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The AI Evolution

Why all boards should be thinking about artificial intelligence in 2018

A roller coaster year for corporate governance

Protecting the board against shareholder scrutiny

Hot-button boardroom issues for 2018

Creating diverse board committees

Interviews with Betsy Atkins, CEO and Founder of Baja Corporation and multi-boarded director, and James Lam, board member at E*TRADE Financial

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The Year in Corporate Governance

By Matthew Goforth

Board performance and social responsibility lead going into 2018

2017 was a roller coaster year for corporate governance. Corporate America engaged in a deeper critical review of progress (or lack thereof) in boardroom composition, acute responses to high impact events (such as those at Wells Fargo and Equifax) and preparation for relative unknowns in 2018 (including the CEO Pay Ratio disclosure requirement and reaction to tax code changes). Meanwhile, shareholders voiced their highest satisfaction with executive pay practices while concerns on environmental, social and governance (ESG) issues such as climate change and sustainability rose in prominence. There was no shortage of activist investor campaigns or proxy fights either, with the most visible pitting the Proctor & Gamble (P&G) board against Trian Fund Management Co-Founder Nelson Peltz.

For its annual report *Corporate Governance Outlook 2018*, published with commentary partners Donnelley Financial Solutions and Hogan Lovells, Equilar analyzed shareholder voting results for the 500 largest U.S. public companies by revenue (Equilar 500) and conducted a manual review of proxy disclosures for a subset of the largest 100 companies (Equilar 100). The results shed light on where corporate governance has been and, potentially, where it's headed in the coming years.

"The pace of technological innovation has created unprecedented challenges for executives and boards of directors," wrote Amy Freed, partner at Hogan Lovells, in her commentary for the report. "Businesses are changing quickly ... [and] directors must be attentive to the changing landscape so they can hold management accountable and ensure that management is engaged in a productive and ongoing dialogue with shareholders."

Composition of Shareholder Proposals Shifts

In total, the number of shareholder proposals in Equilar 500 proxy statements remained steady at about 350 in both 2013 and 2017 (Graph 1). Although the totals in both years were similar, the composition of shareholder proposals shifted markedly over the five-year period. Notably, shareholders submitted fewer proposals relating to executive compensation. Tracking the reduced number of pay-related proposals, corporate America enjoyed the strongest Say on Pay support in 2017 since the ubiquitous proposal was introduced in 2011. Nonetheless, environmental and social issues gained momentum with shareholders as proposals centered on climate change and diversity ticked up in 2017. Driven by proxy access proposals, shareholder rights proposals ticked up 74%, though such proposals fell year-over-year between 2016 and 2017.

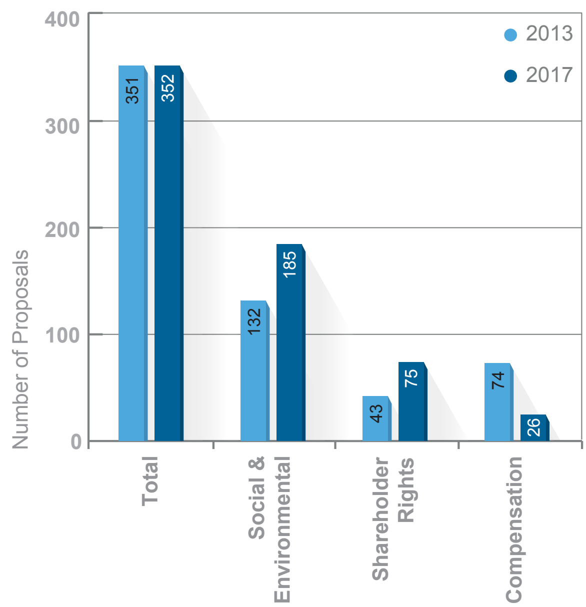
Large asset managers BlackRock, Vanguard and State Street voiced support for additional climate-related disclosure through the proxy vote in 2016 and 2017, focused mainly on sizable oil and gas companies such as Exxon Mobil.

"Climate change, gender and diversity issues, and political spending continue to be front-page news," said Lillian Tsu, partner at Hogan Lovells. "Large institutional shareholders are becoming more and more vocal and likely to support shareholder proposals on environmental topics in particular, especially in industries where environmental matters and climate change risks are material to company performance."

Graph 1

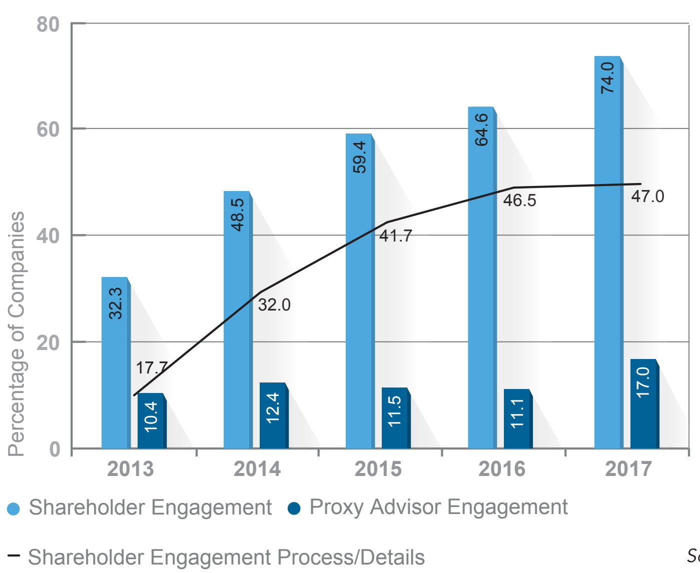
Equilar 500 Shareholder Proposals

Source: Equilar



Graph 2

Equilar 100 Shareholder and Proxy Advisor Engagement Disclosure



Source: Equilar

Recent history has shown that shareholders leverage more than proxy proposals to communicate with their portfolio companies. Not only has annual engagement with shareholders been on the rise since Dodd-Frank and Say on Pay, but disclosure of such engagements increased more than twofold to nearly three-quarters of the Equilar 100 (Graph 2). Almost half of the companies reviewed included specific details to outline their annual shareholder engagement processes and responses to investor feedback. More and more, consistent dialogue with shareholders is viewed favorably as part of a comprehensive governance program. While conventional wisdom holds that Say on Pay largely drove engagement's recent prominence, today's shareholder communications have expanded and often involve conversations around executive succession planning, board composition and heightened focus on risk management given climate concerns and cybersecurity risk.

According to Ron Schneider, Director of Corporate Governance Services at Donnelley Financial Solutions, "While the number of companies disclosing the practice and even the results of engagement is steadily increasing, there remains a gap in which some companies that engage are not taking credit for engagement by failing to discuss this topic in their proxies." Schneider added that "proactive companies often feature in their 'engagement, feedback and actions' disclosure timelines of the engagement scope and process, as well as a graphic treatment of what was discussed, including tables with headings, such as 'We spoke, we listened and we acted.'"

Disclosure of Board Evaluation Ticks up Alongside Calls for Diversity

Board performance, composition and refreshment remained at the forefront of governance issues in 2017, and some of the largest institutional investors took their

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positions a step further when it comes to gender diversity last year. State Street Global Advisors made headlines with its "Fearless Girl"—a bronze statue facing off with the Wall Street "Charging Bull" in Lower Manhattan—and vowed to scrutinize boards without women directors. Other institutional asset managers like BlackRock, Vanguard and CalPERS issued their own memos stating intentions to scrutinize and potentially vote down boards lacking gender diversity. Both State Street and BlackRock voted against some boards that lacked diversity last year, sending a message that these guidelines will carry weight.

Likewise, proxy advisory firms Institutional Shareholder Services (ISS) and Glass, Lewis & Co. will begin highlighting boards without women in 2018 (in the case of ISS) and recommending against directors responsible for nominating new directors in 2019 (in the case of Glass Lewis).

"Investors increasingly expect the board to comprise individuals who bring identified, important skill sets to the boardroom and, at the same time, include women and under-represented minorities," said Alan Dye, partner at Hogan Lovells. "Companies are responding to this increased investor interest and related activism by providing more detailed disclosure in the proxy statement regarding the specific skills the company regards as important to have in the boardroom and identifying, in a matrix, which of those skills each director has."

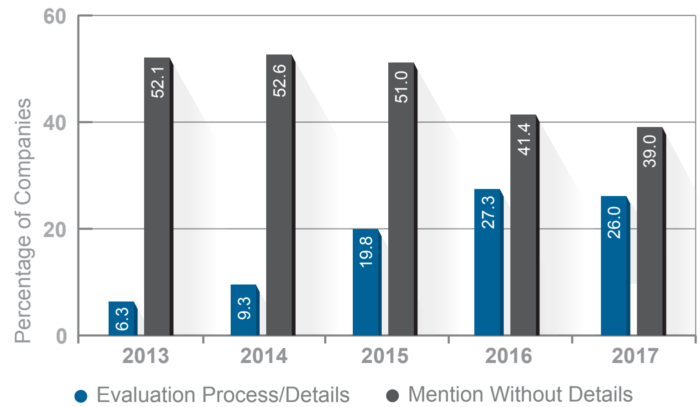
The percentage of Russell 3000 board seats occupied by women climbed from 12.3% in 2013 to 16.0% in 2017—a gain of nearly one percentage point per year—according to Equilar data. In the Equilar 500, female representation on boards was higher, at about 21%, in 2017.

In tandem with the discussion around board composition and refreshment in corporate boardrooms, the rate at which the largest companies disclose a board evaluation process rose from just over 6% in 2013 to 26% in 2017 (Graph 3). Such disclosures offer investors a window into a company's review of the board's overall performance, standards and succession procedures. As more and more companies disclosed granular detail around board evaluation, fewer gave cursory mention to the process of board review as opaque disclosure yielded to more robust descriptions of board processes. Though investors do not expect boards to disclose specific details about individual director performance, they appreciate transparency around the process. Without a window into the boardroom, shareholders want assurance of how decisions are being made to the extent that information is available.

Graph 3

Equilar 100 Board Evaluation Disclosures

Source: Equilar



Issuers Prepare to Disclose the CEO Pay Ratio

Beginning in 2018, public companies will be required to disclose their CEO Pay Ratios, or the ratio of the CEO's compensation to that of the median employee. While CEO compensation has long been accessible in annual proxy filings, employees and investors alike will soon see the median employee's total pay for the first time in public disclosures. Investor sentiment on the ratio thus far has been mixed, and time will tell whether large asset managers will integrate the ratio (or median employee compensation) into their proxy voting assessments, like those designed for Say on Pay. Only a handful of companies have disclosed a ratio thus far, but review of publicly available U.S. Bureau of Labor Statistics data indicates that the median Equilar 500 CEO made a total of about 250 times the median worker in reported compensation for fiscal 2016, a ratio that's held steady since 2013.

According to Schneider, "A handful of companies have voluntarily disclosed some version of a CEO/median pay ratio for several years. A common thread among them has been that their ratios (calculated in various ways, not all consistent with the SEC version) were almost universally below 100 to 1, so these companies had far fewer concerns about the optics surrounding this disclosure or what investors' reactions would be."

> BlackRock, Vanguard and CalPERS issued their own memos stating intentions to scrutinize and potentially vote down boards lacking gender diversity.

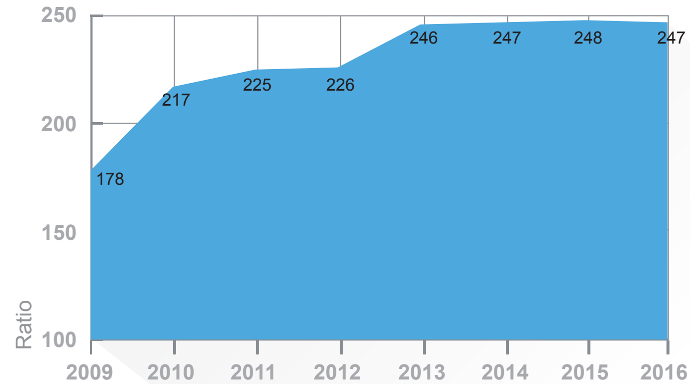
"There has been a recognition that internal communications will, at many companies, be at least as important as external communications as employees will focus not on how their pay compares to the CEOs, but rather to how their pay compares to the median employee," added Martha Steinman, partner at Hogan Lovells. "Accordingly, in preparing their disclosures, companies should consider how they can best communicate the nature and geography of their workforce—e.g., full-time vs. part-time vs. seasonal, U.S. vs. global—and whether it is typical of the workforce composition in their industry or, if not, what distinguishes their business model."

There was certainly no shortage of governance news in 2017 undiscussed in this review. Spurred by Snap Inc.'s IPO, institutional investors clambered for "one-share-one-vote" rights while largely criticizing multi-class stock structures that establish asymmetric voting power. In November 2017, MSCI announced a temporary ban of stocks with "no-vote" shares from its indices. Also in late 2017 (as of this writing), changes to the tax code set the corporate tax rate to be cut from 35% to 21%. Moreover, performance-based executive compensation that was previously deductible under section 162(m) of the tax code will be treated similarly to other forms of executive pay, meaning it will not be exempted from the $1 million cap for the first time since the previous treatment went into effect in the early 1990s.

From board performance and composition, corporate social responsibility, and pay equity to expanded shareholder rights, activists and corporate tax law changes, the governance landscape continues to become more complex. With these burgeoning responsibilities comes the widening field of view that directors, executives and governance professionals must canvass to identify risks and opportunities. Professionals in the field will certainly need to keep their heads on a swivel to take advantage of the positives and simultaneously avoid pitfalls. CS

Graph 4

Equilar 500 CEO-to-Median-Worker Pay Ratio*



Source: Equilar, CEO Pay U.S. Bureau of Labor Statistics, median U.S. employee compensation

> **"There has been a recognition that internal communications [regarding CEO pay ratio] will, at many companies, be at least as important as external communications."**
>
> Martha Steinman, Partner at Hogan Lovells

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**Editor's Note: Equilar conducted an anonymous survey of public companies in January 2018 for an early gauge on CEO Pay Ratios. The results are now available.*