs to comply with Sarbanes Oxley, and for the JV CEO and JV CFO to provide a written "Sarbanes Oxley Attestation" on a quarterly basis to the company. This attestation is not a legally binding document, but is a powerful signifier of shareholder expectations and driver of individual accountability among the JV management team. The approach is notable because it is above what is required from a legal standpoint: Sarbanes Oxley, as a piece of regulation, applies only to publicly-traded US companies, and therefore is not something that joint venture companies must per se comply with.

5. The Board has established and maintains an active Compensation Committee<sup>55</sup>, which meets regularly and is responsible for: (i) approving the compensation and incentive framework for the venture's top management team, including developing an annual Performance Contract for the JV CEO; (ii) nominating, evaluating, and determining compensation for the CEO; (iii) overseeing succession planning for the JV CEO and other members of venture top management; and (iv) assisting the JV CEO in ensuring access to skills and people, as needed, from the parent companies.
6. The JV Board conducts an annual audit of the joint venture's governance performance, which would include compliance with these governance guidelines and a view of the overall health of the governance system<sup>56</sup>. Related to this:
  - a. The JV Board has designated at least one Board member (likely a Lead Director, as described in section B.4) to lead such a review and discussion
  - b. The review involves a level of rigor and seriousness similar to other major reviews, and includes a set of criteria against which the shareholders agree to evaluate the venture, a summary of performance, and a discussion of opportunities to improve how the shareholders relate to each other and the venture

#### **B. Board Composition and Individual Roles**

1. Absent compelling, unusual circumstances, the JV Board should range from 4 to 10 members. If outside that range, the number of members should be justified.
2. The JV Board has established – and at least annually updates – a set of skills it seeks from Director candidates. Minimally, these skills, across the Board, should include general management experience, finance expertise, experience in the JV industry and with the geographic markets in which the JV operates, and prior experience with other JVs. In selecting members of the Board, the parent companies explicitly account for the desired mix of skills and personal dynamics within the Board overall.
3. Each shareholder has appointed to the JV Board *at least one representative* who is a senior executive of the parent company, and who is able to truly represent the interests of the parent company and command internal resources to support the venture. The following test is to be used to determine if such authority level exists: that Board member has the proven authority to: (i) sign-off on the JV's annual budget and operating plan, within limits consistent with the parent company strategy, budget, and operating plan; (ii) approve the JV's material supply or service contracts; and (iii) approve the JV CEO's annual performance contract and, when needed, the selection of a new CEO of the joint venture.
4. Each parent has designated a Lead Director. The Lead Director is a senior executive of the parent company who:
  - a. Spends at least 20 days per year in an active non-executive capacity overseeing and supporting the venture<sup>57</sup>

<sup>55</sup> This committee may operate under different names, such as Human Resource, People or Talent Committee.

<sup>56</sup> Assessments of governance health would likely relate to decision making speed and effectiveness, the delivery of resources and people between the shareholders and parents, the level of transparency and rigor in the reporting and challenge processes, and other factors that the Board deems important to a well-working joint venture governance system.

- b. Performs the following roles: (i) coordinates other Directors from his or her parent company – i.e., ensure opinions heard, consistent voice presented to JV and partner; (ii) accesses resources from inside the parent company in support of the JV; (iii) works with the other Lead Director(s) and JV CEO between Board meetings to resolve issues that do not require full Board approval; (iv) shields the JV from excessive parent company information requests and bureaucracy (e.g., duplicative reporting requirements, slow capex approval processes); and (v) supports the parent executive team and parent board in ensuring that the JV is meeting governance, compliance, risk management and transparency requirements; and, ideally, (vi) explains the JV's strategy, performance, risks and prospects at corporate-level reviews in the parent company.
5. Each Lead Director has an element of his or her annual performance review and short-term variable compensation tied to the performance of the joint venture, and his or her performance as the Lead Director. In no circumstances does the JV account for less than 10 percent of his or her total performance review and short-term variable compensation calculation.
6. The JV Board has designated a Chairperson (who may be the Lead Director from one parent company) to be additionally responsible for: (i) managing the overall Board agenda (including syndication prior to Board meetings of key issues and decisions); and (ii) overseeing the quality, quantity and timeliness of the flow of information to the Board from venture management; and, (iii) unless assigned to another Board member or committee, ensuring the integrity of the governance system, including being responsible for an annual assessment and discussion about governance performance, underlying health, and potential changes to the governance, scope or structure venture to improve its performance.
7. No member of the Joint Venture Management Team is a member of the JV Board.<sup>57</sup>
8. The JV Board ensures that it has a strong independent perspective, preferably by the inclusion of an Independent Director, with stature in the industry.<sup>58</sup> An Independent Director would not be expected to hold a swing vote in Board decisions, and may be a non-voting member of the Board. To additionally promote independence, the Board should: (i) endorse the principle that Board members and full-time venture staff (including secondees) are first and foremost to promote the interests of the venture as a whole (rather than the singular interests of one shareholder), and (ii) periodically invite independent outsiders (e.g., industry experts, customers) to Board meetings to share

<sup>57</sup> Our research indicates that such 20-days-per-year Director commitment is in the upper quartile of large joint ventures today; however, we do not believe that this represents exceptional or unrealistic commitment. For comparison purposes, in Corporate Boards, directors spend an average of 24 days (190 hours) per year preparing for and attending Company Board and Board Committee meetings. [Source: Jeremy Bacon, *Corporate Boards and Corporate Governance*, 22-24 (New York, The Conference Board, 1993).

<sup>58</sup> It is expected that the JV CEO, JV CFO, and other members of the JV management team may be present at JV Board meetings, and may make specific presentations to the Board on the business, operational and financial affairs of the joint venture company.

<sup>59</sup> We define an "Independent Director" as a Board Member not currently an employee of any of the parent companies, and who does not receive compensation for goods and services performed, excluding director fees, for any parent. Despite very limited usage in joint ventures today, we believe that Independent Directors have the potential to be an extremely powerful lever to improve governance performance – creating an independent perspective that is often missing from joint ventures.

their perspectives and challenge the Board.<sup>60</sup> To function effectively, an Independent Director needs to have a professional stature and personality that allows him or her to raise issues to and influence the shareholders.

### C. Board Processes and Evaluation

1. Working with executives in the parent companies if need be, the JV Board establishes and periodically updates a set of guiding principles defining the parents' shared philosophy toward the venture.<sup>61</sup> These principles include statements regarding the desired level of independence from the parents, whether the venture is to be run as a business or an operating asset,<sup>62</sup> and the evolution path and, if possible, planned end-game of the venture.
2. The Board has established *performance criteria* for itself as a collective body, and periodically reviews its performance against these criteria.
3. The Board has established performance criteria for its individual Board members, including *individual behavioral expectations*. Minimally, these criteria address the level of Board member attendance, preparedness, participation, and candor. To be re-nominated, directors must satisfactorily perform based on the established criteria; re-nomination on any other basis is neither expected nor guaranteed.
4. Each director has an attendance rate of at least 75 percent at Board meetings and 75 percent of Board Committee meetings of which they are members, and the Board has established a minimum standard to that effect.

### D. Management Incentives and Reporting Relationships

1. The JV CEO reports *solely* to the JV Board, which alone reviews his or her performance and determines his or her compensation.<sup>63 64</sup>

<sup>60</sup> Another – and more aggressive – approach to fostering independence (and a strong performance culture) within the JV is to bring in an outside investor (e.g., venture capital or private equity firm) as a 5-10 percent owner of the JV.

<sup>61</sup> As an illustration, one joint venture adopted a set of ten guiding principles that included the following statements: "No Slots – best people for available jobs", "JV Board Members must promote the interests of the JV as a whole – not merely advance their own parent's interests," and "Equal Communication – information available to one parent is available to all parents."

<sup>62</sup> By "operating asset" we mean an entity whose purpose is to perform specific operating activities at worldclass levels but is not judged based on its ability to grow into new areas or to drive bottom-line profits. This distinction from a "business" is especially important in the energy, basic materials, and semiconductor industries, where we have seen numerous production joint ventures encounter significant inefficiencies because the management team or one shareholder believed that the venture was to operate as a business, while one or more shareholders believed that the venture was a narrow-purpose production asset.

<sup>63</sup> One allowable exception to this guideline would be joint ventures that are clearly operated by one partner, depend on that partner to supply significant numbers of loaned employees to perform the work of the joint venture, and are essentially run as business units of that parent company.

<sup>64</sup> This practice, which WaterStreet Partners strongly endorse, is a matter of some controversy. An argument is sometimes made that when a JV CEO is a seconded – or loaned – employee from one shareholder, that it is impractical to expect that the JV CEO will have no objectives or interests outside the scope of the joint venture, and it is unrealistic to believe that the JV CEO truly reports solely to the JV Board. This argument is based on a view individuals seconded in as JV CEOs tend to be high-potential individuals who have career goals greater than the specific JV they are running, and that acting solely based on the joint venture's interests – rather than protecting their long-term employer's vested interests when in conflict with the joint venture's interests – turn out to be "career-limiting moves." Our view is that while this may be the unfortunate reality in some cases, it should not be an excuse

2. The JV Board has collectively endorsed an annual "performance contract" for the JV CEO, which includes a balanced set of key performance indicators.
3. The JV CEO compensation package is structured to *promote the interests of the joint venture as a whole*, and not asymmetrically advance the interests of a subset of parent companies. The details of this compensation package (including determinants and actual payout) are disclosed to all members of the Board even if the JV CEO is a loaned /seconded employee from one parent company.
4. The JV CEO, working in consultation with the Compensation Committee, has the freedom to offset any compensation disadvantages associated with the joint venture structure (e.g., lack of stock options, reduced career headroom relative to larger global companies, added career risk) with other forms of remuneration.<sup>65 66</sup>

#### E. Financial and Compliance Policies

1. The parents have explicitly established – and collectively endorsed and updated – specific financial hurdle rates for additional investments, dividend repatriation policies, and other key financial policies of the joint venture. (Note: Defining these hurdle rates is typically the job of the parent companies, and therefore JV Board members, depending on their role in the parent company, may or may not have the authority to do this on their own.)
2. The Board subjects the JV to a "challenge process" of equal intensity to similar-sized 100%-owned business units in the corporate parents, and does not allow the JV to be subject to a lower performance bar.<sup>67</sup> However, the JV is **not** subject to "double jeopardy" – i.e., full and separate reporting to both corporate parents where the JV must comply with different data and format requirements.<sup>68 69</sup>

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for a poor practice that drives added misalignment into the system and likely leads over the long-run to suboptimal returns for all shareholders as a group

<sup>65</sup> In one financial services industry JV, members of the JV management team (direct reports to the CEO) were paid annual base salaries of 25 percent higher than similar positions inside the parent companies of the venture, and annual bonuses on par with parent company employees. The rationale for higher base and annual bonus pay relative to the owner banks was that the JV employees, who did not have stock options, had significantly lower opportunities for long-term wealth creation. Similarly, in a multi-billion dollar downstream oil industry venture, the JV pegged employee base pay at the 50<sup>th</sup> industry percentile benchmark, and the performance-based short-term bonus at the 75<sup>th</sup> industry percentile benchmark as a way to compensate for some inherent long-term incentive disadvantages of its JV structure.

<sup>66</sup> This problem generally does not exist in joint ventures that are either (i) partially floated on public stock exchanges, or (ii) where the JV employees have phantom equity options based on JV performance.

<sup>67</sup> A number of different approaches can be used to ensure that the JV Board has access to the performance and other information that it needs. In one industrial JV, the parent created a small "affiliate analysis unit" of 4-6 finance staff whose sole job was to make sure that the Board members of three major JVs got the data and analysis they needed (beyond what the JV CEO was providing). In another case, a US-Japanese joint venture made a very deliberate decision to staff the JV itself with very strong finance talent *and* build the financial systems within the JV to create these insights.

<sup>68</sup> There are many different ways to do this. For example, in one 70-30 JV, the approach taken to avoid double jeopardy was for the JV to report to the senior parent management team of the 70% owner in a way that was similar to any business unit, with the key difference being that the Board members from the 30% partner participated in these meetings, challenging the JV from its perspective. In a multi-billion dollar oil industry JV with 50-50 ownership, the JV Board established an independent review process, including a separate and very strong finance and audit committee, as well as aggressive use of outside auditors to benchmark venture performance.

3. The joint venture service and supply agreements with the shareholders are disclosed and made available to all JV Board members, are actively monitored and governed, and ideally, unless there are compelling business reasons otherwise, are set up on an arms-length basis with externally-sourced specifications, with market-based pricing, and with the JV having the option to source externally.
4. In the event that a Parent Company provides significant and strategically sensitive services to the venture (e.g., potential for leakage of intellectual property, or compromise of customer data or relationships), that parent company provides “compliance training” to those individuals within its own organization who are involved in providing those services to the venture. This training includes what information can – and cannot – be shared, how to prioritize work for the venture relative to internal requests, treatment of cost allocations, and reporting of potential incidence, etc. The Parent Company also reinforces these compliance policies through regular communications regarding the importance of complying with these guidelines and variations.
5. The JV Board takes active and regular steps to ensure compliance with all applicable safety, environmental, anti-corruption (e.g., FCPA), and other regulatory and social requirements of responsible corporate citizenship. A recommended medium for disclosing economic, environmental, and social risks and impacts is the Global Reporting Initiative Sustainability Reporting Guidelines. In particular, the joint venture adopts practices to ensure that the JV does not commit or support human rights violations in countries in which the venture operates.

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Today, there are few if any JVs that follow all of the above governance guidelines, and indeed relatively few companies that have adopted *any* explicit governance guidelines for JVs. Nonetheless, we believe that each of these guidelines is relevant to all material joint ventures of public companies, and that each has the potential to improve venture performance and reduce risk. A decade ago, a growing chorus of commentators began to forcefully make the case that good governance was a key contributor to corporate performance. As one wrote:

*“Darwin learned that in a competitive environment an organism’s chance of survival and reproduction is not simply a matter of chance. If one organism has even a tiny edge over the others, the advantage becomes amplified over time. In ‘The Origin of the Species,’ Darwin noted, ‘A grain in the balance will determine which individual shall live and which shall die.’ I suggest that an independent, attentive board is the grain in the balance that leads to a corporate advantage. A performing board is most likely to respond effectively to a world where the pace of change is accelerating. An inert board is more likely to produce leadership that circles the wagons.”<sup>70</sup>*

We assert that good governance matters at least as much in joint ventures – and that there is a significant performance opportunity for public companies. The first step toward capturing the

<sup>69</sup> This form of double jeopardy occurs when a JV is forced to comply with both / multiple parents’ planning and review processes for the operating plan, budget, and/or capex approval. We believe that in well-governed JVs, the JV Board will coordinate and align these information requests from the parents.

<sup>70</sup> Ira M. Millstein, *New York Times*, April 6, 1997.

performance upside is for corporate and JV Boards to adopt a set of guidelines to serve as a measuring-stick.



Written Testimony of  
Darla C. Stuckey  
President and CEO  
Society for Corporate Governance

September 21, 2016

Subcommittee on Capital Markets and Government Sponsored Enterprises  
Committee on Financial Services  
US House of Representatives

"Corporate Governance: Fostering a System that Promotes Capital Formation and  
Maximizes Shareholder Value"

### **Introduction**

My name is Darla C. Stuckey and I am President and CEO of the Society for Corporate Governance, formerly known as the Society of Corporate Secretaries & Governance Professionals (the "Society"). The Society is a professional association, founded in 1946, with 3,300 members who serve approximately 1,000 public companies, which make up over two thirds of the S&P 500. About half of our members are from small and mid-cap companies. Our members are responsible for supporting the work of corporate boards of directors and their committees and the executive management of their companies on corporate governance and disclosure issues. At our companies, we seek to develop corporate governance policies and practices that support boards in their important work and that serve the interests of long-term shareholders. Our members generally are responsible for compliance with the federal securities laws and regulations, state corporate law, and stock exchange listing requirements. The majority of Society members are attorneys, although our members also include compliance officers and non-attorney corporate secretaries and other governance professionals. The Society is honored to give testimony before this Committee.

### **Background**

The Subcommittee has asked for our testimony on the following three issues related to the corporate governance of public companies:

- The potential need for reform of Rule 14a-8 of the Securities Exchange Act of 1934
- The current disclosure obligations of publicly traded companies and SEC mandates to modernize disclosure
- The impact of mandatory disclosure obligations and other corporate governance provisions in Titles IX and XV of the Dodd-Frank Wall Street Reform and Consumer Protection Act on corporations and shareholder value

### **Overview**

Each of these topics is part of a larger narrative: US public companies are bearing the brunt of a broken disclosure regime.

Mandated disclosures prompted by individuals or groups advancing their own special interests have resulted in a waste of shareholder money and management time, and an abuse of disclosure rules, particularly Rule 14a-8. Corporate proxy statements (and other disclosure documents) have been used by those insisting that their special interest issues be disclosed, in the hopes that corporations will be shamed into changing their behavior. They believe US

public companies should solve not only our country's, but some of the world's, most intractable social problems. Whether in the form of challenges to the existing materiality standard, abuse of the shareholder proposal process, or new requirements imposed by Congress that offer little meaningful information for investors, the current disclosure regime should be reexamined. It is time to look carefully at where we are and what impact the broken system is having on US publicly traded corporations, the US capital markets, and the cost to the shareholders collectively. We should ask ourselves: is this what we want the federal securities laws to do?

What are the special interests? Any social issue you can imagine: how our political elections should be funded, whether wealth should be redistributed from executives to workers, or how to stop torture in the Democratic Republic of Congo. In the past they included the privatization of social security, nuclear energy use, and doing business in Burma, Angola, China, Kazakhstan or Nigeria. Current hot topics are gender pay equity, the minimum wage, tax inversions, civil rights including sexual orientation and political speech rights, animal rights, and even the sale of firearms. And - based on our members' experience - the next few proxy seasons will likely bring a host of new social issues sought to be resolved inappropriately via the corporate disclosure regime. All of these are in addition to numerous climate change-related requests ranging from studies and reports -- to reductions of and caps on greenhouse gas emissions or hydraulic fracturing.

Specific examples include a request by a shareholder of a pharmaceutical company for a report "on the risks associated with increasing pressure to contain U.S. specialty drug prices" (defined as those that cost more than \$600 per month). Another example is a proposal submitted to DuPont asking the company "to create a committee, with members drawn from the employee work force of Du Pont, the union leadership of Du Pont, the management of Du Pont, and any necessary independent consultants, to report on the impact to communities as a result of Du Pont's action in laying off mass numbers of employees, selling its plants to other employers, and closing its plants."

We could cite more examples from our members; however, suffice it to say that nothing is off-limits for a shareholder proposal under the modern day Rule 14a-8. While we agree that most of these are compelling social issues, corporate disclosure documents are not appropriate place to vet and solve these issues.

What are the costs? The costs come in many forms: regulatory and compliance costs to capture, analyze, disclose, test, certify and audit the information required by existing regulations and rules; consulting costs for the companies to gather the information to respond to shareholder requests; legal costs to respond to proposals and for litigation by plaintiffs'

lawyers inevitably prompted by each new socially-driven disclosure mandate; and the lost opportunity cost for boards and management who have to take significant time and use other limited resources to understand and analyze each of the various issues that shareholders or politicians put forth. Yes, the cost is high, and might be justified; unfortunately, many of the disclosures “teach little,” to paraphrase former SEC Commissioner Daniel Gallagher. How did we get to this point? A brief history is illustrative: in the 1970s, there were few ways for social activists to disseminate their message. They had small budgets for publishing pamphlets or other materials. Access to a public company proxy, with 100,000 shareholders (now in the millions) for example, gave them a free way to distribute their message broadly across America.

What members of Congress must remember is that many of the SEC rules predate the Internet. This is important to today’s testimony simply because proponents now have alternative ways to reach millions of citizens for free via the Internet. With refined use of technology, even the smallest proponents can access billions of people around the world for nominal cost. While it was never an appropriate use of the disclosure regime, the need for using a corporate proxy statement as a public forum for social issues is moot.

My testimony today will focus on just a few areas that illustrate the waste and abuse associated with our disclosure regime. The first is Rule 14a-8, which allows proponents to submit proposals for corporate proxy statements at annual shareholder meetings. The second is the US Supreme Court’s materiality standard, which is the underpinning of the federal securities disclosure rules. Finally, I will address the regulatory disclosure burden on companies from governance reforms that should be helping investors making investment and voting decisions, but which in fact overloads them with meaningless, but costly information.

## I. SHAREHOLDER PROPOSALS

The Rule 14a-8 shareholder proposal process needs immediate attention. Rule 14a-8 allows shareholders who have held \$2,000 of a company’s stock for one year to submit a proposal to be included in the company’s proxy statement for a vote by all shareholders. **The rule provides an avenue for communication between shareholders and companies, as well as among shareholders themselves.** However, it has limits. The limits are designed to restrict shareholder proposals to matters of common interest to a significant number of holders, and to preclude a miniscule minority of shareholders from burdening other shareholders with proposals that a majority of shareholders do not favor.

The rule has procedures that must be followed, as well as 13 substantive bases for exclusion. One of the bases for exclusion is Rule 14a-8(i)(12). This provision allows a company to exclude a shareholder proposal if the proposal failed to receive achieve a 3% favorable vote of shareholders the last time it was included, a 6% favorable vote if it was voted on twice in the past five years, and 10% support if it was voted on three or more times in the past five years. If a proposal does not receive these minimum levels of vote support from all shareholders, a proponent cannot resubmit them. These are known as the Resubmission Thresholds. Under Rule 14a-8, if a proposal receives over 10% support, it can be resubmitted each year thereafter so long as it continues to hit that threshold.

Some of the other substantive bases for exclusion are: Rule 14a-8(i)(1) requests that are not a proper subject for action by shareholders under the laws of the corporation's jurisdiction; (i)(2) actions that would cause the company to violate Federal or State law; (i)(3) statements in a proposal that are false and misleading; (i)(4) something that involves a personal grievance of the shareholder; (i)(5) requests for action relating to operations that account for less than 5% of the company's total assets at the end of its most recent fiscal year, and for less than 5% of its net earnings and gross sales for its most recent fiscal year; (i)(7) an action that relates to a company's ordinary business operations; (i)(9) a proposal that directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting, or (i)(10) one that has already been substantially implemented by the company. Unfortunately, succumbing to pressure from special interest groups, the SEC has watered down many of these substantive bases for exclusion so that in reality it is very difficult for companies to receive no-action relief from the SEC when these exclusions are raised.

My testimony will cover just two of the bases for exclusion: resubmission thresholds and relevance, and one procedural issue.

A. Resubmission Thresholds

*The Commission should raise the thresholds for resubmission of shareholder proposals. The thresholds have not been changed since 1954. As the US Chamber explained in its Petition for Rulemaking Regarding Resubmission of Shareholder Proposals Failing to Elicit Meaningful Shareholder Support filed by the US Chamber on April 9, 2014 ("Petition for Rulemaking"), <https://www.sec.gov/rules/petitions/2014/petn4-675.pdf>, the Resubmission Thresholds are crucial to avoid rendering shareholder decisions futile, and to avoid requiring companies to respond to too many proposals of little or no relevance to their businesses.*

**Notwithstanding this view, to reiterate: the thresholds have not been changed since President Eisenhower was in office.**

We strongly believe that Rule 14a-8 needs to be modernized. The most recent attempt to have the thresholds revised was in 1997, when the Commission proposed to raise the thresholds to 6% on the first submission, 15% on the second submission, and 30% on the third. The Commission said at the time that “a proposal that has not achieved these levels of support has been fairly tested and stands no significant chance of obtaining the level of voting support required for approval.”

However, the Commission nevertheless failed to adopt these thresholds. The 1998 Adopting Release explained that it decided not to require higher “Shareholder Support Thresholds” because of “serious concerns” from the shareholder community. The concerns were that the higher thresholds would result in the exclusion of too many proposals—particularly those focusing on social policy issues which at that time tended to receive lower percentages of the shareholder vote.

As noted in the Petition for Rulemaking: “In offering this rationale for rejecting its own proposal, the Commission did not reference its three core mandates under the federal securities laws—protection of investors, facilitation of capital raising, and enhancing the effectiveness and efficiency of the Nation’s capital markets—or how the rejection of its own proposal would serve any, much less all, these core mandates.”

Shareholder proposals are expensive for companies and their shareholders, both in terms of dollars spent on legal fees as well as extra management time and board time. Frequently companies will negotiate with proponents and agree to particular requests such as undertaking a reporting obligation, rather than have a proposal go into the proxy for a vote. Aside from the consumption of time, these types of reports are also commonly expensive, particularly if they require detailed information (which most do).

We know first-hand that the real reason some proponents submit proposals is to get the attention of management for the purpose of engaging with them on issues. Shareholder proponents should be encouraged to seek engagement without the need for a proposal. Eliminating shareholder proposals that don’t get high enough votes does not preclude engagement.

The current 3% threshold is meaningless as a gating mechanism because nearly every proposal that goes to a vote gets 3% support.

The Society recently did a study on voting statistics for shareholder proposals for 1997 and 2015. ISS provided us with the voting statistics for 1997; Proxy Insight provided us with the voting statistics for 2015.

As an initial matter, we found that there was a substantial increase in the number of shareholder proposals that have gone to a vote. In 1997, 386 proposals went to a vote; while in 2015, 585 proposals went to a vote. This is during a time period in which the number of public companies shrunk by approximately a half (7300 to 3700 today). These figures do not include the number of proposals submitted that are withdrawn or excluded through the no action process. Based on this data, in 1997, assuming each proposal went to one company, about 5% of companies had a shareholder proposal on its ballot. In 2015, under the same assumption, almost 16% of companies had a proposal on its ballot. In 2013, the Society's shareholder proposal database--which collects all proposals from members who volunteer to share them in addition to publicly available proposals--had 739 proposals at 396 companies.

Our voting data on proposals for 1997 and 2015 shows the following:

- o In both 1997 and 2015, 96% of all shareholder proposals achieved the 3% threshold.

If the threshold had been raised to 5% in 2015, 90% of all shareholder proposals would have made the cut for resubmission.

- o In 1997, 77% of all shareholder proposals achieved the 6% threshold. Now 88% of all proposals hit that mark.

If the threshold had been raised to 15% in 2015, 80% of all shareholder proposals would have hit the threshold for resubmission.

- o In 1997, 56% of all shareholder proposals achieved the 10% threshold. Now 82% of all proposals receive 10% favorable votes.

Even raising the threshold to 25% in 2015 would have resulted in 63% of all shareholder proposals hitting the mark for resubmission. Raising it to 30% shows that 52% of proposals would have been eligible for resubmission.

The data shows that an increase in the current thresholds is appropriate to maintain the various percentage approval rates consistent with that of 1997. Viewing this, a case can be made for an increase in the thresholds to 6/15/30% as the Commission staff proposed almost 20 years ago. The so-called "failure rate" under the 3/6/10 thresholds of 1997 would compare to current voting patterns under 5/15/25%.

Here's a real example for context. Consolidated Edison shareholders had to vote on essentially the same proposal from Evelyn Y. Davis every year from 1997 to 2012. It was voted on for 16 years in a row and received between just over 10% to 17.1% of votes cast – but still never qualified for exclusion under the existing resubmission thresholds. It was a proposal asking for disclosure of every employee who made more than \$100,000 (over the years raised to \$250,000):

RESOLVED: That the shareholders recommend that the Board take the necessary steps that Con Edison specifically identify by name and corporate title in all future proxy statements those executive officers, not otherwise so identified, who are contractually entitled to receive in excess of \$100,000 [\$250,000] annually as base salary, together with whatever other additional compensation bonuses and other cash payments were due them.

#### Costs

As noted in the Chamber petition citing a Navigant study (A. Ingraham & A. Koyfman, "Analysis of the Wealth Effects of Shareholder Proposals"—Vol. III, Navigant Consulting, at p. 13 (May 2, 2013) ("Navigant Study"), available at <http://www.workforcefreedom.com/sites/default/files/Navigant%20Study%20III.pdf>), costs directly incurred by companies have been estimated at \$87,000 per proposal -- or if aggregated, \$90 million annually. Even using a lower legal cost estimate based on anecdotal discussions with Society members of about \$50,000 per proposal, the result for 2015 is about \$30 million for companies.

This does not include management and board time, nor does it include SEC staff time and costs. In 2015, according to the SEC Division of Corporation Finance staff, the group had 18 attorneys working on 285 no action requests with an average response time of 39 days per request.

#### B. Shareholder Proposal by Proxy

*The Commission should prohibit shareholder proposals "by proxy." A small group of individuals submit numerous proposals to companies without owning a single share, and with NO economic stake in the company.*

Not only is the shareholder proposal process costly for companies, it has also been subject to abuse. SEC Rule 14a-8(b), requires a proponent of a shareholder proposal to provide evidence that he or she has "continuously held at least \$2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year" prior to the date a proposal is submitted. This minimum-ownership requirement was adopted to "requir[e]



shareholders who put the company and other shareholders to the expense of including a proposal in a proxy statement to have some measured economic stake or investment interest in the corporation.” Amendments to Rule 14a-8, 48 Fed. Reg. at 38,219. Despite this rule, the Commission staff routinely allows individuals, advisors, and attorneys to submit 14a-8 proposals without requiring them to have an economic stake or investment interest in the company.

We do not believe that 14a-8(b) authorizes a shareholder to appoint a proxy or attorney-in-fact to submit a proposal on the shareholder’s behalf. While SEC Rule 14a-8(h), 17 C.F.R. § 240.14a-8(h) does authorize a shareholder to appoint a qualified representative to **present a proposal** at the meeting, there is no language authorizing the submission of a proposal by a proxy. Why should a shareholder who has no interest in submitting a proposal be permitted to “lend” his or her shares to an individual with a personal grievance or interest or a socially motivated “investor” who doesn’t actually own a single share?

This argument has been raised by numerous companies like Ameriprise Financial, Inc. (December 21, 2012), Apple (December 17, 2013), and The Coca-Cola Company (January 15, 2014), Chevron Corp. (avail. Mar. 11, 2014, recon. denied Apr. 4, 2014) and most recently Baker Hughes (2016). It has been asserted in federal district court in KBR Inc. v. Chevedden, 2011 WL 1463611 (S.D. Tex. Apr. 4, 2011), aff’d 478 Fed. Appx. 213 (5th Cir. June 11, 2012), Apache Corp. v. John Chevedden, 696 F. Supp. 2d 723 (S. D. Tex. 2010) and Waste Connections, Inc. v. John Chevedden Waste Connections Inc. v. Chevedden, 2014 WL 554566 (5th Cir. Feb. 13, 2014), where the US District Court for the Southern District of Texas excluded the proposals. These courts have given companies relief, even though the SEC Staff does not. But it is too expensive and takes too much time for a company to go to court every time they receive a proposal by proxy in order to seek relief.

The SEC staff now allows proponents to submit letters stating that “[t]his is my proxy for Mr. or Ms. Y [the actual shareholder] and/or their designee to forward this Rule 14a-8 proposal to the company” for inclusion in the company’s proxy materials. Many times these are “cookie cutter” proposals sent to multiple companies, in multiple years. It is not clear from the letter submitted that the actual shareholder even knows to which company a proposal will be sent or on what topic. For example, in Chevron Corp. (avail. Mar. 11, 2014, recon. denied Apr. 4, 2014), a company submitted a shareholder proposal purportedly on behalf of a shareholder and asked that it – not the shareholder – be identified in the proxy statement as the proposal’s “sponsor.” After Chevron requested proof that the shareholder had authorized the submission of the proposal, the company provided a letter from the shareholder that was more than a year old and that did not identify: (i) the proposal that had been submitted, (ii) Chevron as the company

to receive a proposal, or (iii) the meeting for which it was submitted. Despite those disconnects between the shareholder and the proposal, the SEC staff denied a no-action request arguing that this proposal was not valid under Rule 14a-8 because it had not been submitted by a shareholder.

Therefore, at a minimum, the Society has asked the Commission staff to require proof that the shareholder has given authority to the proponent to submit a *specific* proposal to a *specific* company, for a *specific* annual meeting. We understand that some proponents may assist a group of interested shareholders by “representing” them in the proposal process. However, so much abuse has occurred with these types of submissions, that it is impossible for companies to determine whether a proposal actually reflects the interests of the shareholder rather than the proponent, who is not a shareholder.

More recently, a registered investment advisor was allowed to submit a proposal for one of its clients with a letter from a separate brokerage firm stating that the client/shareholder owned the shares. Yet there was nothing from the actual shareholder stating that the investment advisor was authorized to submit the proposal on the shareholder’s behalf. Instead, the advisor relied on the fact that since the advisor was registered, it had certain duties to represent its clients faithfully. The advisor stated that it was authorized to submit a proposal on the shareholder’s behalf “since it is clear that as a Registered Investment Advisor registered with the SEC, [it represents] clients of all types and [has] both ethical and legal obligations to do so faithfully.”

Proposal recipients - our members – do not understand why the Staff allows this, as it only encourages abuse of the 14a-8 process, allows evasion of its eligibility requirements, and undermines the policy reasons for the shareholder proposal process. In fact, on the SEC website, the stated purpose of the Rule is to provide **an avenue for communication between shareholders and companies, as well as among shareholders themselves**. That is not in fact what is happening. The Rule allows non-shareholders to submit proposals and companies cannot communicate with the actual shareholder; nor is the actual shareholder communicating with other actual shareholders.

This is an abuse of the shareholder proposal system. We believe the Staff should issue a Legal Bulletin clarifying the plain language of 14a-8: a proponent must be a shareholder with an economic stake in the company. Unlike the right to vote, the right to submit a shareholder proposal should not be freely assignable.

Finally, the \$2,000 ownership threshold should also be reviewed. It has not been changed since 1998 when it went from \$1,000 to \$2,000. We would be pleased to offer more thoughts on this if the Subcommittee so desires.

C. Relevance Rule

*Rule 14a-8(i)(5), also known as the relevance rule, should be interpreted so as not to gut the economic tests set forth in the rule.*

There is one other exclusion that was intended to protect against abuse of the shareholder proposal process that I would like to raise here. Rule 14a-8(i)(5) provides that a proposal is excludable when the proposal relates to operations that account for less than 5% of the company's total assets at the end of its most recent fiscal year, and for less than 5% of its net earnings and gross sales for its most recent fiscal year, *and is not otherwise significantly related to the company's business*. It is known as the "relevance rule."

Five percent is a commonly used "rule of thumb" threshold used to evaluate materiality. However, in interpreting Rule 14a-8(i)(5), the Staff has refused to allow companies to exclude proposals from proxy statements when they relate to matters that fall below the 5% economic thresholds if the proposals are deemed to be of social or political "significance" to the company's business. In fact, Rule 14a-8(i)(5) is rarely applied today because the Commission and its Staff interpretations provide that a proposal is "significantly related" to a company's business if the proposal meets the significant policy exception in the ordinary business exclusion. Thus, a company with operations related to the subject matter of the proposal – even if below the 5% thresholds, cannot exclude it.

Here's an example. Assume a proponent does not believe a company should be doing business in Myanmar because of human rights concerns in the country. Even if less than 1% of a company's revenues are from Myanmar, the company must include the proposal in its proxy statement because the Commission has said that the issue of human rights is a significant policy issue. Why should a company with minimal revenues from or assets in a country have to publish (at its own expense) a manifesto of a social proponent? This is a waste of resources.

One easy fix therefore is to ask the SEC to bring logic back into its interpretation of the relevance rule, at a minimum. If a socially active shareholder wants access to a corporate proxy statement, he or she should demonstrate that the issues are relevant to at least 5% of the company's business. That is the rule. If it is not material to investors under the federal securities laws, it has no business in the proxy.

Last, as previously mentioned, the SEC Staff has interpreted several exclusions to shareholder proposals provided in Rule 14a-8 in favor of proponents, so that they basically no longer exist.

This is particularly true for the ordinary business exclusion in 14a-8(i)(7) and the competing proposals exclusion in 14a-8(i)(9). While we have not taken them up here, we would be happy to provide further testimony on the need for reform in the future if the Subcommittee is interested.

## II. MATERIALITY AND DISCLOSURE EFFECTIVENESS

*The materiality standard as promulgated by the U.S. Supreme Court should not be changed.*

The Commission has as its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. There is no better way to protect investors than to require companies to provide clear disclosure of material information. Materiality is the foundation upon which disclosure is made under the US securities laws. One could say it follows the Goldilocks rule: Not too much, not too little, but just right. However, getting it just right is not easy. Luckily, there is a test promulgated by the US Supreme Court:

The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

But just because a reasonable investor might consider a fact important, does not mean the fact is material. In fact, the U.S. Supreme Court explained that a low standard of materiality could result in too much disclosure, namely that "management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making." TSC, at 448-49. Who is this "reasonable investor"? We assume that a reasonable investor makes investment and voting decisions based on maximizing financial value. Having a specific interest does not make an investor "reasonable". In fact, we would posit that a reasonable investor is one who does not have a particular social agenda.

We applaud the SEC for undertaking its Disclosure Effectiveness project. We believe that many prescribed disclosures can and should be eliminated, particularly if they are available elsewhere, or are no longer relevant or material. However, we are concerned that the Commission may use the project to require new disclosures in response to pressures from shareholders or other interested groups motivated by special, social interests.

We believe that disclosure should be principles-based and centered on materiality. Although we acknowledge that there is some basic information about a company that should be helpful to a broad range of investors, a materiality-centered, principles-based disclosure framework will elicit more relevant and useful information than a strictly rules-based framework.

We note that the SEC's Regulation S-K Concept Release solicits input on sustainability reporting, in particular: (i) whether it is important to voting or to investment decision-making, (ii) whether more reporting would result in immaterial information, and (iii) whether website disclosures are sufficient. Some special interest groups support this disclosure to promote social and environmental change even when in many cases they do not have an investment in a company. Those groups wish to add disclosure to documents filed with the SEC which may not be material in the context of a particular company's business, and which could subject companies to more potential litigation. It would add to the "information overload" which contradicts what we believe is the purpose of the Disclosure Effectiveness project. Finally, many companies voluntarily provide sustainability information in annual published sustainability reports and/or on their public websites.

The Society believes that determining whether line item sustainability reporting is important depends on the company and the industry. Materiality must be determined in the context of a particular company rather than in a vacuum (i.e., absent company-specific facts and circumstances). Further, any line item disclosure that does not seek material information would necessarily result in reporting immaterial information.

We believe that the "reasonable investor" standard is still the proper and best standard - that it adjusts itself and is flexible. As the courts have shown, "reasonable investors" differ and are hard to define absent any context. Because there is a broad diversity of interests among stakeholders, it is not feasible or desirable to cover every aspect in our public disclosure regime. And, the desires of investors are fluid and changing constantly. Consider how investors have viewed ESG (environmental/social/governance) topics in the last 10 years. Climate change has evolved substantially. The issues of human trafficking due to global supply chains was not a priority ten years ago as it is to some today. And data privacy was not an issue ten years ago. If

a new series of disclosures is mandated based on today's "hot topics," in a few years, companies will be reporting on things that are no longer relevant. For example, the notion of reporting on board gender diversity may soon be outdated as gender identification changes.

In closing we must also consider the following:

- 1) The SEC is the federal agency (subject to Congressional oversight) responsible for public company disclosure requirements. It should not let other quasi-governmental or interested bodies who claim to be standard setters (e.g., the Sustainability Accounting Standards Board), usurp that role.
- 2) Writing an actual "materiality" rule would be impossible. What is material for one company is based on the facts and circumstances of that company. For this reason, we believe the U.S. Supreme Court definition remains the best test.
- 3) Not every piece of information important to an investor needs to be in a publicly filed document subject to certification requirements and the attendant liability. In this new tech era, companies have greater flexibility to communicate information outside of traditional '34 Act regulatory filings. Most will agree that a great deal of helpful ESG and sustainability reporting is posted on corporate websites or in other standalone published reports.
- 4) Whether there is potential substantial investor harm because our disclosure regime lacks mandatory ESG disclosure outside of current materiality requirements (e.g., Risk Factors, MD&A, etc.) should be considered. We believe there is no evidence of any such harm at this point. However, if a company has material undisclosed ESG risks, current SEC rules cover that scenario and should be enforced.
- 5) Significant resources are being spent on managing corporate disclosure, so any new required disclosure items should be weighed against the already significant burden. Companies have different methods to manage this process. Some large sophisticated companies use internal teams who oversee substantially all aspects of this process. Smaller companies may use outside counsel and advisors. Significant resources, both time and money, are required to support the disclosure process for any company - regardless of size.

## II. TITLES IX AND XV OF THE DODD-FRANK ACT

Finally, the Subcommittee has asked us to comment on the mandatory disclosure obligations and other governance provisions in the Dodd-Frank Wall Street Reform and Consumer

Protection Act and their impact on shareholder value. The Society is not aware of any provision in Titles IX or XV that create shareholder value.

In fact, the costs on companies to comply with the mandates, has and will continue to be, substantial. There is no better example of this than Section 953(b), the CEO-median worker pay ratio rule. This rule requires companies to disclose the ratio of the principal executive officer's total compensation against the compensation of the median worker. Coming back to the theme with which I began, the pay ratio rule is an attempt by a special interest group to force a corporation to "disclose" something it believes to be embarrassing and which will change behavior and cause social change. The proverbial scarlet letter. As former Commissioner Daniel Gallagher said in his Dissenting Statement at an Open Meeting to Adopt the "Pay Ratio" Rule:

The purpose of this rule is not to inform a reasonable investor's voting or investment decision. The AFL-CIO, which lobbied for the rule's inclusion in Dodd-Frank, has explained for us its true purpose: "Disclosing this pay ratio will shame companies into lowering C.E.O. pay." And, "They will be embarrassed, and that's the whole point." But addressing perceived income inequality is not the province of the securities laws or the Commission. And yet here we are, on the cusp of adopting a nakedly political rule that hijacks the SEC's disclosure regime to once again effect social change desired by ideologues and special interest groups (footnotes omitted).  
<https://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-to-adopt-the-pay-ratio-rule.html>

The trifecta of the "say on pay" vote, conflict minerals disclosure, and the pay ratio disclosure feels like "piling on" in the words of one commentator. "Somewhere along the line there needs to be some objective assessment of whether the putative value of these requirements that Congress is piling on to companies justifies the burdens the requirements impose on companies."

Justifying the burden requires a cost analysis. The Center on Executive Compensation estimates that the compliance costs to companies for the pay ratio rule will be about \$189 million. (See report of Dr. Stuart Gurrea and Dr. Jonathan Neuberger of Economists Inc. to review the estimates and assumptions in the Commission's cost-benefit analysis and to conduct its own cost estimate based upon the responses from the Center's survey.)

And added to that, the rule will have an impact in terms of indirect financial and competitive costs. For example, in response to the survey conducted by the Center on Executive

Compensation and the Society, 55% of respondents said they anticipate the pay ratio disclosure will impose indirect financial and competitive costs (e.g., adverse impact on sales, brand damage, increased public relations costs). These comments are noteworthy:

- “Our competitive advantage, recognized by analysts and our shareholders is our low cost country footprint which provides a distinct disadvantage when calculating a global pay ratio.”
- “Certain marketing groups and NGO's will likely use the data to embarrass the company and will work to drive certain customers to other vendors or alternate sources.”
- “Most or all of our direct competitors are foreign private issuers and will not be subject to the disclosure, putting us at a competitive disadvantage.”
- “The sole purpose of the disclosure is to enable organized labor to further incite union activity within the work force. This will no doubt increase costs to address labor risks and cost jobs.”
- “While shareholders generally see little value in this ratio, this type of measure ends up being a tool for those with an agenda to cause disruption and controversy; the response to which diverts attention and drains resources from more productive activities (like creating more jobs). It is the unintended consequences that will be the real cost, which is why this continues to be a bad idea.”

The pay ratio rule, as finally adopted, gives some flexibility to corporations to determine their median employee, in an attempt to ease the financial burden; however, it remains unworkable in that it requires inclusion of non-US employees and temporary part time and seasonal employees, as well as those of all consolidated subsidiaries.

Add this to the conflict minerals disclosure rule, and you get costs in the billions. The cost of compliance with the conflict minerals rule has been estimated at approximately \$710 million according to a new Tulane University and Assent Compliance study.

Last month's GAO Report: <http://www.gao.gov/assets/680/679232.pdf>, also notes that even at this price, companies are having challenges determining whether their products are free of minerals from the Democratic Republic of the Congo. And more importantly, there is no apparent evidence that violence has been reduced as a result of their significant efforts.

#### **Summary**

In conclusion, the Society thanks the Subcommittee for soliciting our views. Our recommendations are as follows:



- 1) The corporate proxy should not be used as a vehicle for special interest proposals unless a substantial number of shareholders support them. For this reason, Rule 14a-8 should be reformed to increase the proposal resubmission thresholds, and to require proposals from actual shareholders with an economic interest in the company.
- 2) The existing materiality standard set forth by the US Supreme Court should not be changed. Any contemplated new disclosure items, including ESG or other sustainability metrics, should be subject to the materiality standard in which case, they are already covered by existing, principles-based SEC requirements.
- 3) The burdens of the corporate governance provisions of the Dodd-Frank Act have been, and will continue to be, substantial. We do not believe that the purported benefits of conflict minerals disclosure, pay-ratio disclosure, and other compensation-related disclosures outweigh the costs to companies. Nor do we think they provide even remotely relevant information; rather, they are merely designed to “name and shame.”

We would be pleased to respond further to any issues that are particular interest.

**Capital Markets Subcommittee Hearing Entitled, “Corporate Governance: Fostering a System that Promotes Capital Formation and Maximizes Shareholder Value”  
September 21, 2016**

***Questions for the Record from Congressman French Hill (R-AR)***

**Questions for Mr. James R. Copland, Senior Fellow and Director of Legal Policy, Manhattan Institute; Ms. Darla Stuckey, President & CEO, Society of Corporate Secretaries and Governance; and Governor John Engler, President of Business Roundtable**

**Question One**

What is a “corporate gadfly”?

***Governor Engler’s Response to Question One***

Business Roundtable uses the term “corporate gadfly” to refer to an investor who uses the shareholder proposal process to pursue idiosyncratic, social or political agendas unrelated to the interests of shareholders as a whole. These individuals often have insignificant economic stakes in the companies they target, but their proposals impose significant costs and distractions on the company, which are passed on to ordinary, long-term investors, including senior citizens, savers and retirees.

For example, three shareholders and their families have sponsored nearly 22 percent of nonmanagement shareholder proposals submitted in 2016. One of these shareholders have holdings in companies at which he submitted proposals that ranged from as low as \$2,172 to a high of \$16,433 in ownership, and from a low of 0.000003 percent to a high of 0.00008 percent in percentage ownership.

**Question Two**

Why should our families who own stock in many 401(k) plans care about the topic of this hearing?

***Governor Engler’s Response to Question Two***

The current U.S. shareholder proposal process limits a company’s ability to devote resources to long-term value creation for shareholders – including those shareholders who have invested in those companies over the long haul through their 401(k) plans. Further, the current shareholder proposal process costs companies tens of millions of dollars and countless hours of management time through the cost of negotiating with proponents, seeking SEC no-action relief to exclude proposals from proxy statements, preparing opposition statements and other activities that divert attention and resources from creating long-term shareholder value.

The unintended consequences of these activities can cause shareholders to lose sight of matters of true economic significance to the company if simultaneously presented with

numerous immaterial proposals to consider. In addition, companies will incur the costs of implementing successful proposals, even if they are immaterial to the operation of the company, wasting shareholder resources. These significant and unnecessary costs are then passed on to ordinary investors – including senior citizens and retirees – and can erode the value of a family's 401(k) plan.

**Questions for Mr. James Copland**

1. Your testimony states that state and municipal pension funds have about \$4 trillion in obligations, but they only have about \$3 trillion in assets to meet these obligations, leaving about a \$1 trillion shortfall that threatens retirement security for millions of Americans, as well as the budgets of many states and municipalities.
  - Given this shortfall, should these funds not be doing everything to modify benefits and improve investment performance?
  - Can you elaborate on the relationship between pension funds' social-issue activism and share value?
  - As you know, in October 2015, the Department of Labor (DOL) released an interpretive bulletin for economically targeted investments and investment strategies' environmental, social and governance (ESG) factors, which allows these factors and collateral benefits to be considered when selecting an investment in an ERISA plan. I am concerned that this guidance could undermine ERISA's mandate that plan assets are invested solely in the interest of plan participants and that other factors may take precedent and deviate from maximizing returns for beneficiaries. Can you comment on this DOL guidance?
2. In your testimony you note that between 2007 and 2016, about one-third of shareholder proposals were resubmissions of a prior year's proposal. What percentage of these resubmissions are "gadfly" proposals?
3. Can you further explain the relationship between proxy advisory firms and shareholder resubmissions of shareholder proposals and the relationship with the average shareholder?
4. What is the core principal behind state corporate law on officer and director fiduciary duty? What percentage of Rule 14-8(a) proposals deal with the fundamental American corporate governance tenant of maximizing shareholder value?

**Additional Question for Governor Engler**

Can you describe issues with the current no-action letter process administered by the Securities and Exchange Commission (SEC) that need to be reevaluated and revised? Can you explain the issues with the current process, and what are your recommendations as to how the SEC can restructure its process to benefit both public companies and investors?

*Governor Engler's Response*

The SEC's current no-action letter process relating to shareholder proposals is inconsistent and unpredictable – partly due to its structure. Currently, members of the SEC's staff administer the no-action letter process on an issue-by-issue basis. This decentralized, issue-by-issue review leads to inconsistent guidance and interpretations and, in some cases, complete reversals of staff positions, which undermines the public's confidence in the no-action process.

Public confidence in the SEC's ability to administer an objective and predictable no-action process effectively has also eroded due to Chair White's decision to reverse a high-profile staff no-action decision relating to a shareholder proposal submitted to Whole Foods last year.

Greater consistency in the SEC no-action process will benefit both public companies and investors. To make the guidance process more consistent, the SEC could convert the no-action letter process into an SEC advisory opinion process, whereby the SEC would issue opinions on major policy issues, rather than issuing no-action letters. Alternatively, if the current no-action letter process is maintained, the SEC should establish enhanced review and oversight mechanisms to achieve greater consistency.

**Capital Markets Subcommittee Hearing Entitled, “Corporate Governance: Fostering a System that Promotes Capital Formation and Maximizes Shareholder Value”  
September 21, 2016**

*Questions for the Record from Congressman Hultgren (R-IL)*

**Questions for Mr. James R. Copland, Senior Fellow and Director of Legal Policy, Manhattan Institute**

**Question One**

How would you improve the shareholder proposal system? Does it make sense to increase the monetary threshold for submission? If so, what should it be increased to?

- a. Would such an increase be sufficient or should there be other qualitative factors – for example, should eligibility depend more on subject matter than on level of stock ownership?
- b. Alternatively, do you believe that the SEC should implement or provide greater guidance that describes which shareholder proposals are material or relevant to the company’s business?

**Question Two**

Mr. Copland, are shareholder-proposal sponsors currently required to reimburse the corporation for at least some portion of the direct costs of assessing, printing, distributing etc., if any of their proposals fail? What about for resubmissions? Do you believe that such a requirement would ensure that shareholder proposals are more appropriately tailored to material concerns of the company and its shareholders?

**Questions for Governor John Engler, President, Business Roundtable**

**Question One**

Governor Engler, you note in your written testimony that the “current shareholder proposal process has been hijacked by corporate gadflies and political activist investors.” You state that there are two factors that are driving the increased pressure from social interests: (1) The threshold for submitting a proposal is too low, and (2) it is difficult for a company to exclude proposals relating to general social issues. Could you please explain?

- a. What would you recommend for a change in the threshold? For example, by how much would you recommend increasing the monetary threshold for submission? Do you believe it would be appropriate for the threshold to be indexed to the market capitalization of the company?
- b. Furthermore, are there any specific changes you would recommend to the requirements for resubmission?

*Governor Engler's Response to Question One, Part One*

The threshold for submitting a shareholder proposal is indeed too low and outdated. It was set decades ago and has fallen out of step with stock price valuations in the current market.

Under the current rules, to be qualified to submit a proposal, a shareholder must own only \$2,000 in market value or 1 percent – whichever is less – of a company's outstanding stock for at least one year. The \$2,000 threshold, in particular, falls well short of any reasonable material ownership standard for public companies. Case in point, at current market prices, a shareholder would need to purchase only three shares of Alphabet (Google) stock to meet this requirement.

Further, a number of shareholders take advantage of this "absurdly low" holding threshold to submit proposals to a broad spectrum of companies to advance their personal agendas, rather than to create shareholder value or address concerns material to the long-term performance and health of the company. This practice is evidenced by the fact that while Fortune 250 companies, on average, faced more proposals in 2015 and 2016 than in any year since 2010, the number of shareholders actually participating in the shareholder proposal process remains low.

In addition, some proponents are able to pursue their agendas at companies where they have no relationship and own no shares by submitting proposals as a "proxy" for a shareholder of the company, even if the shareholder has little or no interest in the proposal.

*Governor Engler's Response to Question One, Part Two*

For several decades, the SEC permitted corporate managers to exclude proposals submitted "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes." In 1970, however, the D.C. Circuit Court of Appeals ruled against the SEC and found that shareholder proposals are not excludable when they raise issues of corporate social responsibility or question the "political and moral predilections" of management. In response, the SEC narrowed the "general economic, political, racial, religious, social or similar causes" exclusion to proposals that are "not significantly related to the business of the issuer nor within its control."

This court-driven change in SEC policy has facilitated a continuous influx of proposals on social issues. Last year, activist shareholders filed 479 social, environmental and political proposals, and this stream of proposals remains steady with more than 400 such proposals submitted for 2016 meetings. Furthermore, most social, environmental and political proposals, such as those related to corporate political spending, climate change and human rights, have only an attenuated connection to shareholder value and are generally not issues material to a company's business. In addition, these proposals rarely garner meaningful shareholder support, with support for such proposals hovering around 20 percent of shares cast in both 2015 and 2016.

In 2016, average support for shareholder proposals is the lowest it has been in the past four years, based on proposals voted on through June 1, 2016. However, even if the vast majority of a company's shareholders vote against a shareholder proposal, under the current resubmission rules, it is nearly impossible for the company to exclude the proposal. Under the current rules, proposals getting a mere 3 percent of the votes cast qualify for resubmission at least once, and as long as the proposal obtains 10 percent of the votes cast, it may be submitted indefinitely. As a result, a fraction of small-stakes shareholders motivated by concerns unrelated to enhancing shareholder value and immaterial to the company can override the expressed will of a majority of shareholders indefinitely – a situation frequently dubbed “tyranny of the minority.”

*Governor Engler's Response to Question One, Part A*

The \$2,000 monetary holding requirement for shareholder proposals was implemented in 1983 and last updated in 1998 to adjust for inflation. It is no longer a reasonable standard for ownership. Rather than setting a threshold based on a dollar amount that will need to be adjusted for inflation periodically and has a disparate effect based on the size and stock price of the company, the SEC should instead use a holding requirement based on the percentage of stock owned by a proposal proponent. This would be similar to the general practice that has been established for proxy access rights for shareholder-nominated director candidates.

For proposals related to topics other than director elections, a reasonable standard to adopt may be to use a sliding scale based on the market capitalization of the company, with a required ownership percentage of 0.15 percent for proposals submitted to the largest companies and up to 1 percent for proposals submitted to smaller companies. Additionally, if a proposal were submitted by a group or by a proponent acting by proxy, the ownership percentage sliding scale could be increased to up to 3 percent.

The length of the holding requirement should also be increased. The current holding period requirement encourages a focus on short-term goals at the cost of long-term investing. Proponents holding the stock for as little as one year can hijack the proxy as a means to promote their short-term social and political agendas without regard to the effect on long-term shareholder value. Requiring a longer holding period would better align the interests of the shareholders making the proposals with the long-term success of the company. As with the ownership requirement, a better standard for the holding requirement could be to mirror the three-year holding period that has become the standard established for proxy access.

*Governor Engler's Response to Question One, Part B*

We have several recommendations to strengthen the thresholds for resubmissions of shareholder proposals, which are outlined in [Attachment A](#). [Note: Attach booklet with specific proposals.]

**Question Two**

Governor Engler, do you believe that “information overload” for investors is a true issue and concern? If the SEC were to expand the amount of information that must be disclosed in SEC filings, what impact would it have on investors, particularly retail investors?

*Governor Engler’s Response to Question Two*

Investors today receive an ever-increasing amount of information about the companies in which they invest, much of which is not directly related to investment or voting decisions. Expanding mandatory disclosure requirements absent a materiality component would increase costs to public companies without delivering meaningful benefit to investors and shareholders. An expansion in mandatory disclosure may be particularly burdensome for retail investors, who may not have the tools to sort through volumes of disclosure to determine which information is material to their investment decisions. To address this real concern of information overload, investors need our government to embrace a renewed commitment to the materiality standard, the bedrock principle underlying the U.S. securities laws since 1933.

For example, Congress has enacted legislation requiring public companies to disclose information in SEC filings related to conflict minerals and payments to foreign governments for resource extraction and mine safety – irrespective of the materiality of the information to investors and that the federal securities laws are ill-equipped to address these issues effectively. The SEC and public companies – and, ultimately, the investing public – have borne enormous costs and burdens in adopting, complying with and monitoring these new types of requirements.

Rather than benefitting investors, these mandates require expending extensive SEC resources proposing, adopting and implementing regulations that distract from its core statutory objectives, including investor protection. Compliance costs for public companies and their shareholders have been extraordinary in many cases. Further, investors receive information that is irrelevant and distracts from their investment and voting decisions. Congress and the SEC should therefore abstain from enacting new mandates and review earlier actions that are contrary to the materiality standard.

**Question Three**

Mr. Copland, are shareholder-proposal sponsors currently required to reimburse the corporation for at least some portion of the direct costs of assessing, printing, distributing etc., if any of their proposals fail? What about for resubmissions? Do you believe that such a requirement would ensure that shareholder proposals are more appropriately tailored to material concerns of the company and its shareholders?

**Questions for Ms. Darla Stuckey, President & CEO, Society for Corporate Governance****Question One**

As you note in your testimony, SEC Rule 14a-8 allows shareholders who have held \$2,000 of a company stock for one year to submit a proposal to be included in the company’s proxy



statement for a vote by all shareholders. How is compliance with these requirements determined? Is the burden placed on the shareholder or the company, and what recourse is there for challenging it?

**Question Two**

In your written testimony you note the \$2,000 ownership threshold should be reviewed since it has not been changed since 1998 when it went from \$1,000 to \$2,000. What changes do you believe should be made to the threshold?

- a. Would it be appropriate to adjust the threshold for inflation?
- b. Alternatively, would it be appropriate to index the threshold to the total market capitalization of the company?
- c. Would you make any recommendations for the length of time the shares should be held?