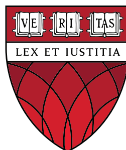

HLS Program on Corporate Governance & Program on Institutional Investors

Harvard Law School Corporate Governance Roundtable

June 14-15, 2022

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I. The SEC's Proposed Climate Disclosure Rule

Statement by Chair Gensler on ESG Disclosures Proposal

Posted by Gary Gensler, U.S. Securities and Exchange Commission, on Thursday, May 26, 2022

Editor's note: Gary Gensler is Chair of the U.S. Securities and Exchange Commission. This post is based on his recent public statement. The views expressed in the post are those of Chair Gensler, and do not necessarily reflect those of the Securities and Exchange Commission or the Staff.

Today [May 25, 2022], the Commission is considering a proposal to improve disclosures by certain investment advisers and funds that purport to take Environmental, Social, and Governance (ESG) factors into consideration when making investing decisions. I am pleased to support this proposal because, if adopted, it would establish disclosure requirements for funds and advisers that market themselves as having an ESG focus.

It is important that investors have consistent and comparable disclosures about asset managers' ESG strategies so they can understand what data underlies funds' claims and choose the right investments for them.

When I think about this topic, I'm reminded of walking down the aisle of a grocery store and seeing a product like fat-free milk. What does "fat-free" mean? Well, in that case, you can see objective figures, like grams of fat, which are detailed on the nutrition label.

Funds often disclose objective metrics as well. When doing so, investors get a window into the criteria used by the asset managers for the fund and the data that underlies the claim.

When it comes to ESG investing, though, there's currently a huge range of what asset managers might disclose or mean by their claims.

As investor interest in ESG investments has grown, so too have ESG investment products and services. For example, we've seen an increasing number of funds market themselves as "green," "sustainable," "low-carbon," and so on. While the estimated size of this sector varies, one estimate says that the "U.S. sustainable investment universe" has grown to $17.1 trillion.[1] Suffice it to say there are hundreds of funds and potentially trillions of dollars under management in this space.

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[1] *See* US SIF Comment Letter (June 14, 2021). The proposal takes into account the comments received in response to Acting Chair Allison Herren Lee's requested public input on climate change disclosure from investors, registrants, and other market participants. *See* Acting Chair Allison Herren Lee Public Statement, *Public Input Welcomed on Climate Change Disclosures* (Mar. 15, 2021), ***available at*** https://www.sec.gov/news/public-statement/lee-climate-change-disclosures ("Climate RFI"). The comment letters are available at https://www.sec.gov/comments/climate-disclosure/cll12.htm. ***See*** also: US SIF, "Sustainable Investing Basics," ***available at*** https://www.ussif.org/sribasics.

"ESG" also encompasses a wide variety of investments and strategies. Some funds screen out certain industries. Others specifically include certain industries. Others may claim to have a particular impact on an issue. Some may track board votes or make assertions about the greenhouse gas emissions, labor practices, or water sustainability of their underlying assets. Some funds involve human judgments. Others might track an outside index.

Needless to say, there's a wide range here.

When an investor reads current disclosures, though, it can be very difficult to understand what some funds mean when they say they're an ESG fund. There also is a risk that funds and investment advisers mislead investors by overstating their ESG focus.

People are making investment decisions based upon these disclosures, so it's important that they be presented in a meaningful way to investors.

What information stands behind funds' claims?

Which data and criteria are funds using to ensure they're meeting investors' targets?

I think investors should be able to drill down to see what's under the hood of these funds. This gets to the heart of the SEC's mission to protect investors, allowing them to allocate their capital efficiently and meet their needs.

Thus, this proposal would do a number of broad things with respect to registered investment funds:

- First, it would require funds that say they consider ESG factors to provide investors with information in the prospectus about what ESG factors they consider, along with the strategies they use. This could include, for example, whether a fund tracks an index, excludes or includes certain types of assets, uses proxy voting or engagement to achieve certain objectives, or aims to have a specific impact.
- Second, a subset of those funds—ESG-focused funds, as defined in the proposal—also would need to disclose details about the criteria and data they use to achieve their investment goals, as well as more specific information about their strategies. These disclosures would enable investors to dig into the details of a fund's strategy.
- Third, the proposal would require particular types of ESG-focused funds to disclose relevant metrics. For example, certain funds would be required to report the greenhouse gas emission metrics of their portfolios, and an impact fund would be required to disclose metrics about and annual progress toward its ESG goals.

In addition, under the proposal, certain investment advisers would be required to disclose similar types of information as registered investment companies regarding their ESG factors and strategies in their client brochures. These disclosures would be tailored to help clients make an informed decision about whether to engage an adviser and how to manage that relationship.

I'd like to extend my gratitude to the members of the SEC staff who worked on this rule, including:

- Sarah ten Siethoff, Brian Johnson, Thoreau Bartmann, Mike Spratt, Sara Cortes, Michelle Beck, Michael Kosoff, Frank Sensenbrenner, Chris Staley, Zeena Abdul-Rahman, Pamela Ellis, Robert Holowka, Amy Miller, Nathan Schuur, Sam Thomas, Elena Stojic, Matthew Williams, Asaf Barouk, and Emily Rowland in the Division of Investment Management;
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Statement by Commissioner Peirce on ESG Disclosures Proposal

Posted by Hester M. Peirce, U.S. Securities and Exchange Commission, on Thursday, May 26, 2022

Editor's note: Hester M. Peirce is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on her recent public statement. The views expressed in this post are those of Ms. Peirce and do not necessarily reflect those of the Securities and Exchange Commission or its staff.

Thank you, Mr. Chair. A key impetus for today's rulemaking[1] is a legitimate concern about the practice of greenwashing by investment advisers and investment companies. This concern is real because advisers can mint money by calling their products and services "green" without doing anything special to justify that label. Only days ago, we settled an enforcement proceeding in which we alleged that an adviser said one thing about ESG and did another.[2] Yet while enforcement proceedings of this sort illustrate the problem, they also show that we already have a solution: when we see advisers that do not accurately characterize their ESG practices, we can enforce the laws and rules that already apply.[3] A *new* rule to address greenwashing, therefore, should not be a high priority.

In any event, this proposed rule misses the mark.

I could have supported a proposal to require advisers and funds to answer three questions about their ESG products and services:

1. If you offer products or services you label as some formulation of "E," "S," or "G," what does the label mean with respect to each such product or service?
2. What do you do to make your product or service line up with E, S, or G, as you have defined it for that product or service?
3. For each such product or service, what—if any—is the cost to investors, including in terms of forgone financial returns of pursuing E, S, or G objectives alongside of or instead of financial objectives?

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[1] *See* Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (May 25, 2022), [_______________] [hereinafter Proposal].

[2] *See* Press Release, SEC, SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations (May 23, 2022) https://www.sec.gov/news/press-release/2022-86 (announcing settled charges against an adviser for "misstatements and omissions about Environmental, Social, and Governance (ESG) considerations in making investment decisions for certain mutual funds that it managed").

[3] *See, e.g.*, Proposal, *supra* note 1, at 166-68 ("reaffirm[ing] existing obligations under the compliance rules when adviser and funds incorporate ESG factors" and discussing "current regulations seek to prevent false or misleading advertisements by advisers").

This proposal touches on some of these questions,[4] but embodies a fundamentally different approach. It avoids explicitly defining E, S, and G, yet *implicitly* uses disclosure requirements to induce substantive changes in funds' and advisers' ESG practices. Investors will pick up the tab for our latest ESG exploits without seeing much benefit.

The Commission seems to have assumed that today's investor is driven by concern for environmental, social, and governance matters, not an anachronistic desire to earn returns on her hard-earned money. So the SEC comes to the aid of the ESG-minded investor with a purportedly "consistent, comparable, and decision-useful regulatory framework for ESG advisory services and investment companies to inform and protect investors while facilitating further innovation in this evolving area of the asset management industry."[5] Regardless of what one generally thinks of the SEC mandating hyper-specific ESG disclosures, the proposals we are voting on today will fail of their purpose because they are not so much built on sand as they float on a cloud of smoke, false promises, and internal contradiction.

E, S, and G cannot be adequately defined, nor will they be, should the proposal eventually find its way into the Code of Federal Regulations. All you will learn from the proposed definitions is that "E" stands for environmental, "S" stands for social, and "G" for governance, but I suspect that you already knew that. The cool kids already have moved on to "*E*ESG"—*Employees*, Environmental, Social, and Governance. We better amend that proposal before it goes out the door lest a fund or adviser that prioritizes human capital issues despairs of being able legally to offer an ESG fund. Our refusal to define ESG is, of course, wholly understandable. Can you imagine an issue that would *not* fit within the ambit of at least one of those letters, based on someone's reading? Take, for example, the recent suggestion by some analysts that investments in defense stocks be added to the European Union's Social Taxonomy.[6] Imagine trying to conjure up a definition that not only met the universe of current understanding, but was flexible enough to grow to meet the hour-by-hour expansion of just what makes up E, S, and G.

From a regulatory perspective, the implications of this nod to reality make today's proposals incapable of enforcement on a practical level. How precisely do we envision determining whether a fund has incorporated "ESG factors" into its investment selection process when we have not defined just what those factors are? "I'll know it when I see it" is not a practice currently recognized in administrative law. The application of the rules to advisers is also awkwardly ambiguous. The proposal would require, for example, "an adviser to provide a description of the ESG factor or factors it considers for each significant investment strategy or method of analysis for which the adviser considers any ESG factors."[7] The broad sweep of this requirement will affect even advisers who do not consider themselves ESG advisers. Given the ambiguity and

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[4] Proposal, *supra* note 1, at 35 (The proposal, for example, would require funds and advisers to explain "the relationship between the impact the fund is seeking to achieve and financial returns" and to disclose, if true, that financial returns are secondary to achieving the stated impact or that achieving the fund's stated impact is intended to enhance financial returns. *See* proposed Item 7 of Form N-1A [17 CFR 274.11A]).

[5] *See* Proposal, *supra* note 1, at 1.

[6] *See, e.g.*, Julien Ponthus, *When defence stocks become an unlikely ESG play*, Reuters (Mar. 2, 2022), https://www.reuters.com/markets/stocks/live-markets-when-defence-stocks-become-an-unlikely-esg-play-2022-03-02/ (quoting analysts, "We believe defence is likely to be increasingly seen as a necessity that facilitates ESG as an enterprise, as well as maintaining peace, stability and other social goods . . . . Recent events in Europe, we think, will significantly increase the likelihood of defense's inclusion in the EU's Social Taxonomy'."); Brooke Sutherland, *Defense Stocks Search for Their Place in the ESG Universe*, Bloomberg (Mar. 25, 2022), https://www.bloomberg.com/opinion/articles/2022-03-25/industrial-strength-defense-stocks-search-for-their-place-in-the-esg-universe-l16s9bcq.

[7] *See* Proposal, *supra* note 1, at 129.

breadth of the proposed requirements, the planned one-year compliance date[8] for funds and advisers to get their Es, Ss, and Gs in order is laughably short.

In an attempt to generate comparable metrics, the proposal does get specific in some places. The specificity of these metrics is as problematic as the ambiguity around ESG. The proposed amendments, for example, generally would require that environmentally-focused funds disclose two separate greenhouse gas ("GHG") emission metrics: one describing a fund portfolio's carbon footprint, and the other the extent to which the fund is exposed to carbon-intensive companies.[9] The latter is the fund's weighted average carbon intensity, also known—I say without comment—as "WACI."

This attempt to provide verifiable data that will allow investors to compare greenhouse gas exposure across funds does not survive close inspection. For some companies, the data will be available, albeit not reliable, if we adopt the climate rule for public companies.[10] If portfolio companies do not provide disclosures, the proposal would require the fund to cobble data together as best it can. The fund would be required to make a good faith effort to estimate each portfolio company's Scope 1 and Scope 2 emissions, along with providing data sources and a brief explanation as to how it reached its conclusions.[11] Formulating these estimates is about picking and choosing among a selection of data points and models, which is another way of saying that these estimates will differ from fund to fund. Rather than get a uniform range of emission statistics, investors concerned with greenhouse gas numbers will have to do a separate assessment of each fund's process for making up those numbers. So much for consistency and comparability.

We also are proposing to impose a prescriptive "nag rule" on ESG-Focused funds. The proposal defines an ESG-Focused Fund as a fund that "focuses on one or more ESG factors by using them as a significant or main consideration (1) in selecting investments ***or*** (2) in its engagement strategy with the companies in which it invests."[12] Conducting a few earnest meetings during which ESG issues are raised will not do; to count for purposes of the rule, such engagements must be "part of an ongoing dialogue with the issuer regarding this goal."[13] More to the point, an ESG-Focused fund that implements its investment strategy via "ESG engagement meetings," not only must advocate "for one or more specific ESG goals to be accomplished over a given time period," the progress toward achieving those goals must be "measurable."[14]

Rather than allow funds to determine what constitutes meaningful interaction with issuers, we are proposing a system that is prescriptive almost to the point of parody. One substantive meeting might be better than five short interactions, but the rule values quantity over quality because the former can be reduced to numbers. If you think I am exaggerating, here is language directly from the release meant to clarify expectations:

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[8] *See* Proposal, *supra* note 1, at 168.
[9] *See* Proposal, *supra* note 1, at 88.
[10] For my comments on that proposal, *see* Hester M. Peirce, Commissioner, SEC, We are Not the Securities and Environment Commission – At Least Not Yet (Mar. 21, 2022), https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321.
[11] *See* Proposal, *supra* note 1, at 106.
[12] *See* Proposal, *supra* note 1, at 33 (emphasis added).
[13] *See* Proposal, *supra* note 1, at 84.
[14] *See* Proposal, *supra* note 1, at 81.

> [F]unds may hold meetings with certain issuers on an infrequent or ad hoc basis rather than as a significant part of their strategy, and may incorrectly believe that such infrequent or ad hoc engagement would be sufficient for them to claim that engagement is a part of their strategy.[15]

Funds are admonished to:

> include[] in their compliance policies and procedures a requirement that employees memorialize the discussion of ESG issues, for example by creating and preserving meeting agendas and contemporaneous notes of engagements relating to ESG issues to assure accurate reporting on the number of engagements, as we propose to define it.[16]

I will be interested to see what commenters say on the matter. Among other things, would such a rule set a precedent for SEC micromanagement of asset management?

Why do we feel compelled to propose such sweeping and prescriptive new rules when we can and do use existing rules to hold funds and advisers to account? Part of the answer seems to be yet another instance of a troubling trend of not-so-subtle coercion through disclosure mandates. Recent proposals, including this one, introduce new pressure points that activists—or stakeholders as some prefer to call them—can use to strong-arm uncooperative companies into instituting policies more conducive to the activists' agendas or punish companies that fail to fall in line.

I pointed out this coercive trend in my opposition to last September's proposed Form N-PX amendments governing disclosure of fund votes.[17] This proposal would intensify the pressure on funds to vote and to do so in a particular way. For example, it would require a fund to disclose "the percentage of ESG-related voting matters during the reporting period for which the Fund voted in furtherance of the initiative."[18] Consider the following deforestation-focused fund example:

During the reporting period, the fund was eligible to vote on 100 voting matters that would have limited deforestation. If the fund voted in favor of 75 of those matters, then the fund would report that it voted in furtherance of limiting deforestation 75% of the time during the reporting period.[19]

This type of requirement pressures funds to vote for ESG matters even if the fund has real concerns about the particulars of an initiative. Questioning the wisdom of any initiative labeled ESG is hard enough as it is. This proposal would only make it harder. We may end up with companies implementing policies that are neither good for the environment nor for investors.

The proposal's coercion is not limited to proxy voting. What will the practical implications be for an ESG-Focused fund for which issuer engagement is *not* now a strategy? Under the proposal such

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[15] *See* Proposal, *supra* note 1, at 62.
[16] *See* Proposal, *supra* note 1, at 82.
[17] *See* Hester M. Peirce, Commissioner, SEC, Statement on Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers (Sep. 29, 2021), https://www.sec.gov/news/public-statement/peirce-open-meeting-2021-09-29#_ftnref2.
[18] *See* Proposal, *supra* note 1, at 77-78.
[19] *See* Proposal, *supra* note 1, at 78 n.109.

a fund would have to declare that it has *no intention* of engaging with portfolio companies on ESG matters. A fund that does engage with portfolio companies would be required to disclose the number or percentage of issuers with whom the fund held such meetings during the reporting period. These proposed requirements are designed to manufacture activism by funds on ESG issues.

The proposal also requires all "ESG-Focused Funds" that indicate that they consider environmental factors to disclose the carbon metrics I mentioned earlier unless they affirmatively state that they do *not* consider issuers' GHG emissions as part of their investment strategy.[20] Environmental funds are not monolithic, and a fund that focuses water quality or biodiversity might not otherwise track greenhouse gas emissions. The proposal suggests that it really should.

Forcing ESG-Focused funds to make good faith estimates of a portfolio company's greenhouse gas emissions, when they cannot get such data from "non-reporting portfolio companies," will in turn play a coercive role. This time the coercion will be on companies to disclose greenhouse gas emissions so that funds will invest in them without the burden of greenhouse gas guessing (and subsequent enforcement second-guessing). If demand for greenhouse gas disclosures is becoming the norm, let the standards and expectations develop organically; let investors shape industry practice through their investing decisions, not through regulatory mandates about what investors *ought* to be considering.

Our markets are dynamic and equipped in ways we can never duplicate when it comes to the efficient dissemination of information. This proposal would displace the market's efficient signaling mechanisms with value-laden regulatory nudges. I have little faith that that change will lead to more efficient capital allocation or greater investor wealth accumulation.

The proposal reflects countless hours of careful work to translate the Commission's policy objectives into regulatory text and to craft a robust set of questions to accompany it. That task was not easy. So I will end my remarks by thanking the hardworking men and women of the Divisions of Investment Management and Economic and Risk Analysis, the Offices of the Chief Accountant, and General Counsel, and others at the Commission for rising to the challenge. I will also thank in advance the many commenters who will take the time to provide us with their thoughts and insights, which will inform how I vote should there be an adopting release.

[20] *See* Proposal, *supra* note 1, at 88.

Statement by Commissioner Lee on ESG Disclosures Proposal

Posted by Allison Herren Lee, U.S. Securities and Exchange Commission, on Thursday, May 26, 2022

Editor's note: Allison Herren Lee is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on her recent public statement. The views expressed in the post are those of Commissioner Lee, and do not necessarily reflect those of the Securities and Exchange Commission or the Staff.

I am pleased to support today's proposal to bring greater transparency and accountability to sustainable investing. There has been explosive growth in investor interest and demand around such investments, both domestically and internationally.[1] With that increasing demand comes increasing need for consistent, comparable, and reliable information—information to help protect investors from "greenwashing," or exaggerated or false claims about ESG practices. Greenwashing can mislead investors as to the true risks, rewards, and pricing of investment assets.[2]

This goes to the heart of our mission at the SEC, which is to protect investors by promoting transparency and accountability around investment decision-making. Those offering investments must fully and fairly disclose what they are selling, and act consistently with those disclosures. In others words: say what you mean and mean what you say. That is what today's proposal is designed to promote for sustainable investments.

I want to highlight briefly three key areas of the proposal, including those areas where public feedback will be critical.[3] These include how to categorize the various types of funds engaged in

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[1] Estimates of size of this market vary widely, but by all accounts the size is quite large and the growth, tremendous. *See, e.g.*, SustainFi, *30 ESG and Sustainable Investing Statistics*, *available at* https://sustainfi.com/articles/investing/esg-statistics/#:~:text=In%20the%20U.S.%2C%20ESG%20fund,from%20the%20end%20of%202020 (estimating that "[g]lobal ESG fund assets hit roughly $2.7 trillion at the end of last year, with US ESG fund assets accounting for roughly $357 billion of that amount."). *Compare* U.S. Securities & Exchange Commission, Asset Management Advisory Committee, Recommendations for ESG (July 7, 2021), *available at* https://www.sec.gov/files/spotlight/amac/recommendations-esg.pdf (noting that "ESG investing has grown significantly in recent years; according to the ICI, 'socially conscious' registered investment products grew from 376 products/$254 billion in assets under management ('AUM') at the end of 2017 to 1,102 products/$1.682 trillion in AUM by the end of June, 2020."); US SIF Comment Letter (June 14, 2021), *available at* https://www.sec.gov/comments/climate-disclosure/cll12-8916213-245007.pdf (noting that "[s]ince 1995, when the US SIF Foundation first measured the size of the US sustainable investment universe—the pool of assets whose managers consider ESG criteria as part of investment analysis and engagement—at $639 billion, these assets have increased more than 25-fold to $17.1 trillion in 2020, a compound annual growth rate of 14 percent.").

[2] *See, e.g.*, IOSCO, *Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management* (Nov. 2021), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD688.pdf (discussing global developments and investor protection concerns with respect to greenwashing).

[3] The proposal also includes enhanced disclosure requirements for certain investment advisers that consider ESG factors as part of their advisory business, such as a requirement to describe the ESG factor(s) an investment adviser considers for each significant investment strategy. *See* Enhanced Disclosures by Certain Investment Advisers and

ESG investing; whether we have calibrated disclosures sensibly for each category; and finally, the significant question of when and how to require disclosure of greenhouse gas (GHG) emissions.

First, the proposal would categorize funds engaging in ESG investing into two buckets: Integration Funds and ESG-Focused Funds, with a third category that is a subset of ESG-Focused funds to be known as Impact Funds. An Integration Fund would be defined as one that considers one or more ESG factors alongside other non-ESG factors, but generally gives ESG factors no greater prominence than non-ESG factors in its investment selection process.[4] An ESG-Focused Fund, by contrast, would focus on one or more ESG factors as a significant consideration in its investment selection process or as part of its engagement with portfolio companies. Finally, Impact Funds (a subset of ESG-Focused Funds) would be comprised of those with a goal of achieving a specific ESG impact.[5]

Do we have this categorization right? Given that this is the premise upon which we have calibrated disclosure requirements, it's important to get input on whether we have appropriately captured the various iterations of ESG investing.

Second, are the proposed disclosures for each category tailored appropriately to the risks each poses? For instance, an Integration Fund would be required to disclose, in a few sentences, what ESG factors it incorporates and how it incorporates those factors in its decision-making process. By contrast, ESG-Focused and Impact Funds would be required to provide top-line disclosures (in a standardized tabular format) about the fund's ESG strategies, such as whether they track an index, seek to achieve a particular impact, or apply inclusionary or exclusionary screens, and then provide more granular information in the prospectus[6] And for each ESG strategy a fund pursues, it would provide information on *how* it incorporates ESG factors into the investment decision process by, for example, explaining how it applies an inclusionary or exclusionary screen, or how an index the fund uses factors in ESG in determining its constituents. And finally, an Impact Fund would disclose even more detailed information, such as how it measures progress towards its stated impact goals.

I welcome input on whether the information required of Integration Funds sufficiently enhances transparency around how ESG is truly being considered in these funds' investment selection processes. I also welcome input as to whether the granularity and types of information provided in the summary table and in the prospectus will facilitate sufficient transparency and comparability.

Third, the proposal would require an ESG-Focused Fund that considers environmental factors to provide aggregated, quantitative GHG emissions data, unless the fund does not in fact consider emissions data in its investment strategy and it specifically discloses that fact to investors.[7] The same quantitative GHG emissions data, however, would not be required for an Integration Fund—even when such fund purports to consider environmental factors (among other non-ESG

Investment Companies about Environmental, Social, and Governance Investment Practices, Investment Advisers Act No. 6034 (May 25, 2022) ("Proposing Release"), at Section II.B.

[4] *See id.*, at Section II.A.1.

[5] *See id.*

[6] *See id.*

[7] Proposing Release, *supra* note 4, at Section II.A.3(d).

factors). In that case, an Integration Fund would simply need to describe, in narrative form, if and how it considers the GHG emissions of its portfolio holdings.

Thus, under today's proposal, even if an Integration Fund considers GHG emissions data, it need not disclose that data to its investors. While it may make sense not to require disclosure of emissions data from an Integration Fund that doesn't consider it, it's more difficult to justify permitting funds that *do* consider GHG emissions data to nevertheless not disclose that data.

I look forward to public comment on this, as well as all other aspects of today's proposal, which represents a significant step forward in bringing transparency and accountability to this rapidly growing space. I'd like to thank the staff in the Division of Investment Management, the Division of Economic and Risk Analysis, and the Office of the General Counsel for your commitment to improving the quality and accuracy of fund and adviser-related disclosures.

Ten Thoughts on the SEC's Proposed Climate Disclosure Rules

Posted by Michael Littenberg, Marc Rotter, and Hannah Shapiro, Ropes & Gray LLP, on Saturday, April 30, 2022

Editor's note: Michael Littenberg is partner, Marc Rotter is counsel, and Hannah Shapiro is a law clerk at Ropes & Gray LLP. This post is based on their Ropes & Gray memorandum. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); and Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock by Leo E. Strine, Jr. (discussed on the Forum here); Stakeholder Capitalism in the Time of COVID by Lucian Bebchuk, Kobi Kastiel and Roberto Tallarita (discussed on the Forum here); Corporate Purpose and Corporate Competition by Mark Roe (discussed on the Forum here).

Last month, the Securities and Exchange Commission proposed long-awaited rules that would mandate enhanced climate-related disclosures by public companies. In this post, we provide an overview of this significant, and controversial, rulemaking proposal. We also provide our views on where the rules fit into governance, compliance and disclosure more broadly.

A Bit of Background and the Broader Context

Enhanced environmental disclosure has been a topic of discussion within the SEC since the 1970s. More recently, with the January 2021 change-over in administration and the resulting shift in rulemaking philosophy, climate disclosure has been an area of increasing SEC focus. Among other actions, during February 2021, shortly after taking office, then-Acting Chair Allison Herren Lee issued a statement directing the SEC's Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings.

In March 2021, the SEC launched a public consultation requesting input from investors, registrants and other market participants about whether current disclosures adequately inform investors about climate change. Approximately 600 unique comment letters were submitted to the SEC by leading issuers, institutional investors, trade associations, NGOs and others (Ropes & Gray advised several clients on their comment letters). Many of the more significant letters are cited in the SEC's Proposing Release for the new climate disclosure rules.

In September 2021, the SEC's Division of Corporation Finance published a sample comment letter related to climate change disclosures, which is discussed in our earlier post here. The sample comment letter followed the views expressed in the interpretive release on climate change disclosure published by the SEC in 2010, discussed in our earlier article here. The 2010

Interpretative Release and 2021 sample comment letter both focused on ways in which the SEC's existing principles-based disclosure requirements elicit climate-related information.

In its filing reviews, the SEC also has been increasingly, albeit selectively, focused on climate disclosures. In 2021, the SEC issued comments relating to climate disclosures to more than 40 registrants.

Alignment with Third-Party Frameworks

The proposed rules are in part based on (but not identical to) the frameworks published by the Task Force on Climate-related Financial Disclosures and the Greenhouse Gas Protocol.

The objective of the TCFD framework is to encourage companies to evaluate and disclose, as part of their financial filing preparation and reporting processes, the material climate-related risks and opportunities pertinent to their business activities. This is intended to help investors and other financial market participants, such as lenders and insurance underwriters, to assess and price climate-related risks and opportunities. The TCFD's high level recommendations for all sectors consist of eleven recommended disclosure topics grouped into four elements: (1) governance; (2) strategy; (3) risk management; and (4) metrics and targets. The TCFD recommendations also include supplemental guidance for the financial sector (banks, insurance companies, asset owners and asset managers) and non-financial groups (energy, transportation, materials and buildings and agriculture, food and forest products), including suggested metrics. The TCFD is a voluntary framework. However, it is being incorporated to varying degrees into national legislation and/or securities exchange requirements in several jurisdictions, including, among others, Canada, Hong Kong, Japan, New Zealand, Singapore, Switzerland and the United Kingdom. Even without the force of law, TCFD reporting has increased significantly over the last few years, although most companies only publish disclosures aligned with a subset of the TCFD recommendations.

The Greenhouse Gas Protocol consists of global standardized frameworks to measure and manage greenhouse gas (GHG) emissions from operations, value chains and mitigation actions. The GHG Protocol Corporate Accounting and Reporting Standard provides requirements and guidance for companies and other organizations preparing a corporate-level GHG emissions inventory. The standard covers the accounting and reporting of seven greenhouse gases covered by the Kyoto Protocol: carbon dioxide; methane; nitrous oxide; hydrofluorocarbons; perfluorocarbons; sulphur hexafluoride; and nitrogen trifluoride. All seven of these GHG emissions come within the scope of the SEC's proposed rules.

The standard was designed with the following objectives in mind:

- to help companies prepare a GHG inventory that represents a true and fair account of their emissions, through the use of standardized approaches and principles;
- to simplify and reduce the costs of compiling a GHG inventory;
- to provide businesses with information that can be used to build an effective strategy to manage and reduce GHG emissions; and
- to increase consistency and transparency in GHG accounting and reporting among various companies and GHG programs.

To complement the standard, a number of cross-sector and sector-specific calculation tools are available. These tools provide step-by-step guidance and electronic worksheets to help users calculate GHG emissions from specific sources or industries.

Covered Registrants; Compliance Dates

The rules would apply to SEC registrants broadly, other than registered investment companies, asset-backed issuers and Canadian issuers that are MJDS filers. Accordingly, the rules would apply to other foreign private issuers, even if they are subject to a home country reporting regime that requires climate disclosures, although the SEC asks for feedback on this portion of the rules in the Proposing Release.

The initial compliance date would vary based on filer size. Compliance would be keyed off of the number of fiscal years following the effective date of the rules. Assuming the rules are adopted in December 2022 (which we expect the SEC to push hard to achieve) and a registrant has a fiscal year ending December 31, the first compliance period for large accelerated filers would be the first fiscal year after the effective date of the rules, or fiscal 2023. The first compliance period for accelerated and non-accelerated filers would be the following year, or fiscal 2024. Compliance would be required by smaller reporting companies the year after that, or fiscal 2025.

However, compliance with Scope 3 greenhouse gas emissions and associated intensity metrics disclosure requirements—both of which are discussed later in this post—would not be required until the second fiscal year for which a registrant is required to comply with the rules. Smaller reporting companies would be exempted from the Scope 3 disclosure requirements.

To the extent third-party attestation is required, that would not begin for large accelerated filers and accelerated filers until the second fiscal year for which they are subject to the rules. Non-accelerated filers and smaller reporting companies would not be subject to the attestation requirements. Attestation is discussed in further detail later in this post.

Applicable Filings

Disclosures would apply to both Securities Act registration statements and Exchange Act periodic reports. More specifically, the disclosures called for by the rules would be required to be included in registration statements on Forms 10, S-1, S-11, S-4, F-1 and F-4 and primarily in periodic reports on Forms 10-K and 20-F.

Disclosures under the rules would be treated as "filed" rather than "furnished." Accordingly, they would be subject to potential liability under Section 18 of the Exchange Act or Section 11 of the Securities Act, as applicable.

A 100,000 Foot Look at the Disclosure Requirements

In contrast to the current principles-based approach to climate disclosure, the proposed rules take a different tack, requiring specific and detailed disclosures relating to climate matters. Key components of the proposed rules include the following:

- Oversight and management of climate risk.
- Impacts of climate-related risks on the business, financials, strategy, business model and outlook over the short, medium and long terms.
- Processes for identifying, assessing and managing climate-related risks.
- Historical GHG emissions data (Scopes 1 and 2, and in many cases Scope 3), with third-party assurance.
- Climate-related targets and goals, if set.
- Financial statement disclosure on the financial impacts of physical and transition risks.

Key elements of the proposed rules are summarized in subsequent sections of this post.

Climate-related Opportunities

Disclosure regarding climate-related opportunities would largely be optional under the rules. The Proposing Release indicates this is to allay any anti-competitive concerns that might arise from a requirement to disclose a particular business opportunity. However, disclosure of climate-related opportunities may nevertheless be required under the existing principles-based disclosure framework. For example, in the 2010 Interpretative Release, the SEC noted that a registrant's plans to reposition itself to take advantage of potential opportunities may be required by Item 101(a)(1) of Regulation S-K.

GHG Emissions Metrics

The rules would require registrants to disclose Scope 1 and Scope 2 emissions for the same periods for which information is presented in their audited financial statements, unless for prior historical periods the data is not reasonably available. For purposes of the calculation, registrants would use the sources included in their organizational and operational boundaries. In a deviation from the GHG Protocol for some companies, these boundaries would follow the same principles used when determining whether entities should be consolidated or proportionally consolidated for financial statement purposes.

Scope 3 emissions would be required to be disclosed if material to the registrant or the registrant has set reduction targets or goals that include Scope 3 emissions. As earlier noted, the Scope 3 disclosure requirement would phase in one year after Scopes 1 and 2 disclosures are required and would not apply to smaller reporting companies.

In the Proposing Release, the SEC indicates that, consistent with its definition of "material" and Supreme Court precedent, Scope 3 emissions would be required to be disclosed if there is a substantial likelihood that a reasonable investor would consider Scope 3 emissions important when making an investment or voting decision. The SEC further states that, when assessing the materiality of Scope 3 emissions, registrants should consider whether Scope 3 emissions make up a relatively significant portion of their overall GHG emissions. Although the SEC indicated it is not proposing a quantitative threshold for determining materiality (and that a quantitative threshold alone would not suffice for determining whether Scope 3 emissions are material), it goes on to note that some companies rely on, or support reliance on, a quantitative threshold such as 40% when assessing the materiality of Scope 3 emissions. The Proposing Release also suggests, although the rules would not mandate, that registrants that determine that Scope 3

emissions, or categories of Scope 3 emissions, are not material should explain the basis for that determination.

GHG emissions data for each Scope presented would be required to be presented disaggregated by each constituent GHG and in the aggregate. Each Scope would be required to be separately disclosed. The impact of purchased or generated offsets would be required to be excluded. If Scope 3 emissions are disclosed, the registrant would be required to indicate the categories of upstream and/or downstream activities included in the calculation and, for each significant category, the emissions would be required to be separately broken out.

Additionally, registrants would be required to disclose GHG intensity per unit of total revenue and per unit of production for the sum of Scope 1 and Scope 2 emissions and, if Scope 3 emissions are disclosed, separately for Scope 3.

Registrants would be required to disclose the methodology, significant inputs and significant assumptions used to calculate GHG emissions, including any material gaps in the data and material changes to the methodology or assumptions from the prior fiscal year. Third-party data sources used for calculating GHG emissions would also need to be disclosed, as well as the process the registrant undertook to obtain and assess the data.

Estimates could be used, provided that the underlying assumptions and reasons for using estimates are disclosed. When disclosing GHG emissions for the most recently completed fiscal year, if actual reported data is not reasonably available, a registrant would be permitted to use a reasonable estimate of its GHG emissions for its fourth fiscal quarter (together with actual, determined GHG emissions data for the first three fiscal quarters), so long as the registrant promptly discloses in a subsequent filing any material difference between the estimate used and the actual, determined GHG emissions data for the fourth fiscal quarter.

Scope 3 Safe Harbor

Scope 3 disclosures would benefit from a safe harbor from liability that would deem those disclosures to not be fraudulent statements unless made or reaffirmed without a reasonable basis or disclosed other than in good faith. The rules would not include a safe harbor for Scope 1 and Scope 2 disclosures, or other disclosures required by the rules.

Other than the foregoing Scope 3 disclosure safe harbor, the rules would not include any new safe harbors. Instead, in several places in the Proposing Release, the SEC notes the availability of the Private Securities Litigation Reform Act safe harbor for forward-looking statements. In order to rely on that safe harbor, the relevant forward-looking statement must be accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement. The PSLRA safe harbor does not apply to disclosures in initial public offerings or tender offers or to disclosure made by certain “bad actors” (among other exclusions).

Attestation Requirements

Scope 1 and Scope 2 emissions disclosures by accelerated filers and large accelerated filers would require third-party attestation, following a phase-in period. Because the assurance

requirements would be limited to accelerated filers and large accelerated filers, a new registrant would not be subject to these requirements until it has been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act for at least twelve months and has filed one annual report pursuant to the Exchange Act. Therefore, the assurance requirement would not apply to IPO issuers.

As earlier noted, the third-party attestation requirements would not kick in until the second fiscal year for which a registrant is subject to the rules. If the rules are adopted in 2022, this means that attestation would be required for large accelerated filers beginning with fiscal 2024 and for accelerated filers beginning with fiscal 2025. Non-accelerated filers and smaller reporting companies would not be subject to the attestation requirements.

Initially, for the first two years, limited (negative) assurance would be required. After the first two years, attestation would be required to be at a reasonable assurance level. Attestation would not be required to cover the effectiveness of controls around GHG reporting.

Attestation would not be required for Scope 3 emissions disclosure. However, if voluntarily obtained, it would be required to satisfy the same standards as attestation relating to Scope 1 and Scope 2 emissions disclosures.

The attestation report would need to be provided by an independent firm qualified to do so. It would not need to be a PCAOB-registered accounting firm.

Disclosures Regarding Targets, Strategy, Risk Management and Governance

Targets and Goals

Climate-related targets or goals set by a registrant would need to be disclosed. The rules would require a description of (1) the scope of activities and emissions included in the target, (2) the unit of measurement, including whether the target is absolute or intensity based, (3) the time horizon and (4) the baseline against which progress is tracked, with a consistent base year set if there are multiple targets. The rules would also require a description of any interim targets set by the registrant.

Registrants would also need to describe how they intend to meet climate-related targets and goals. As part of this requirement, they would be required to provide specified information regarding carbon offsets or renewable energy credits (RECs) that are part of the registrant's plan.

Registrants also would be required to disclose relevant data to indicate whether the registrant is making progress toward meeting the target or goal and how such progress has been achieved. Each year, the registrant would be required to update this disclosure by describing the actions taken during the year to achieve its targets or goals.

Strategy, Business Model and Outlook

The rules would require detailed disclosure of climate-related risks and how they may impact a registrant. Specifically, the rules would require a description of climate-related risks reasonably

likely to have a material impact on the registrant, including on the registrant's business or consolidated financial statements, which may manifest over the short, medium and long terms.

Among other things, registrants would be required to disclose how they define their short-, medium- and long-term time horizons and indicate whether risks are physical or transition risks. For physical risks, registrants would be required to indicate, among other things, the nature of the risk and the location (including zip code or similar geographic identifier) and nature of the properties, processes or operations subject to the risk. For transition risks, disclosure regarding the nature of the risk and how relevant transition-related factors impact the registrant would be required.

Registrants would need to also describe the actual and potential impacts of their physical and transition risks on their strategy, business model and outlook and whether and how any such impacts are considered as part of the registrant's business strategy, financial planning and capital allocation, including both current and forward-looking disclosures that facilitate an understanding of whether the implications of the identified risks have been integrated into the registrant's business model or strategy. The registrant would also need to include a discussion of how any resources are being used to mitigate climate-related risks, the role that carbon offsets or RECs play in the strategy (if applicable) and financial statement impacts.

The rule would also require granular disclosure of certain metrics and tools if they are used by a registrant. If the registrant maintains an internal carbon price, it would be required to disclose that price, the boundaries for measurement, the rationale for selecting the price and how the registrant uses it to evaluate and manage climate-related risks. Scenario analysis and other analytical tools used by the registrant to assess the impact of climate-related risks would also need to be disclosed, together with the scenarios considered and related parameters, assumptions and analytical choices and the projected principal financial impacts on the registrant's business strategy under each scenario.

Risk Management

In addition to requiring disclosure of climate-related risks, the rules would require disclosure of a registrant's processes for identifying, assessing and managing those risks.

The rules would include a number of specific items that registrants would be required to discuss, if applicable, when describing their processes for identifying, assessing and managing climate-related risks, including how the registrant:

- determines the relative significance of climate-related risks compared to other risks;
- considers existing or likely regulatory requirements or policies, such as GHG emissions limits, when identifying climate-related risks;
- considers shifts in customer or counterparty preferences, technological changes or changes in market prices in assessing potential transition risks;
- determines the materiality of climate-related risks;
- decides whether to mitigate, accept or adapt to a particular risk;
- prioritizes whether to address climate-related risks; and
- determines how to mitigate any high priority risks.

Registrants would be required to disclose whether and how any such processes are integrated into the registrant's overall risk management system or processes.

Registrants also would need to describe any transition plan adopted as part of their climate-related risk management strategy, including how the registrant plans to mitigate or adapt to climate risks and the relevant metrics and targets used to identify and manage physical and transition risks. The disclosure would need to be updated annually to describe the actions taken during the preceding fiscal year to achieve the transition plan's targets or goals.

Governance

The rules would require registrants to describe how their board of directors oversees and management assesses and manages climate-related risks.

Registrants would be required to disclose if any member of the board has expertise in climate-related risks. That follows the approach taken in the SEC's recent proposal on cybersecurity disclosure, which would similarly require registrants to disclose if any member of the board of directors has relevant subject matter expertise. However, unlike the recent cybersecurity proposal and the existing disclosure requirements regarding audit committee financial experts, the Proposing Release and proposed rules do not state that being identified as having climate-related expertise would not result in a director being deemed to be an "expert" for purposes of Section 11 of the Securities Act, impose duties or liabilities on that director or relieve other directors of any of their obligations.

Additionally, registrants would be required to identify which directors or board committees are responsible for the oversight of climate-related risks, the processes by which board members are informed about and the frequency of board-level discussions regarding climate-related risks and whether and how the board considers climate-related risks as part of its business strategy, risk management and financial oversight. Whether and how the board sets climate-related targets or goals and oversees their progress, including the establishment of any interim targets or goals, would also be required to be disclosed.

In addition, registrants would be required to describe management's role in assessing and managing climate-related risks. That disclosure would need to address whether certain management positions or committees are responsible for assessing and managing climate-related risks and, if so, the identity of the positions or committees and the relevant expertise of the position holders or committee members, the processes by which the positions or committees are informed about and monitor climate-related risks and whether and how frequently such positions or committees report to the board or a board committee on climate-related risks.

Financial Statement Requirements

The rules would amend Regulation S-X to require inclusion of a note to the audited financial statements disclosing among other things the financial impacts of physical conditions and transition activities. As part of a registrant's financial statements, these metrics would be subject to audit by an independent registered public accounting firm and would come within the scope of the registrant's internal control over financial reporting. Selected elements of this aspect of the rules are described below.

The registrant would be required to disclose the impact on relevant financial statement line items of severe weather events and other natural conditions (such as flooding, drought, wildfires, extreme temperatures and sea level rise). The registrant also would be required to disclose the impact of transition activities (including any efforts to reduce GHG emissions or otherwise mitigate exposure to transition risks) on each impacted line item. At a minimum, impacts would be required to be presented on an aggregated line-by-line basis, separately for negative and positive impacts. The note would also be required to separately indicate the aggregate amount of expenses and capitalized costs incurred to mitigate the risks of severe weather events and other natural conditions and to reduce GHG emissions or otherwise mitigate exposure to transition risks.

Inclusion of the foregoing information would be subject to quantitative thresholds. Disclosure of the financial impact on a line item would not be required if the sum of the absolute values of all impacts on the line item is less than 1% of the line item. Disclosure of the aggregate amount of expenses and/or capitalized costs would not be required if the amount incurred is less than 1% of the total expensed or capitalized costs incurred.

Disclosures would be required for the registrant's most recently completed fiscal year, and for the historical fiscal year(s) included in the consolidated financial statements in the filing. A registrant that is required to include balance sheets as of the end of its two most recent fiscal years and income statements and cash flow statements as of the end of its three most recent fiscal years would be required to disclose two years of the climate-related metrics that correspond to balance sheet line items and three years of climate-related metrics that correspond to income statement or cash flow statement line items. For fiscal years preceding the then-current reporting year, the registrant would be able to rely on Rule 409 or Rule 12b-21, to the extent the information is not reasonably available and would require unreasonable effort or expense to obtain.

The note also would be required to include contextual information describing how each specified metric was derived, including a description of significant inputs and assumptions used, and, if applicable, policy decisions made by the registrant to calculate the specified metrics.

Additionally, registrants would be required to include (if applicable) a qualitative description of how the development of the estimates and assumptions used to produce the financial statements were impacted by exposures to risks and uncertainties associated with, or known impacts from, (1) severe weather events and other natural conditions and (2) a potential transition to a lower-carbon economy or any climate-related targets disclosed by the registrant.

Ten Take-aways for Registrants

The Final Rules Are Likely to Differ from the Proposal, Perhaps Substantially

The rules are arguably the most significant new public company disclosure and compliance requirements in a generation. Compliance costs will be significant. The SEC will therefore receive a significant volume of comments from individual registrants and trade associations advocating for modifications to various aspects of the rules.

In addition, several members of Congress already have expressed their opposition. Congressman Joyce (R-Ohio) has introduced a resolution critical of the SEC's proposed

approach to climate-related disclosure. Additionally, a number of members of Congress have publicly indicated they oppose the SEC's proposal, including Senator Manchin of West Virginia and 19 Republican senators. Senator Hagerty (R-TN), in addition to publicly opposing the proposed rules, has written to Chairman Gensler indicating that he will seek to review any final rules under the Congressional Review Act, although disapproval of the rules under the CRA is unlikely.

Undoubtedly, none of this is a surprise to the SEC. It knew going in that rulemaking in this area would be controversial. With that in mind, many commentators expect the final rules to soften some aspects of the proposal. Putting aside more philosophical questions around the SEC's authority to adopt the rules, the debate over rulemaking versus private ordering and the effect of the rules on capital formation, specific areas that will draw a significant number of comments will include, among others, (1) the phase-in periods for compliance; (2) the granularity of required GHG emissions disclosures; (3) Scope 3 emissions disclosure requirements, including the triggers; (4) the timing for filing GHG emissions disclosures; (5) required disclosures around board oversight and qualifications and management practices; (6) the extensive and prescriptive nature of the disclosures relating to strategy, business model, outlook and risk management, including relating to targets, goals and transition plans; (7) the extensive audited financial statement disclosure requirements and the low thresholds for quantitative disclosures; (8) the phase-in period for third-party assurance and the reasonable assurance requirement; (9) the lack of a broad-based safe-harbor from liability for historical GHG emissions data, which is often based on estimates, assumptions and methodologies that may be revised in the future; (10) the industry-agnostic approach taken by the rules; and (11) differences between the rules and voluntary frameworks and/or other non-SEC registrant compliance requirements.

Based on their public statements and reports in the press, it is widely believed the three Democratic Commissioners that voted in favor of releasing the proposed rules (Chair Gensler and Commissioners Lee and Crenshaw) had divergent views on some aspects of the Proposing Release and negotiated certain compromises prior to its release. The composition of the SEC will change before final rules are voted on. Commissioner Lee, a vocal advocate for robust climate-related disclosures, has announced she will be stepping down at the end of her term in June once her replacement is confirmed. The seat vacated by Commissioner Roisman, who left the SEC in January, may also be filled prior to a vote on the final rules. President Biden recently nominated Jaime Lizárraga, a Senior Advisor to Speaker of the House Nancy Pelosi, and Mark T. Uyeda, a career attorney with the SEC who is currently on detail to the U.S. Senate Committee on Banking, Housing, and Urban Affairs, where he serves as Securities Counsel on the Committee's Minority Staff. If confirmed, Mr. Lizárraga's views may be particularly impactful, as the final rules are highly likely to require the affirmative votes of all three Democratic Commissioners for adoption. As such, any divergence between Mr. Lizárraga's and Commissioner Lee's views may result in differences between the proposed and final rules.

The Final Rules Will Be Challenged in Court

It is a virtual certainty that there will be a court challenge to the final rules. Critics of the rules, including Commissioner Peirce in an extensive dissenting statement, have highlighted three objections to the proposed rules that are likely to form the basis for future litigation.

First, critics argue the SEC does not have authority to propose the rules. A group of Republican senators summarized that argument in a letter to Chair Gensler, stating that “The SEC is not tasked with environmental regulation, nor has Congress amended the SEC’s regulatory authority to pursue the proposed climate disclosures.” Second, critics argue the proposal violates First Amendment restrictions against compelled speech. This argument prevailed in the challenge to the Conflict Minerals Rule the SEC was required to adopt pursuant to the Dodd-Frank Act, resulting in parts of that rule being overturned, as discussed in our earlier Alert here. Finally, critics have argued the economic and cost-benefit analyses in the Proposing Release do not meet the requirements of the Administrative Procedure Act. That argument was successfully made in connection with the first iteration of the Resource Extraction Payments Disclosure Rule adopted by the SEC pursuant to Dodd-Frank, as discussed in our earlier Alert here.

It is premature to speculate on the challenges that will be brought, since that will to some extent depend on the final rules. It is even more premature to speculate on how litigation will play out. In some cases when rules have been challenged, the SEC has stayed their application pending resolution of the legal challenge. That is unlikely to happen here. Litigation concerning the Conflict Minerals Rule went on for four years, with registrants required to comply with the Rule while the litigation played out (in a bit of trivia, the final judgment in that case was entered by Judge Ketanji Brown Jackson). Ultimately, the rule was only partially scaled back, and companies will soon be making their ninth year of filings under the rule.

The Rules Are Not Just About Disclosure; They Will Drive Changes to Oversight and Management of Climate-Related Risks

Although the express purpose of the rules is to provide decision-useful information to investors to enable them to make informed judgments, many corporate social responsibility advocates view the rules as important for mitigating climate change. The rules will therefore be part of stakeholders’ CSR toolkit for driving corporate practices. In CSR legislation, disclosure is intended as a catalyst for driving a race to the top in company practices. The power of disclosure-only CSR legislation to drive substantive change is illustrated by modern slavery legislation in California, the United Kingdom and Australia. Although detractors argue that these instruments have not done enough to address modern slavery, it is clear that, due to modern slavery disclosure requirements, many companies have over the last several years significantly enhanced their policies, procedures and practices to address this issue. Similarly, NGO and other pressures resulting from disclosures made pursuant to the SEC’s Conflict Minerals Rule have led registrants to, in many cases, go well beyond the requirements of the Rule in furtherance of responsible minerals sourcing. Although framed as a disclosure requirement, SEC climate rules will have an even greater impact on company practices than these other regulations, including how registrants oversee, manage, assess and mitigate climate risk and the impacts of climate change, as well as the data they collect and how they assess and validate that data.

Even with the Rules, Shareholder Demands for Greater Transparency and Action Will Continue

SEC rules will not end the call for more climate-related and other environmental disclosures. Investors will continue to seek climate-related and environmental disclosures that go beyond SEC disclosure requirements. In addition, even before the SEC’s proposed rules phase in, some

institutional investors will encourage registrants to voluntarily early adopt those standards in their SEC or voluntary sustainability disclosures.

Large institutional investors that invest globally seek globally comparable climate data. Therefore, International Sustainability Standards Board requirements relating to climate change will inform investor requests and expectations. On March 31, the ISSB published consultation drafts of both general sustainability and climate-related disclosure requirements. The climate standard is based on the TCFD framework, although it differs from that framework in many respects, including requiring many additional disclosures. To the extent ISSB standards go further than SEC climate disclosure requirements, expect many global institutional investors to seek additional voluntary disclosures from U.S. registrants that align with at least some additional elements of the ISSB standard.

Global institutional investor expectations also will be informed by the requirements of the European Union's Corporate Sustainability Reporting Directive. During April 2021, the European Commission adopted the CSRD, which would replace the current Non-Financial Reporting Directive and expand its scope. Among other things, subject companies would be required to assess sustainability risks and impacts associated with their business model and strategy, sustainability opportunities and compatibility with the Paris Agreement. Companies would be required to provide qualitative and quantitative sustainability information. New sustainability reporting standards would be developed by the European Financial Reporting Advisory Group. The proposed CSRD also would introduce an assurance obligation for reported sustainability information. Next steps are for the European Parliament and European Council to negotiate a final legislative text. In parallel, the EFRAG is working on a first set of draft sustainability reporting standards, which it aims to have proposed by mid-2022.

Furthermore, the focus of institutional investors is broader than just enhanced climate-related disclosure. Investors will continue to encourage companies to align their oversight and management practices with the TCFD framework and other best practices requests. Investors will also continue to encourage companies to align their business practices with investors' environmental sustainability objectives.

For all these reasons, one-on-one engagement, shareholder proposals and multi-stakeholder investor initiatives, such as Climate Action 100+, focused on climate will continue and are likely to increase due to both rising expectations and enhanced transparency.

For Now, the Primary Focus Should Be on TCFD and the GHG Protocol

Registrants should of course familiarize themselves with the rules, assess what enhancements to current voluntary disclosures and processes and procedures would be required to meet the requirements of the rules, start to develop an action plan for compliance and continue to monitor the rulemaking process. Given the uncertainty surrounding both the ultimate requirements and timing of the rules, most registrants are likely to conclude it is premature to start implementing compliance processes and procedures specifically designed to conform to the requirements of the rules.

However, registrants would be well-served to continue their journey integrating the TCFD framework and GHG Protocol standards into their oversight, management, processes and

procedures and reporting. Doing so is aligned with both evolving market practices and institutional investor pressures. Furthermore, registrants will be well-positioned once final rules are adopted, given the likely general alignment of the final rules with both the TFCD framework and the GHG Protocol standards.

Don't Forget About Existing SEC Rules and Guidance

Once in effect, the rules will largely subsume the SEC's 2010 climate change guidance, discussed in our earlier article here. In the meantime, registrants should continue to consider the extent to which climate-related disclosures are appropriate in MD&A, risk factor, business and legal proceedings sections under existing principles-based requirements. As part of considering the interplay between current principles-based rules and climate risk, registrants should take into account the Division of Corporation Finance's sample comment letter relating to climate change disclosures (discussed in our earlier Alert here), as well as comments issued to comparable registrants.

Even once the rules are adopted, registrants still will need to consider whether climate-related disclosures may be required by other SEC rules. For example, registrants still will need to consider the inclusion of climate-related risk factor disclosures. In addition, even though climate-related opportunities would largely be a voluntary disclosure topic under the rules, as earlier noted, the Proposing Release indicates that disclosure of climate-related opportunities may nevertheless be required under the existing principles-based disclosure framework.

The Search for Climate-Competent Directors Will Intensify

As previously discussed, the rules as proposed would require registrants to disclose if any member of the board has expertise in climate-related risks. If this requirement ultimately makes its way into the final rules, it will put pressure on many registrants to be able to indicate they have at least one director with this expertise. In addition, large institutional investors are increasing their focus on and expectations regarding the climate competency of boards.

Today, there are a limited number of individuals with the requisite subject matter expertise and that otherwise have the experience and background typically sought for public company board service. Even before the rules were proposed, many registrants were actively looking to add climate-related expertise to their board. If this disclosure requirement is part of the final rules, it is likely to drive an exponential increase in these searches.

Keep an Eye on State and Other Federal Initiatives

Although the focus is on climate rulemaking by the SEC, the states also bear watching. For example, a bill is under consideration in California that would require public companies with annual revenues in excess of $1,000,000,000 that do business in California to disclose Scope 1, Scope 2 and Scope 3 emissions, and to have that disclosure audited. A bill in New York that is specific to the fashion industry also has a climate-related component. That bill is discussed in our earlier Alert here. We would not be surprised to see additional climate-related disclosures proposed by some blue states if SEC climate-risk disclosure rules are perceived as falling short.

Furthermore, federal and state industry regulators will continue their focus on the substantive management of climate risk. For example, on March 30, the Federal Deposit Insurance Corporation published for comment draft principles for climate-related financial risk management for large financial institutions. Final guidance for domestic insurers on managing the financial risks from climate change was issued by the New York State Department of Financial Services during November 2021. Industry-focused prudential regulations will in many cases impose additional substantive requirements that directly or indirectly impact registrants.

Foreign CSR Regulations Also Will Add New Climate-Focused Requirements for U.S.-Based Companies

Over the next few years, many U.S.-based multinationals also will need to begin complying with foreign CSR legislation that to varying degrees seeks to address climate-related matters.

The United Kingdom adopted the Environment Act during November 2021. Among other things, that Act addresses deforestation and the use of forest risk commodities and derived products. The UK government is in the process of adopting secondary regulations in furtherance of the Environment Act. According to some studies, deforestation is responsible for approximately 15% of global carbon emissions. Deforestation is therefore inextricably linked to the debate over climate change and initiatives to address climate change. The Environment Act and proposed U.S. and EU legislative initiatives to address deforestation are discussed in our earlier Alert here.

Recently adopted and proposed mandatory human rights due diligence legislation in some jurisdictions also addresses climate where it intersects with human rights. For example, some of the environmental practices that come within the scope of the German Due Diligence in the Supply Chain Act (deforestation and water usage) may contribute to or be exacerbated by climate change. The German Act, which takes effect at the beginning of 2023, is discussed in our earlier Alerts here and here. The Corporate Sustainability Due Diligence Directive proposed by the European Commission in February 2022 also would, within its covered human rights, pick up adverse impacts that may contribute to or be magnified by climate change. In addition, as proposed in the Directive, directors of a large number of subject companies would be required to take into account the consequences of their decisions for sustainability matters, including, where applicable, climate change and environmental consequences, in the short-, medium- and long-term. In addition, a large number of subject companies would be required to adopt a plan to ensure their business model and strategy are compatible with the transition to a sustainable economy and with limiting global warming to 1.5°C in line with the Paris Agreement. The proposed EU Corporate Sustainability Due Diligence Directive is discussed in detail in our earlier Alert here.

Focus on Climate-Related Opportunities

As earlier noted, the SEC's proposal focuses largely on climate-related risks, rather than climate-related opportunities. Although not central to the proposed rules, climate risk is only part of the story. The TCFD framework explicitly takes climate-related opportunities into account. In any event, where appropriate, boards and management teams should be taking climate-related opportunities into account. In addition, many institutional investors are focused on climate-related

opportunities in their engagements with companies. Furthermore, as earlier noted, climate-related opportunities may need to be disclosed under other, existing SEC rules.

How to to Prepare for the SEC's Proposed Climate Disclosures Rules

Posted by Jason Halper, Erica Hogan, and Michael Ruder, Cadwalader, Wickersham & Taft LLP, on Wednesday, May 11, 2022

Editor's note: Jason Halper and Erica Hogan are partners and Michael Ruder is special counsel at Cadwalader, Wickersham & Taft LLP. This post is based on a Cadwalader memorandum by Mr. Halper, Ms. Hogan, Mr. Ruder, and Lauren Russo.

Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock by Leo E. Strine, Jr. (discussed on the Forum here); and Stakeholder Capitalism in the Time of COVID, by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here).

On March 21, 2022, the U.S. Securities and Exchange Commission (the "SEC") proposed far-reaching amendments to Regulation S-K and Regulation S-X that would mandate significant additional climate-related disclosures for public companies. A summary of the new disclosure requirements is available in our Clients & Friends Memo dated March 23, 2022. In brief, the proposed rules would require a public company to make significant additional disclosures regarding, among other things, its board and management's oversight of climate-related risks; its processes for identifying, assessing and managing climate-related risks; and its climate-related targets and goals. In addition, a company would be required to disclose how climate-related risks have had or are likely to have an impact on its business and consolidated financial statements, as well as on its strategy, business model and outlook. A company also would be required to disclose its greenhouse gas emissions and provide an attestation report to provide reasonable assurance, after a phase-in period, covering certain disclosed emissions.

Although the SEC's proposal made clear that asset-backed securities issuers are not covered by the proposed rules, the SEC indicated that it is continuing to consider whether and how to apply this type of regulation to asset-backed securities issuers.

If adopted as proposed, the amendments would impose significant reporting requirements on registrants, which in turn would increase compliance costs and require additional managerial time and attention. Although the proposed rules contain various phase-in periods dependent upon filer status, there are steps, discussed below, that public companies can act on today to prepare for the new rules.

1) Review Existing Public Disclosures

Although not yet required to do so by a specific climate-related rule (existing securities law disclosure requirements dependent on general determinations of materiality always have applied), many companies already make a variety of climate-related disclosures to meet investor and legal demands. Some metrics that are currently being reported on a voluntary basis might need to be revised going forward in order to satisfy the technical requirements of the SEC's proposed rule. For example, even if not mandated under a traditional materiality analysis, companies may already be releasing information about their greenhouse gas emissions and other metrics in their voluntary ESG or corporate sustainability reports. To prepare for the new proposed SEC rule, companies should evaluate their existing disclosures, and the internal processes, procedures and quantitative methodologies underlying such disclosures (*i.e.*, a climate audit), to determine how to bring them into alignment with the SEC's proposed requirements. Particular attention should be paid to identifying which areas will require the most time to develop new internal processes and procedures to comply with the proposed SEC rule.

2) Review and/or Implement Policies and Procedures Related to the Board's Oversight of Climate-Related Risks

The proposed rule will require a company to disclose information about the board and management's oversight and governance of climate-related risks, which include physical risks (*i.e.*, risks to company assets as a result of acute climate events or chronic climate change) and transition risks (*i.e.*, risks and opportunities associated with the transition to a low-carbon economy). Accordingly, a company should evaluate the board and management's roles, and the processes in place, for assessing, managing and overseeing climate-related risks. Companies could also consider whether any changes to the board, the committees and their charters, or management roles are appropriate to ensure those with proper expertise on climate-related matters are in leadership positions.

3) Engage Climate Change Experts—Both Internal and External

Given the breadth of the proposed rule, companies should consider whether their personnel that will be addressing climate-related risks and opportunities possess the relevant knowledge, skills and resources. Companies may consider implementing training or professional development programs for those new to such undertakings to ensure the companies are considering the full range of risks—both physical and transition risks—as required by the proposed rule. A company could also consider engaging outside consultants or counsel to help evaluate the company's climate-related risks and advise the company on complying with the SEC's proposed new requirements.

4) Measure Scope 3/Supply Chain Emissions

The proposed rule requires companies to disclose their Scope 3 emissions only if material or if a company has set a particular target or goal with respect to Scope 3 emissions. Companies could thus begin to measure their Scope 3 emissions now to determine materiality and if they will eventually need to make Scope 3 emissions-related disclosures. Unfortunately, there is no consensus around how exactly to measure these emissions (a process known as "carbon accounting"), in part because companies must rely on their supply chains to provide this

information. Nevertheless, companies could still initiate these conversations with their supply chains. For companies in the financial sector, the Partnership for Carbon Accounting Financials' Global GHG Accounting and Reporting Standard for the Financial Industry provides useful guidance on carbon accounting for different asset classes. Given the uncertainty around measuring Scope 3 emissions, the proposed rule contains a safe harbor provision that provides that Scope 3 emissions disclosures will not be deemed fraudulent unless it is shown that the statement was made without a reasonable basis or was disclosed in other than good faith.

5) Discuss with Auditors

To develop a better understanding of the new rule and its implications, companies should be engaging in a dialogue with their independent auditors. Under the proposed rules, large accelerated filers and accelerated filers will need to provide an attestation report from an independent GHG emissions attestation provider to cover Scope 1 and 2 greenhouse gas emissions metrics, subject to a phase-in period. While the report need not be provided by an outside auditor, many companies likely may opt to have an accounting firm issue the attestation. The proposed rules will likely create high demand for service providers in this space, so registrants may wish to begin discussions with potential service providers.

6) Write a Comment Letter to the SEC

The SEC has requested public comments on the proposed amendments by either May 20, 2022 or 30 days after the date of publication in the Federal Register, whichever is later. The SEC will review and take these comments into consideration before issuing a final rule. Accordingly, a company should consider filing a comment letter with the SEC to express any particular points of concern or support regarding the new rule, as well as to suggest any necessary changes that should be made before the rule is finalized.

II. The SEC’s Proposed 13d Rule

Statement by Chair Gensler on Beneficial Ownership Proposal

Posted by Gary Gensler, U.S. Securities and Exchange Commission, on Friday, February 11, 2022

Editor's note: Gary Gensler is Chair of the U.S. Securities and Exchange Commission. This post is based on his recent public statement. The views expressed in the post are those of Chair Gensler, and do not necessarily reflect those of the Securities and Exchange Commission or the Staff. Related research from the Program on Corporate Governance includes The Law and Economics of Blockholder Disclosure by Lucian Bebchuk and Robert J. Jackson Jr. (discussed on the Forum here); and Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

Today [Feb. 10, 2022], the Commission proposed to shorten the deadlines by which beneficial owners of a company — those who own at least 5 percent of the company — have to inform the public and other investors of their position. I am pleased to support this proposal because it would update our reporting requirements for modern market, reduce information asymmetries, and address the timeliness of two key filings.

In 1968, Congress mandated that large shareholders of public companies disclose information that helps the public understand their ability to influence or control that company. Under current rules, beneficial owners of more than 5 percent of a public company's equity securities who have control intent have 10 days to report their ownership.

Congress also closed a loophole in 1977 to ensure that significant owners without control intent also provided disclosure to the market (via Schedule 13G). Congress left those filing deadlines to the discretion of the Commission.

We haven't updated these deadlines in decades. Those decades-old rules might've been appropriate in the past, but I think we can update them given the rapidity of current markets and technologies.

In the wake of the 2008 financial crisis, Congress came back to the issue of 13D filings. Under the Dodd-Frank Act, Congress gave the SEC the authority to shorten the beneficial ownership reporting deadline. Today's proposal thus makes use of that authority.

The changes in today's proposal would reduce information asymmetries and promote transparency, thereby lowering risk and illiquidity. Specifically, it would do three things:

First, it would shorten the filing deadlines for Form 13D and Form 13G from 10 to 5 days, and 45 days from the end of the year to 5 business days from the end of the month.

The filing of Form 13D can have a material impact on share price; that means activist investors currently get to withhold market moving information from other shareholders for 10 days after crossing the 5 percent threshold. This creates an information asymmetry between these investors and other shareholders.

Second, today's proposal would clarify when and how certain derivatives acquired with control intent count towards the 5 percent threshold for reporting.

Third, today's proposal would clarify group formation and related exemptions, largely consistent with existing staff and Commission views as well as the statutory provision itself.[1]

I am pleased to support today's proposal and look forward to the public's feedback. I would like to recognize and thank the hard work of our dedicated staff, specifically:

- Renee Jones, Erik Gerding, Connor Raso, Michele Anderson, Ted Yu, Nicholas Panos, Valian Afshar, Anne Krauskopf, Chris Windsor, and Wilson Guarnera in the Division of Corporation Finance;
- Dan Berkovitz, Megan Barbero, Bryant Morris, Alex Ledbetter, and David Russo in the Office of the General Counsel.
- Jessica Wachter, Oliver Richard, Lauren Moore, Jill Henderson, Robert Miller, Vlad Ivanov, Qiao Kapadia, Charles Woodworth, Tasaneeya Viratyosin, Matthew Pacino, Julie Marlowe, PJ Hamidi, Gregory Scorpino, Mike Willis, and Walter Hamscher in the Division of Economic Risk and Analysis;
- Brian Johnson and Michael Neus in the Division of Investment Management; and
- Carol McGee and Andrew Bernstein in the Division of Trading and Markets.

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[1] The Commission in a '98 release articulated policy concerns similar to those that underlie this proposed exemption. For example, in a rulemaking effort in the late 1990s, the Commission took steps to ensure that "the Section 13(d) reporting obligations [do not] restrict a shareholder's ability to engage in proxy related activities," including their "ability to use the proxy rule exemptions that were adopted in 1992 to facilitate communications among shareholders." Amendments to Beneficial Ownership Reporting Requirements, Release No. 34-39538 (Jan. 12, 1998) [63 FR 2854 (Jan. 16, 1998)] at 2858. In adopting those proxy rule exemptions, the Commission noted that "[t]he purposes of the proxy rules themselves are better served by promoting free discussion, debate and learning among shareholders and interested persons." Regulation of Communications Among Shareholders, Release No. 34-31326 (Oct. 16, 1992) [57 FR 48276 (Oct. 22, 1992)] at 48279.

Statement by Commissioner Peirce on Beneficial Ownership Proposal

Posted by Hester M. Peirce, U.S. Securities and Exchange Commission, on Friday, February 11, 2022

Editor's note: Hester M. Peirce is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on her recent public statement. The views expressed in this post are those of Ms. Peirce and do not necessarily reflect those of the Securities and Exchange Commission or its staff.

This proposal is characterized as modernization, but it fails to contend fully with the realities of today's markets or the balance embodied in Section 13(d) of the Exchange Act. The proposed amendments acknowledge some of the challenges, but do not fully grapple with or resolve them in a consistent manner. Accordingly, I do not believe the proposed amendments are prudent and respectfully dissent.

Congress passed the Williams Act and enacted Section 13(d) in response to hostile takeovers in the form of cash tender offers in the 1960s.[1] The Williams Act balanced shareholders' interest in learning of potential changes in corporate control with the benefit of allowing the party seeking to engage in a change in control of the company to keep that information private. The balance—requiring a person who has acquired five percent of a class of shares to file within ten days of that acquisition—recognizes both the need for other shareholders to know of the impending change in control and the need to allow the person seeking control to reap some of the benefit of the work it did in determining that a change in control would be beneficial.

Ten days is not a magic number. As Congress recognized when it authorized us to shorten the number of days, it might not be the right number. But to move from ten to five requires a justification, and the one included in the proposal is not compelling. The release suggests that shortening the ten-day reporting window to five days is appropriate given the significant technological advances that have occurred since 1968, when Section 13(d) was enacted. Given that the ten-day window does not seem to be based on the limitations of 1960s technology,[2] why should we consider technological advancements as a deciding factor in our consideration of the reporting window?

The Commission more generally sees an inconsistency between the ten-day filing period and how quickly today's markets move.[3] Market participants receive and process information quickly and can build up large positions rapidly. In recognition of these changes, the Commission has shortened reporting timelines imposed for Section 16 reports and Form 8-Ks, and foreign

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[1] *See* Section II.A.1 of Proposing Release, Modernization of Beneficial Ownership Reporting, Rel. No. 33-11030; 34-94211 (Feb. 10, 2022) (hereinafter "Proposing Release"), available at https://www.sec.gov/rules/proposed/2022/33-11030.pdf.

[2] *See* Proposing Release at footnote 17.

[3] *See id.* at 18-20.

jurisdictions also have shorter timelines for reports comparable to Schedule 13D. Of course, reports by insiders and issuers are distinguishable from reports by investors, and foreign markets' regulatory choices might not be appropriate for our markets.

The crux of the Commission's justification, however, seems to be that shareholders need to have confidence that their trades are not being made based on stale information.[4] Presuming that stock prices generally rise when a Schedule 13D is filed, this theory of investor harm posits that a shareholder who sells during the ten-day window would be harmed by not knowing that someone else had acquired a large stake in the company; if the Schedule 13D had been filed, she might have sold at a higher price or re-evaluated whether to sell at all. The Commission invents investor harm and unduly paints the selling shareholder as a victim; she chose to transact at the prevailing market price on the date she sought liquidity. Are there other pieces of information that other market participants have that might have informed her decision? Sure, but information disparities make markets function. Issuers and insiders have reporting obligations to resolve the problem of information asymmetry between these groups, who have privileged access to information, and investors. Apart from the Williams Act requirements, investors, on the other hand, generally do not have disclosure obligations with respect to information they have, including their own ownership positions and plans. We want to encourage investors to ferret out information and find undervalued companies. Indeed, information asymmetries in this sense—where investors have equal access to disclosure from the issuer and insiders, but come to different conclusions about the long term prospects of a company based on their respective due diligence—are a feature, not a bug, of our capital markets.

While the release acknowledges that there must be a balancing of interests between timely dissemination of the five percent ownership threshold and preserving an incentive structure for investors to seek change of control at under-performing companies, it summarily concludes that the proposed amendments will achieve the proper balance. While "many Schedule 13D filers currently do not avail themselves of the full 10-day filing period,"[5] over 55 percent of Schedule 13Ds filed in 2020 were made on Day 10 or later.[6] My former colleague Rob Jackson, along with Professor Lucian Bebchuk, advised the Commission in 2012 that shortening the reporting window "cannot be justified by an appeal to general intuitions about market transparency or by the claim that tightening is required to achieve the objectives of the Williams Act."[7] Regrettably, I think we attempt to do just that with this release.

The release also makes a number of other policy choices that I hope commenters will address. The proposed expansion of the definition of beneficial ownership to cover certain cash-settled derivative securities lacks sufficient justification given that these securities do not convey ownership or voting rights. The proposed amendments to Rule 13d-3 appear to be based on concerns raised in academic literature that focus on transactions in foreign jurisdictions and security-based swaps, both of which are excluded from the scope of these rules. Perhaps commenters will provide evidence establishing a clearer link between ownership of cash-settled derivatives and the potential to change control of the issuer. On the other hand, the release takes a very narrow view of the pressure placed on companies by institutional activists. Proposed Rule

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[4] *See id.* at 125-30.

[5] *Id.* at 20.

[6] See *id.* at 124.

[7] Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 Harv. Bus. L. Rev. 39, 59 (2012).

13d-6(c) contains a broad exemption for groups engaged in concerted actions related to an issuer or its equity securities, and the release cites as an example the following behavior that presumably would fit within the proposed exemption:

> [I]nstitutional investors or shareholder proponents may wish to communicate and consult with one another regarding an issuer's performance or certain corporate policy matters involving one or more issuers. Subsequently, those investors and proponents may take similar action with respect to the issuer or its securities, such as engaging directly with the issuer's management or coordinating their voting of shares at the issuer's annual meeting with respect to one or more company or shareholder proposals.[8]

Given the kind of activism that occurs today, will that exemption swallow the rule? As others have pointed out, our markets are different than when the Williams Act was adopted.[9] Hostile takeovers are less frequent, institutional shareholders are more dominant, and activist investors rely on methods other than taking control to force change at companies.

I look forward to reviewing the public's comments on the proposal. Thank you to the staff of the Division of Corporation Finance, Division of Trading and Markets, Division of Investment Management, Division of Economic and Risk Analysis, and the Office of the General Counsel for your work on this release. I will be very interested to hear what commenters have to say about the proposal. Is ten days right? Is five days right? Or is some number in between better?

[8] Proposing Release at 95.
[9] *See generally id.* at 113-14.

Comment Letter on Modernizing Section 13(d) and (g) Beneficial Ownership Reporting

Posted by Theodore N. Mirvis, Adam O. Emmerich, and David A. Katz, Wachtell, Lipton, Rosen & Katz, on Thursday, April 14, 2022

Editor's note: Theodore N. Mirvis, Adam O. Emmerich, and David A. Katz are partners at Wachtell, Lipton, Rosen & Katz. This post is based on a comment letter to the U.S. Securities and Exchange Commission by Mr. Mirvis, Mr. Emmerich, Mr. Katz, Trevor S. Norwitz, William Savitt, and Sabastian V. Niles.
Related research from the Program on Corporate Governance includes The Law and Economics of Equity Swap Disclosure by Lucian A. Bebchuk (discussed on the Forum here); The Law and Economics of Blockholder Disclosure by Lucian Bebchuk and Robert J. Jackson Jr. (discussed on the Forum here); and Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

We are pleased to submit the following comments with respect to the Securities and Exchange Commission's Release Nos. 33-11030; 34-94211; File No. S7-06-22 (the "Release"). We have long been advocates for reform in this area and we have previously petitioned the Commission for rulemaking to modernize aspects of the beneficial ownership reporting rules that are the subject of the Release. [1] The Commission's proposed rulemaking outlined in the Release (the "Proposal") is an important step forward for market transparency and addresses many of the deficiencies in the current rules that inappropriately permit investors to accumulate significant stakes in publicly traded securities in secrecy and profit from information asymmetries at the expense of other market participants. We applaud the efforts of the Commission and the Staff in making the Proposal and creating greater market transparency.

We, however, urge the Commission to take further steps to ensure that Section 13(d) of the Securities Exchange Act of 1934 (as amended, the "Exchange Act") completely fulfills its stated purpose, which is to "alert investors in securities markets to potential changes in corporate control and to provide them with an opportunity to evaluate the effect of these potential changes."[2] Specifically, we recommend the adoption of the following additional changes to ensure that the amended rules deliver greater accountability, transparency and fairness to the public markets:

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[1] Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, submitted by Wachtell, Lipton, Rosen & Katz (Mar. 7, 2011), File No. 4-624, available at http://www.sec.gov/rules/petitions/2011/petn4-624.pdf ("WLRK Section 13 Petition"); Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, Securities & Exchange Commission (Apr. 15, 2011), available at https://www.sec.gov/comments/s7-10-11/s71011-2.pdf; letter from Wachtell, Lipton, Rosen & Katz to Ms. Vanessa A. Countryman, Secretary, Securities & Exchange Commission (Sept. 29, 2020), available at https://www.sec.gov/comments/s7-08-20/s70820-7860154-223924.pdf

[2] *Wellman* v. *Dickinson*, 682 F.2d 355, 365-66 (2d Cir. 1982) (citing *GAF Corp.* v. *Milstein*, 453 F.2d 709, 717 (2d Cir. 1971)).

- Require initial Schedule 13D filings to be made within one business day, instead of five days, following the crossing of the five percent ownership threshold;
- Institute a moratorium on the acquisition of beneficial ownership of additional equity securities of an issuer by any acquirer required to file a Schedule 13D that would be in effect from the acquisition of a 5% ownership stake until two business days after filing the Schedule 13D;
- Revise the definition of "beneficial ownership" under Rule 13d-3 to include ownership of any derivative instrument that includes the opportunity, directly or indirectly, to profit or share in any profit derived from any increase in the value of the subject security (with exceptions discussed in our petition to the Commission and related writing)[3]; and
- Require groups formed for the purpose of acquiring a substantial equity investment in an issuer in order to influence control of that issuer to ensure that they are, and remain, aware of the equity ownership of the group members in that issuer and not remain willfully blind so as to avoid their disclosure obligations under Section 13(d).

The above recommendations will help bring the Proposal in line with the Commission's proposed rulemaking with respect to security-based swap transactions that would require a one-day reporting window for applicable equity-based swaps.[4] Our recommendations are also in line with existing comparable disclosure requirements in other sophisticated jurisdictions (including the United Kingdom, Germany, Australia and Hong Kong). Moreover, it has been over a decade since the Dodd-Frank Act modified Section 13(d)(1) of the Exchange Act to expressly permit the Commission to reduce the ten-day beneficial ownership reporting window[5] and the abuses[6] we have witnessed over the past decade only further underscore the urgent need to correct the power and information imbalance between select hedge funds and activist investors and the rest of the investing public, that have allowed the former to benefit from the anachronistic rules at the expense of the latter.

Initial Schedule 13D Filing Window

As we have previously noted in our comment letters and petition to the Commission, the current reporting window under Rule 13d is far too long, enabling the continued trading of millions of shares before market-moving information is eventually revealed to the public.[7] In today's world, where significant purchases of public securities can be executed in a matter of seconds and where voting and economic interests can be further amplified through the use of derivative

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[3] *See* WLRK Section 13 Petition at 8; *see also* Theodore N. Mirvis, Adam O. Emmerich & Adam M. Gogolak, *Beneficial Ownership of Equity Derivatives and Short Positions—A Modest Proposal to Bring the 13D Reporting System into the 21st Century* (Mar. 3, 2008) ("A Modest Proposal") at 13d-3-3, available at https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.15395.08.pdf

[4] Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition against Undue Influence over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions, Release No. 34-93784; File No. S7-32-10 (Dec. 15, 2021).

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1375 (2010); see in particular §§766(e) and 929R.

[6] *See* Theodore N. Mirvis, Andrew R. Brownstein, Adam O. Emmerich, David A. Katz and David C. Karp, *Activist Hedge Fund Abuses Require Immediate SEC Action to Modernize Section 13(d) Reporting Rules and Ensure Fair Reporting of Substantial Share Accumulations* (Mar. 28, 2014), available at https://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.23259.14.pdf.; Susan Pulliam et al., *Activist Investors Often Leak Their Plans to a Favored Few: Strategically Placed Tips Build Alliances for Campaigns at Target Companies*, Wall Street J. (Mar. 26, 2014), available at https://www.wsj.com/articles/activist-investors-often-leak-plans-to-peers-ahead-of-time-1395882780.

[7] WLRK Section 13 Petition at 3.

securities, five days can be an eternity.[8] If the Commission adopts a five-day window for Schedule 13D filings, the rules will still substantially fail to serve the purpose of the Williams Act to require the timely release of information to the investing public with respect to the accumulation of substantial ownership of an issuer's voting securities.[9] In today's trading environment, a five-day filing window continues to provide hedge funds and activist shareholders ample time to accrue significant stakes in an issuer and improperly exploit, and profit from, information asymmetries at the expense of other public investors.

We also respectfully ask the Commission to draw a distinction between short-term profiteering (which benefits a small minority of activist shareholders at the expense of other public investors) and long-term value creation. While a Schedule 13D filing by an activist may often lead to an immediate bump in the issuer's stock price, there remains no compelling evidence that activist interventions deliver long-term value to shareholders.[10] Accordingly, we urge the Commission to be cautious in determining whether investors seeking to change or influence control of issuers ought to be further incentivized by a longer reporting window, as suggested in the Release. In any event, the shortening of the Schedule 13D window, as the Commission notes, is more likely to adversely affect short-term behaviors than long-term oriented activism—shortening the reporting window to one day will only help to further deter opportunistic short-term trading.

We further note that the compliance costs of the Proposal are unlikely to be unduly burdensome, in a manner that outweighs the benefits, on covered shareholders given technological developments during the fifty years since the rules were introduced, including the automation of trading reporting. The type of investor that acquires a 5% stake in a public company and may become subject to Schedule 13D will almost certainly be well-resourced and experienced enough to make prompt filings, especially as a Schedule 13D filing can be substantially completed prior to crossing the reportable threshold. We also note that, in recent years, the Commission has moved to shorten the reporting window for other key periodic reports, including Current Reports on Form 8-K,[11] Statements of Changes in Beneficial Ownership for officers, directors and 10% shareholders,[12] and disclosures in compliance with Regulation FD.[13] We note that the compliance window for each of these disclosures, together with the Commission's proposed disclosures relating to equity-based swaps,[14] ranges from the same day to four business days—all shorter than the proposed five-day window for Schedule 13D filings. Given the Commission's trend toward encouraging more immediate disclosure of material information to investors and the speed

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[8] As noted below, if the Commission were to adopt a moratorium on additional purchases from the acquisition of a 5% ownership stake until two business days after filing the Schedule 13D, the five-day period is less important and most acquirors will likely file their Schedule 13D earlier in order to avoid prolonging the moratorium.

[9] S. Rep. No. 550, 90th Cong. 1st Sess. 3 (1967) ("The bill is designed to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case.").

[10] *See* John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 565–66 (2016); *see also* Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1896–97 (2017).

[11] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release Nos. 33-8400, 34-49424; File No. S7-22-02 (Mar. 16, 2004).

[12] Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release Nos. 34-46421, 35-27563, IC-25720; File No. S7-31-02 (Aug. 27, 2002).

[13] Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154, IC-24599; File No. S7-31-99 (Aug. 15, 2000) (adopting Regulation FD).

[14] *Supra* note 3.

at which information travels through today's markets, we urge the Commission to adopt a one business day window for Schedule 13D filings.

Moratorium on Acquisitions After 5% Threshold is Crossed

As we have previously noted in our comment letters and petition to the Commission,[15] we regard a moratorium on acquiring beneficial ownership of any additional equity securities of an issuer from the acquisition of a 5% ownership stake until two business days after filing the Schedule 13D as necessary to address informational asymmetries and to ensure the public markets have sufficient time to assess and react to the potential impact of the Schedule 13D disclosure. With the current ten-day reporting lag, investors can—and frequently do—continue to accumulate significant stakes that enhance their ability to influence and acquire potential control over an issuer without the knowledge of the issuer and other shareholders.[16] Even with a one-day reporting lag, investors can still accumulate significant interests without the knowledge of the broader market. Indeed, the very brief "cooling-off" period we propose is akin to the ten business day cooling off period applicable to passive investors switching from Schedule 13G filers to Schedule 13D filers; its purpose being to "prevent further acquisitions or the voting of the subject securities until the market and investors have been given time to react to the information in the Schedule 13D filing."[17] In 1987, then-Chairman David Ruder of the Commission proposed that the filing deadline be reduced to five business days and that the filing person be prohibited from acquiring additional securities until the filing was made.[18]

The Commission states in the Proposal that "[i]n proposing to establish new timeframes for filing reports, we are mindful of the need to balance the market's demand for timely information against the administrative burden placed upon a filer to adequately and accurately prepare that information."[19] It is unclear why, at the same time that the Commission is establishing a one business day filing deadline for material amendments to Schedule 13D, the Commission believes that five days are needed to prepare the initial filing. But, if the Commission were to adopt its proposed five-day initial filing period for Schedule 13D, implementing our recommended moratorium on additional trading until two business days after filing would be even more critical, as it could significantly address the informational asymmetries provided by the reporting delay.

The Commission also references in the Proposal the legislative history that in enacting the Williams Act, Congress considered the interests of both issuers and persons making takeover bids. However, there is no specific evidence that the length of the ten-day window was based on a balancing of such interests rather than just the pragmatic and administrative issues associated with making such a filing in 1968.[20] Indeed, in 1983, the Advisory Committee on Tender Offers

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[15] *Supra* note 1.

[16] *Id.* at 3.

[17] Amendment to Beneficial Ownership Reporting Requirements, Release No. 34-39538; File No. S7-16-96 (Jan. 12, 1998).

[18] Statement of David S. Ruder, Chairman of the Securities and Exchange Commission, Before the House Subcommittee on Telecommunications and Finance, Sept. 17, 1987; Statement of Charles C. Cox, Acting Chairman of the Securities and Exchange Commission, Before the Senate Committee on Banking, Housing and Urban Affairs, June 23, 1987 ("[The] Commission could also support legislation to require that a Schedule 13D be filed within five business days of crossing the 5 percent threshold, and that a prohibition on further purchases be imposed until the filing requirement is satisfied.").

[19] Release at 14.

[20] The article cited in the Proposal relies only on circumstantial evidence that would equally apply to every subsection included in the final version of the Williams Act, without any direct evidence that Congress crafted the ten-day

established by the Commission cited the ten-day window as "a substantial opportunity for abuse, as the acquiror 'dashes' to buy as many shares as possible between the time it crosses the 5% threshold and the required filing date."[21] The Commission should act to correct such abuses, not to incentivize them by permitting further purchases after crossing the 5% threshold prior to filing the Schedule 13D.

Definition of Beneficial Ownership

While the Commission's proposal to deem holders of certain cash-settled derivatives as beneficial owners of the reference securities goes some way in addressing the myriad of avenues in which an investor can acquire influence and control over an issuer, many loopholes remain open. Investors have used—and continue to use—swaps and other equity derivatives, including long and short position swaps and derivatives (cash-settled and otherwise) to exert voting influence and control over issuers in a manner that is neither captured under the existing beneficial ownership definition nor under the proposed amendments to Rule 13d-3. The influence of such instruments can be substantial: the instruments decouple economic ownership from voting rights and provide investors the ability to quickly morph from mere economic ownership to economic ownership and voting rights.[22] In addition, the counterparties to these arrangements often hedge their positions by buying or selling the underlying securities, further impacting the trading of such securities.

As we have stated in the past, the definition of "beneficial ownership" should encompass ownership of any derivative instrument that includes the opportunity, directly or indirectly, to profit or share in any profit from any increase in the value of the subject security.[23] Specifically, our view is that derivative instruments should include, subject to limited exceptions discussed in our petition to the Commission and related writing:[24]

Any option, warrant, convertible security, stock appreciation right or similar right with an exercise or conversion privilege or a settlement payment or mechanism at a price related to an equity security, or similar instrument with a value derived in whole or in part from the value of an equity security, whether or not such instrument or right shall be subject to settlement in the underlying security or otherwise.

Beneficial ownership should also extend to short positions in a security, as we view such positions as having the same potential as long positions to influence the trading of the subject security. Only through a proper and coherent definition of beneficial ownership can we be assured that investors who enter into arrangements that have the same economic effect and market impact as ordinary trading will be subject to the same level of disclosure under Rule 13d-3.

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window for that purpose. *See* Lucian A. Bebchuk and Robert J. Jackson Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39, 44-47 (2012).

[21] Advisory Committee on Tender Offers, SEC, Report of Recommendations (July 8, 1983), reprinted in Fed. Sec. L Rep. (CCH) No. 1028 (Extra Edition) 22.

[22] Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006), and Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 Iowa J. Corp. L. 681 (2007).

[23] WLRK Section 13 Petition at 8.

[24] *See supra* note 3.

Prohibition of Circumvention by Willful Blindness

Some hedge funds pursue activism by creating special purpose vehicles through which they create a formal group of investors, often in the form of a limited partnership or limited liability company, who may pool their resources to acquire a large enough investment in a public issuer to assume or influence control. This is squarely within the language and spirit of the group concept as defined. Section 13(d)(3) states: "When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection." Although the statute and rules promulgated by the Commission do not limit the filing obligations to shareholders of the issuer, certain judicial pronouncements have narrowed the "group" required to file to those members who own shares.[25]

It appears that some activist hedge funds seek to avoid the filing obligation of the group they are putting together by avoiding asking members of their group whether they are shareholders of the issuer and sometimes allowing them to subsequently become shareholders without having to inform them of their trading in the shares (although the organizing activist investor is leading the group and thus responsible for the group's securities law compliance).

This "willful blindness" enables the group to accumulate larger undisclosed positions in the issuer than if they knew of all group members' trading and can lead to filings being made later than they should be and not including all required information. This also relates to the Commission ensuring that director candidates nominated by a 13D filer are included as group members, whether or not they are also investors in the special purpose vehicle (or the activist investors' general fund).

The Commission should close this loophole and end this abuse by requiring any person building a group through a special purpose vehicle for the purpose of acquiring an investment in a public issuer to influence its control to ensure that it is at all times aware of the holdings of the members in the group (that is, the investors in the vehicle who are investing for that purpose) so that the group can fulfill its obligations under Regulation 13D. Willful blindness should not be an excuse for noncompliance.

* * *

We applaud the Commission's work in proposing much needed amendments to modernize aspects of the beneficial ownership reporting rules that have become increasingly outdated since the passage of the Williams Act over half a century ago and which have provided significant opportunities for abuse by hedge funds and activist investors at the expense of the broader investing public. We urge the Commission to take this opportunity to incorporate our recommendations, which are necessary to mitigate the ongoing practice of stealth and ambush accumulations of significant direct and derivative stakes in U.S. public companies. In an age where trades are made in nanoseconds and reported automatically, the Proposal, even as modified with our recommendations, should hardly present a burden to the sophisticated shareholders who typically cross the 5% ownership threshold.

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[25] *See, e.g.*, *Hemispherix Biopharma, Inc.* v. *Johannesburg Consolidated Investments*, 553 F.3d 1351 (11th Cir. 2008).

Proposed Rule Changes to SEC Beneficial Ownership Reporting

Posted by Eleazer Klein, Adriana Schwartz, and Clara Zylberg, Schulte Roth & Zabel LLP, on Thursday, March 10, 2022

Editor's note: Eleazer Klein and Adriana Schwartz are partners and Clara Zylberg is special counsel at Schulte Roth & Zabel LLP. This post is based on their SRZ memorandum. Related research from the Program on Corporate Governance includes The Law and Economics of Blockholder Disclosure by Lucian Bebchuk and Robert J. Jackson Jr. (discussed on the Forum here) and Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

On Feb. 10, 2022, the Securities and Exchange Commission ("SEC") proposed amendments to the rules governing beneficial ownership reporting ("Proposal").[1] The Proposal seeks to:

- Tighten filing deadlines for Schedule 13D and Schedule 13G;
- Require inclusion of certain cash-settled derivative securities (other than cash settled swaps) in determining beneficial ownership for Schedule 13D filers and require disclosure of all cash settled derivative securities in Item 6 of Schedule 13D;
- Clarify when persons form a "group"; and
- Require that Schedules 13D and 13G be filed using a structured, machine-readable data language.

The following is an overview of the Proposal.

Initial Filing Deadlines

- *Schedule 13D*. The Proposal shortens the Schedule 13D filing deadline from 10 days to **5 days** following the acquisition of beneficial ownership of more than 5% or losing eligibility to file a Schedule 13G.
- *Institutional/Exempt Schedule 13G.* The Proposal requires an initial Schedule 13G filing for institutional investors and exempt investors by the **5th business day after month-end** in which their beneficial ownership exceeds 5% (in place of the current 45 days after the calendar-year-end in most circumstances).
- *Passive Schedule 13G*. The Proposal shortens the initial Schedule 13G filing deadline for passive investors from 10 days to **5 days** after acquiring beneficial ownership of more than 5%.

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[1] "SEC Proposes Rule Amendments to Modernize Beneficial Ownership Reporting," *SEC Press Release*, Feb. 10, 2022, available here.

Amendments

- *Schedule 13D.* The Proposal requires Schedule 13D amendments to be filed **one business day** following a material change (in place of the current "prompt" requirement).
- *Schedule 13G.* The Proposal requires amendments to Schedule 13G filings **within 5 business days after the month-end** of a **material change** (in place of the current 45 days after year-end if there is any change in the reported information). The Proposal also shortens the amendment requirement for exceeding 10% beneficial ownership and thereafter, increasing or decreasing beneficial ownership by more than 5%, from the current 10 days after month-end to **5 days** after crossing the relevant threshold for institutional investors and **one business day** for passive investors (in place of the current "prompt" requirement).

Filing Day Deadline

The Proposal extends the deadline for filings from the current 5:30 p.m. eastern time to **10 p.m. eastern time.**

Reporting of Cash-Settled Derivatives

Under the Proposal, the holder of a cash-settled derivative security (other than security-based swaps which disclosure is the subject of a separate rulemaking proposal from the SEC[2]), will be deemed to be the beneficial owner of the shares referenced by the derivative security if such holder would be a Schedule 13D filer, even absent an express right to direct the voting, acquisition or disposition of such shares.

Groups

- The Proposal expands the definition of a group for reporting purposes from an agreement to act together to also include, depending on the particular facts and circumstances, concerted actions by two or more persons for the purpose of acquiring, holding or disposing of securities of an issuer.
- Additionally, a group will exist where in advance of filing a Schedule 13D a filing person discloses to any other person that such filing will be made if the other person acquires securities subject to the Schedule 13D.
- The Proposal exempts certain actions taken by two or more persons from forming a group if those actions do not have the purpose or effect of changing or influencing the control of an issuer and are not made in connection with or as a participant in any transaction having such purpose or effect.
- Under the Proposal, no group is formed solely by virtue of an agreement governing the terms of a derivative security, provided that the agreement is a bona fide purchase and sale agreement entered into in the ordinary course of business and provided that such persons do not enter into the agreement with the purpose or effect of changing or

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[2] "SEC Proposes Rules to Prevent Fraud in Connection With Security-Based Swaps Transactions, to Prevent Undue Influence over CCOs and to Require Reporting of Large Security-Based Swap Positions," *SEC Press Release*, Dec. 15, 2021, available here.

influencing control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect.

Disclosure of Derivative Securities

The Proposal amends Item 6 of Schedule 13D to clarify that disclosure of all derivative securities that use the issuer's equity security as a reference security is required, including disclosure of cash-settled security-based swaps and other cash-settled derivatives.

Structured Data Requirement

The Proposal requires Schedules 13D and 13G to be filed using a structured, machine-readable data language.

Section 16

The proposed changes of the beneficial ownership and group formation rules discussed above will also apply when determining if a shareholder is subject to Section 16 as a greater than 10% beneficial owner or part of a group that is over 10%.

Modernization of Beneficial Ownership Reporting

Posted by Robert Eccles (Oxford University), and Charlie Penner, on Thursday, May 19, 2022

Editor's note: Robert G. Eccles is Visiting Professor of Management Practice at Oxford University Said Business School, and Charlie Penner is former head of impact engagement at JANA Partners and former head of active engagement at Engine No. 1. This post is based on their recent comment letter to the U.S. Securities and Exchange Commission. Related research from the Program on Corporate Governance includes The Law and Economics of Equity Swap Disclosure by Lucian A. Bebchuk (discussed on the Forum here); The Law and Economics of Blockholder Disclosure by Lucian Bebchuk and Robert J. Jackson Jr. (discussed on the Forum here); Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

In this post, we provide comments on the proposed rules. We appreciate the opportunity to provide comments on the proposed rules relating to the Modernization of Beneficial Ownership Reporting. One of us, Charlie Penner, has been working in shareholder activism for over a decade, starting in traditional activism and more recently focusing on expanding activist efforts to environmental, social, and governance (ESG) issues that are material to long-term investors. Examples include campaigns to encourage Apple to give families more effective tools to address the negative impacts of excessive screen time on kids and to place highly qualified directors on ExxonMobil's board to help better prepare for the future in a gradually decarbonizing world. The other, Professor Bob Eccles, has been working for decades to demonstrate that companies need to manage their material ESG issues in order to generate long-term shareholder value. He was a tenured professor at the Harvard Business School and now has an appointment at the Saïd Business School at the University of Oxford. He is also the Founding Chairman of the Sustainability Accounting Standards Board (SASB) and one of the founders of the International Integrated Reporting Council (IIRC).

Shareholder activism has long served as a market-driven solution when boards and management have ignored shareholder concerns like poor governance, wasteful spending, or excessive management compensation and, more recently, concerns like climate change, human rights in company supply chains, responsible technological development, and other ESG matters. If activists are successful, they can be rewarded for their efforts by an increase in the value of their holdings, which is shared by all other existing shareholders. Activist shareholders are a small percentage of the overall market, and to be successful they must offer ideas that will resonate with other shareholders, including long-term investors. While many shareholders engage with companies, activists are unique in their ability to put shareholder democracy into action by giving shareholders a choice of new board representation in the small number of cases where such change is warranted. Otherwise, directors of public company boards run unopposed, which is the case at almost every public company every year.

For almost as long, corporate interest groups have sought to avoid the accountability that shareholder activism creates, including putting pressure on the SEC to make narrow changes like the ones the SEC has proposed that would reduce the incentives for such activity. In prior cases, under both Republican and Democratic administrations, such attempts have failed to gain traction at the SEC, which has listened to shareholders who have made the case that they benefit overall from activist efforts, which they can support or oppose, and do not want the balance tilted in favor of inoculating companies from accountability. [1]

While the SEC argues in its release that such investors will benefit from earlier disclosure of activist efforts, this is paradoxical given that forcing such earlier disclosure will reduce the incidents of such value-creating activity. It is telling that the groups supporting such changes have been almost exclusively those seeking to protect boards and management teams from being held accountable by their shareholders. In the past, the SEC has opted not to side with such corporate advocates, which makes sense given the likely impact of such changes on activism, the empirical evidence about the net benefits of activism to investors, and the long-standing balance between providing necessary disclosure and not overly burdening beneficial economic activity, which was explicitly recognized by the drafters of the Williams Act themselves.

This is why we are so confused by the SEC's proposed changes, which ignore entirely the impact of such changes, including on the growing ESG activist movement, and include amendments to beneficial ownership reporting obligations that would chill valuable conversations between investors regarding material ESG matters. None of the arguments for placing such new burdens and complications on shareholder engagement have grown stronger in recent years. In fact, they have grown weaker as activism has continued to evolve to focus not just on near-term corporate finance and governance matters but to longer-term considerations including the importance of a company's relationship to its workers, customers, society, and the planet to creating long-term value for shareholders.

A good example of the function activists can serve in the public markets is the recent ExxonMobil campaign. For years, ExxonMobil's shareholders had called upon the company to add directors with relevant energy experience to help the company navigate the challenges of the energy transition. However, it took a shareholder activist campaign to actually give shareholders that choice, which they chose to embrace. As the New York Times noted, this effort showed "there is a path for shareholder activism to change how companies approach issues like racial diversity and the environment, often considered distractions from producing profits." [2] While some claim that shareholders should not concern themselves with ESG considerations, we disagree. As a growing number of investors have realized, the long-term value of the typical investor's portfolio is increasingly threatened by short-term thinking about material ESG matters.

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[1] Gina Chon, Share Buying Plan Opposed, *Wall Street Journal*, (August 20, 2011) ("A diverse group of investors are lobbying against a proposed change in a federal rule that would speed up the time frame for alerting the public to the amassing of shares in a company … Investors resisting the Wachtell proposal include big money managers BlackRock Inc., TIAA-CREF and T. Rowe Price Group Inc., public pension funds California State Teachers' Retirement System, Florida's State Board of Administration, New York State Common Retirement Fund and Ontario Teachers' Pension Plan, union pension funds and activist hedge funds Jana Partners LLC and Pershing Square Capital Management, according to SEC public documents.")

[2] Matt Phillips, Exxon's Board Defeat Signals the Rise of Social-Good Activists, *The New York Times*, (June 9, 2021)

The changes proposed by the SEC move in the wrong direction by disincentivizing shareholder activism of any type without addressing the substantive tradeoffs in doing so. By eroding a powerful mechanism for ensuring corporate accountability, these changes threaten public trust in our capital markets.

III. ESG Proposals in the 2022 Proxy Season

2022 Proxy Season and Shareholder Voting Trends

Posted by Matteo Tonello, The Conference Board, Inc., on Wednesday, March 30, 2022

Editor's note: Matteo Tonello is managing director of ESG at The Conference Board, Inc. This post is based on a The Conference Board/ESGAUGE memorandum, in collaboration with Russell Reynolds Associates and The Rutgers Center for Corporate Law and Governance, by Mr. Tonello, Paul Washington, and Merel Spierings.

Introduction

The 2021 proxy season was unprecedented, with record support for shareholder proposals on environmental and social (E&S) issues, growing opposition to director elections, and significant support for governance proposals, especially at midsized and smaller companies.[1]

The season was unpredictable as well. Not only did institutional investors move faster than ever before to implement their views through their voting—thereby often getting ahead of proxy advisory firms and leaving companies with little time to adjust their practices—at times they surprised boards and management teams by voting against the company's position after what seemed to be positive discussions.

This shift in voting practices is expected to continue into 2022 and should be considered in the context of the related underlying shifts currently underway in corporate America: changes in both "what" companies are supposed to address (that is, the ever-growing array of environmental, social & governance (ESG) issues) and "who" (that is, the shift toward multistakeholder capitalism in which companies are placing a higher priority on serving the long-term welfare of constituents, such as employees, beyond their shareholders).[2] Major institutional investors, especially those with large passive index funds, have embraced these shifts toward a focus on ESG and a multistakeholder model, and that is coming through in their support for E&S shareholder proposals.[3]

But institutional investors are not the only driving force here: the ongoing COVID-19 pandemic and the current US administration's agenda have accelerated the focus on E&S issues. And in many ways, investors are responding to mounting pressures from their own upstream clients. This means the proxy season has become an arena where the broader evolution of the role of the corporation in society is playing out. In that broader context, there is no single correct answer for

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[1] The data and figures in this post and all six supplemental briefs represent shareholder proposals submitted at Russell 3000 companies in the first half of 2021, 2020, and 2018. About 90 percent of shareholder meetings at Russell 3000 companies take place in the first half of the year, and this cutoff point also allows easy comparisons with our prior-year shareholder voting benchmarking reports.

[2] Charles Mitchell et al., "Toward Stakeholder Capitalism: What the Shift Means for CEOs and the C-suite," The Conference Board, December 2021.

[3] See, for example, BlackRock's "Larry Fink's 2022 Letter to CEOs," State Street Global Advisors' "CEO's Letter on Our 2022 Proxy Voting Agenda," and Vanguard's "Proxy Voting Policy for U.S. Portfolio Companies.

what companies should do. But this post and its six supplemental briefs highlight what to expect in the coming proxy season and—perhaps more importantly—suggest steps boards and CEOs can take to prepare.

Insights for What's Ahead

Environmental & social proposals in general

Companies should brace for a challenging E&S shareholder proposal season in 2022. Expect more E&S proposals across all industries—driven by the success of such proposals last year—and for more E&S proposals to come to a vote as emboldened proponents see less incentive to negotiate a withdrawal of their proposals. And anticipate more support for proposals that do go to a vote, due not only to the growth in ESG funds, but also the increased incentive and willingness of major institutional investors—pressured by their own clients to make strides on ESG and evaluated on how they vote—to support such proposals.

But CEOs and their management teams can take several steps to prepare their boards:

- **Start planning *now* to involve directors proactively in engagement with shareholders and on an ongoing basis—**not only in response to a crisis. Also be sure directors can demonstrate fluency in ESG issues. Investors increasingly expect board members to be able to talk about E&S as well as G subjects.
    - Ensure directors are well versed not only in the firm's main ESG risks and opportunities, but also how the company compares to peers.
    - Inform directors on the ESG issues their key investors care about most—and prepare them for the different expectations investors may have on some of these issues.
    - Conduct mock meetings to prepare directors for in-depth engagement meetings with investors—and be sure they are prepared for tough questions.
- **Analyze institutional investors' proxy voting guidelines and policies *now*** to ensure proxy statement disclosures (and other communications) address the issues their key investors care about.
    - Ask institutional investors about their views on your firm and their evolving thinking about E&S issues in general during the "off season." If you wait until their voting guidelines are issued, it may be too late for the board to take action that can be reflected in the proxy statement.
- **Ramp up *ongoing* engagement efforts with institutional investors**, despite the challenges the COVID-19 pandemic presents in building and maintaining relationships. While both companies and investors are hard pressed for time, there are still opportunities for constructive dialogue. Companies should be mindful that more investors 1) are becoming interested in ESG, 2) are expanding their stewardship teams, 3) have significant turnover, and/or 4) include portfolio managers in engagements, so companies will want to educate these "new faces" on their approach to ESG.
    - Engage your major investors—old and new—not just during the regular "proxy season" but also during "off season" engagement calls to let them know what ESG issues you're focusing on, why you're focusing on those issues, and what your plans are.

- **Expand engagement strategies to reach audiences beyond their major institutional investors**. Investors' upstream clients are increasingly interested in ESG—and are making their voices heard.[4] And retail investors, who are becoming more influential but don't always have the same focus as their institutional counterparts, need to be educated as well. It is therefore vital that these stakeholder groups be brought along on the company's ESG journey.
    - Implement processes for identifying emerging trends with different stakeholder groups and adopt engagement strategies for each group. While some stakeholders might prefer formal communication, others might prefer to engage through public channels.
    - Adopt a retail-facing strategy to help promote retail investors' participation in the proxy voting process. Companies may want to gain access to retail investor data to better understand who their retail investors are, what their sentiment and voting behavior is on key issues, and where and how they can best engage and educate them on ESG issues (e.g., on social media or digital trading platforms, online finance communities, or through retail investor events).
- **Ensure the board knows that a new (and potentially more intense) wave of E&S proposals is coming**—and with it a greater chance of negative votes from traditionally supportive investors—and understands which proposals are likely to gain majority support unless the board commits to fulfilling them to the letter. This can help prevent the board from being surprised or blindsided.
    - Make the board understand that a successful proxy season is no longer about minimizing the number of proposals that go to a vote. Instead, a successful proxy season is measured by the more qualitative judgment of whether the firm has maintained a constructive ongoing dialogue with the firm's major investors, which is more important than any vote on a precatory shareholder proposal.

See Brief 1: Environmental & Social Proposals in General for more shareholder voting trends and insights.

Human capital management proposals

The sustained focus on racial, gender, economic, and health equality and fairness means companies should expect a continued push by shareholders on human capital management (HCM) topics, with a strong focus on diversity and increased attention to disclosure. Many investors will continue to advocate for more HCM disclosure through engagement and shareholder proposals, especially since any new SEC rules on HCM and board diversity disclosure will take effect after the 2022 proxy season. EEO-1 data disclosure, workplace diversity, and employee arbitration will continue to be major topics of discussion. Additionally, anticipate a greater push on board diversity that will increasingly spill over into director elections, as proxy advisors and investors continue to make their voting guidelines relating to issues such as board diversity more stringent.

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[4] Noteworthy is BlackRock's recent move, starting in 2022, to allow institutional investors in some of its index strategies in the US and UK to cast proxy votes in line with their own values and goals: "Working to Expand Proxy Voting Choice for Our Clients," BlackRock, October 7, 2021.

To address these issues and to reduce the likelihood of HCM shareholder proposals succeeding, CEOs and boards can take several steps:

- **Develop and adopt a board-approved HCM strategy** that is integrally tied to the business strategy and sets forth a plan for taking the company from the workforce it currently has to the one it will need in the coming years.
    - This involves identifying the key areas where the company's workforce drives business success, evaluating the firm's current capabilities in those key areas, assessing the broader trends and competitive environment for talent, setting clear goals, and choosing metrics to report progress.
- **Clarify and codify the board's role with respect to HCM**—and ensure it demonstrates its own commitment in this area, particularly through long-term director succession planning that prioritizes board diversity and provides enough lead time to identify, recruit, and onboard directors with the appropriate diversity of thought, experience, and background.[5]
    - Boards have multiple levers with respect to HCM, including the selection, promotion, and compensation of management; approval of workforce policies; review of key disclosures; and general oversight and advisory powers. It is pivotal that these levers be deployed in a concerted manner.
    - Ensure governance guidelines, as well as committee charters and policies, reflect the ways directors engage in HCM. Often, governance documents don't keep pace with the good practices companies already have in place.
- **Accelerate the diversification of the board** 1) through the director search process (e.g., by adopting the "Every Other One" strategy that sets a target of recruiting women for one of every two board seat openings, as well as by defining search criteria based not on job title but on a set of skills and experiences) and 2) by adopting or more strictly adhering to policies that foster board refreshment (e.g., reducing overboarding, lowering average tenure of directors, not making exceptions to a mandatory retirement policy).[6]
    - To meet investors' increasing demands on board diversity, boards should aim for gender parity and substantial minority representation on their boards.
- **Consistently communicate the company's HCM story**—beyond diversity—through various channels (10-K, proxy, ESG or stand-alone HCM reports, and website) and via shareholder engagement.

See Brief 2: Human Capital Management Proposals for more shareholder voting trends and insights.

Environmental proposals

With climate change front and center on the SEC's and investors' agenda—and proponents encouraged by the success of climate-related proposals last year—companies across all industries should anticipate a sustained push on climate issues as well as on broader environmental topics. Shareholder activism on environmental issues is expected to continue beyond shareholder proposals, especially after the successful proxy fight against

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[5] Matteo Tonello and Paul Hodgson, "Corporate Board Practices in the Russell 3000, S&P 500, and S&P MidCap 400: 2021 Edition," The Conference Board, October 2021.

[6] "Board Practices: A Look Ahead," The Conference Board ESG Watch webcast, July 13, 2020.

ExxonMobil, in which Engine No.1—a small hedge fund—won three director seats at the energy giant with the goal of, among other things, implementing more forceful decarbonization strategies. Other tactics, such as vote-no campaigns against directors, are also likely to increase. In fact, proxy advisors and investors are updating their proxy voting guidelines and adopting policies to hold directors accountable for what they perceive to be ineffective oversight of ESG issues, especially as it pertains to climate change.

To avoid the risk of shareholder activism with a big "A"—that is, efforts aimed at altering the company's strategy or its board—CEOs and boards may want to consider:

- **Providing more detailed—and where possible forward-looking and quantitative—disclosure** of the company's governance, strategy, and risk mitigation efforts regarding environmental issues, including a capital expenditure program in line with its greenhouse gas (GHG) emissions reduction commitments.
    - Consider disclosing in accordance with the Sustainability Accounting Standards Board (SASB) and Task Force on Climate-Related Financial Disclosures (TCFD), as these are among the frameworks that are primarily geared toward and therefore generally favored by investors.
- **Assessing how their supply chain can affect, or be affected by, biodiversity loss and deforestation**, as well as assessing their exposure to water-use risks.
    - Understand that the financial cost of inaction can significantly outweigh the cost of mitigation.[7]
- Demonstrating responsiveness to investors' concerns by enhancing climate-related performance and disclosures even when not yet in line with peers or with Paris Agreement emissions reduction targets, strengthened at the UN Climate Change Conference of the Parties (COP26) in Glasgow in late 2021.[8]
    - Through shareholder engagement and company disclosures, boards can convey they are taking investors' concerns seriously and state the company's plans (not just goals) to reduce Scope 2 and 3 emissions—even if they are not there yet.

See Brief 3: Environmental Proposals for more shareholder voting trends and insights.

Corporate political activity proposals

Corporate political activity was under intense scrutiny in 2021—and it will continue to be in 2022. The immediate and unprecedented success of the new proposal on climate-related lobbying—which asks companies to explain how their lobbying efforts align with the Paris Agreement—emphasizes that companies need to strengthen their climate-related disclosures and match their climate-related statements and commitments with consistent action on the policy front. At the same time, proposals on political contributions are evolving—from seeking disclosure on companies' campaign financing policies and practices to asking firms how their political expenditures align with their stated corporate values. Moreover, proposals on traditional lobbying—typically asking for disclosure on companies' lobbying policies and practices—will

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[7] Thomas Singer, "Sustainability Disclosure Practices: 2022 Edition," The Conference Board, January 2022.

[8] The central goal of the COP21 Paris Agreement is to "strengthen the global response to the threat of climate change" by holding the increase in the global average temperature to well below 2°C above preindustrial levels and pursuing efforts to limit the temperature increase to 1.5°C. The COP26 Glasgow Climate Pact reaffirms this goal and its resolve to pursue efforts to limit the temperature increase to 1.5°C.

remain an area of tension between shareholders and companies, especially those whose lobbying efforts contrast with their positions on broader E&S issues.

To address these issues and prepare for shareholder proposals on political contributions, traditional lobbying, and climate-related lobbying, CEOs and boards can take concrete steps, including:

- **Increasing board oversight—not only of their corporate contributions but also of their lobbying and other political activities.** The board's role might include approving broad principles and processes for corporate political activity.
    - Some companies may choose policy over politics and decide to limit, or avoid engaging in, political contributions altogether given today's intense political polarization and ever-greater scrutiny of corporate political activities.
- **Ramping up educational and engagement efforts with key audiences—and expanding disclosure** to investors and other stakeholders regarding their firm's types of political activity and the policies and controls in place.
    - Focus on employees—they were a significant driver in making corporate political activity challenging in 2021—and investors.
    - Clarify the role of political action committees (PACs). The press, employees, and others conflate corporate giving and PAC giving, even though corporate-sponsored PACs are funded by voluntary contributions from employees, not by corporate funds.
    - Clarify the process for deciding whether and how to communicate PAC decisions, including changing contribution criteria—and be mindful that the legal, communications, and government relations functions may have conflicting views on publicizing PAC decisions.
- **Aligning political contributions and lobbying with corporate values and vetting all political activity** to ensure their public policy positions are aligned with their broader corporate citizenship positions.
    - Keep it simple: the more complex the corporate political activity, the more difficult it may be to manage reputational risk.
    - Rigorously vet third-party organizations to which the company donates money, including the governance process in place to control their activities, and ask for reports on how they are using company funds.
    - Consider involving the corporate citizenship function in reviewing political activity.
    - Adopt (or have your PAC adopt) a policy for political contributions that incorporates the company's and employees' values as part of the framework for managing political activities.

See Brief 4: Corporate Political Activity Proposals for more shareholder voting trends and insights.

Corporate governance proposals

Corporate governance continues to be a hot topic for shareholders, as demonstrated by the success of governance-related proposals in the 2021 proxy season. CEOs and boards, especially at midsized and smaller companies, should consider revising their governance practices to align with common practices among companies with larger market capitalization,

such as expanding special meeting rights and written consent rights, declassifying the board, or eliminating the supermajority voting requirement.

Companies that are out of alignment with long-standing investor expectations in these areas should be prepared to have such proposals pass—or come close to passing. By removing wedge issues, companies are less likely to be exposed not only to shareholder proposals but also to big "A" activism aimed at altering the company's strategy or its board.

See Brief 5: Corporate Governance Proposals for more shareholder voting trends and insights.

Company-sponsored proposals

Shareholders continue to scrutinize the largest companies for their executive compensation practices, and they are increasingly holding smaller companies to account for their governance practices. Expect negative say-on-pay votes, especially at the largest companies that don't provide sufficient context and detail on executive compensation decisions. When it comes to governance practices—including board composition and oversight of ESG issues—shareholders perceive smaller companies to be lagging their bigger counterparts, as evidenced by significant opposition to director elections at those companies. This trend is expected to continue in 2022, as proxy advisors and investors have updated their proxy voting guidelines and policies for 2022 to hold directors accountable for what they see as lack of board diversity and effective ESG oversight.

See Brief 6: Company-Sponsored Proposals for more shareholder voting trends and insights.

Where to Expect the Most Tension in the 2022 Proxy Season

Several factors lead to a challenging proxy season for companies:

1. The number of shareholder proposals that investors submit, which is expected to increase this year;
2. The number of proposals going to a vote because of the difficulty of negotiating proposal withdrawals or omitting them through the no-action letter process;[9] and
3. The level of support for those proposals that come to a vote.

The following charts map the E&S shareholder proposals and the governance proposals from the 2021 proxy season against these three dimensions and indicate which topics are most and least likely to cause tension between companies and investors in the 2022 proxy season.

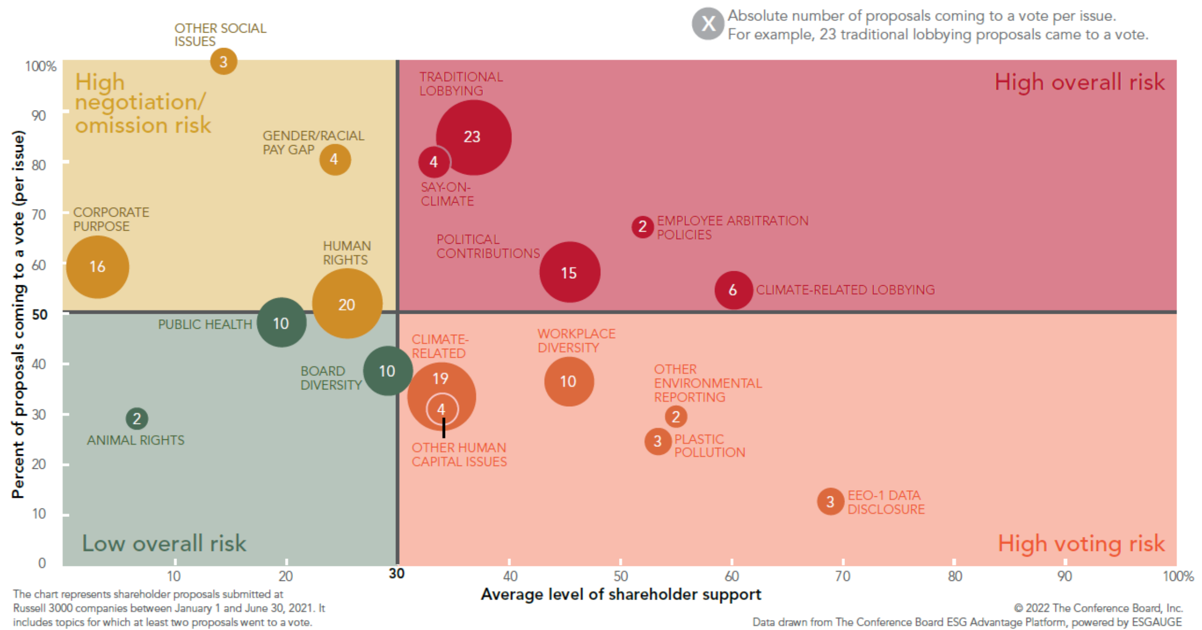
For proposals on topics that fall above the Y-axis demarcation line, it was relatively difficult to negotiate a withdrawal or have it omitted. Proposals on topics that sit right of the X-axis

[9] Proponents may decide to withdraw the proposal they submitted before the proxy statement is officially filed; this usually only happens after a negotiation during which the company makes specific commitments to the proponent. Omission of a shareholder proposal, on the other hand, often happens against the proponent's will. Rule 14a-8 of the Securities Exchange Act of 1934 permits a company to exclude a shareholder proposal from its proxy materials if the proposal fails to meet any of several specified requirements. If a company wants to omit a proposal, it submits a letter to the SEC asking for no-action relief from the staff.

demarcation line received high levels of shareholder support when voted on. And along the borders are the topics that could very well migrate into the red zone this upcoming proxy season.

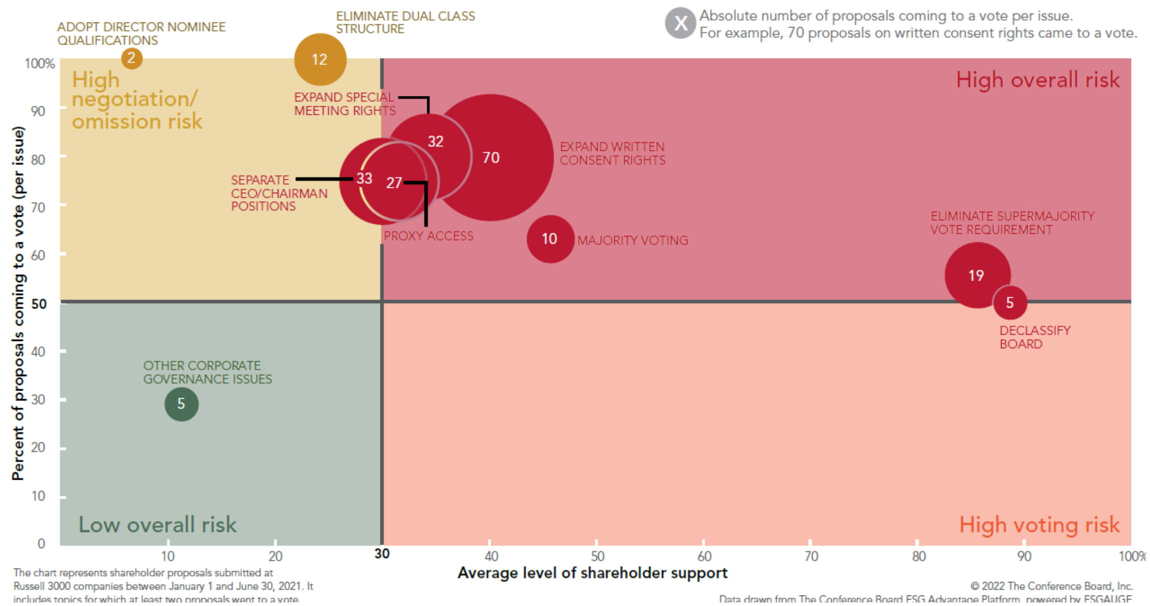
Where Boards and Investors Collide: **Environmental & Social Proposals**

Percent of shareholder proposals voted and average level of shareholder support



Where Boards and Investors Collide: **Governance Proposals**

Percent of shareholder proposals voted and average level of shareholder support



- **Upper right-hand quadrant: Shareholder Proposals in the Red Zone**
    - Proposals on topics that were hard to get withdrawn or omitted and that received high levels of shareholder support when going to a vote.
    - These proposals will very likely continue to create the most friction between companies and proponents, so boards will want to make engagement and disclosure on these topics, especially on corporate political activity, a high priority.
- **Lower right-hand quadrant: Shareholder Proposals in the Orange Zone**
    - Proposals for which it was somewhat easier to negotiate a withdrawal or seek their omission but still received high levels of shareholder support when going to a vote.
    - These topics will likely continue to present challenges to boards, especially board diversity, workplace diversity, and climate-related issues. And these topics may move into the red zone if proponents become less willing to negotiate because of the high level of shareholder support these proposals receive.
- **Upper left-hand quadrant: Shareholder Proposals in the Yellow Zone**
    - Proposals on topics that were difficult to negotiate away or omit from the proxy statement but that received—on average—not as much support as their counterparts in the red zone.
    - Even though these proposals garner lower levels of average support, boards should be mindful that with a little boost from institutional investors, some of these proposals (e.g., on gender/racial pay gap, human rights, and dual class structure) could migrate into the red zone in the 2022 proxy season. Therefore, board attention for these topics is warranted.
- **Lower left-hand quadrant: Shareholder Proposals in the Green Zone**
    - Proposals on topics that were rather easy to get withdrawn or omitted and received lower levels of shareholder support.
    - Generally speaking, these proposals are least contentious and need less board attention. However, proposals on these topics still need to be monitored, as over time they can be modified to receive higher shareholder support and proponents can become less willing to negotiate a withdrawal.

The complete publication, including footnotes and appendix, is available here.

Harvard Law School Forum on Corporate Governance

A Mid-Season Look at 2022 Shareholder Proposals

Posted by Michael Peregrine and Eric Orsic, McDermott Will & Emery LLP, on Tuesday, May 17, 2022

Editor's note: Michael W. Peregrine and Eric Orsic are partners at McDermott Will & Emery LLP. This post is based on a *NACD BoardTalk* publication.

As we sit squarely in the middle of proxy season, we have a useful vantage point from which to consider already announced shareholder proposals and anxiously await investor feedback on those matters presented for shareholder votes. From this vantage point, corporate directors can better anticipate and prepare for trends that may ultimately be presented to them.

If the most recent shareholder proposals can be considered a guide, directors should plan on a busy wrap-up to this proxy season. This is the case given continued investor focus on environmental, social, and governance (ESG) matters, renewed pressures on diversity, equity, and inclusion (DE&I) initiatives, and increased attention to the corporation's social voice. All of these issues must be considered against the backdrop of the war in Ukraine and the twin economic pressures of increasing inflation and the prospect of an economic slowdown.

Corporate boards should keep their fingers on the pulse of possible investor interest in these and other nontraditional topics emerging from the 2022 proxy season.

Established Procedures

Public company shareholders can submit proposals for consideration at a corporation's annual meeting through a well-established process that is administered by the US Securities and Exchange Commission (SEC). The SEC requires proponents to satisfy certain procedural and substantive requirements before a proposal is included in a company's proxy statement. The SEC views the shareholder proposal process as fundamental to shareholder democracy and it is actively involved in adjudicating disputes between companies and proponents as to whether a company may properly exclude a shareholder proposal from its proxy statement.

In November 2021, the SEC issued guidance in which it scaled back the basis on which companies could properly exclude shareholder proposals. In applying the "ordinary business" exclusion, in which companies are permitted to exclude a proposal if it deals with a matter relating to the company's ordinary business operations, the SEC had historically focused on the nexus between a policy issue and the company's business, which led to many shareholder proposals being excluded where nexus was lacking. In the recent guidance, the SEC clarified that it will no longer focus on the nexus between the policy issue and the company but will instead focus on the social policy significance of the issue that is the subject of the shareholder proposal. In so doing, the SEC indicated it will consider whether the proposal raises issues with a broad social impact such that it transcends the ordinary business of the company. For example, a proposal relating to greenhouse gas emissions would not be excludable solely because greenhouse gas emissions

are not a significant business issue for a company since climate change has broad societal impact.

What We've Seen to Date

A variety of indicators, including SEC data, suggests that the volume of shareholder proposals submitted during this proxy season will meet or exceed the heightened pace of the last several years. Many of these proposals fall into the ESG field. Indeed, a recent news report noted that more than 500 ESG-related shareholder proposals had been submitted by mid-March, which reflects a 22 percent increase compared to the same time last year.

Significant and potentially controversial resolutions continue to be proposed outside of the ESG area, including those dealing with topics such as new product risk and the conduct of business in countries with authoritarian governments.

Based on available data, many of the resolutions submitted to date can be allocated into the following categories:

- **Corporate Governance:** Resolutions in this bucket focus on special meeting thresholds, employee representation on corporate boards, use of an independent board chair, director background evaluations, DE&I and civil rights expertise for directors, written consent practices, continued use of dual class shares, virtual shareholder meetings, and director retirement requirements.
- **Environmental:** Resolutions relate to the removal of certain ingredients or practices from the supply chain, environmentally sensitive packaging, terminating support of fossil fuel initiatives, greenhouse gas emission controls, ending deforestation, environmental justice audits, limitation of natural gas use, recycling commitments, climate change risks, and food and water equity matters.
- **Discrimination:** Proposals target the institution of civil rights and DE&I audits, workplace non-discrimination, and management diversity commitment.
- **Human Rights:** Proposals relate to human rights violations in countries where a company conducts business, forced labor in the supply chain, use of child labor, human rights audits in certain international business lines, and the rights of indigenous peoples.
- **Lobbying:** Resolutions target the alignment of lobbying activity and support of the Paris accords.
- **Executive Compensation:** Proposals focus on pay equity gaps along gender and racial lines, review and approval of executive severance and termination pay, restatement clawbacks, limitation of the use of options and bonuses, deducting legal defense costs from incentive compensation, regulating changes to compensation metrics, and golden parachutes.
- **Political Spending:** Proposals suggest banning the practice.
- **Business Practices:** Resolutions relate to conversion to a Delaware public benefit corporation or California social purpose corporation, employment agreement concealment clauses, anticompetitive business practices, arbitration of securities law matters, the development of certain controversial products, investments in certain industries and products, and paid sick leave.

Primary Lessons and Projections from the Proxy Season

Midway through the 2022 proxy season, the following lessons and projections can be gleaned by boards:

1. ESG-related initiatives will remain front and center, particularly as climate change-related policy initiatives move forward and environmental incidents are highlighted in the media.
2. Social justice issues are primarily (but not exclusively) focused on the performance of racial, gender, and DE&I audits. Human rights concerns remain of interest with proposals relating to international companies.
3. Proposals remain with respect to traditional governance issues such as the status of the lead independent director, board composition, and director background evaluations.
4. There is continuing interest in resolutions aimed at curtailing certain controversial business practices.
5. Greater attention may be given to board commitments to compliance in response to evolving Delaware decisions on board oversight of mission-critical risks.
6. There may be a need to respond to governance-related proposals arising from recent challenges to state diversity statutes and from pressure to increase director refreshment in order to make room for additional diverse directors.
7. Increased emphasis on director effectiveness may lead to additional demands for enhanced full board and individual director evaluation processes.
8. New resolutions may arise from the acute social issues of the day, including legislation and judicial decisions regarding abortion, voting rights, and sexual preference, and their impact on a company and the culture of its workforce.

Overarching lessons relate to both the enduring value associated with a board commitment to direct engagement with major shareholders and the ability to respond to acceptable resolutions with internal reviews and other measures intended to address shareholder concerns in as confined and restricted a way as possible.

BlackRock on Climate-Related Shareholder Proposals

Posted by Sandra Boss and Michelle Edkins, BlackRock, Inc., on Thursday, May 12, 2022

Editor's note: Sandra Boss is Global Head of Investment Stewardship and Michelle Edkins is Managing Director of Investment Stewardship at BlackRock, Inc. This post is based on their BlackRock memorandum.

- BlackRock Investment Stewardship (BIS) takes a case-by-case approach to shareholder proposals and, without exception, takes voting decisions on proposals as a fiduciary acting in clients' long-term economic interests.
- BIS continues to see voting on shareholder proposals playing an important role in stewardship.
- Having supported 47% of environmental and social shareholder proposals in 2021, BIS notes that many of the climate-related shareholder proposals coming to a vote in 2022 are more prescriptive or constraining on companies and may not promote long-term shareholder value.

BlackRock Investment Stewardship

The assets we manage are owned by other people—our clients—who depend on BlackRock to help them achieve their investment goals. These clients include public and private pension plans, governments, insurance companies, endowments, universities, charities and, ultimately, individual investors, among others. Consistent with BlackRock's fiduciary duty as an asset manager, BIS' purpose is to support companies in which we invest for our clients in their efforts to create long-term durable financial performance.

BIS serves as an important link between our clients and the companies in which they invest, and the trust our clients place in us gives us a great responsibility to work on their behalf. That is why we are interested in hearing from companies about their strategies for navigating the challenges and capturing the opportunities they face. As we are long-term investors on behalf of our clients, the business and governance decisions that companies make will have a direct impact on our clients' investment outcomes and financial well-being. In all our stewardship work on behalf of our clients, the asset owners, we therefore focus on engagement and voting outcomes that support companies' long-term ability to maximize durable financial returns.

This paper frames our approach to shareholder proposals generally and, more specifically, our initial assessment of some of the climate-related themes that are emerging in the 2022 proxy season. We set out some preliminary considerations in relation to these proposals in the context of our fiduciary duty to act in the best interests of clients who have authorized us to vote their holdings on their behalf.

BIS approach to shareholder proposals

BIS takes a case-by-case approach to voting on shareholder proposals. Without exception, our decisions are guided by our role as a fiduciary to act in our clients' long-term economic interests. We continue to see voting on shareholder proposals playing an important role in our stewardship efforts around material risks and opportunities.

In 2021, we observed a shift in climate-related shareholder proposals with requests that addressed material business risks or that were anchored in reports providing information, which would be useful to investors in assessing a company's ability to generate durable long-term value. In 2021 BIS supported 47% of environmental and social shareholder proposals (81 of 172), as we determined these proposals to be consistent with long-term value creation and not unduly constraining on management in pursuing their strategies to create shareholder value.

BIS is more likely to support shareholder proposals that are consistent with our request to companies to deliver information that helps us to understand the material risks and opportunities they face, especially where this information is additive given the company's existing disclosures. As noted below, as relates to climate risk, this is principally climate action plans with clear explanations of how the energy transition will affect a company's long-term business model and financial performance, supported by quantitative information such as scope 1 and 2 greenhouse gas (GHG) emissions and short-, medium-, and long-term targets for emissions reductions. Similarly, we may support climate-related proposals that encourage companies to provide investors with comprehensive and accessible information on how their corporate political activities support their long-term strategy.

Conversely, we are not likely to support those that, in our assessment, implicitly are intended to micromanage companies. This includes those that are unduly prescriptive and constraining on the decision-making of the board or management, call for changes to a company's strategy or business model, or address matters that are not material to how a company delivers long-term shareholder value. [1]

BIS dialogue with companies regarding the energy transition

As BIS stated in our 2022 Global Principles and commentary on Climate Risk and the Global Energy Transition, we find it useful to our understanding of the long-term climate-related risks and opportunities companies face when they disclose to investors how climate risks and opportunities might impact their business, and how these factors are addressed in the context of a company's business model and sector. Specifically, investors have greater clarity—and ability to assess risk—when companies detail how their business model aligns to scenarios for the global economy that limit temperature rises to well below 2°C, moving toward net zero emissions by 2050.

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[1] We recognize that some of our clients may take a different view, and more of our clients are interested in having a say in how their index holdings are voted. Beginning in 2022, BlackRock is taking the first in a series of steps to expand the opportunity for clients to participate in proxy voting decisions where legally and operationally viable. To do this, BlackRock developed new technology and worked to enable a significant expansion in proxy voting choices for more clients. For more information see: https://www.blackrock.com/corporate/about-us/investment-stewardship/proxy-voting-choice

We look to companies to help their investors understand how climate risks and opportunities are integrated into their governance, strategy, and risk management, to provide scope 1 and 2 GHG emissions disclosures, and meaningful short-, medium-, and long-term science-based reductions targets, where available for their sector.

We also welcome disclosures on how companies are considering scope 3 GHG emissions, the impacts of the energy transition on their stakeholders and operations, and how they will contribute to a reliable and affordable energy system over time. Many companies are already providing robust disclosures on scope 3 GHG emissions, which we recognize are provided on a good-faith basis as reporting methods develop. Over time, the development of a widely accepted approach to consistently measure and disclose scope 3 GHG emissions would both reduce the reporting burden on companies and improve the quality of information available to investors.

At BlackRock, we believe that climate risk is investment risk, and we see growing recognition that climate risk and the energy transition are already transforming both the real economy and how people invest in it. We have been encouraged by the progress many companies in key sectors have made in their energy transition planning and actions, as detailed in their enhanced disclosures. Market-level initiatives, such as the Net Zero Banking Alliance and Oil & Gas Methane Partnership 2.0, have helped companies take steps relevant to their business models and sectors. We have also seen enhanced disclosure by many companies on how they are engaging on policy matters, through their own corporate political activities and those of the trade associations of which they are active members. This has enabled us to be more supportive of management in our voting on these issues at the shareholder meetings held to date this year.

As we outlined in our commentary Climate Risk and the Global Energy Transition, BIS will, as in prior years, be unlikely to support the re-election of directors considered responsible for climate risk oversight when corporate disclosures do not sufficiently enable investors to assess risk through the TCFD framework—including in relation to governance, strategy, and risk management—or when companies have not provided scope 1 and 2 GHG emissions disclosures and meaningful short-medium-, and long-term targets.

BIS' observations on climate-related shareholder proposals in 2022

Ahead of the peak 2022 shareholder meeting season, BIS has had an opportunity to observe and assess some of the themes in focus in the climate-related shareholder proposals on which we will vote over the coming weeks and months.

At the same time, there are some unique dynamics playing out for the first time this shareholder meeting season.

- In the U.S., the Securities and Exchange Commission revised guidance [2] on shareholder proposals, and broadened the scope of permissible proposals that address "significant social policy issues." This has resulted in a marked increase [3] in environmental and

[2] Pensions & Investments: SEC guidance opens the door for more ESG proxy proposals, 29 November 2021: https://www.pionline.com/regulation/sec-guidance-opens-door-more-esg-proxy-proposals
[3] Politico: SEC shift fuels surge in climate-linked proxy proposals, 4 April 2022: https://www.politico.com/news/2022/04/19/sec-investor-sustainability-agenda-00026200

social shareholder proposals of varying quality coming to a vote. Our early assessment is that many of the proposals coming to a vote are more prescriptive and constraining on management than those on which we voted in the past year.

- Importantly, in the context of voting on shareholder proposals regarding climate-related risk, companies face particular challenges in the near term, given under-investment in both traditional and renewable energy, exacerbated by current geo-political tensions. In recent research, BlackRock noted that reducing reliance on Russian energy in the wake of the invasion of Ukraine will impact the net zero transition that is already underway. Net exporters of energy are likely to be required to increase production, while net importers are expected to accelerate efforts to increase the proportion of renewables in their energy mix. This set of dynamics will—at least in the short- and medium-term—drive a need for companies that invest in both traditional and renewable sources of energy and we believe the companies that do that effectively will produce attractive returns for our clients.
- Companies, particularly in Europe, are increasingly choosing to introduce management proposals to approve a company's climate action plan or progress in realizing its objectives. These proposals are a tool for companies seeking investor feedback on climate risk and the energy transition. In those cases where both a climate-related management proposal and a similar shareholder proposal are on the ballot, we have observed that investors, including BlackRock, are increasingly inclined to support the management proposal, as the company is demonstrating commitment to act by setting out their business plan for how they intend to deliver long-term financial performance through the energy transition. BIS continues to monitor the development of proposals on climate action plans and progress in this context.

Consistent with BIS' approach to shareholder proposals as set out above, and mindful of the current geo-political context, energy market pressures, and the implications of both for inflation, we have observed several themes of shareholder proposals that warrant special attention. These themes include:

- Ceasing providing finance to traditional energy companies
- Decommissioning the assets of traditional energy companies
- Requiring alignment of bank and energy company business models solely to a specific 5ºC scenario
- Changing articles of association or corporate charters to mandate climate risk reporting or voting
- Setting absolute scope 3 GHG emissions reduction targets [4]
- Directing climate lobbying activities, policy positions or political spending

Although it is still early in the shareholder meeting season, we note that many of these more prescriptive climate-related proposals are attracting lower levels of investor support. [5] In such

[4] This is not to minimize value chain, or scope 3, GHG emissions. They are a major global societal issue and, for companies where they are material, the prospect of future policy change could affect the economic viability of their business models. To effect change in scope 3 GHG emissions in a fair and balanced way, policy action by governments will be necessary. Companies cannot solve scope 3 on their own. As national and regional policy expectations around scope 3 evolve and crystallize, we will look to companies to align their disclosures and commitments accordingly.

[5] Financial Times: Investors at top US banks refuse to back climate proposals, 26 April 2022: https://www.ft.com/content/740b55f8-fa2e-4b66-9398-9f84aedbe8d8

cases, we also note that global proxy advisors ISS and Glass Lewis have been recommending that shareholders not support overly prescriptive or constraining proposals.

In conclusion, BIS is focused on supporting companies as they address the material business challenges they face, including the decades-long transition to a low carbon economy. In our voting determinations it is crucial that we take into consideration the context in which companies are operating their businesses. As we engage companies in an active dialogue about the climate-related risks and opportunities in their business models, we advocate for steps aligned with our clients' interests as long-term shareholders. Our voting on our clients' behalf, where so authorized by them, signals our support for—or concerns about—a company's approach and will always be undertaken with the appropriate consideration of our clients' long-term economic interests as their fiduciary. The nature of certain shareholder proposals coming to a vote in 2022 means we are likely to support proportionately fewer this proxy season than in 2021, as we do not consider them to be consistent with our clients' long-term financial interests.

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An Early Look at the 2022 Proxy Season

Posted by Hannah Orowitz, Rajeev Kumar, and Lee Anne Hagel, Georgeson LLC, on Tuesday, June 7, 2022

Editor's note: Hannah Orowitz is Head of ESG, Rajeev Kumar is Senior Managing Director, and Lee Anne Hagel is Director at Georgeson LLC. This post is based on a Georgeson memorandum by Ms. Orowitz, Mr. Kumar, Ms. Hagel, and Kilian Moote.

Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy: A Reply to Professor Rock by Leo Strine (discussed on the Forum here); and Stakeholder Capitalism in the Time of COVID, by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here).

Introduction

An early examination of 2022 proxy season voting statistics yields a number of notable observations:

At the time of this writing, we have observed

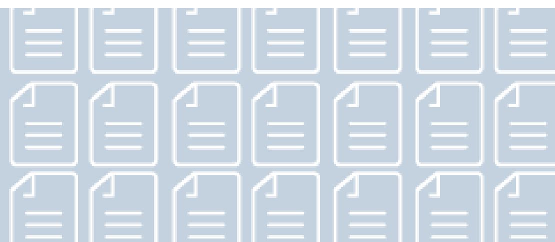
a total of 924

shareholder proposal submissions, significantly surpassing what was a record-breaking number of submissions in the 2021 season.

It is possible that up to

621 proposals

will go to a vote this season.



Of the 286 proposals voted to date:

30
relate to environmental matters

107
involve social issues

149
relate to governance issues

We have seen several types of proposals that attracted majority support for the first-time this season, including shareholder proposals addressing racial equity and civil rights audits, sexual harassment concerns and gender pay equity.

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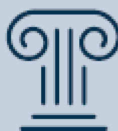
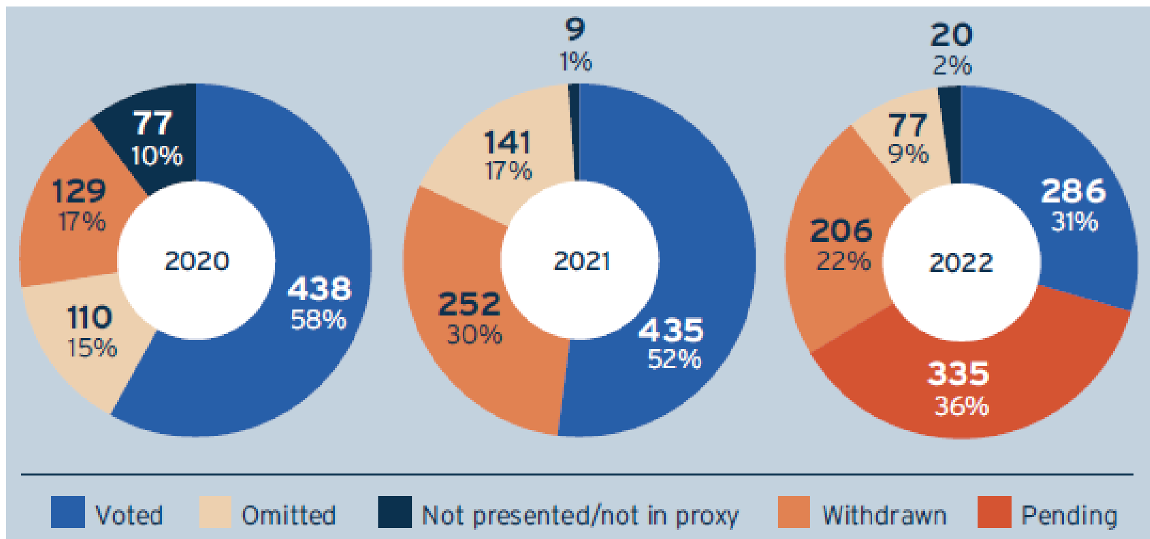


28

Across E, S and G,
6, 10 and 28
proposals have passed in each respective category.

This translates into passage rates of approximately
20%, 9% and 19%,
respectively.

On the heels of a record-breaking 2021 proxy season, it appears that many proponents were emboldened to submit a greater number of ESG proposals this season, with many making more significant demands on companies. For example, while shareholder proposals related to greenhouse gas (GHG) emissions reduction targets of a more general nature were filed in the 2021 season, the majority filed in 2022 are explicitly seeking targets across Scopes 1, 2 and 3 emissions. At the same time, as the season unfolds, we are seeing that some institutional investors may be less willing to support these proposals, based on the passage rates YTD.



Average support for director elections is roughly in line with 2021 support levels, although appears to be trending downwards when results are limited to the 2022 calendar year (which more accurately assesses the impacts of policy changes that went into effect during the 2022 calendar year).

While overall passage rates YTD may be indicative of somewhat muted support compared to 2021, we note there was significant withdrawal activity in certain proposal categories—discussed in more detail within the Environmental and Social sections below—and several weeks of peak proxy season meetings remain. In our view, we see this potentially muted support less as a matter of decreasing shareholder attention on ESG matters and more a reflection of proponents' heightened ambitions in the proposals voted upon in 2022.

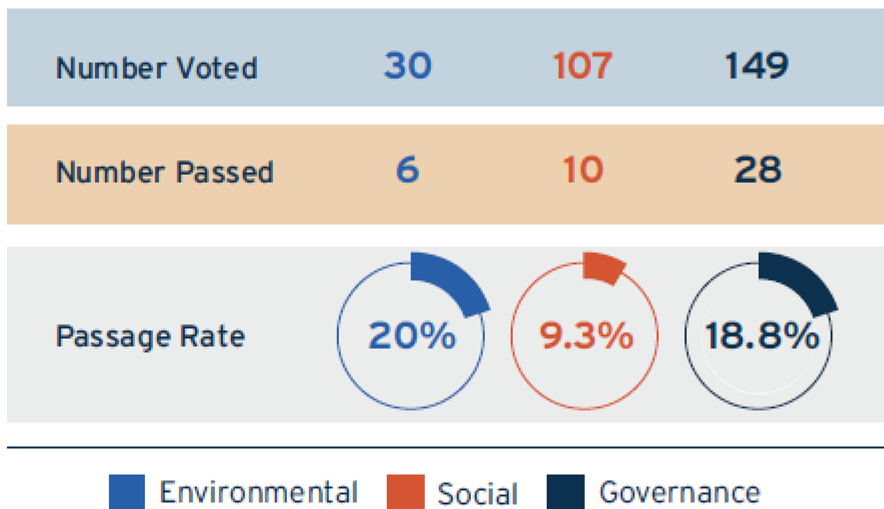
Thematically, we have seen several new trends across both environmental and social proposals. On the environmental side, proposals requesting Scope 3 emissions reductions targets, policy alignment with the International Energy Agency's, or IEA's, Net Zero scenario, and cessation of financing to fossil fuel projects are gaining prominence. On the social side, we have noticed an increased focus on companies' impacts to broader systems, with proposals focused for example on the public health costs of protecting vaccine technology at healthcare companies and external costs of misinformation at technology companies.

Average support for Say on Pay proposals to date is roughly in line with support experienced in the 2021 proxy season.	**90.2%** in 2022 as compared to **91%** in 2021.

We have also seen the trend continue this season of companies recommending that shareholders vote in support of, or not make a recommendation with respect to, shareholder proposals.

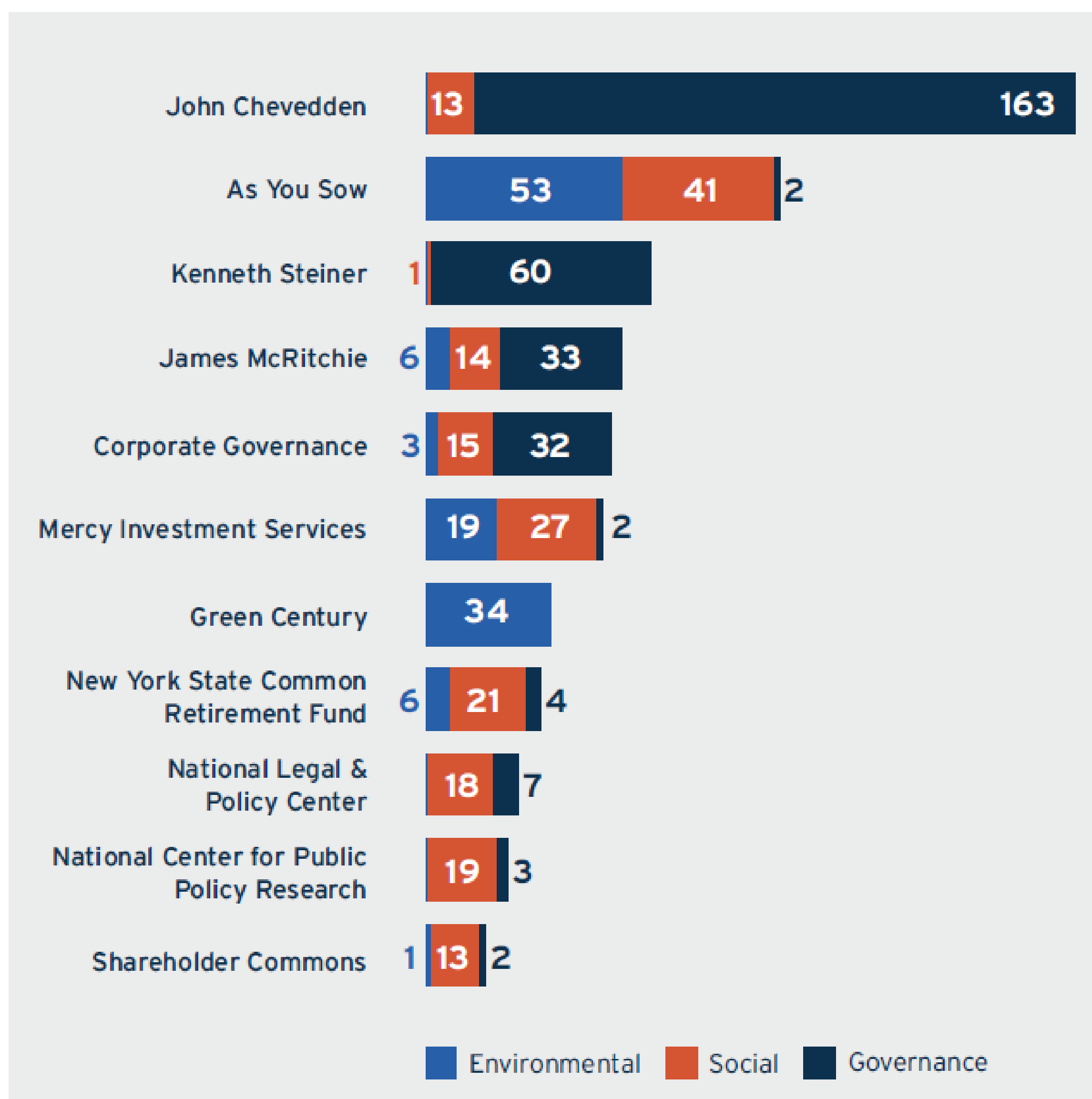
As a result, we have seen four shareholder proposals so far this season receive support above 80% in instances where management recommended in favor of or provided no recommendation on a proposal.

2022 YTD PROPOSALS VOTED AND PASSED



As for proponents, familiar names continue to account for most proposals filed this season. However, we believe coordination among proponents may be increasing, perhaps—at least in part—in response to changes to Rule 14a-8 finalized last year that prohibit proponents from filing more than one shareholder proposal at a given company. In particular, we have observed increasing coordination among Chevedden group members, who historically focused on governance matters, with proponents and advocacy groups across the ESG spectrum, including The Shareholder Commons, As You Sow and various Interfaith Center for Corporate Responsibility members.

Top Shareholder Proponents*

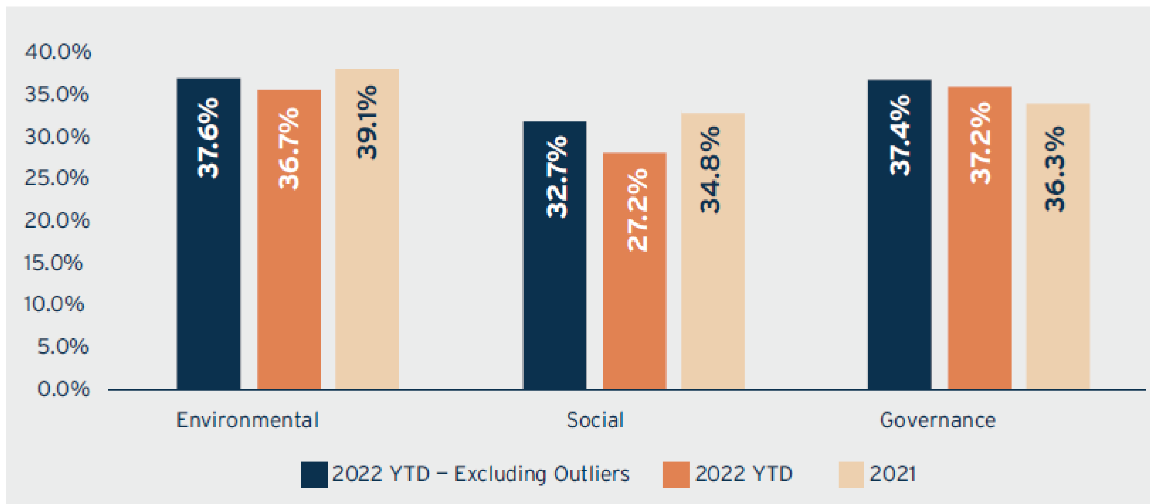


*Amounts represent number of proposals where the proponent is listed as the lead filer or co-filer. Proposals may be double counted given coordination among these proponents.

Shareholder Proposals

There also appears to be a notable increase in so-called “conservative” proposal submissions this season that are often critical of the evolving ESG landscape. Based on our examination of three primary proponents of these proposals—Steven Milloy, The National Legal and Policy Center and the National Center for Public Policy Research, the number of such proposals increased from 26 in 2021 to 52 in 2022.

2021—2022 YTD Average Support by Proposal Category; Average Support Excluding Outlier Proponents*



*Outliers for purposes of this chart refers to systems-related proposals and proposals filed by "conservative" proponents.

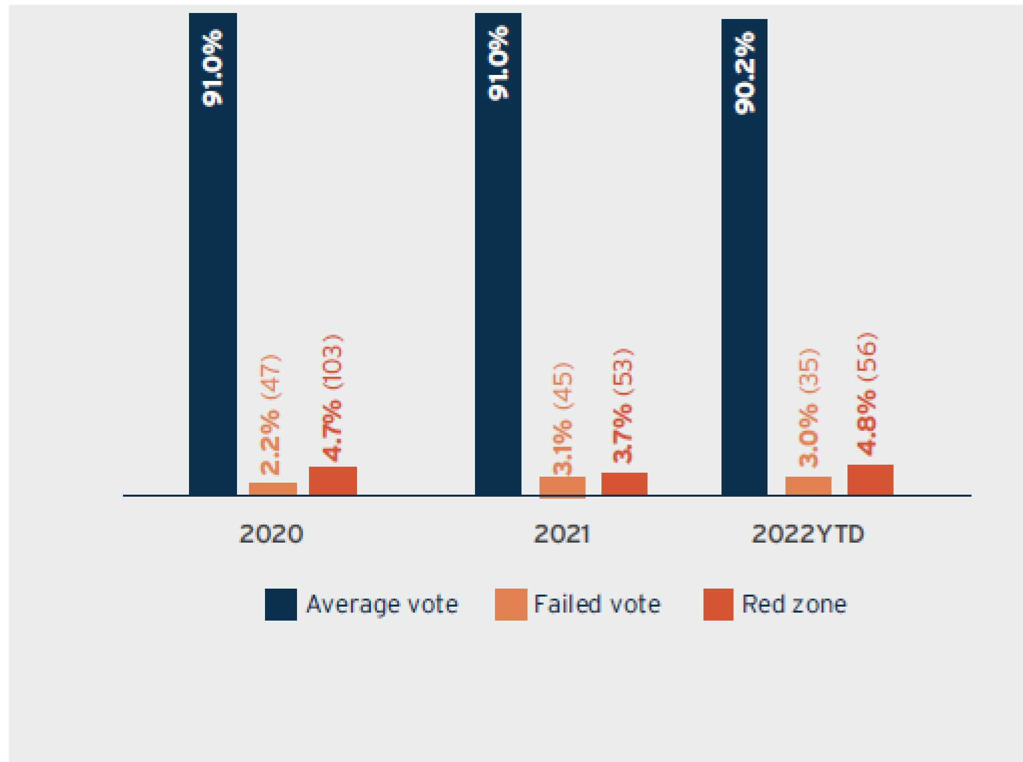
Say on Pay

Say-on-pay vote results for 2022 season YTD are witnessing a marginal decline in the average support for Russell 3000 companies, with approximately 90.2% of votes cast in favor (excluding abstentions), compared to 91% support in 2021. As we have been seeing in recent years, S&P 500 companies have garnered slightly lower support, with approximately 87.8% of votes cast in favor YTD, also down slightly from 2021 when they received 88.5% favorable support.

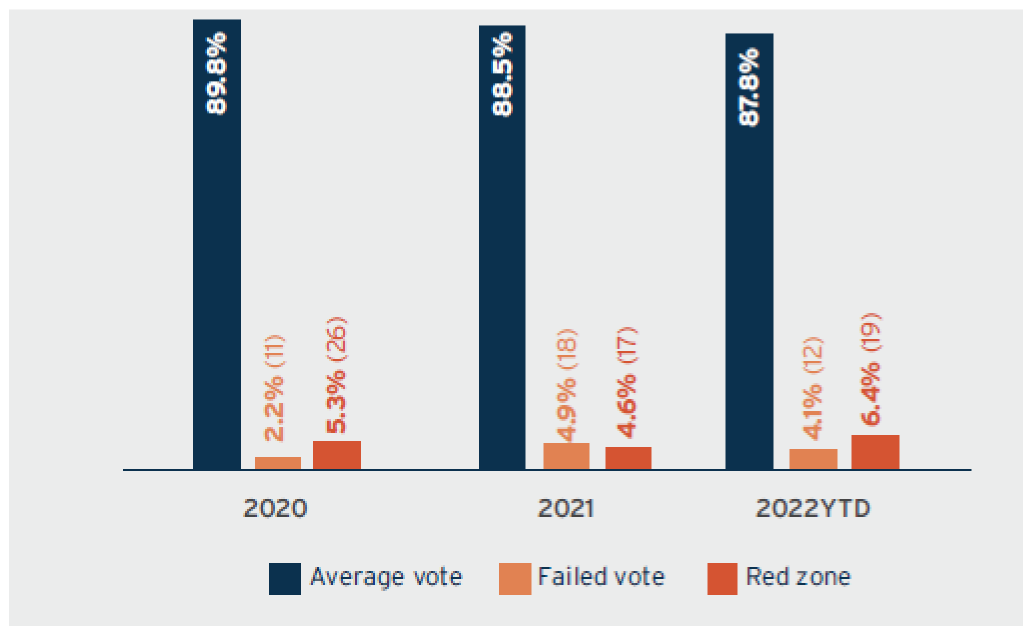
VOTING RESULTS	2021	2022 YTD
RUSSELL 3000 COMPANIES	91%	90.2%
S&P 500 COMPANIES	88%	87.8%

35 Russell 3000 companies have failed to receive majority support for their say-on-pay proposals so far in the 2022 season, with 27 failed votes occurring since January 1, 2022. Nearly one-third of these companies are in the S&P 500 index, with 12 failed votes in 2022 YTD and 9 since January 1, 2022. These nine S&P 500 companies that failed to receive majority support are D.R. Horton, CenterPoint Energy, Centene Corporation, Ventas, Global Payments, Paycom Software, CME Group, Wynn Resorts and Intel Corporation. CenterPoint Energy received the lowest support, with only 22.2% support. The sizable retention grant to the CEO, which is entirely time-based and also vests after a relatively short period of time, seems to have contributed to significant shareholder opposition. Additionally, 4.8% of Russell 3000 companies 2022 YTD have had say-on-pay “red zone” voting results—i.e. vote support falling between 50% and 70%. By comparison, 6.4% of S&P 500 companies so far have results falling within the “red zone.”

2020 – 2022 YTD SAY-ON-PAY SUPPORT – RUSSELL 3000



2020 – 2022 YTD SAY-ON-PAY SUPPORT – S&P 500

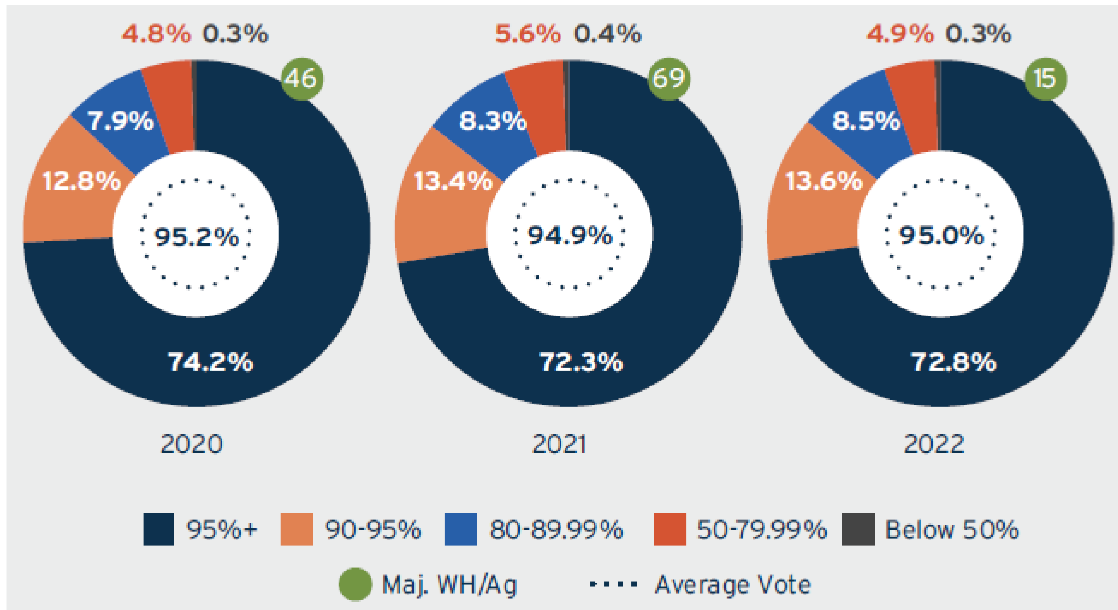


Director Elections

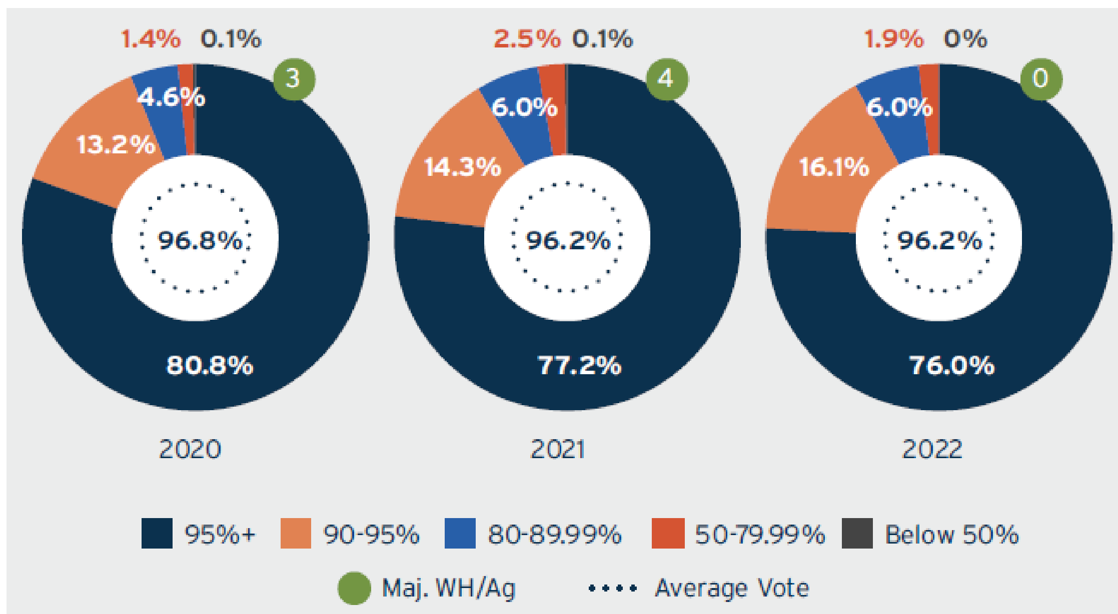
ISS's negative recommendations at Russell 3000 companies during the first 4 months of the year in 2022 were comparable to the same period in 2021, at approximately 9.3%. Negative ISS vote recommendations may have reduced shareholder support by as much as 36.1% of votes cast at such companies during this period in 2022, compared to 38.0% in 2021. ISS has recommended "Against" a slightly lower percentage of S&P 500 companies for the period from January 1 through April 30, 2022, with 11.5% of say-on-pay proposals garnering a negative recommendation, compared to 13.7% for the same period in 2021. The impact of ISS's negative versus favorable recommendation during these 4 months has been 36.4% in 2022 compared to 39.2% in 2021.

In assessing pay for performance alignment in 2022, a common concern for both shareholders and ISS seems to relate to goal rigor of incentive programs, as some companies have lowered targets following challenging business conditions due to the ongoing pandemic. ISS has particularly scrutinized maximum or above target payouts where targets were lowered compared to last year, or where there has been inadequate disclosure of how companies determined award payouts. As ESG metrics are increasingly used in incentive compensation, proxy advisory firms and investors are asking for enhanced disclosure relating to use of such metrics and achievement against the related goals. Among poor pay practices, retention grants without performance conditions or additional compensation without adequate justification are seen as being especially problematic.

AVERAGE DIRECTOR SUPPORT 2020 – 2022 YTD – RUSSELL 3000



2022 YTD DIRECTOR SUPPORT LEVELS – S&P 500



As for areas of focus driving investors' director election decisions, board composition and oversight appear to continue to be at the top of the list in the 2022 proxy season. Racial and ethnic diversity expectations are likely contributing to the slight increase in opposition observed. Significantly, as ISS's and many investors' policies to hold nominating committee chairs/members accountable where their boards lack of racially and ethnically diverse members went into effect this year. Glass Lewis and many investors have also increased their board gender diversity expectations, from one to at least two women on the board. Relating to oversight, both proxy

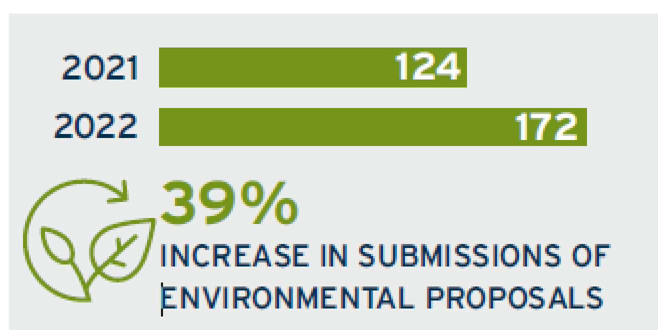
advisory firms and some investors have also increased expectations as to how boards should oversee material environmental and social matters and companies' sustainability disclosures, especially those relating to climate change. Lastly, overboarding continues to result in director opposition, as investors increasingly tighten their policies relating to directors' time commitments.

Vote No campaigns—Majority Action

Vote No campaigns continue to gain momentum in 2022, with Majority Action filing what appears to be the **largest number of exempt solicitations in its history**. At the time of writing, **14 companies** targeted by Majority Action had held their annual meetings. Director elections support across those 14 companies suggest that directors targeted by Majority Action received an average of approximately **245** basis points lower support compared to company peers. Of the 14 companies that have held annual meetings in 2022 thus far, 10 are repeat Majority Action campaigns from 2021. In 2021, Majority Action-flagged directors at these 10 companies had lower average support of approximately 425 basis points.

Shareholder Proposals: Environmental

Climate remains a key focus in the 2022 proxy season, and the various environmental shareholder proposals showcase heightened proponent ambitions. Year-over-year, submissions of environmental proposals increased 39%, with 172 proposals submitted during the 2022 season compared to 124 during the 2021 season. Despite the increased volume of submissions, early voting results suggest dampened support. At the time of writing, we have observed six environmentally focused shareholder proposals pass, representing a passage rate of approximately 20%. While this initial passage rate suggests somewhat weaker support relative to 2021, we view this less as a matter of decreasing shareholder support and more the result of heightened ambitions in this year's proposals, as discussed further below.



Emissions reduction targets

Like 2021, shareholder proposals calling for companies to adopt or enhance greenhouse gas (GHG) emissions reduction targets represent the most common environmental sub-category this season. However, this year's proposals often request for targets or strategies that specifically

include or account for Scope 3 emissions. Of the 71 submitted proposals related to GHG reduction strategies or targets, at least 56 specifically request inclusion of Scope 3 emissions. [1]

56/71 SUBMITTED PROPOSALS RELATED TO GHG REDUCTION STRATEGIES OR TARGETS SPECIFICALLY REQUEST INCLUSION OF SCOPE 3 EMISSIONS.

To date, we note that 31 of the 56 Scope 3 proposals have been withdrawn, and 12 have been voted upon. Of the 31 proposals that were withdrawn, 23 specifically reference withdrawal due to an agreement being reached, a commitment being made, or general constructive dialogue. Notably, As You Sow was listed as a filer in 17 of the 31 withdrawn proposals. Turning to proposals that were brought to a vote, of the 12 proposals voted upon, eight failed and four passed. Further, of the four that passed, in one instance management recommended that shareholders vote in favor of the proposal, and in another management did not make a recommendation with respect to how shareholders should vote on the proposal.

TABLE OF SCOPE 3 PROPOSALS

COMPANY	MEETING DATE	RESULT
Berkshire Hathaway	4/30/2022	Failed
Phillips 66	5/11/2022	Failed
Occidental Petroleum	5/6/2022	Failed
Dominion Energy, Inc.	5/11/2022	Failed
ConocoPhillips	5/10/2022	Failed
United Parcel Service, Inc.	5/5/2022	Failed
DTE Energy Company	5/5/2022	Failed
Valero Energy Corporation	4/28/2022	Failed
The Boeing Company	4/29/2022	Passed
Costco Wholesale Corporation	1/20/2022	Passed
AutoZone, Inc.	12/15/2021	Passed
Sysco Corporation	11/19/2021	Passed

[1] This includes the Net Zero Indicator proposal filed at Boeing, which provides: “Shareholders request the Board issue a report, at reasonable expense and excluding confidential information, evaluating and disclosing if and how the company has met the criteria of the Net Zero Indicator, including scope 3 use of product emissions, or whether it intends to revise its policies to be fully responsive to such Indicator.”

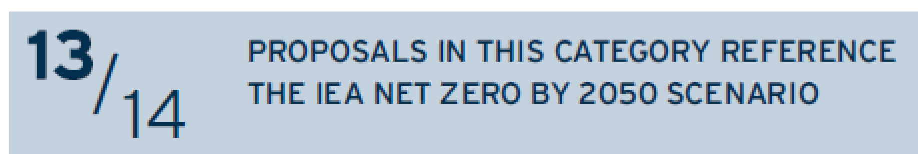
No New Fossil Fuel Financing

Several environmental proposals within financial services have focused on financing policies, requesting companies to cease financing fossil fuel projects. At the time of writing, we have observed 14 of such proposals filed across 12 companies. [2]

Most proposals within this category (13 out of 14) reference the International Energy Agency's (IEA) Net Zero by 2050 scenario. In this context, these proposals request that the subject company refrain from financing or underwriting activities that would be inconsistent with said scenario. In practical terms, these proposals effectively call for an end to the financing or underwriting of new fossil fuel projects. **At the time of writing, we have observed results for seven such proposals, with all seven failing to pass and *none receiving support above 12.8%*, as shown below.**

COMPANY	MEETING DATE	STATUS	RESULT
Royal Bank of Canada	4/7/2022	Failed	9.0%
Bank of Montreal	4/13/2022	Failed	7.6%
Toronto-Dominion Bank	4/14/2022	Failed	6.5%
Bank of America Corporation	4/26/2022	Failed	11.0%
Citigroup Inc.	4/26/2022	Failed	12.8%
Wells Fargo & Company	4/26/2022	Failed	10.8%
The Goldman Sachs Group, Inc.	4/28/2022	Failed	11.2%

The results displayed utilize the relevant method of calculating votes for determining whether the proposal has been approved.



Audited Report on Impact of IEA's Net Zero by 2050 Scenario

In addition to the aforementioned proposals regarding financing policies, we have also seen IEA's Net Zero by 2050 scenario referenced across companies within the energy and utility sectors. In these proposals, proponents request companies to issue audited reports on the impacts of the IEA's Net Zero by 2050 scenario, including how applying the scenario's assumptions regarding fossil fuel demand would impact each company's underlying assumptions and financial positions. At the time of writing, we have observed six proposals within this category, four of which have been withdrawn. The remaining two proposals are on the proxy statements at Chevron and

[2] Three of the 13 companies referenced are not part of the Russell 3000 (Bank of Montreal, Royal Bank of Canada and Toronto-Dominion Bank). These proposals and results are included within this narrative for reference purposes, but are not part of the aggregated data set of R3000 proposals.

ExxonMobil, both of which have meetings scheduled for May 25th. We note that preliminary results from ExxonMobil's annual meeting suggest that this proposal has passed, though final results were not available at the time of writing.

BlackRock's Bulletin on 2022 Climate-related Proposals

We expect many of the early voting trends on climate proposals to persist throughout the remainder of the season, a sentiment that was bolstered following BlackRock's recently published commentary regarding 2022 climate-related proposals. In the bulletin, BlackRock characterizes this year's climate proposals as more prescriptive than 2021's proposals and notes that "[t]he nature of certain shareholder proposals coming to a vote in 2022 means we are likely to support proportionately fewer this proxy season than in 2021, as we do not consider them to be consistent with our clients' long-term financial interests." [3]

BlackRock flags specific categories of proposals that they believe warrant special attention. These themes include:

- Ceasing providing finance to traditional energy companies
- Decommissioning the assets of traditional energy companies
- Requiring alignment of bank and energy company business models solely to a specific 1.5°C scenario
- Changing articles of association or corporate charters to mandate climate risk reporting or voting
- Setting absolute scope 3 GHG emissions reduction targets
- Directing climate lobbying activities, policy positions or political spending

Consistent with its commentary on climate-related proposals, and promptly thereafter, BlackRock published a vote bulletin summarizing the rationale for its vote against a shareholder proposal requesting the Bank of Montreal to adopt a policy to ensure financing consistent with the IEA's Net Zero by 2050 scenario.

In the bulletin, BlackRock notes the proposal is "overly prescriptive, unduly constraining on management and board decision-making, and would limit the company's ability to support an orderly energy transition." Throughout the bulletin, BlackRock emphasizes its role as an asset manager, noting: "It is not BIS' position to tell companies what their strategies should entail, as this proposal prescribes. Rather, we assess, based on their disclosures, their climate action plan, board oversight and business model alignment with a transition to net zero by 2050."

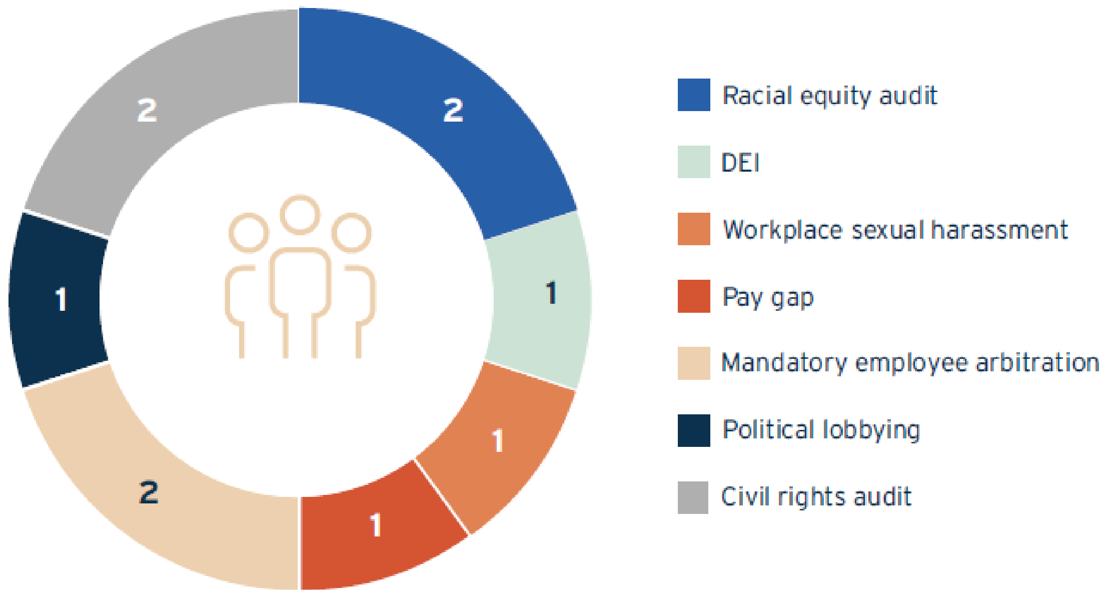
Pre-disclosing Voting Decisions

We've seen the trend of investors pre-disclosing voting decisions continue in 2022, with more investors providing voting rationales in advance of N-PX filings. While BlackRock and Neuberger Berman have historically led this effort, we have seen an uptick from investors such as Engine No. 1 and AllianceBernstein. Given the voluntary nature of such disclosure, there are differences in the consistency and timing of these publications. For

[3] BlackRock's 2022 Climate-Related Shareholder Proposals More Prescriptive Than 2021 is available at https://www.blackrock.com/corporate/literature/publication/commentary-bis-approach-shareholder-proposals.pdf

example, Neuberger Berman often provides voting rationale in advance of an AGM, whereas BlackRock generally publishes its rationale shortly after the AGM but well in advance of N-PX filings.

Shareholder Proposals: Social

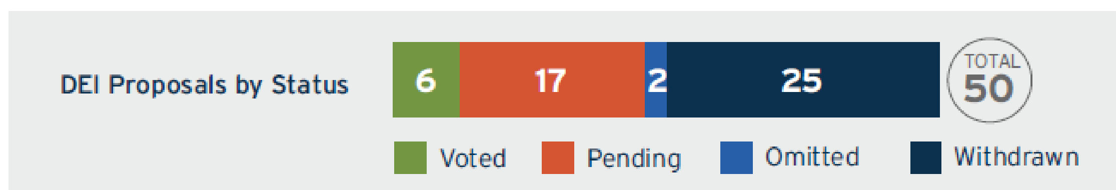


Diversity, Equity & Inclusion

Consistent with the 2021 shareholder season, diversity equity and inclusion remains a major theme for shareholders in 2022, with 50 proposals identified. The variety within proposal resolutions relating to DE&I matters is illustrative of the variety of ways that investors believe DE&I matters can be material to companies. One notable trend is the growth in shareholder proposals seeking reporting on workforce data beyond disclosure of EEO-1 survey workforce diversity data. Data requests this year included disclosure of recruitment, retention, and promotion information specifically addressing diverse employee populations, or reporting on steps by the company to implement their stated diversity and inclusion initiatives. So far this season 25 proposals have been withdrawn and 6 have gone to a vote. 1 such proposal has passed. Average support has been 36% for these proposals. 17 proposals remain pending as of the writing of this post.

As for EEO-1 reporting, proposals seeking such disclosure decreased dramatically in 2022 compared to 2021 (7 vs 47), and all but two such proposals have been withdrawn. The one pending proposal is critical of such diversity reporting and may attract modest support. We believe the decline in the number of such proposals does not represent a decreased demand for workforce diversity data, but rather is an indication of the rapid increased prevalence of this disclosure, particularly across S&P 500 companies.

DIVERSITY, EQUITY AND INCLUSION PROPOSALS 2022 YTD



2022 YTD AVERAGE SUPPORT FOR DIVERSITY, EQUITY AND INCLUSION PROPOSALS

Board Diversity

An additional 18 proposals filed this year addressed board diversity matters, a slight decline as compared to the 2021 season. As with EEO-1-related proposals, we believe this decline in proposal volume is not indicative of waning importance of this topic, but rather an indication of progress. Many companies have made meaningful strides in diversifying their boards—and providing disclosure thereon, whether as a result to Nasdaq's recently revised listing standards or otherwise—and institutional investors have increasingly revised proxy voting guidelines to provide for votes against directors where companies fall short of their diversity expectations.

Civil Rights and Racial Equity Audits

Another subject of shareholder proposals that was new in 2021 were those relating to racial equity audits, which were largely (although not exclusively) focused within the financial services sector. This year, these proposals have been expanded upon to include civil rights audits and proponents have submitted them across several industries. Such proposals typically focus on both internal and external procedures at the company that may negatively impact minority or protected groups. While no proposals on this topic passed in 2021, so far in 2022 two racial equity and two civil rights audit proposals have passed. Average support across both types of proposals is 31%; however, when adjusted to exclude the results of four "conservative" outlier proposals (none of which received more than 3% support), average support increases to 42%.

One proposal seeking an environmental justice audit is outstanding as well. Like the racial equity and civil rights audits, this proposal considers the company's impact on communities of color.

Workforce Harassment/Mandatory Employee Arbitration

Concern around risks posed by workplace harassment also seems to have increased among shareholder proponents, with both proposal submissions on this topic and the number going to a vote increasing year-over-year. So far this year one proposal on sexual harassment has passed and two proposals on the use of binding arbitration provisions within employment contracts have passed. Critics contend that binding arbitration within employee contracts may pose a barrier to an employee's ability to make known harassment or discriminatory practices occurring within a company's workplace. In the case of both proposal types, we believe these represent the first such proposals to have passed. Further, average support for proposals related to workplace harassment and mandatory arbitration voted upon to date was 54%, a meaningful increase compared to average support of 45% for such proposals in the 2021 season.

Pay-Gap

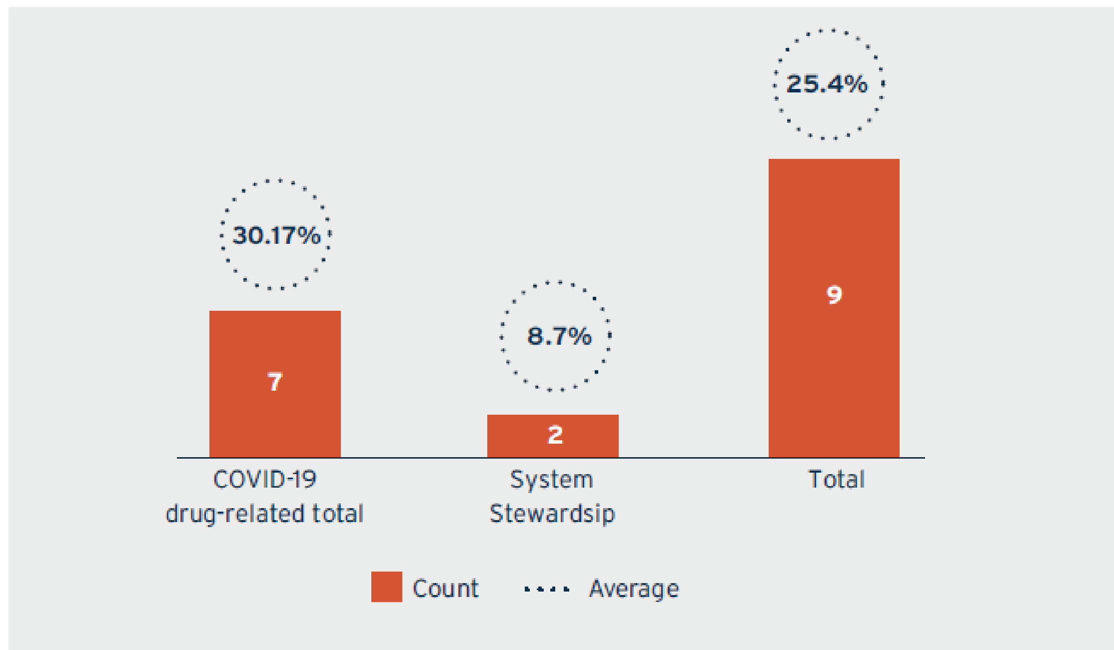
While pay gap proposals have appeared on proxy ballots for several seasons, 2022 marks the first time that such a proposal passed to our knowledge. Typically, these proposals seek reporting on any pay discrepancy that exists between minority groups or women and the average pay within a company. In 2021 no pay gap reporting proposals passed, and average support was below 30%. So far this season one such proposal has passed and average support across the 5 voted upon has increased to 37%. A number of proposals asking companies to conduct a pay gap analysis remain to be voted upon as of the date hereof, as do a series of proposals that relate to paid leave.

All paid leave-related proposals were either omitted or were withdrawn in 2021 and YTD only one such proposal has gone to a vote.

Covid-19/Drug-Related

With the pandemic now entering its third-year, vaccine access remains a focus for shareholder proponents in 2022. 12 proposals were filed with healthcare companies relating to intellectual property and vaccine access. Across the 9 proposals voted on thus far in 2022, none have passed, consistent with 2021 results. Average support for these proposals has been relatively unchanged year over year

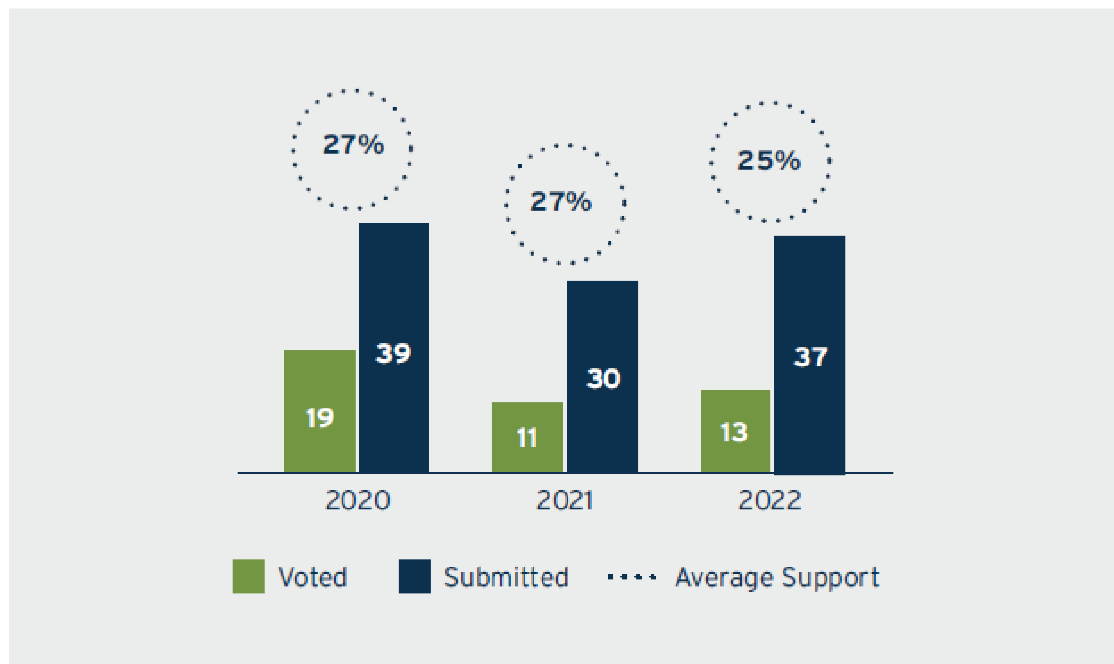
NUMBER OF PROPOSALS AND LEVEL OF SUPPORT RELATED TO COVID-19/DRUG RELATED



Human & Labor Rights-Related

Thus far 13 human rights related proposals have been voted on in 2022. These 13 proposals relate to how companies manage or address human rights or labor rights issues within their direct operations or value chains. Average support across the proposals has been 25%, in line with average support in 2021 (excluding the one passing proposal on this topic in 2021, which was supported by management). We note that three "conservative" proposals in this category voted upon to date are negatively impacting average support for 2022; adjusting for these outlying proposals, average support increases to 27%. This could indicate that shareholders' willingness to support human rights-related proposals is increasing. However, approximately 24 such measures remain outstanding, and accordingly the average support for these proposals could shift meaningfully before season end.

HUMAN RIGHTS – YEAR OVER YEAR CHANGE IN SUPPORT LEVELS FOR HUMAN RIGHTS PROPOSALS



Shareholder proponents have stayed fairly consistent in their requests year-over-year, with the majority of proposals focusing on human rights due diligence or risk assessment processes of companies. However, some proposals this year do identify company-specific risks. Notably, of the proposals that remain outstanding, at least 2 relate in some way to human rights matters within conflict-affected areas. The topic has received renewed media attention following Russia's invasion of Ukraine. State Street Global Asset Management (SSGA) took the unique step of issuing mid-season guidance on this topic, providing more context on what they expect of companies operating in areas where geopolitical risks may create material risk for a company. In their note SSGA stated they expect detail on:

- Management and mitigation of risks related to operating in impacted markets, which may include financial, sanctions, regulatory, and/or reputational risks, among others
- Strengthened board oversight of these efforts; and
- Detail on these efforts in public disclosures [4]

While not explicitly mentioning Russia, it is fair to assume that this statement was in response to the geopolitical risk created by Russia's invasion in Ukraine. The guidance follows other actions in response to the conflict—by SSGA and other asset managers—which have included withdrawal of business operations from Russia. It remains unknown how investors will respond to the conflict-related human rights risk proposals. However it is clear that the Russian invasion has

[4] State Street's Framework for Stewardship in the Context of Geopolitical Risk Arising from Unexpected Conflict Between or Among Nations is available at https://www.ssga.com/library-content/pdfs/global/framework-for-stewardship-in-context-of-geopolitical-risk.pdf

increased investors' collective awareness and focus on how geopolitical conflicts may pose myriad risks to companies.

Further, at least 6 proposals cite alleged exploitation of the Uyghur minority population in China as a human rights issue relevant to the companies in question. There are also a series of new proposals this year filed within the technology sector that relate to how technologies, such as Meta's (formerly Facebook's) virtual reality platform ("the Metaverse") or Google's algorithms may inadvertently cause or enable human rights impacts.

Worker Classification

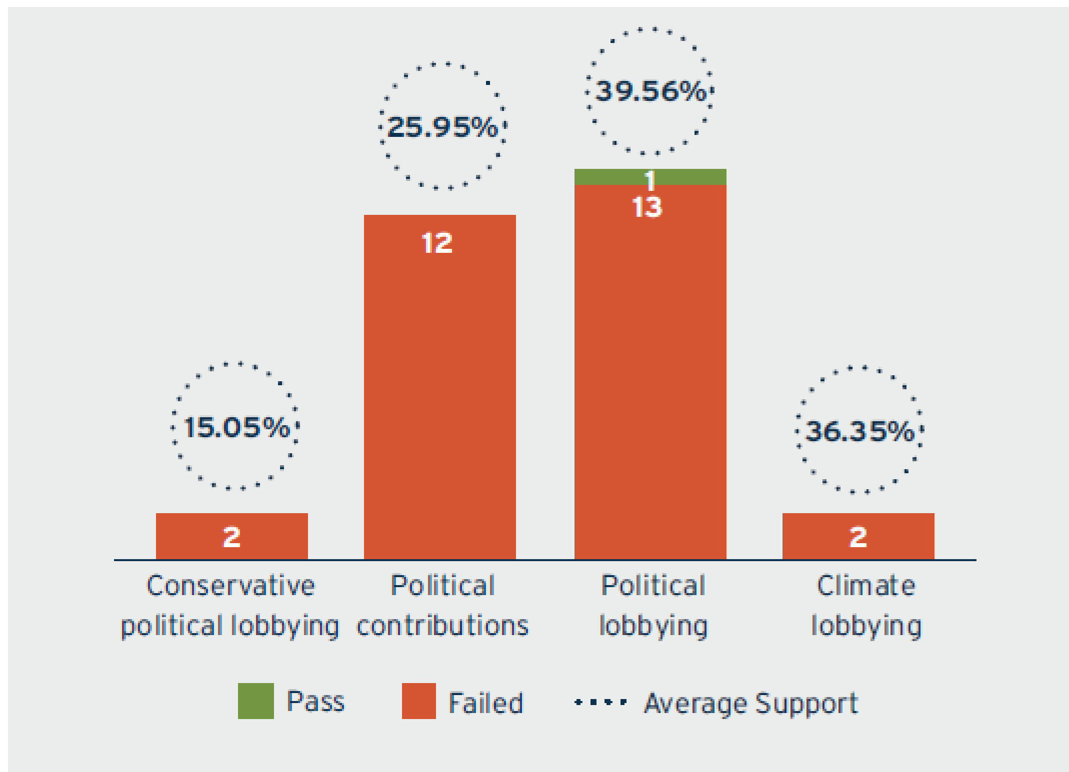
Another new shareholder proposal type this year addresses the risk posed to retailers by third-party logistics providers who may have misclassified their truck drivers as independent contractors rather than employees. The proposals hinge on a new California law that extends liability to logistic providers for the treatment of drivers they employ. All three of such proposals expected to be voted upon in 2022 remain pending as of the date of this post.

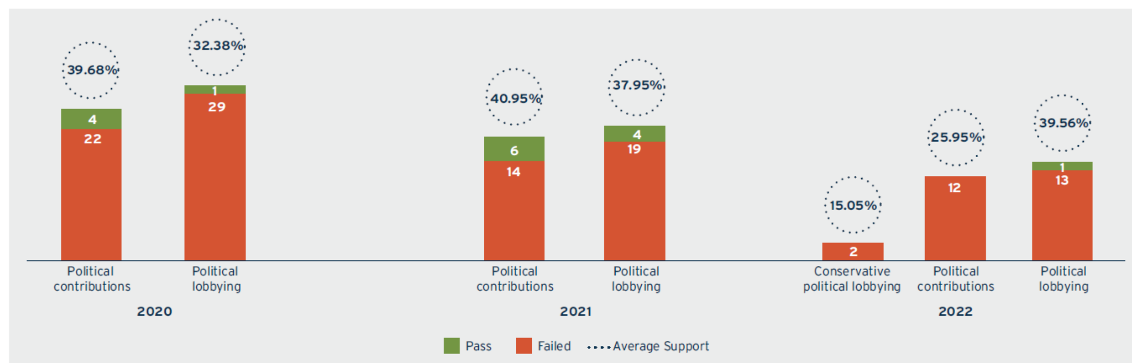
Political Lobbying and Contributions

As in previous years, political spending continues to be a major theme of shareholder proposals. In 2022 political spending accounted for 26% of all the estimated 399 social shareholder proposals filed. This represents an increase compared to 2021, where political spending proposals accounted for roughly 23% of social proposals filed.

On the other hand, average support for political contribution proposals has dropped from 40% average support in 2021 to 26% average support in 2022. So far this year no political contribution proposals have passed, compared to 6 passing in 2021. However as many as 13 political contribution proposals remain outstanding. How they perform could meaningfully influence the average support level and passage rate for 2022.

Political spending has also proven to be another area where proponents are exploring additional racial justice-related themes in 2022, namely environmental justice. At least 3 shareholder proposals were filed questioning how companies' political contributions align or conflict with stated racial justice commitments. Climate-focused lobbying proposals also continues as an area of focus in 2022. Submission volumes for climate lobbying proposals were up year-over-year, with 16 proposals filed in 2022, compared to 12 in 2021. Note that we have categorized these proposals as environmental, and therefore included them within the number of environmental proposal submissions discussed above.





System Stewardship

Proposals related to system stewardship, spearheaded by The Shareholder Commons, represent another new proposal type for the 2022 proxy season. There are 21 such proposals across a wide range of environmental, social and governance topics (and bucketed across all categories), such as environmental racism and wage inequality. These measures share a common theme in requesting that subject companies address what the proponents contend are externalities of a company's practices pose systemic risks to broadly diversified shareholders. Rather than focus on a company specific risk, these proposals focus on the risk that companies' practices pose to the broader market, an approach that highlights perceived risks due to the proponents' diversified

portfolios. Support for those voted upon to date has been relatively low, although three have crossed the 10% threshold necessary to be eligible for resubmission in the 2023 proxy season.

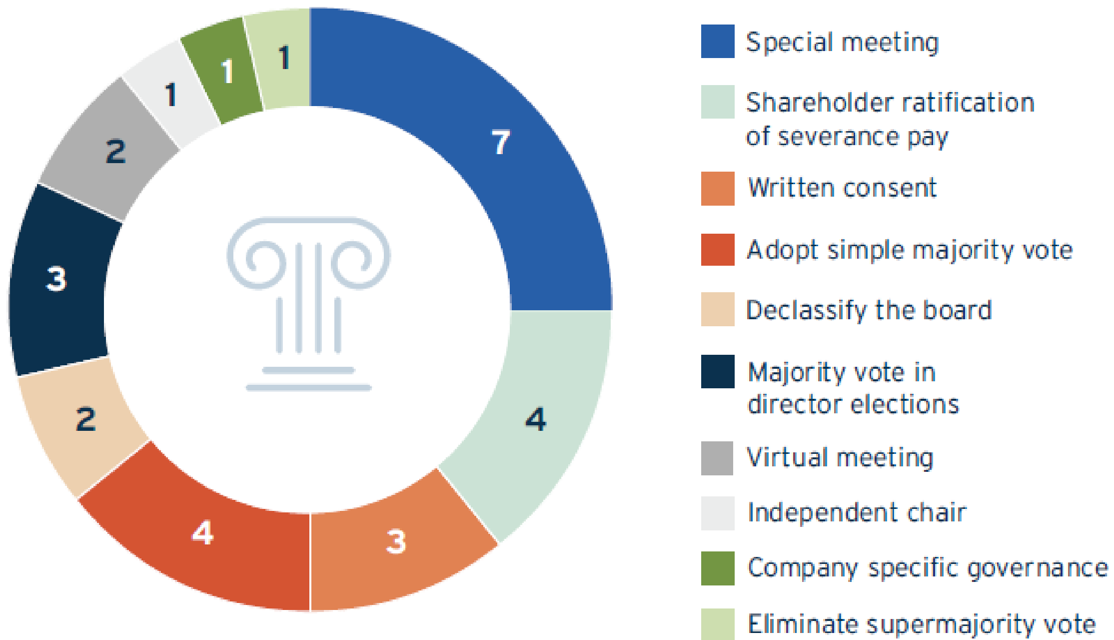
Shareholder Proposals: Governance

The volume of governance-focused proposals appears to have decreased in 2022, with 353 proposals filed as compared to 392 in the 2021 season. Of the 149 proposals voted upon to date, 28 have passed. Many of the topics addressed by these proposals are perennial and not particularly remarkable.

While submission volume is down across the governance category, the number of special meeting-related proposals submitted more than doubled year over year, with 110 such proposals filed in 2022, compared to 41 in 2021. Accordingly, the number of special-meeting related proposals that have passed YTD in 2022 (7) has already exceeded the number passing in the 2021 proxy season (4), with as many as 51 still awaiting a vote as of the date hereof.

Within the sub-category of ESG-linked compensation proposals, one notable development this season is a number of new proposals leveraging companies' CEO pay ratio information. These proposals request that companies take broader workforce compensation into consideration when setting target CEO compensation. This strikes us as an interesting development—while CEO pay ratio disclosure has been a requirement since 2017, it has received relatively little attention from proponents (or otherwise) since enactment. To date, it appears that 13 such proposals were filed; of the three voted upon so far this season, support ranged from just under 8% to nearly 11%. Considering this relatively low support YTD, it remains to be seen if this will be a continued area of focus in subsequent seasons. Anecdotally, we note that Carl Icahn emphasized CEO pay ratio as an area of concern in his campaign against Kroeger, which focuses on animal welfare and fair wage practices.

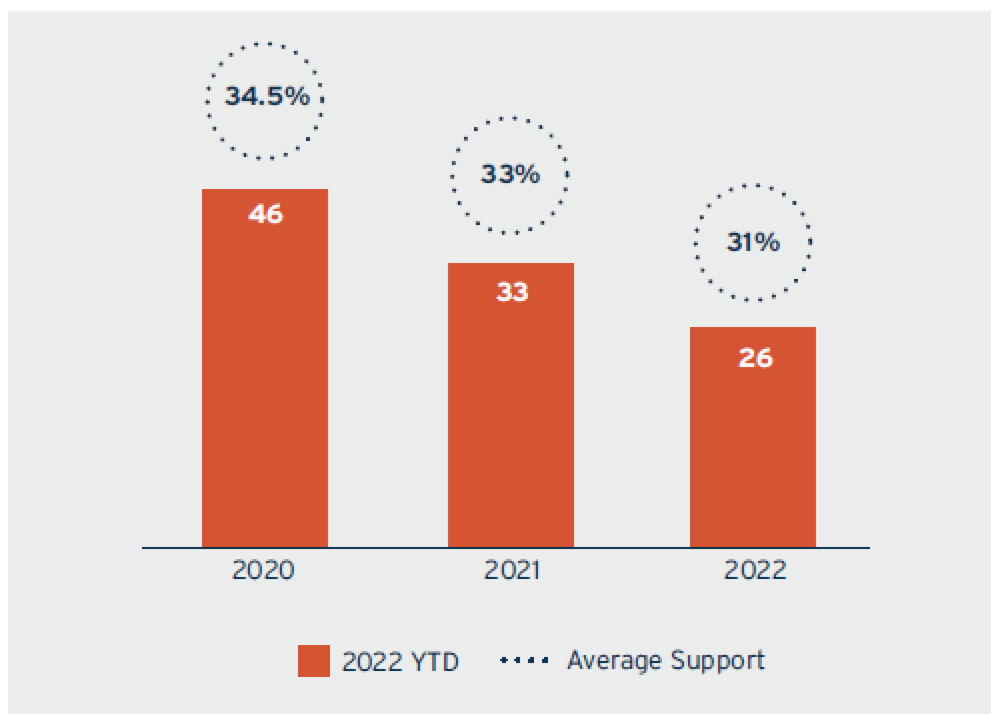
2022 YTD PASSING GOVERNANCE PROPOSALS BY CATEGORY



During the 2021 season, we saw 18 proposals filed, 14 of which were voted upon, seeking amendments to companies' articles of incorporation to become public benefit corporations, which in all but one case—where support approached 12%—failed to receive support in excess of 4%. Given the extremely low rate of support, we see these proposals have dramatically tapered off in the 2022 season, with only 4 such proposals filed, 2 of which appear to be "conservative" proposals filed at companies that signed the Business Roundtable Statement of the Purpose of a Corporation, where the proponent argues that such companies' incorporation as conventional Delaware corporations contradicts the commitments of the Business Roundtable statement. Of the three voted upon to date, support continues to be extremely low, ranging from 1.1% to just over 3% respectively. We note that the main proponent of these proposals in the 2021 season was The Shareholder Commons, which is focusing its efforts this season on the system stewardship proposals discussed within the Social section of this post.

The topic of separation of the roles of board chair and CEO also continues to be a focus in 2022, with 51 such proposals submitted, a slight increase from the 43 submitted in the 2021 season. To date this season, one such proposal has passed, compared to none in the prior season. Interestingly, this topic appears to be one area where mainstream and ESG critics align, as the National Legal and Policy Center is the proponent of 7 of these proposals this season, which

appear to advance the same arguments in favor of separation of the two roles as do other proponents.



Conclusion

Unlike prior proxy seasons, the 2022 proxy season so far is characterized by increased scrutiny towards ESG matters. While this scrutiny has been evident in recent seasons through anti-ESG shareholder proposals, it may be expanding. Much of this newfound attention—from state pension funds and politicians alike—focuses on ESG's impact on voting and investing decisions. States like Texas, Utah, and West Virginia have made public statements suggesting that ESG's influence on fossil fuel companies is inappropriate. Further, on May 18th, legislation was introduced in the Senate calling for asset managers to make client voting choice available to individual investors in passive funds when the asset manager owns more than 1% of a company's voting securities. [5]

This increased attention has created tension between asset managers and asset owners, some of whom believe that managers are not doing enough to advance ESG goals, while others believe that ESG expectations for public companies are becoming overly prescriptive. This tension may be a driver behind some of the recent pullback in support of proposals from asset managers like BlackRock, who characterized many of this year's climate-related proposals as overly prescriptive

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[5] In October 2021, BlackRock announced client choice voting for certain institutional accounts as the first in a planned series of steps to expand its clients' abilities to make proxy voting decisions. Based on our experience so far, we have not observed a significant change in BlackRock's voting activity as a result of this change.

and questioned whether certain proposals would promote long-term shareholder value. With several weeks remaining in the 2022 proxy season, including the "peak" weeks of May 16 and May 23, ultimate voting outcomes remain unknown. As of the date hereof, 286 proposals have been voted upon, and 335 remain pending. Accordingly, it remains to be seen whether the number of shareholder proposals passing in 2022 will surpass the record-breaking levels experienced in the 2021 season. Regardless, a dramatic increase appears unlikely. Once the 2022 season is complete, we expect shareholder proponents and advocacy groups will heavily scrutinize individual investors' voting decisions.

The complete publication, including footnotes, is available here.

IV. ESG Oversight and Decisions

Harvard Law School Forum on Corporate Governance

Board Oversight of ESG: Preparing for the 2022 Proxy Season and Beyond

Posted by David M. Silk, Sabastian V. Niles, and Carmen X. W. Lu, Wachtell, Lipton, Rosen & Katz, on Monday, March 28, 2022

Editor's note: David M. Silk and Sabastian V. Niles are partners and Carmen X. W. Lu is counsel at Wachtell, Lipton, Rosen & Katz. This post is based on their Wachtell memorandum.
Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver Value to All Stakeholders?, both by Lucian A. Bebchuk and Roberto Tallarita; Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock by Leo E. Strine, Jr. (discussed on the Forum here); Stakeholder Capitalism in the Time of COVID, by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); and Corporate Purpose and Corporate Competition (discussed on the Forum here) by Mark J. Roe.

Last year's proxy season saw investor support for an unprecedented number of ESG proposals, on issues ranging from climate change to human capital management to diversity, equity and inclusion. Proxy advisory firms increasingly recommended that shareholders vote for such proposals. We also saw the emergence of ESG-driven withhold campaigns targeting individual directors. This upcoming 2022 proxy season will likely remain hotly contested as investors, proxy advisors and other stakeholders further scrutinize companies' ESG credentials. The Securities and Exchange Commission's recent guidance limiting exclusion of Rule 14a-8 proposals and proposed new rules on climate-related disclosures, and the new ISS and Glass Lewis proxy voting guidelines on climate, board and workforce diversity and "responsiveness" will continue to lend support to ESG-related shareholder proposals. As a result, companies and major institutional investors will need to continue to focus on the relevance, impact and risks of a proposal on an individual company.

Boards now face heightened expectations for how they oversee ESG, with some investors prepared to hold directors, particularly committee chairs, directly accountable (through director specific withhold/against votes and targeted public commentary) for a company's perceived ESG underperformance, shortfalls versus peers or failures of oversight.

We set forth below some key considerations for companies and directors as they continue to prepare for the upcoming proxy season and beyond:

1. ***The board is a core part of a company's ESG narrative.*** Over the past year, we have seen the growing integration of ESG into corporate communications and disclosures, whether it be discussion of ESG in earnings calls, transaction announcements, 10-Ks, proxy statements or press releases. Companies are also increasingly taking a fresh look at how the business of the board is allocated, organized and prioritized across the full

board and individual board committees, especially as it relates to ESG matters. The proxy season has become another opportunity for companies to convey their ESG positioning and progress to investors, including especially the board's involvement with those items. Investors want to understand with which ESG issues the board engages, what efforts have been made to identify ESG risks and opportunities that are significant to the company, whether and how often the board is getting updates from management on ESG matters, and whether ESG considerations have been woven into key strategic decision-making. Investors are looking for boards that comprehend and are transparent with their company's progress, targets and aspirations on ESG. Directors and management teams that are able to tell their company's ESG story can demonstrate the scope of their ESG oversight and confirm that the board is equipped to oversee and address material ESG issues.

2. ***Understand what is material and why.*** Materiality as it applies to ESG continues to be debated, with the EU and certain ESG disclosure frameworks used by investors calling on companies to consider material impacts on stakeholders alongside the financially material impact of ESG items on the company, while the SEC (and U.S. securities law) continues to view materiality through the lens of a reasonable investor. Directors should understand how their company has assessed materiality, including whether it has done a materiality assessment that considers issues from long-term and downside risk perspectives, and be conversant, in particular, with the ESG issues that have been identified as material to the short-, medium- and long-term financial health of the company's business.
3. ***Seek quality data.*** While ESG data has proliferated in recent years, investors continue to voice concern regarding the quality of the data that is publicly available. When overseeing their company's ESG disclosures, directors may wish to consider with management whether the data disclosed would be decision-useful and comparable for investors and whether there is an appropriate balance between quantitative and qualitative disclosures. Directors should also consider whether sufficient processes and internal controls are in place for tracking and reporting key ESG metrics, bearing in mind that the SEC has indicated it expects ESG metrics to be treated with a comparable degree of scrutiny as financial metrics. In engagement sessions with investors, a company may find it useful to inquire as to perceived data gaps that may be holding back investment or other specific concerns in the company's sourcing, confirmation or choice of ESG data. Whether or not a company is externally disclosing ESG data, directors are increasingly seeking to understand and receive material ESG data to support their decision-making, and companies are working on accommodating this desire.
4. ***Search for blindspots.*** Integrating ESG issues into business decisions will also require boards and management to regularly assess potential blindspots, given the multi-faceted nature and impact of many ESG issues: for example, the net zero transition raises questions regarding timing, feasibility, expectations regarding technological solutions, access and affordability. Diversity, equity and inclusion affects not just a company's workforce but also customers and suppliers. Cybersecurity and data privacy implicate operational, product and service safety and consumer welfare issues. More recently, the Russian war in Ukraine has exposed geopolitical blindspots in risk management practices and medium- to longer- term consequences of the war may require many companies to conduct a more fulsome review of their global business activities and supply chain dependencies. As the war continues, the consequences on companies' near-term energy resilience and medium- to long-term transition plans should also be closely monitored.

Boards and management should recognize that ESG issues will continue to evolve and look for ways to identify and adapt to changes.

5. ***Focus on goals and progress; not ratings.*** While ESG ratings may in some cases be useful to help companies hone in on potential opportunities, they are, at best, a historical snapshot, and because of their reliance on publicly disclosed data (and sometimes inconsistent methodologies), may not provide a full or useful picture of the company's comparative ESG performance. The different proprietary methods to assess ESG performance can also result in inconsistent outputs. The ultimate test of a company's ESG performance is whether it can sustainably generate return over the long-term. Each company will need its own strategy for doing so, and management and directors should remain focused on evolving and adapting the business while recognizing the limitations of ESG ratings.
6. ***Demonstrate accountability and credibility.*** When companies commit to net zero, diversity and other ESG targets, investors and other stakeholders look for evidence of accountability and credibility. Boards can help management parse between goals that have achievable pathways and those that are still aspirational. Particularly where targets include commitments over multiple decades, boards should increasingly appreciate that they will be expected to monitor progress and consider interim reporting and goal-setting. Compensation committees should also be judicious when approving the addition of ESG metrics into executive compensation plans and engage on the metrics being used, and companies will increasingly be considering financing solutions linked to ESG metrics. Companies should prepare for enhanced pressure for independent or other third-party verification of the measurement of performance against metrics.

As ESG issues continue to evolve, expand and become increasingly integrated into business strategy and decision-making, boards will continue to adapt their oversight—and even board evaluation and recruitment processes—to align with business needs and investor, stakeholder and regulator expectations.

How to Identify Top ESG Priorities

Posted by Steven Rothstein (Ceres), Olivia Tay (Semler Bross LLC), and Yamika Ketu (Ceres), on Tuesday, May 10, 2022

Editor's note: Steven Rothstein is managing director, Yamika Ketu is an associate, and Melissa Paschall is director of governance at Ceres; Olivia Tay is senior consultant, Kathryn Neel is managing director, and Blair Jones is managing director at Semler Brossy LLC. The post is based on a Ceres/Semler Brossy client memo and article in *Corporate Board Member*.

Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy – A Reply to Professor Rock by Leo Strine (discuss on the Forum here); Stakeholder Capitalism in the Time of COVID, by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here).

As investors, regulators, and stakeholders increasingly recognize environmental, social and governance (ESG) risks and opportunities as financially material, companies are looking for ways to link management incentives with ESG performance on climate change, diversity and inclusion, and other key issues. Though integrating ESG goals into the existing compensation program may seem like the obvious next step, there are several processes that board members need to implement first—and critical questions that they need to address—to ensure the new compensation structure is appropriately tied to corporate strategy.

We have teamed up to provide guidance to companies that have begun to integrate ESG issues into their corporate strategies and may be considering ESG in incentives. This three-part series focuses on that process, including guidance to corporate boards on how they can: 1) effectively identify and oversee top ESG issues, 2) focus and clarify efforts around establishing a select set of critical performance goals for material ESG issues, and 3) consider whether and how to integrate ESG metrics into incentive compensation programs. In this first article, we will focus on how companies can implement the foundational steps of board-level ESG oversight.

The board's role in ESG oversight

As stewards of long-term corporate performance, boards have a critical role to play in ensuring that companies are aware of, and able to navigate, an ever-evolving risk landscape—one that increasingly involves social and environmental impacts. It is the board's responsibility to ensure that processes are in place to identify material risks and opportunities—including those that arise from ESG concerns. In doing so, directors should look beyond the information they receive from management and actively inquire about processes employed and issues identified. This is not

only best practice, but a fulfillment of director fiduciary duty, which includes the “duty of care,” or responsibility to adequately inform oneself prior to making decisions.

The direct consequences of directors failing to take ESG concerns into account are growing. So-called Caremark claims, in which investors hold directors accountable for failing to implement or monitor key reporting systems, were dismissed for many years—but since 2019, five such claims have been allowed to proceed. Noting this trend, the Commonwealth Climate and Law Initiative recently published an analysis indicating that U.S. directors may be liable under the duty of care for failure to oversee climate risks, particularly if they ignore red flags from investors and other stakeholders. Such lapses may become increasingly obvious to investors as the US Securities and Exchange Commission (SEC) and other financial regulators implement and strengthen mandatory disclosure rules.

A first step for responsible board oversight is to assess the extent to which the company’s existing processes allow for systematic identification and assessment of ESG risks—and whether those processes are inclusive of a wide range of perspectives, to allow the company to consider risks that may not already be on its radar. This may involve internal and external research, engaging employees and customers, and consulting experts, such as insurance brokers and risk managers, to identify the set of issues the company should examine. Many companies hire outside consultants to do a full organizational review to determine top ESG risks, in addition to reaching out to top shareholders and other stakeholders to collect their views.

It’s important to remember that ESG issues present not only risks, but opportunities as well—new technologies, new product markets, and shifting customer preferences. Boards should ensure that management is also exploring the upside potential of ESG trends through strategic offsites or other regular meetings focused on defining and aligning the company’s strategic plan. As the Ceres Roadmap 2030 notes, leading companies will recognize that the integration of sustainability into governance systems enables opportunity for improved performance, risk mitigation, cost reduction, increased revenue and competitive differentiation.

The board’s role in ESG risk and opportunity identification and oversight

Questions for Directors to Ask*

- **Consider how ESG risks and opportunities could affect your company:**
  - What kind of risks or opportunities could ESG issues pose to the company?
  - How could these risks and opportunities interrelate?
  - When could these risks or opportunities manifest?
- **Evaluate whether existing processes allow the discovery of ESG risks and opportunities:**
  - What is the company’s process to identify risks and opportunities from ESG factors?
  - Which ESG risk factors is the company already tracking?
  - Is the company looking at the right range of sources—including investors and peers—to identify risks and opportunities?
- **Be aware of assumptions in the risk and opportunity identification process:**
  - Did management assess ESG risks and opportunities that the company could face in 1, 5, 10 and 20 years?

    - What blind spots about ESG risks may exist in the risk identification process?
- **Integrate identified ESG risks into the Enterprise Risk Management (ERM) process:**
    - Who owns the ERM process internally?
    - Does the ERM process consider ESG risks?
    - Is the ERM process agile?

**Excerpted from "Running the Risk: How Corporate Boards Can Oversee Environmental, Social and Governance Issues" (Ceres, 2019)*

The company may already track some ESG risks within its Enterprise Risk Management system, without necessarily labeling them as social or environmental issues but rather as operational, supply chain or regulatory risks. Where material ESG risks are known, incorporating them into existing systems can help ensure they are taken seriously as business risks so that identification, prioritization and mitigation take into account their material financial impacts.

For many companies, existing processes are necessary but not sufficient for identifying ESG risks and opportunities—especially when the risks or opportunities are difficult to quantify or manifest over very long time horizons. In some cases, internal sustainability teams may be well aware of these issues, but the challenge is to incorporate them into organization-wide systems. Generally speaking, material risks identified in the company's sustainability report should also appear in the company's financial disclosures.

Boards should work with management to examine whether existing risk processes are sufficient, and how they might be strengthened. This may include evaluating business model assumptions. Practically, processes companies can adopt for identifying ESG risks can include megatrend analysis, SWOT analysis (which identifies strengths, weaknesses, opportunities and threats), impacts and dependency mapping, scenario analysis and facilitated stakeholder engagements. The Ceres report, "Running the Risk: How Corporate Boards Can Oversee Environmental, Social and Governance Issues" contains several toolkits to guide directors in these processes.

Board committee structure for ESG oversight

Integrating ESG considerations into boardroom decision-making on strategy needs to happen at both the full board and committee levels—with all significant ESG efforts being reviewed by the full board, at least at a summary level. In practice, this means directors need to ensure material ESG topics are standing items on the board's agenda in order to address them systematically and integrate them consistently into strategic planning and execution. Without a systematized approach, companies will be forced to react with a crisis response when negative impacts occur and can miss out on opportunities presented by new markets and shifting customer and employee expectations.

The best way for boards to systematize ESG oversight is by amending one or more board committee charters to include formal responsibilities related to material ESG issues. This is important even for boards that are already engaged on ESG because charter language can outlast any individual directors or executives who may currently be driving that work—ensuring board oversight of ESG risks and opportunities both now and in the future.

There are many models for board committee oversight, and pros and cons to each approach. One key decision is whether to establish a dedicated committee, such as a Sustainability Committee, versus integrating ESG oversight within one or more existing committees.

For instance, an Audit and Risk committee could focus on material financial risks impacts of climate change, while a board's Human Resources and Compensation committee may be best suited to oversee human capital issues in the workforce, such as diversity and inclusion and pay equity, and a Nominating and Governance committee may be the right body to ensure directors with appropriate ESG expertise serve in these committee roles. A simple mapping exercise of ESG issues and board committees can be useful, and may be modeled after table 1 below—adapted to fit the company's material issues and committee structure.

TABLE 1

Sample Framework for Board and Committee Allocation of ESG Issues

	CLIMATE CHANGE	DIVERSITY & INCLUSION	WATER RESOURCES	HUMAN RIGHTS	PRODUCT SAFETY	COMMUNITY IMPACTS	WASTE & RECYCLING
Full Board							
Nominations & Governance							
Audit & Risk							
HR & Compensation							
Public Policy							
Sustainability							

One of the advantages of a dedicated ESG committee is that it signals, both internally and externally, that there is commitment to keeping an eye on these issues and that they are important to the company—and ensures thoughtful deliberation of their business implications. On the other hand, a standalone committee can lead to siloed discussions of ESG topics, which might not be meaningfully connected to other business priorities that the board is driving. Integrating ESG oversight into an existing committee addresses this issue, but given increasingly crowded board agendas, it runs the risk of ESG issues being crowded out.

As of July 2021, around 88% of the S&P 100 had integrated ESG oversight into specific board committee charters. Nomination and governance committees were the most common placement for ESG oversight, with nearly half of companies (47%) placing responsibility there. The next most common placements were standalone sustainability committees (14%), audit, risk and compliance committees (10%) and public policy committees (10%). Around 4% of these companies integrated ESG oversight into multiple committee charters, and 3% placed it within a single committee other than the ones already mentioned. In the several months since, at least two companies that previously lacked committee-level responsibilities have integrated them—and, notably for this article series, about half of the Fortune 100 companies have expanded the

names of their compensation committees to include broader human capital items including leadership or management development and people resources.

Table 2. Examples of committee placement of ESG risks (*Running the Risk*, Ceres 2019)

Board Committee	ESG Risk Oversight Examples	Company Example
Audit/Risk	• Ensure material ESG risks are brought to the attention of the full board • Ensure compliance with new ESG regulations • Disclose ESG risks in financial filings	Alphabet *(Audit and Compliance Committee)*
Nominating & Governance	• Include ESG in board skills matrix • Require board training on ESG • Integrate ESG in board performance evaluations	Mastercard [1] *(Nominating and Corporate Governance Committee)*
Compensation/ Human Resources	• Incentivize executives to take action on mitigating risks from ESG issues • Oversee policies and procedures on workforce development including safety and diversity • Engage with investors on ESG and compensation	T. Rowe Price *(Executive Compensation and Management Development Committee)*
Sustainability/ Diversity	• Review key sustainability programs and related goals…and monitor the Corporation's progress toward achieving those goals • Review and discuss the Corporation's diversity, equity and inclusion policies, programs and initiatives	PepsiCo *(Sustainability, Diversity and Public Policy Committee)*

[1] *More information can be found in Mastercard's 2021 Proxy Filings.*

Environmental Health & Safety	- Oversee acute and chronic impacts of hazards posed by the company to employees, contractors and the general public - Oversee company response to developing EHS regulations and development of policies to comply, including those related to climate change	Consolidated Edison *(Safety, Environment, Operations, and Sustainability)*

At a management level, because the impacts of ESG issues can manifest across multiple areas of a business, an important structural element of managing ESG oversight and efforts is cross-functional collaboration. Boards should ensure that the management team not only has expert leadership for its most material ESG issues, but also that those leaders are coordinating with other teams across the company and they have a voice in strategic decision-making for the business. By asking ESG managers and business leaders to regularly present to the board, directors help ensure that this cross-organizational collaboration is taking place.

At the end of the day, there is no single solution for how to structure board oversight and companies should choose a model that best fits their own situation—but some formalized committee-level responsibility is crucial. It's also critical to ensure that the oversight structure is reevaluated from time to time. Issues will continue to evolve, and the structures to address them will need to advance as well.

Below are examples of different approaches to committee oversight of ESG issues:

	Committee	Charter Language
Nike	Corporate Responsibility, Sustainability & Governance Committee	*"Review and evaluate the Company's significant strategies, activities, policies, investments and programs regarding corporate purpose, including corporate responsibility, sustainability, human rights, global community and social impact, and diversity and inclusion."*
FedEx	Nominating and Governance Committee	*"Review and discuss with the Executive Vice President, General Counsel and Secretary, the Chief Sustainability Officer, and other members of management, at least annually, the Company's (i) corporate social responsibility strategies and programs, including with respect to sustainability, and (ii) management of sustainability-related risks."*
Alphabet	Audit and Compliance Committee	*"Review and discuss with management Alphabet's major risk exposures, including financial, operational, data privacy and security, competition, legal, regulatory, compliance, civil and human rights, sustainability, and reputational risks, and the steps Alphabet takes to prevent, detect, monitor, and actively manage such exposures."*

What about executive compensation?

We've now covered the first steps that boards need to take, which include ensuring the company is identifying and prioritizing key ESG risks and opportunities, and formalizing and structuring board oversight of ESG.

With those practices in place, boards can move towards measuring, monitoring and tracking key ESG metrics over time, establishing appropriate goals, communicating those metrics and goals to key stakeholders, and considering the metrics for incentives. These are subjects that will be covered in future posts.

Revisiting the Board's Oversight Role After In re: Boeing Co.

Posted by Cynthia Mabry, Kerry Berchem, and John Goodgame, Akin Gump Strauss Hauer & Feld LLP, on Wednesday, June 1, 2022

Editor's note: Cynthia Mabry, Kerry Berchem and John Goodgame are partners at Akin Gump Strauss Hauer & Feld LLP. This post is based on their Akin Gump memorandum, and is part of the Delaware law series; links to other posts in the series are available here.
Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver Value to All Stakeholders? (discussed on the Forum here), both by Lucian A. Bebchuk and Roberto Tallarita; Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock by Leo E. Strine, Jr. (discussed on the Forum here); and Stakeholder Capitalism in the Time of COVID, by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here).

Recent rulings in the United States and overseas, coupled with the Securities and Exchange Commission's (SEC) recently proposed disclosure rules covering climate-risk disclosures, underscore the attention boards of directors and management must continue to pay to climate change and its potential impact on business operations and the risks faced by companies across all sectors of the economy. Obviously, the energy industry is acutely attuned to these issues and last year's decision in *In re: Boeing Co. Derivative Litigation* (discussed in detail below) only serves as the most recent reminder of the potential exposures (including personal liability) companies, boards of directors and management may face when they fail to consider these issues seriously.

May 26, 2021, marked the first time that a court imposed a bright-line emissions reduction requirement on a private corporation unrelated to an independent statutory or regulatory mandate. The District Court of The Hague ruled that Royal Dutch Shell must uphold a duty of care owed to Dutch citizens to reduce its carbon dioxide (CO_2) emissions. The District Court of The Hague grounded the obligation in the "unwritten standard of care" enshrined in Dutch tort law that dictated "what may be expected of [Shell] . . . with respect to Dutch residents." In its decision the District Court of The Hague considered a number of factors, including Shell's and other actors' contributions to and responsibilities for climate change, human rights concerns, climate science, regulatory pathways to address climate change and feasibility. The District Court of The Hague criticized Shell's existing policy for merely monitoring developments, for being intangible and undefined, and for allowing other parties to take the lead in addressing climate change. Ultimately the District Court of The Hague ordered Shell to enact a new policy to address climate change.

Shell has made clear that it intends to appeal the decision, yet regardless of any precedential value the decision adds further pressure on companies to proactively implement policies that

align with the Paris Agreement targets and basic human rights to a clean and healthy environment, and not just react to government-imposed laws and policies. In the United States, the decision will continue to attract significant attention in the oil and gas and other energy-intensive sectors, as well as in the financial industry. It also may cause companies promoting corporate sustainability to take a closer look at how they set environmental targets and substantiate their claims. While it is unlikely that United States courts will follow the reasoning set forth by the District Court of The Hague, in part due to the conservative majorities on the United States Supreme Court and in the federal judiciary, the focus on a corporation's duty of care calls to mind a line of Delaware cases that address boards of directors duty to oversee risk and safety, which are highlighted below. Similar to the *Shell* case, this line of cases presents an avenue for activists to bring litigation related to climate risks.

In a derivative case against directors of The Boeing Co., the Delaware Court of Chancery allowed *Caremark* [1] claims against The Boeing Co. directors to survive a motion to dismiss—confirming that the plaintiffs satisfactorily alleged that Boeing's board breached its duty of oversight by failing to establish and oversee compliance procedures related to the company's "mission critical" airplane safety risks. This post further provides background on the *Caremark* line of cases and an overview of the Delaware Court of Chancery's ruling in *Boeing* [2] on September 7, 2021.

Caremark and Director Liability

Delaware corporations may include provisions in their certificate of incorporation that exculpate their directors from monetary liability for any breach of the fiduciary duty of care. [3] However, breaches of the fiduciary duty of loyalty and bad faith conduct cannot be exculpated. If a plaintiff asserts a claim for breach of the duty of care against a director or directors where such an exculpation provision exists, that claim would be subject to dismissal at the early stages of the case.

In *Caremark*, the Delaware Court of Chancery stated that when directors of a Delaware corporation are exculpated from liability for breach of the duty of care or attention, they may nonetheless be held liable on a breach of loyalty theory if such directors have (1) utterly failed to implement any reporting system or controls and (2) consciously failed to monitor such a system. Both prongs of this *Caremark* test require that the directors have had knowledge that they were not discharging their fiduciary obligations. At the time, the court characterized this theory of liability as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."

In *Caremark*, the court reviewed a proposed settlement of shareholder derivative claims that arose from the company's guilty plea and payment of criminal and civil penalties for violations of state and federal health care fraud laws. The court focused on the plaintiffs' claim that "directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance." The court established a high bar for such a claim, stating "only a sustained or systematic failure of

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[1] *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).
[2] *In re* the Boeing Co. Derivative Litig., No. 2019-0907 (Del. Ch. Sept 7, 2021).
[3] Delaware General Corporation Law §102(b)(7).

the board to exercise oversight such as an utter failure to attempt to assure a reasonable information and reporting system exists will establish the lack of good faith that is a necessary condition to liability."

As a result of *Caremark*, the board, among its other fiduciary obligations, must undertake a duty of oversight to make a good faith effort to put into place a reasonable board-level system of monitoring and reporting.

Decisions Since *Caremark*

In *Marchand*, [4] plaintiffs' alleged breach of fiduciary duty claims against the board of directors of a company survived a motion to dismiss. The Delaware Supreme Court concluded that the plaintiff had adequately pled a *Caremark* claim that directors had acted in bad faith and breached their duty of loyalty by failing to have a board-level compliance monitoring and reporting system related to food safety. The court, focusing on regulatory risks, held that board oversight of such risks must be "rigorously exercised" when dealing with "mission critical" risks.

Plaintiffs in *Marchand* alleged that the board in question did not have a board committee to oversee food safety, nor did it have any protocol for advising the board of food safety reports. Plaintiffs also alleged there was no evidence in board's minutes or schedules of any regular discussion of food safety issues. Notably, the court acknowledged such company's nominal compliance with Food and Drug Administration (FDA) requirements for food safety but stated this only showed the management's compliance with the law rather than the board implementing a system to monitor food safety risks. As a result, the *Marchand* decision provides that the directors' lack of attentiveness to key risks in their oversight role may rise to the level of "bad faith indifference" required for a *Caremark* claim.

Subsequently, in *Clovis Oncology*,[5] the Delaware Court of Chancery again allowed the plaintiffs' *Caremark* claim to survive a motion to dismiss. While developing a lung cancer treatment, the company overstated the effectiveness of the treatment and did not comply with the rules for reporting test results set by the FDA. Unlike in *Marchand*, the Clovis board's "Nominating and Corporate Governance Committee was 'specifically charged' with 'provid[ing] general compliance oversight . . . with respect to . . . Federal health care program requirements and FDA requirements.'" As a result, the court stated that it was unlikely the plaintiffs would be able to prove that "the Board had no 'reporting or information system or controls.'" Instead, the court relied on the second prong of the *Caremark* test in which a company "implemented an oversight system but the board failed to 'monitor it.'" The court pointed to allegations that the board knew the requirements for reporting the treatment results and knew that management was reporting inaccurate results, but did nothing to address the problem. Based on these allegations, the court denied the motion to dismiss finding that plaintiffs had successfully plead "that the Board consciously ignored red flags that revealed a mission critical failure to comply with [federal health care protocols] and associated FDA regulations." The *Clovis Oncology* decision highlights the

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[4] Marchand v. Barnhill, 212 A.3d 805 (Del. 2019).

[5] *In re* Clovis Oncology, Inc. Derivative Litig., No. CV 2017-0222-JRS, 2019 WL 4850188, (Del. Ch. Oct. 1, 2019).

importance of not only having in place a system for board oversight, but also for the board to actively use and monitor that system.

Boeing Decision

The Delaware Court of Chancery most recently permitted claims against the Boeing board to survive a motion to dismiss, in a case that some commentators believe has further expanded potential board oversight liability. In the *Boeing* case, shareholders filed a suit against the board following two crashes of the company's 737 MAX aircrafts. In denying the board's motion to dismiss, the court concluded that the pleaded facts showed a board that had "failed to establish a reporting system" for airplane safety. Further, the court stated that the first crash "was a red flag . . . that the Board should have heeded but instead ignored," and "the Board was aware or should have been aware that its response to the [first crash] fell short."

The court pointed to safety being "essential and mission critical" to Boeing's business. Allegedly, there was no board committee assigned the specific task of overseeing airplane safety. Boeing's audit committee was responsible for overseeing legal and regulatory compliance but it is alleged to have "primarily focused on financial risks." The committee charter did not mention safety as part of the committee mandate. Board minutes included in the complaint showed that airplane safety was not addressed as part of the board's yearly updates on compliance, nor was airplane safety regularly on the agenda at board meetings. Instead of direct board oversight, the company had a Safety Review Board run by employees. The complaint further alleged that the board did not have any way to receive internal reports or complaints about safety nor did management report to the board on safety issues.

The court recognized that plaintiffs' pleading burden was onerous, but found that they had made sufficient allegations to survive the motion to dismiss and were entitled to pursue discovery to prove their claims.

Conclusion and Recommendations

Caremark claims likely remain one of the most difficult theories for plaintiffs to use to establish director liability in Delaware and the decisions that have followed do not affect that conclusion. Nevertheless, some commentators believe that decisions subsequent to *Caremark*, including *Boeing* and other recent cases, demonstrate that it has become increasingly easier for plaintiffs to survive the motion to dismiss stage with *Caremark* claims, where the court must assume the plaintiff's allegations are true and draw all reasonable inferences in favor of the plaintiff.

Still, as economic and social consequences of climate change have become increasingly hot topics, and as public figures, regulators and equity holders seek accountability from corporations, we expect climate-focused litigation to continue to increase. Climate-related Caremark claims are one way plaintiffs could attempt to take action in response to perceived inaction by boards in addressing climate-related risks.

As a result, boards should consider taking proactive steps to reduce the risk of similar claims, including reviewing the composition and culture of the board, as well as the areas where the board provides direct oversight. We recommend that boards include members with industry

knowledge or experience, as well as members who can demonstrate objectivity. Too many interrelationships between board members, for example, can make objective opinions harder to obtain. We also recommend that boards cultivate an environment where potential problems can be freely discussed and where constructive criticism is appreciated. Disagreement among directors on governance issues does not, in and of itself, establish a conflict or undermine impartiality; rather, it can enhance the overall oversight provided by the board as different viewpoints are considered. Finally, we recommend that boards review their areas of direct oversight and consider whether additional committees should be formed (or whether additional oversight responsibility should be added to existing committees) to cover any areas—including climate-related areas—that may be argued to be “essential and mission critical” in later litigation.

Additionally, boards can potentially limit the likelihood of facing a suit by adopting practices such as:

- Reviewing their public facing documents, such as board committees and charters, and evaluating whether committee mandates and reviews should be expanded to cover key risks, including climate change.
- Ensuring the board structure reflects the industry and its specific needs and risks.
- Reviewing safety issues regularly. If there is not one already in place, the board should consider creating a committee specifically tasked with this oversight. Alternatively, if a board determines that a stand-alone committee is unnecessary in light of particular facts or circumstances, then it should ensure that another committee (e.g., an audit committee) regularly receives reports from management covering these risks.
- Assessing its protocols for an environmental or personal safety issue occurring. The board should know how it will be notified and how it will follow up with management to resolve the situation and prevent a reoccurrence of the issue.
- Ensuring board and committee minutes memorialize the efforts that are being undertaken with respect to overseeing issues and demonstrate that the board and/or committees are regularly engaged in oversight and compliance programs.
- Discussing worst case scenarios frequently. By periodically hypothesizing problems and proposing potential solutions, boards can improve their ability to react quickly and effectively in the event an actual issue arises.
- Enforcing accountability whenever problems arise. When a board appears to punish wrongdoing and hold people accountable, it inspires trust and faith in the board, making it less likely for shareholders to file suit.

While *Caremark* claims might seem like an obvious course of action to address climate-risks, they are not likely to be the most successful avenue for tackling climate change. *Caremark* claims only allow for companies to recover funds themselves. They would not result in companies paying for any climate risks. As a result, when a board has taken action to insulate itself from challenges related to its oversight, the threat of *Caremark* claims is likely low.

Investors Expect Climate Action in 2022

Posted by Rodolfo Araujo, Marie Clara Buellingen, and Garrett Muzikowski, FTI Consulting, on Monday, March 21, 2022

Editor's note: Rodolfo Araujo is Senior Managing Director, Marie Clara Buellingen is Senior Director, and Garrett Muzikowski is Director at FTI Consulting. This post is based on their FTI memorandum. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); Companies Should Maximize Shareholder Welfare Not Market Value by Oliver Hart and Luigi Zingales (discussed on the Forum here); and Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee by Max M. Schanzenbach and Robert H. Sitkoff (discussed on the Forum here).

In 2021, we saw investors scaling up to hold boards accountable for ESG oversight. Now, simple reporting isn't enough — investors demand action.

From an investor's perspective, a company's directors are expected to proactively handle the governance of the corporation as well as govern risks and opportunities related to environmental and social (E&S) issues. In 2021, we saw the scales tip on holding boards accountable for oversight when it came to environmental, social and governance issues, known collectively as ESG. Such a perspective explains why directors are facing investor pressure on E&S, in particular.

This year might bring another shift of similar scale. While climate change has been a major focus since the 2016 Paris Agreement, our analysis below of shareholder proposals filed to date for 2022 indicates that investors are moving beyond climate change reporting to demanding companies set challenging, realistic, and science-based targets to reduce their greenhouse gas (GHG) emissions.

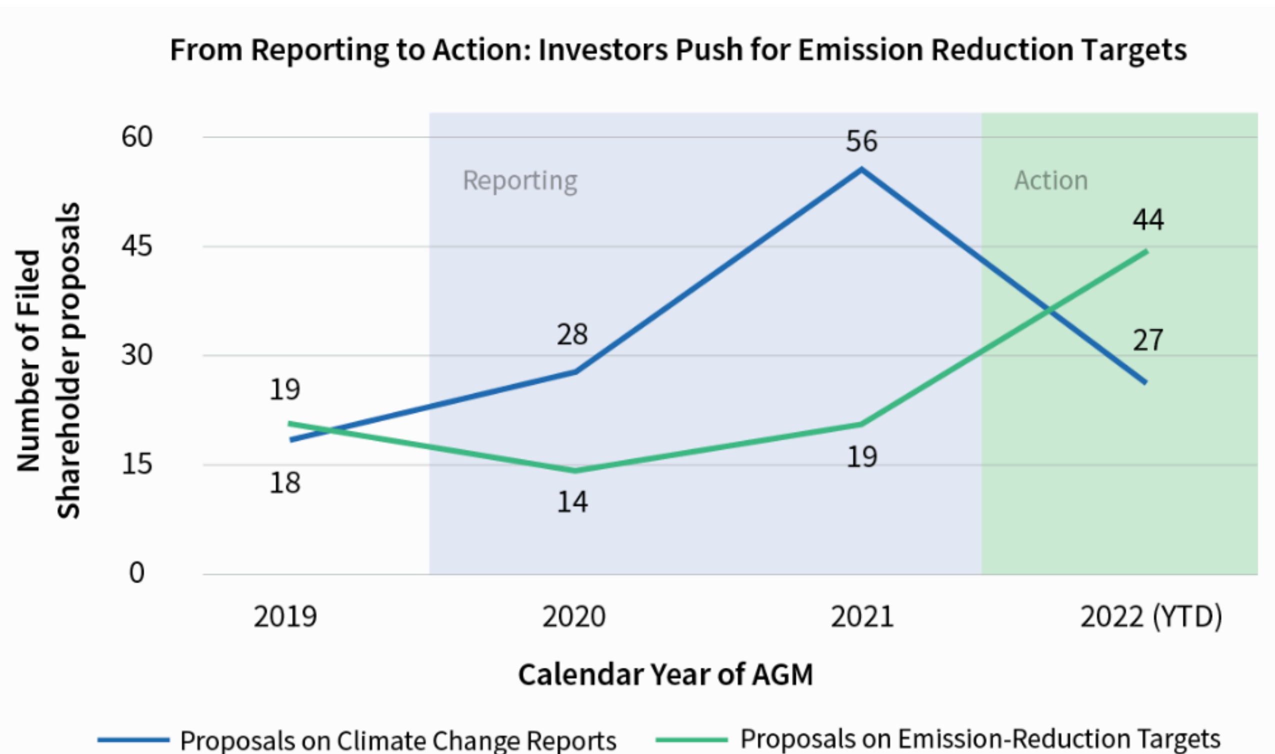
For companies, the message from investors is clear: If you simply track your emissions but do not have a credible and detailed strategy on climate risk mitigation, you are at risk of shareholder activism.

Shifting Investor Expectations on Climate Disclosure

Since 2016, investors have pushed for companies to report on climate change and its impact on the business — whether it be through an annual report, in-depth scenario analyses, or a report on specific risks. In the absence of SEC regulations, companies could exercise considerable latitude in what they would disclose with regard to climate risk. In the case of the most widely adopted framework by the Task Force on Climate-related Financial Disclosures (TCFD), this would mean reporting on the key themes: climate change governance, strategy, risk management, as well as metrics and targets. Despite a range of net-zero commitments from

companies, stringent targets were not commonly included in their disclosures. However, this is expected to change in 2022 under highly anticipated SEC requirements that will likely incorporate core TCFD tenants.

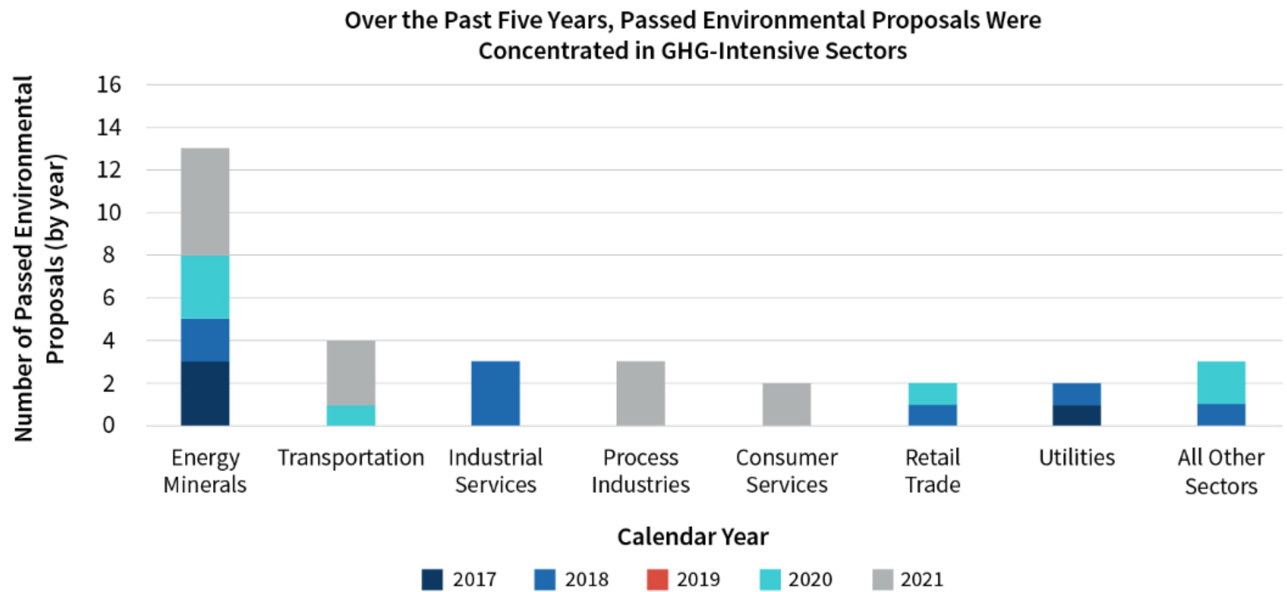
An early look at proposals filed so far for the upcoming 2022 annual meetings indicates a large shift in investor expectations. While they may have been satisfied with general emissions disclosures last year, the 2022 proposals suggest a greater push for quantitative metrics that can inform decision-making, as well as emission-reduction targets for Scope 1-3 emissions.



**2019 to 2021 data reflect proposals filed at annual meetings during that calendar year. 2022 data only reflect proposals filed as of February 15, 2022, for annual meetings occurring in 2022. As a result, 2022 numbers may increase as more proposals are filed. Source: ISS Analytics*

It remains to be seen how many of these proposals will be omitted or withdrawn. However, the new SEC guidance may lead to fewer omissions. The deepening culture around shareholder engagement may also result in additional withdrawals after successful engagement between issuers and shareholders.

While climate risk is spread out across sectors, a company's role in the transition to a low-carbon economy can vary. Case in point, environmental proposals in GHG-intensive sectors generally have the highest chances of passing.



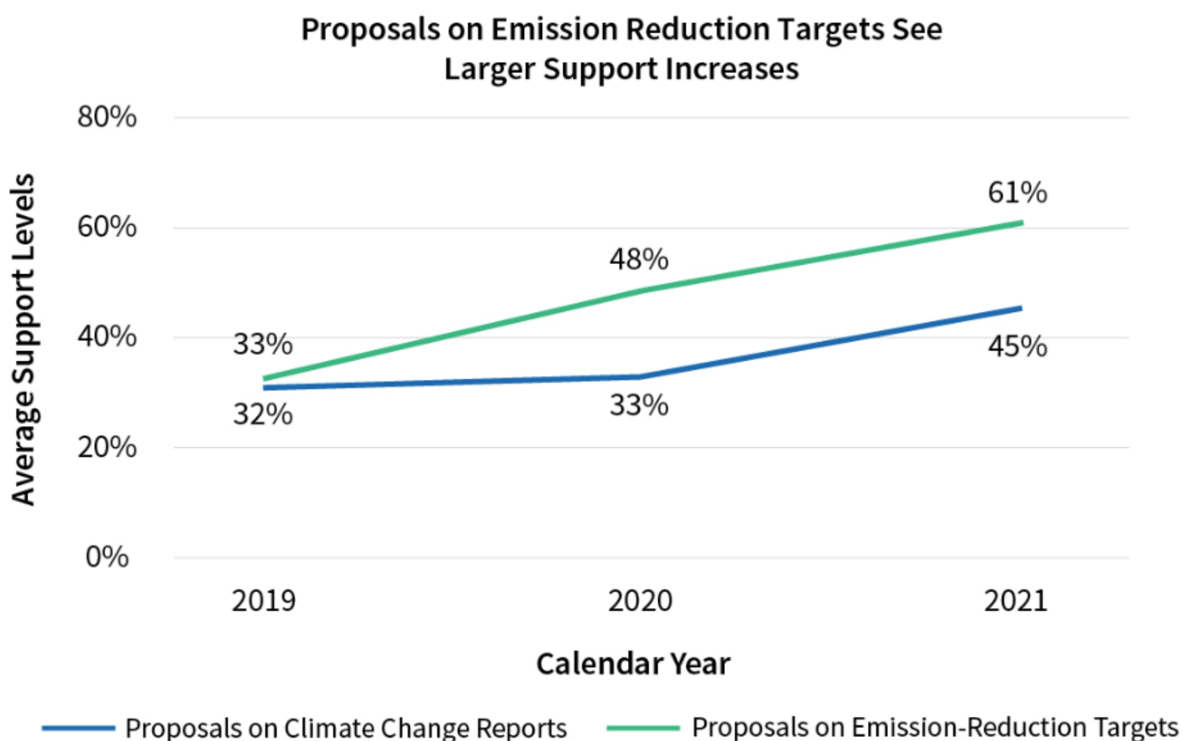
**While many environmental shareholder proposals received significant support in 2019, none of the shareholder proposals that made it to the ballot passed. Source: ISS Analytics*

Changing Regulatory Environment on Climate Disclosure

This shift is happening against the backdrop of anticipated regulatory changes that will require mandatory climate risk reporting. SEC Chair Gary Gensler emphasized in mid-February the importance of *"requiring companies to assess climate risks & collect & publicly disclose relevant metrics for the first time & giving investors info they've needed for years."*

A significant sticking point will be whether companies will be required to not only report on GHG emissions within their direct control (Scope 1 and 2 emissions), but also on emissions resulting from their products and services (Scope 3 emissions). Depending on where a company operates, it may already be required to disclose Scope 1-3 emissions, as is the case under California's Climate Corporate Accountability Act (CCAA) for companies with over $1 billion in revenue.

In addition, the SEC issued a Staff Guidance in November that makes it harder for companies to exclude certain shareholder proposals. This guidance change will likely result in more ESG-related shareholder proposals in general — and in more proposals related to climate change, specifically — making it to the ballot and going to a vote. Companies should take notice: Proposals that make it to a vote are increasingly likely to pass.



Source: ISS Analytics

Companies Need More Than an ESG Strategy

Investors increasingly expect companies to adhere to the gold standard of emission-reduction goals as set out by the Science Based Targets initiative (SBTi). These expectations will likely apply to organizations that have already made a net-zero commitment and morph into broader market expectations for all portfolio companies. Businesses that have recently elevated their climate change disclosures should nevertheless assess current disclosures to make sure they meet evolving market expectations this year and beyond.

Consider Costco's January 2022 annual general meeting (AGM), which provided early insights into how investors have sharpened their focus on emission-reduction targets beyond programmatic reporting on climate action. A shareholder proposal submitted by Green Century Capital Management featured a resolved clause that states, *"Shareholders request that Costco adopt short, medium, and long-term science-based greenhouse gas emissions reduction targets, inclusive of emissions from its full value chain, in order to achieve net-zero emissions by 2050 or sooner and to effectuate appropriate emissions reductions prior to 2030."* The proposal passed with an overwhelming 70% of shareholder support. Such a level of approval would not be possible without broad market support, particularly from large institutional investors. The lack of challenging reduction targets aligned to the SBTi likely drove Costco's shareholders to approve Green Century's proposal.

> A whopping 70% support for emission-reduction targets at the 2022 Costco AGM suggests a detailed “Climate Action Plan” may not be enough.

In comparison, after facing a climate-related proposal from veteran ESG-player Trillium Asset Management in 2021, Costco was able to meet shareholder expectations by releasing a 10-part climate action plan. It includes metrics such as Scope 1 and 2 emissions, along with concrete steps on how the company plans to reduce emissions. Despite a lack of science-based targets, Costco’s action plan seemed to satisfy Trillium, which withdrew its climate proposal after the plan was released.

Investors Want to See Companies Walk the Talk

At the onset of the 2022 proxy season, climate action appeared to be the top ESG priority. To prevent shareholder dissent, companies should proactively set quantifiable emission-reduction targets or, at a minimum, communicate to shareholders when they will be able to set such targets. Climate risk should be a priority for all companies, but that should not minimize the importance of other ESG topics, as shareholders will continue to hold directors accountable for the broader governance of environmental and social issues.

> A message for boards and management: Use quantifiable emission-reduction targets to demonstrate proactive management of climate risks and opportunities now.

Large institutional investors’ focus on improving ESG management has offered a platform for traditional activists to advocate for board refreshment. Engine No. 1’s successful 2021 campaign at ExxonMobil is a high-profile example related to climate risk. Carl Icahn’s proxy fight at McDonald’s — accusing the company of inhumane pork sourcing practices — is another recent example that will play out in the 2022 proxy season.

Such ESG-focused proxy fights may become more common in the future. As universal proxy is implemented for AGMs taking place after August 31 this year, it will become cheaper for dissident shareholders to nominate directors. If ESG activism campaigns continue to receive significant shareholder support, the nomination of directors may also become an attractive tool for smaller, responsibly focused investors to push their agendas.

Together, universal proxy and evolving investor expectations only further heighten the importance of strong governance of E&S issues. With climate change as a case in point, 2022 is shaping up to be the year where investors want to see corporate action behind ESG commitments.

BlackRock's 2022 Engagement Priorities

Posted by Breanne Dougherty, Victoria Gaytan, and Hilary Novik-Sandberg, BlackRock Investment Stewardship, on Monday, March 28, 2022

Editor's note: Michelle Edkins is Managing Director of BlackRock Investment Stewardship. This post is based on a BlackRock Investment Stewardship memorandum by Ms. Edkins, Breanne Dougherty, Victoria Gaytan, and Hilary Novik-Sandberg.

Incentives aligned with value creation

Full commentary available here

Compensation is an important tool to drive long-term value creation by incentivizing and rewarding executives for the successful delivery of strategic goals and financial outperformance against peers.[1] However, when compensation policies are not appropriately structured, and when outcomes are misaligned with performance, companies may face business and/or reputational risks.

We believe companies benefit from disclosing how their compensation policies and outcomes are consistent with the economic interests of long-term shareholders.

BIS looks to a company's board of directors—specifically its relevant committee—to put in place a compensation policy that incentivizes and rewards executives against appropriate, rigorous, and stretching goals tied to relevant strategic metrics, especially those measuring operational and financial performance. BIS also looks to compensation plans to appropriately balance retention-oriented awards with performance-oriented awards in light of the company's and each executive's circumstances.

Executive compensation outcomes are increasingly assessed in the context of the impacts a company has had on key stakeholders over the relevant period.[2] BIS believes that accounting for the interests of key stakeholders in compensation policies recognizes the collective nature of long-term value creation, and the extent to which each company's prospects for growth are tied to an ability to foster strong relationships with and support from those key stakeholders. To aid understanding, companies may consider disclosing how pay outcomes are consistent with their talent strategy and purpose. Such disclosure might discuss how they have considered the interests of their full range of stakeholders when reviewing and approving executive incentive plans and payments.

BIS believes the board should determine the appropriate performance metrics to use in incentive plans, including whether to use sustainability-related criteria. Where companies choose to use sustainability metrics, they should: 1) address issues that are material to the company's business model; 2) be aligned with the company's long-term strategic priorities; and 3) have the same rigor as with other financial or operational targets. Company disclosures can help investors understand the connection between what is being measured and rewarded and the company's strategic priorities. Otherwise, companies may be vulnerable to reputational risks and/or their sustainability efforts may be discredited.

- **KPI—***BIS looks to companies to disclose incentives that are aligned with long-term value creation and sustained financial performance, underpinned by material and rigorous metrics that align with the company's long-term strategic goals.*

Climate and natural capital

Full climate risk commentary available here, full natural capital commentary available *here*

BlackRock's approach to climate risk and opportunities and the global energy transition is based on our fundamental role as a fiduciary to our clients.

As the world works toward a transition to a low-carbon economy, we are interested in hearing from companies our clients are invested in about their strategies and plans for responding to the challenges and capturing the opportunities this transition creates.

As we are long-term investors on behalf of our clients, how well companies navigate and adapt through the transition will have a direct impact on our clients' investment outcomes and financial well-being.[3]

As explained in our Global Principles, climate change has become a critical factor in companies' long-term profitability. **We look to company leadership to disclose to investors how climate risks and opportunities might impact their business, and how these factors are addressed in the context of a company's business model and sector. Specifically, investors have greater clarity—and ability to assess risk—when companies detail how their business model aligns to scenarios for the global economy that limit temperature rise to well below 2°C, moving toward net zero emissions by 2050.**

We recognize that the energy transition will not happen overnight, and that it is already uneven. However, companies that seek to mitigate risks and capture opportunities will be in a stronger position to drive long-term value. A growing number of companies, institutions, as well as governments, have already stated their net zero ambitions, and there is growing consensus that an orderly, just transition[4] to net zero will benefit companies and the economy, which will benefit our clients.[5] Many companies are determining what their role should be in navigating the energy transition and the transformation of how the world produces and uses energy, moves goods and people, and constructs the built environment. They are also controlling for different public policy paths as countries aim to align greenhouse gas (GHG) emissions with their national commitments.

In this context, we seek to understand companies' plans for how they intend to deliver long-term financial performance through the energy transition, consistent with

[3] In the commentary, we make frequent reference to terminology pertaining to the transition to a low carbon economy. The Intergovernmental Panel on Climate Change provides a helpful glossary for this terminology.

[4] The Paris Agreement notes that efforts to transition to a low carbon economy need to take "…into account the imperatives of a just transition of the workforce and the creation of decent work and quality jobs in accordance with nationally defined development priorities". See: https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement.

[5] For example, BlackRock's Capital Markets Assumptions anticipate 25 points of cumulative economic gains over a 20-year period in an orderly transition as compared to the alternative. This better macro environment will support better economic growth, financial stability, job growth, productivity, as well as ecosystem stability and health outcomes.

their business model, sector and geography. We look for companies to demonstrate they have strategies in place that address and are resilient to a range of scenarios, including likely decarbonization pathways well below 2°C, as well as global ambitions to limit temperature rise to 1.5°C.[6] We also encourage companies to disclose how considerations related to having a reliable energy supply and just transition affect their plans.

We are better able to assess the long-term performance of our clients' investments, when companies define short-, medium-, and long-term[7] science-based emissions targets, where available for their sector, and disclose how these targets will affect the long-term economic interests of shareholders. In some sectors, companies may have an opportunity to highlight strategies to develop alternative energy sources and technologies that can create value while contributing to an orderly transition. We recognize that it will take time to retool the capital-intensive industries that provide critical services to global economy, and we maintain that carbon-intensive companies have a crucial role to play in an orderly transition. Continued investment is also required to maintain a reliable, affordable supply of fossil fuels during the transition. As long-term investors, it is easier for us to assess risk and opportunity for our clients when companies disclose how capital allocation across alternatives, transition technologies, and fossil fuel production is consistent with their business strategy and their emissions reduction targets.

At BlackRock, we expect to remain long-term investors in carbon-intensive sectors because these companies play crucial roles in the economy and in an orderly energy transition. We have some clients who avoid such investments and others who take an alternative approach. Recognizing the range of client preferences, we realize the careful balance between risk and opportunity is particularly important for traditional energy companies—as well as those companies that largely rely on carbon-intensive fuels for their operations, such as heavy industrials and utilities.

As outlined in BIS' market-specific voting guidelines (and in more detail in the full commentary), where corporate disclosures are not adequately aligned with the pillars of the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)—governance, strategy, and risk management—or a company has not provided scope 1 and 2 emissions disclosures and meaningful short-, medium-, and long-term targets, we are unlikely to support director(s) considered responsible for climate risk oversight. We may also support, on a case-by-case basis, shareholder or management proposals that we conclude strengthen a company's approach to climate risk and the energy transition.

At this stage, we view scope 3 emissions differently from scope 1 and 2, given methodological complexity, regulatory uncertainty, concerns about double-counting, and lack of direct control by companies. **While we encourage companies to disclose their scope 3 emissions and**

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[6] The global aspiration is reflective of aggregated efforts; companies in developed and emerging markets are not equally equipped to transition their business and reduce emissions at the same rate—those in developed markets with the largest market capitalization are better positioned to adapt their business models at an accelerated pace. Government policy and regional targets may be reflective of these realities.

[7] BIS generally considers short-, medium-, and long-term targets to be a range of years, such as 0-5, 5-10, and 10+ years. Our goal is not to set finite timelines, but to understand how companies consider emissions reduction efforts over the years as they transition toward net zero. Consistent with guidance from TCFD, specifying exact timeframes across sectors could hinder organizations' consideration of climate-related risks and opportunities specific to their businesses. We encourage companies to decide how to define their own timeframes according to the life of their assets, the profile of the climate-related risks they face, and the sectors and geographies in which they operate.

targets where material to their business model, we do not consider such scope 3 disclosures and commitments essential to our support for directors.

As companies consider climate-related risks, it is likely that they will also assess their impact and dependence on natural capital, i.e., the supply of the world's natural resources from which economic value and benefits can be derived. Businesses which impact or depend on natural capital are expected to experience increased financial risks and opportunities as ecosystems come under stress**. As a result, we view the careful management of natural capital as a core component of a resilient long-term corporate strategy for companies that rely on the benefits that nature provides.**

While recognizing that natural capital is a complex issue and ecosystems are interconnected, for the purposes of our work we focus on three key areas—biodiversity, deforestation and water—which we believe can impact the long-term financial returns of some companies. **As long-term investors, we encourage companies to disclose how they have adopted or plan to incorporate business practices consistent with the sustainable use and management of natural capital, including resources such as clean air, water, land, minerals and forests.** We are also interested to hear from companies how they contribute to biodiversity and ecosystem health and consider their broader impact on the communities in which they operate.[8] In our view, the forthcoming recommendations of the Task Force on Nature-related Financial Disclosures will be a valuable resource for companies in their reporting.[9]

Investors' expectations of companies in relation to how they manage their dependencies and impacts on natural capital are growing, given the increasing fragility of the natural resources many depend on in their businesses. BIS will continue to engage with companies to better understand their approach to, and oversight of, the natural capital that underpins their long-term strategy.

- **Climate KPI—***We encourage companies to discuss in their reporting how their business model is aligned to a scenario in which global warming is limited to well below 2°C, moving towards global net zero emissions by 2050.[10] Companies help investors understand their approach when they provide disclosures aligned with the four pillars of the TCFD—including scope 1 and 2 emissions, along with short-, medium-, and long-term[11] science-based reduction targets, where available for their sector.*
- **Natural Capital KPI—***We look to companies to disclose detailed information on their approach to managing material natural capital-related business risks and opportunities, including how their business models are consistent with the sustainable use and*

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[8] Our Global Principles underscore our belief that in order to deliver value for shareholders, companies benefit from also considering their other key stakeholders. As described in our commentary on Our approach to engaging companies on their human rights impacts, we ask companies to implement processes to identify, manage and prevent adverse human rights impacts that are material to their business, and provide robust disclosures on these practices.

[9] The Taskforce on Nature-related Financial Disclosures aims to deliver a risk management and disclosure framework for organizations to report and act on nature-related risks. See: https://tnfd.global/.

[10] Our reference to "net zero" refers to "net zero GHG" emission rather than "net zero carbon dioxide" emissions. We are aware that the goal for a net zero GHG economy is technically more ambitious than the current pathways outlined for a 1.5-degree scenario. However, our ambitious focus highlights the urgency of action in order to maintain the opportunity to achieve this goal. In scenarios limiting warming to 1.5 degrees C, carbon dioxide (CO2) needs to reach net-zero between 2044 and 2052, and total GHG emissions must reach net-zero between 2063 and 2068. Reaching net zero earlier in the range avoids a risk of temporarily overshooting 1.5 degrees C. https://www.wri.org/insights/net-zero-ghg-emissions-questions-answered

[11] See Endnote 7

management of natural resources such as air, water, land, minerals and forests. To support investors' assessments, it is helpful for companies with material dependencies or impacts on natural habitats to disclose how they measure their progress on key issues such as water conservation, reforestation, and pollution control. This may include a discussion of efforts to improve efficiency, minimize and mitigate negative impacts and track positive impacts.

Engaging with Vanguard

Posted by Allie Rutherford, PJT Camberview, on Friday, May 13, 2022

Editor's note: This post is an interview of John Galloway, Principal and Global Head of Investment Stewardship at Vanguard, by Allie Rutherford, Managing Director at PJT Camberview.

Related research from the Program on Corporate Governance includes The Agency Problems of Institutional Investors by Lucian Bebchuk, Alma Cohen, and Scott Hirst (discussed on the Forum here); Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy by Lucian Bebchuk and Scott Hirst (discussed on the forum here); The Specter of the Giant Three by Lucian Bebchuk and Scott Hirst (discussed on the Forum here); and The Limits of Portfolio Primacy by Roberto Tallarita (discussed on the Forum here).

Board Composition and Effectiveness

Allie: You have said that boards are central to how Vanguard thinks about governance. How do you assess board quality?

John: Board composition and effectiveness is where we spend a significant amount of our time because it informs everything. It is also an evolving area where we are seeing demands and expectations on directors continue to increase. We are very aware that it is challenging for Vanguard to assess the composition and effectiveness of any board given that we operate, by design, at a distance. We start with a study of the backgrounds and experiences evident on the board, but in some ways, that is like reading a collection of resumes. You can see that they have *x, y, and z* experiences, but you may not know how strong that experience is, or how relevant it is in the context of the company's needs and opportunities.

This is where good disclosure and effective engagement matters; both disclosure and engagements inform our understanding of how the board itself thinks of its role acting on behalf of shareholders. We regularly ask boards about what skills, experiences, and characteristics they need, about their view on the right mix of director perspectives and how the board's meetings, committees, and processes ensure directors' perspectives add value to the company. Directors and management teams can share this information with us in engagements, but they should also make progress to weave it into their disclosures.

We expect directors to be able to speak candidly (and credibly) about the board's independent oversight. In the case of compensation plans, for example, we have concerns when we hear directors rely heavily on compensation consultants as the rationale for plan design. Similarly, we have concerns if a director defers to company management when asked to discuss the board's role in risk oversight. We do not expect that a board will have an adversarial relationship with the CEO or company management, but we do expect they will demonstrate their independence, bring in external perspectives, and evidence their due diligence on material risks to shareholder value.

On a topic like cybersecurity, we do not believe that every board needs a cyber expert per se. But we would expect boards to ensure they have access to the appropriate external expertise so that they can develop an understanding of the topic and provide appropriate, independent oversight. This is an area where we are actively engaging with companies and asking them to disclose how their board is addressing any gaps in skills or expertise related to cyber (as we do with other material risks).

Allie: Does this board assessment change in an activist situation where it can be hard to assess the strengths of directors simply through their bios and other disclosures? Are you applying a new thinking on this in what we expect will be a relatively activism-heavy proxy season?

John: This is an area where we spend a lot of time and focus. Some of the more high-profile proxy fights we saw last year were enormously time-intensive and required significant research and many engagements from Vanguard with both the company and dissidents. That said, it is tremendously helpful to have that depth of engagement with various directors. I would expect that companies will want to make board members/nominees more available to speak to investors, in part because the activists are making their director nominees available to engage.

It is very important for us to hear not only from the activist investors regarding their case for change, but from companies too. Our analysis of each proxy contest is grounded in an assessment of the clarity of the company's response to an activist's argument for change, and that includes the company's explanation of why their nominees are the best candidates to promote and protect shareholder value. This is one of the areas that we are keeping an eye on, anticipating that activist and company behaviors may change as universal proxy takes effect later this year.

Executive Compensation

Allie: Given how many of Vanguard's engagement conversations focus on executive compensation in the proxy season, can you share what concerns or red flags you expect to focus on?

John: First, we really want to understand the board's role in overseeing and executing the compensation program. Second, we want to hear about the board's role in using discretion for pandemic-related adjustments. We were very understanding and flexible in the first two years of the pandemic, but where there is a departure of the executives' experience compared to shareholders, we need to better understand that logic. Third, we know that some companies have gotten the impression that they need ESG metrics in their plans. To be clear, we are not asking for this. If companies believe ESG metrics are appropriate to align executive compensation with shareholder value, we ask that these metrics be measurable, clearly disclosed, and not detract from the alignment of the executive's goals and long-term shareholder value. Our view is that when these metrics are poorly constructed, they can be a boon to pay without any impact on shareholder value over time.

Environmental and Social Shareholder Proposals

Allie: With the myriad of Environmental and Social-related shareholder proposals going to vote this proxy season, and a number already passing, what can you share about how Vanguard will be evaluating proposals that address novel topics?

John: We are increasingly asking or encouraging companies to be more forthcoming and clear when there is a proposal that they do not believe is in the interests of shareholders. We have seen some companies rely on language in no-action requests or in proxy statements stating that

a proposal is not necessary or is duplicative. What sometimes seems left unsaid are any reasons that the company believes the proposal would not create, or could put at risk, shareholder value.

Vanguard's sole focus is on long-term shareholder value. We have no other objectives. We know that inattentiveness to certain environmental and social issues creates risk to long-term shareholder value. There are many cases where we determine that shareholder proposals address material risks or mitigation of risks, and therefore, we support them. In any case, if a company recommends against supporting a shareholder proposal, we expect the company will explain why the proposal is not in the interests of long-term shareholders.

Other investors, and certain shareholder activists, may take a different approach and some companies will face pressure to take action. From Vanguard's perspective, if a company's board believes that tackling an 'E' or 'S' issue is not appropriate or in the best interests of shareholders, we want to know so that we can take their perspective into account as we do our case-by-case analysis.

Allie: Proposals seeking civil rights or racial equity audits are prevalent this year. What is Vanguard's view on these proposals?

John: We are very clear that when it comes to civil rights, discrimination, and racial equity, there are opportunities and risks to companies ranging from potential consequences for employee attraction and retention, to consumer demand, to potential regulatory and litigation challenges. If a company is not being attentive to diversity, equity and inclusion matters, we believe that there are associated risks. We are looking closely at the facts and circumstances at each company that receives a civil rights or racial equity audit proposal. The level of prescription in these proposals is something we also take into account in our assessment.

On the one hand, if we believe there are unmanaged risks related to civil rights or racial equity, it would be appropriate for shareholders to address those concerns with the board. On the other hand, we are not sure that in every instance investors are in a position to determine that a third-party audit is the right path for a company to take. What we ask companies to help us assess is 'is there a material risk?' and 'what steps are you taking to address any risks?' If a company and its board believes that the right answer to address its risks is to conduct an audit, we would be comfortable with that. If the company believes an audit is not the right answer, we look to understand their rationale as well as the case made by the shareholder proponent.

We observe that the examples of audits that proponents point to as successful examples relate to situations where a company's risk had already materialized and where the audit was a helpful remedy because the company and board credibility on the topic was limited. We are not as clear on whether the same remedy applies as a proactive prescription for companies where the risks are not materialized and where the board and management do not support the audit approach. Again, it is important to note that Vanguard's approach to all shareholder proposals is a case-by-case assessment of what we believe is in the interest of long-term shareholder value at the company in question. We are not looking to prescribe particular actions across our portfolio companies.

Harvard Law School Forum on Corporate Governance

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War in Ukraine: Is ESG at a Crossroads?

Posted by Adam O. Emmerich, Wachtell, Lipton, Rosen & Katz, on Thursday, March 24, 2022

Editor's note: Adam O. Emmerich is partner at Wachtell, Lipton, Rosen & Katz. The following post is based on a Wachtell Lipton memorandum by Mr. Emmerich, David M. Silk, Sabastian V. Niles, and Carmen X. W. Lu. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver Value to All Stakeholders?, both by Lucian A. Bebchuk and Roberto Tallarita; Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock by Leo E. Strine, Jr. (discussed on the Forum here); Stakeholder Capitalism in the Time of COVID, by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); and Corporate Purpose and Corporate Competition (discussed on the Forum here) by Mark J. Roe.

As the world reels from Russia's assault on Ukraine, whither ESG? Western companies have taken unprecedented steps to exit their interests in Russia. Those who have hesitated have faced significant public pressure to take action and have been hit with severe reputational costs. Meanwhile, the spike in global energy prices has led some to speculate whether climate change priorities should take a back seat to the need to address immediate energy shortages and supply dependencies.

While the full economic and political repercussions from the past three weeks continue to unfold, there are some immediate lessons for boards and management:

1. Value and values can and do intersect. While ESG investing is fundamentally about generating long-term financial value and protecting against downside risks to value, the past few weeks have prompted unprecedented support for the liberal international order, the rule of law, democracy and human rights. The global reaction to Russia's war in Ukraine has become a key test of whether companies are living up to their proclaimed purpose and values—including the implicit expectation that they will respect and seek to uphold the norms that have allowed free enterprise to flourish. As we have increasingly seen in recent years, in moments of global and national crisis or controversy, large public companies, particularly household names, do not have the option to sit on the sidelines. Stakeholders are keeping score via social media and leaving a long digital trail, as demonstrated by Yale professor Jeffrey Sonnenfeld's list of corporate activity in Russia.

2. Black swan events in a globalized world will amplify risks to new heights and may demand a new risk management playbook. Russia's invasion of Ukraine is the second major unexpected global shock in as many years, alongside inflationary-related pressures. As already illustrated by the Covid-19 pandemic, today's flat digital economy means that high-impact events will inevitably have global ramifications. In the weeks following Russia's invasion, we have seen the tightening of global supply chains, with countries facing wheat and oil shortages, shortages in minerals and commodities, a halt to Black Sea shipping, and the stranding of a significant portion

of global air freight capacity in Russia. Like the Covid-19 pandemic, early detection and a quick response has proven critical in mitigating losses. The events of the past three weeks are a unique reminder for companies to re-evaluate the resilience of their risk management strategy and their ability to respond to emerging risks.

3. Geopolitical risks are roaring back. The relative peace of the post-Cold War era and the unprecedented expansion in global trade in recent decades have masked the growing geopolitical tensions that have emerged in recent years. The rise of populist and autocratic regimes across the globe and growing competition for resources, technology and talent will continue to test the risk appetite of Western companies seeking opportunities abroad. The sheer number of Western companies that have exited or suspended operations in Russia underscores the fact that there may not be safety in numbers. Companies need to weigh the risks of being caught in the crossfire of geopolitical tensions in addition to the risk of operating in countries where weak rule of law, human rights abuses and autocratic governments impose a de facto financial and reputational tax on doing business. As war in Ukraine redraws the geopolitical landscape in Europe and threatens to erect new barriers between the West and the rest, companies need to carefully consider the risks of all of their global activities.

4. ESG has and will continue to evolve. In the last few days, many have decried the inconsistencies in ESG investing, noting in particular whether carbon reduction initiatives in Europe are inconsistent with correcting a perilous reliance on Russian oil and gas and whether U.S. (and other global) energy companies should be doing more—and given the capital and license to do more—to address energy shortfalls while responsibly navigating the energy transition. However, it is premature to proclaim that the end of ESG is nigh. ESG investing has evolved, from exclusionary screens to today's increasingly sophisticated use of data and proprietary modeling that continue to capture new risks and opportunities. The war in Ukraine provides another series of important lessons and data points and underscores the need for a non-disruptive transition to a low carbon world—a view already shared by major investors.

5. The focus for ESG is still on delivering long-term value. While Ukraine has captured global headlines, we have also been reminded by the latest UN IPCC report that climate change, if unaddressed, will trigger a humanitarian crisis on an unprecedented scale and lead to trillions of dollars in losses. From an ESG perspective, a company's performance is still being measured in returns delivered over decades and not days. As such, the immediate actions necessary to mitigate losses from catastrophic events, including the war in Ukraine and the Covid-19 pandemic, should be distinguished from the steps that are necessary to preserve a company's long-term value.

It is difficult if not impossible today to predict the course of either the ongoing Covid-19 pandemic or the war in Ukraine, or to identify the next global or regional crisis that will impact our companies, markets and society. Having robust and resilient risk management teams and processes, including scenario planning and exercises that inform adjustments to corporate strategies and capital expenditures, with committed leadership from boards and senior management, provides a critical bulwark against the constancy of change.

Five Questions Boards Should Ask About the War in Ukraine

Posted by Matteo Tonello, The Conference Board, Inc., on Tuesday, April 5, 2022

Editor's note: Matteo Tonello is Managing Director of ESG Research at The Conference Board, Inc. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver Value to All Stakeholders?, both by Lucian A. Bebchuk and Roberto Tallarita; and For Whom Corporate Leaders Bargain (discussed on the Forum here) and Stakeholder Capitalism in the Time of COVID, both by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here).

While still recovering from the disruptions of the global pandemic, many companies find themselves grappling with a new and, for the most part, unanticipated emergency. Russia's invasion of Ukraine requires business leaders to remain in crisis-management mode. Many commentators suggest that what we are witnessing is only the beginning of a new, precarious period of reconfiguration of the world order, with unclear economic and political implications. Whether or not it is true, at this stage of the crisis the main role of the board is to exercise oversight by asking probing questions to ensure the company is planning for multiple scenarios, reducing uncertainty, and adapting its business strategy.

The following are five key probing questions board members should consider posing.

1) What is the business impact of the war?

Directors should ask for management's view of the immediate business impact of the invasion, including macro concerns such as rising inflation and impaired economic growth, as well as more specific issues pertaining to the safety of employees in the region, the resilience of supply chains, and legal or compliance issues regarding terminated or defaulted contracts with customers or suppliers in Russia or Ukraine. Special attention must be paid to the impact of measures swiftly introduced by many governments, including the US, to sanction Russian banks, state-owned enterprises, and oligarchs and to control exports from Russia. These measures are meant to impair the country's economic growth by "isolating it from the global financial system" and by curtailing "its access to cutting-edge technology."[1]

In an interconnected global economy, however, sanctions also have unintended consequences on US businesses operating in Russia or relying on Russian suppliers. In fact, either because of the sanctions or because they have decided to avoid the reputation risks of their continued presence in the country, hundreds of public companies—from the financial services to the

[1] Joined by Allies and Partners, The United States Imposes Devastating Costs on Russia, US White House, Press Release, February 24, 2022.

consumer discretionary sectors—have announced their decision to suspend business operations in Russia or halt relationships with Russian suppliers.[2] For many Western firms, what was an enticing emerging market at the end of the Cold War may have suddenly become a major balance sheet liability. The boards of companies with an exposure to Russia should request periodic reports from management on the magnitude of this situation and work with the senior leadership on the appropriate mitigation strategy.

2) Does the company have (direct access to) expertise in geopolitical risk?

This crisis highlights the major repercussions that geopolitical events may have on the company's ability to execute its business strategy. The effects could be felt for years to come, as governments revisit their industrial policy to promote self-sufficiency in strategic sectors. The board and the C-suite need to appreciate these complex evolving scenarios not only to identify emerging policy risks but also to capture potential opportunities in a highly volatile environment. In these unprecedented circumstances—amid high inflation, supply chain disruptions, and the possible ripple effects of a Russian default on the US and global financial markets[3]—even those public companies that do not have multinational operations may want to consider seeking outside geopolitical advice. Our research shows that only a small fraction of the director population (which includes CEOs) in the US have international experience, and that their number has in fact declined in recent years.[4] As boards and C-suites continue to refresh their composition and diversify their skillset, they should consider the importance of recruiting individuals who have been exposed to the specific challenges of running multinational business operations.

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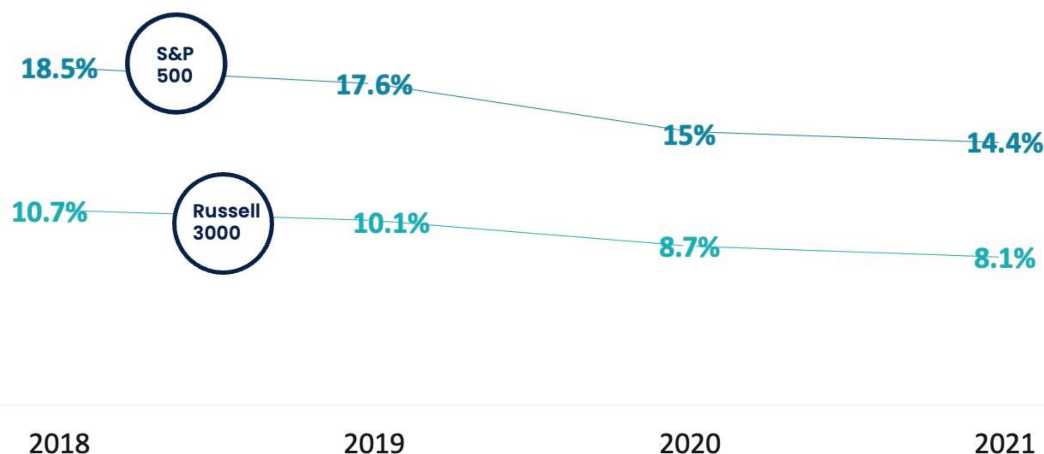
[2] See the list maintained by the Yale School of Management and based on public statements made by companies. For guidance to companies facing a similar decision, see Paul Washington and Merel Spierings, Cutting Ties with Russia: A Guide to Decision-Making Now and in the Future, The Conference Board, March 8, 2022; and Denise Dahlhoff, Six Steps to Guiding Corporate Reputation While Responding to the Crisis in Ukraine, The Conference Board, March 8, 2022.

[3] See Dana M. Peterson et al., Will the War in Ukraine Lead to Recession?, The Conference Board, March 08, 2022.

[4] For up-to-date figures on director qualifications and skills, see the online dashboard on Corporate Board Practices in the Russell 3000, the S&P 500 and S&P MidCap 400, published by The Conference Board and ESG analytics firm ESGAUGE. Also see Paul Washington and Merel Spierings, Governance During a Geopolitical Crisis, *Chief Executive*, March 3, 2022.



3) Is the company prepared for heightened cybersecurity threats?

Though experts have been warning business leaders about cybersecurity threats from Russia for years, the matter has become much more urgent since the onset of the Ukrainian war.[5] The concern is that ransomware actors could aim not only at strategic economic sectors—including energy, transportation, technology, and financial companies—but also target, more opportunistically, a variety of businesses large and small to erode citizens' confidence in the ability of their government to guarantee their safety.[6] This warning may catch many corporate boards unprepared to provide the appropriate risk oversight, as 64 percent of executives recently surveyed by The Conference Board and PwC believe that their board has a fair or poor understanding of cybersecurity.[7] In the words of CISA, the US Cybersecurity and Infrastructure Security Agency, board members and senior management must recognize the present danger and ensure their organizations adopt a "heightened security posture."[8] In practice, it means: (1) Ensuring a Chief Information Security Officer is involved in key risk management discussions at the company; (2) Lowering reporting thresholds regarding suspicious cyber activity; (3) Ensuring the company periodically tests its response plans while involving not only IT and security staff but also senior executives, board members, and other key employees; and (4) Envisioning worst-case scenarios and seeking assurance that the response plan will ensure the continuity of critical business functions if an attack takes place. Cybersecurity is poised to become a recurring board

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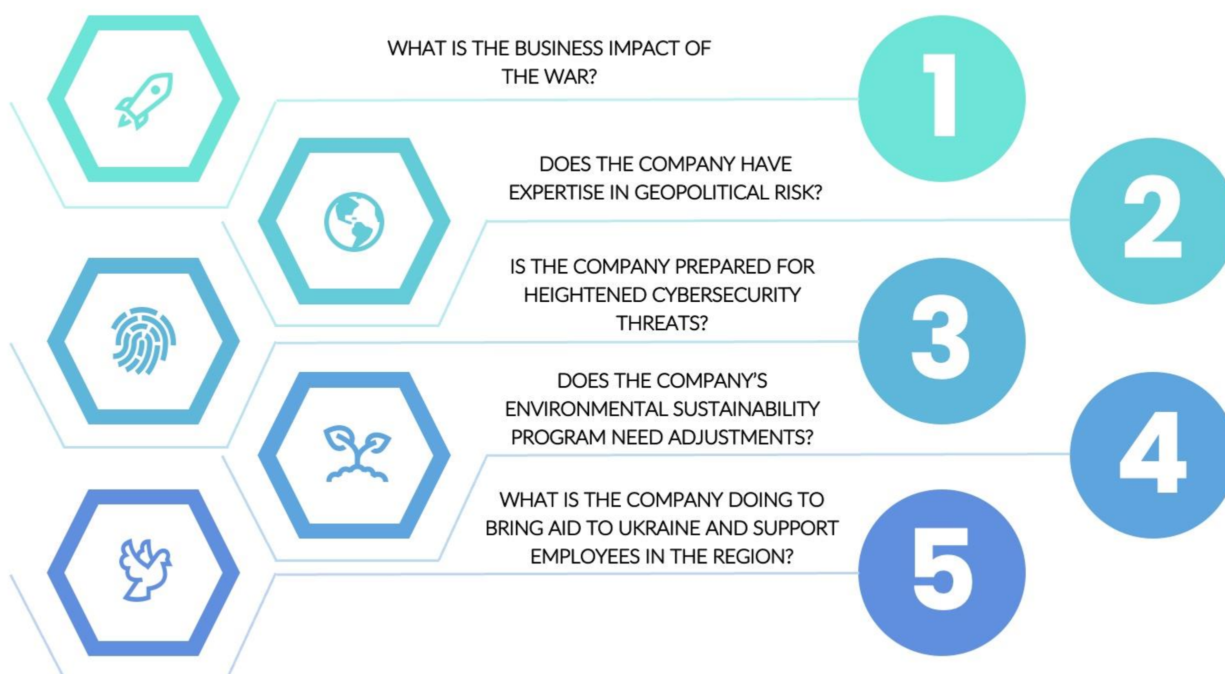
[5] CISA and FBI Publish Advisory to Protect Organizations from Destructive Malware, US Cybersecurity and Infrastructure Security Agency (CISA), February 26, 2022.

[6] Michael L. Gross et al., Cyberterrorism: Its Effects on Psychological Well Being, Public Confidence and Political Attitudes, *Journal of Cybersecurity*, Vol. 3, Issue 1, March 2017, pp. 49-58.

[7] 2021 Board Effectiveness: A Survey of the C-Suite, PwC/The Conference Board, November 2021.

[8] Shields Up: 5 Urgent Cybersecurity Actions for Executives, CISA, February 25, 2022.

agenda item, as confirmed by the newly proposed rules by the US Securities and Exchange Commission that would require, among other things, that companies publicly disclose the board's role in cybersecurity oversight.[9]



4) Do new supply chain disruptions warrant adjustments to the company's environmental sustainability program?

The war in Ukraine is expected to have a short-term impact on corporate sustainability programs, especially as companies reevaluate the resilience of their supply chains. Even though Russia and Ukraine account for a small fraction of global domestic product, they are major suppliers of oil and wheat, with several countries in the world depending heavily on them. The disruption of such supplies could have rippled effects on the global energy and food markets, and force businesses, in Europe and the US, to temporarily reshape their supply chains. It is hard to predict the duration of these shifts, but they may affect corporate emission reduction targets that were set in the last few years by an ambitious climate change risk mitigation agenda. In the long term, however, the crisis will likely reinforce the need for environmental sustainability planning and become yet another driver of the transition to a renewable energy economy, which is much less susceptible to geopolitical risk. Extensive research shows that, unlike oil and gas, renewable energy sources are available in one form or another across different geographies. The declining cost of clean energy technology will therefore offer a pathway to energy self-sufficiency to all countries rather

[9] Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, US Securities and Exchange Commission, Release No. 33-11038; 34-94382, March 9, 2022.

than just those with direct access to fossil fuels.[10] Ultimately, boards should ensure the impact of the crisis on the supply chain is managed effectively and does not derail the company's commitment to the long-term pursuit of a sustainable environmental strategy.[11]

5) What corporate citizenship initiatives is the company promoting to bring aid to the people of Ukraine and support employees of Ukrainian origin and their families?

In the last few years, boards of directors and C-suites have embarked on a debate on the purpose of their corporation—or the appropriate role their business should perform with respect to a broad set of societal interests affecting their stakeholders.[12] While each company's board and management need to exercise their business judgment in determining the appropriate course of action, a geopolitical crisis of this magnitude, just like the global health crisis of the last two years, may be viewed as an important litmus test for those corporate commitments. To be sure, many US public companies have decades-long experience helping communities affected by natural disasters—last, but not least, the COVID-19 pandemic. While there are important distinctions between a natural disaster and an active war zone,[13] many practices in that playbook can serve them well in this new emergency, too.[14] They can also inspire and guide their counterparts in Europe, which is more reliant on publicly funded programs and has a much less established tradition of corporate philanthropy. Directors can be helpful in many ways: They can participate in discussions on how to reprioritize important resources and they can use their contacts to help build alliances with other businesses and humanitarian organizations. While often prompted by the new sanctions, the decision to cut ties with Russia may also be part of the corporate citizenship response, as it is overwhelmingly supported by the US public, including customers and employees.[15]

Unlike other crises faced in recent times, the war in Ukraine brings unique challenges to the urgent attention of corporate directors and senior leaders—including unanticipated geopolitical scenarios, the unintended consequences for businesses from an unprecedented regime of sanctions, and a whole new level of cybersecurity risk exposure. However, just like others before, this crisis can galvanize corporate leadership and employees around commonly shared values and ultimately help companies to further build their muscle memory in crisis management and strengthen their ESG practices.

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[10] See Floros Flouros, et al., Geopolitical Risk as a Determinant of Renewable Energy Investment, *Energies*, February 2022, 15, p. 1498. Also see A New World: The Geopolitics of Energy Transformation, International Renewable Energy Agency, 2019, p. 23.

[11] See Paul Washington and Thomas Singer, Sustainability During a Geopolitical Crisis, The Conference Board, March 1, 2022.

[12] See, among others, Holly Gregory, The Corporate Purpose Debate, *Practical Law Journal*, January 2020; Timothy Powell, Corporate Purpose: A Primer for Marketing & Communications, The Conference Board, November 18, 2021; and Thomas Singer, Purpose-Driven Companies: Lessons Learned, The Conference Board, October 29, 2020.

[13] See Paul Washington and Jeff Hoffman, Corporate Citizenship During a Geopolitical Crisis (Part 1): War Is Different, The Conference Board, March 2, 2022.

[14] Paul Washington and Jeff Hoffman, Corporate Citizenship During a Geopolitical Crisis (Part 2): How the Natural Disaster Playbook Can Help, The Conference Board, March 3, 2022.

[15] Survey Finds 60% of US Consumers Believe Brands Should Reconsider Doing Business in Russia, Gartner, Press Release, March 11, 2022. Also see Businesses Face Pressure to Rethink Russia Operations, The New York Times, March 13, 2022 and Andrew Hill, Companies' Flight From Moscow Sets Some Hard Precedent, Financial Times, March 13, 2022.

The Russian Invasion of Ukraine: A Lesson in Stakeholder Capitalism?

Posted by Peter Essele, Commonwealth, on Wednesday, March 16, 2022

Editor's note: Peter Essele is Vice President of Investment Management and Research at Commonwealth. This post is based on his Commonwealth memorandum. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver Value to All Stakeholders? both by Lucian A. Bebchuk and Roberto Tallarita; and For Whom Corporate Leaders Bargain (discussed on the Forum here) and Stakeholder Capitalism in the Time of COVID, both by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here).

It's possible that the autocratic regime in Russia didn't fully appreciate the power of stakeholder capitalism. In the wake of the invasion, stakeholders have clearly chosen sides—and they do not include the Kremlin. Corporations have responded, and many have decided to sever Russian ties through divestment. Shell and BP recently announced their intention to abandon their involvement in Russia. Further, Sberbank (Russia's largest lender) says it is leaving the European banking market in the face of Western sanctions against Moscow.

The actions are a clear signal that the world is pivoting toward a stakeholder capitalism model, one that is designed to benefit *all* parties. Those parties include customers, suppliers, employees, shareholders, and, most importantly, communities. Stakeholder capitalism proponents argue that serving the interests of all stakeholders, as opposed to only shareholders, offers superior long-term success to businesses. Many believers assert that it is a sensible business decision, in addition to being an ethical choice.

Shareholder Primacy Vs. Stakeholder Capitalism

For decades, shareholder primacy has reigned, which is the notion that corporations are only responsible for increasing shareholder value. In that model, profits are maximized at all costs through open and free competition without deception or fraud. Put simply, corporations are solely motivated by profit potential. End of story.

The recent events in Ukraine highlight a clear evolution beyond the shareholder primacy model, as evidenced by first-movers like BP and Shell, which have placed social good over profits. The decision to divest of Russian assets and partnerships places social responsibility over short-term profits (especially as oil prices skyrocket globally). It's also a move that's aligned with long-term, sustainable value creation in an investment environment that places significant weight on intangibles like brand reputation.

If the shareholder primacy model still dominated the corporate and investment world, it's likely that firms such as Shell and BP would have simply weathered the negative public relations backlash until the Russia-Ukraine episode was in the rearview mirror. In that case, the profit potential and subsequent increase in share price (due to the rise in oil) would've helped placate investors, and they would have brushed off the impartial stance taken by the two firms. Thankfully, for humanity's sake, that world is shifting quickly in favor of stakeholder capitalism, as Larry Fink points out in his prescient 2022 Letter to CEOs.

Recent events have highlighted that stakeholder capitalism and profit maximization are not mutually exclusive outcomes. In fact, they're very closely aligned, particularly as one's time horizon increases.

Russia Exposure and PPS Select

As stewards of more than $12 billion in client assets (as of March 3, 2022), Commonwealth has clearly taken note of recent events and how they could potentially affect clients' long-term goals. As fiduciaries, we are obligated to make decisions in the best interest of clients, which includes maximizing returns for stated levels of risk. It's why we've had many discussions in recent days to discuss the impact to clients as the situation unfolds, particularly as it relates to Russian exposure across portfolios.

Within our Preferred Portfolio Services® (PPS) Select asset management platform, Russian exposure is minimal, and we expect it to decrease further over the coming weeks. Many of the asset managers we've spoken to have plans to divest, and we're hopeful that direct Russian investment will be nonexistent when underlying holdings are released in the next reporting period. Any Russian exposure that remains will likely be the result of illiquidity, where names remain in the portfolio in small portions because of an inability to sell on listed exchanges.

MSCI and FTSE Russell recently announced their intention to cut Russian equities from widely-tracked indices, as they've been deemed uninvestable. As a result, we expect our passive models to be largely void of Russian exposures as well in the coming months.

While some investors may consider Russian equities an investment opportunity, we would caution against this approach at this time, as the previous comments suggest. The public continues to push global exchanges to delist Russian-domiciled firms, so it's very likely that buyers will be left empty-handed without a liquid market. The result would be ruin, as opposed to other geopolitical value opportunities in the past that have presented a more attractive risk/reward scenario. At this time, investors are faced with a boom or bust scenario, skewed mostly toward the latter.

Looking Beyond Investments

From an investment perspective, we remain vigilant as the situation continues to unfold, and we will continue to do what we feel is in the best interest of clients. As mentioned, we are in regular contact with asset managers to understand their position and will react accordingly if it differs from our own.

Finally, our hearts go out to all those affected, directly or tangentially. The discussion of exposures, markets, and profits feels petty when viewed in contrast to the struggle that many of our fellow global citizens face daily. It can be difficult to put on a straight face at times like this when humanity is clearly not okay. Let’s all hope for a resolution where calmer heads prevail.

The False Promise of ESG

Posted by Jurian Hendrikse (Tilburg University), on Wednesday, March 16, 2022

Editor's note: Jurian Hendrikse is a PhD Candidate at the Tilburg School of Economics and Management. This post was co-authored by Mr. Hendrikse; Elizabeth Demers, Professor of Accounting at the University of Waterloo; Philip Joos, Professor of Accounting at the Tilburg School of Economics and Management; and Baruch I. Lev, Philip Bardes Professor Emeritus of Accounting and Finance at NYU Stern School of Management.

Millions of investors and countless fund managers direct their investments to companies that are highly-rated on the basis of their environmental, social, and governance ("ESG") activities in an attempt to do good. The claim by ESG advocates, pundits, and many academics that highly-rated ESG companies and funds also deliver superior returns bolsters this move: Doing better by doing good. The best of all worlds.

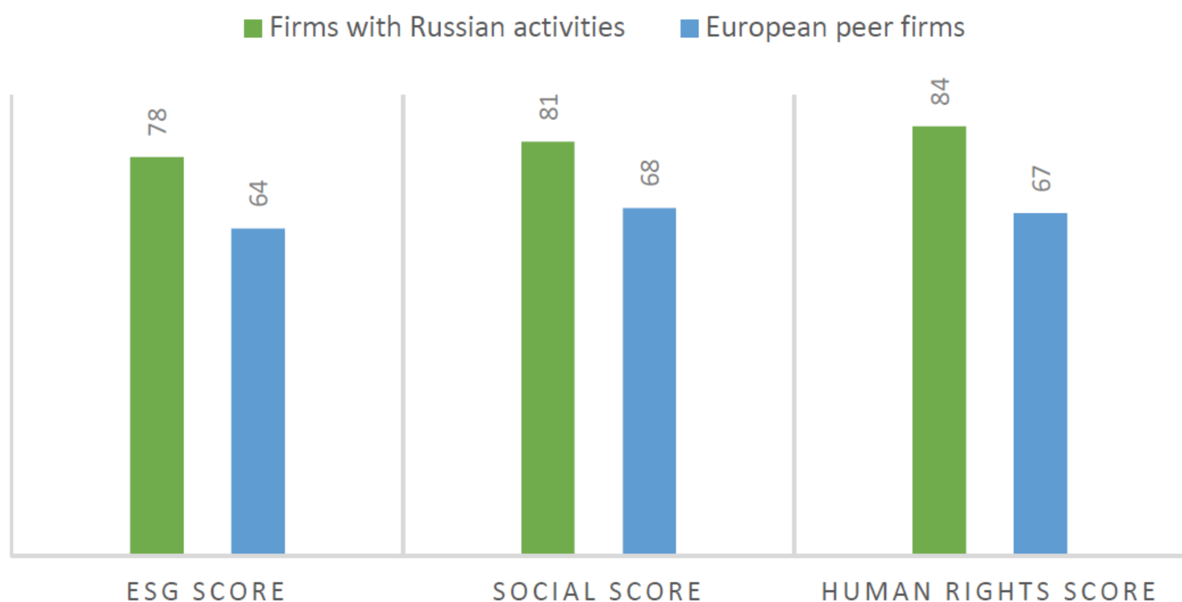
But do ESG ratings really deliver on the promise? Are highly-ranked ESG businesses really more caring of the environment, more selective of the societies in which they operate, and more focused on countries with good corporate governance? In short, is ESG really good? The answer is no.

We demonstrate this by focusing on a group of companies that are now at the center of the world's attention: businesses with substantial operations in Russia. Russia's disregard for the environment, appalling social norms and behaviors, and extremely poor corporate governance are well-known and widely-documented. So one might reasonably expect that business involvement in such a country would detract from the ESG rating of the involved company. To our great surprise, this is not the case.

We examine the ESG scores and response to the Russian invasion of Ukraine for all European firms with a substantial presence in Russia, which we define as companies with Russian subsidiaries that generate more than US$100 million in sales and that have more than US$100 million in total assets. We focus on Russian subsidiaries of large European firms because these represent significant investments of economically important firms that are unambiguously identifiable from standard sources. We search the Amadeus database of Bureau van Dijk for firms that meet these activity thresholds and intersect this with Refinitiv's EIKON database to generate a list of 75 non-financial European firms that have significant subsidiary activities in Russia with available Refinitiv ESG scores. On average these firms earned 6% of their sales in Russia.

Some startling observations emerge. First, as represented in the figure below, the average ESG scores of firms with substantial activities in Russia, a country that is well-known for its corruption and significant human rights abuses, is 78 out of 100. By comparison, the average ESG score of all other similar-sized non-financial European companies (i.e., those with sales in excess of US$2B) in the Refinitiv database is just 64. The average score of the Russia-invested group on

the “S” (i.e., social) pillar dimension is 81 versus a comparable European peer group average of just 68. In terms of their human rights performance (i.e., a subcomponent of the social pillar), the firms profiting from Russian activities earn a whopping average score of 84 versus a much more modest 67 for their European peer firms. Remember, higher ESG scores are supposed to be indicative of *more* socially responsible corporate behavior, so according to Refinitiv, European companies with substantial subsidiary operations in Russia are, on average, significantly *more “responsible,”* both overall (i.e., on the basis of ESG) and on the “social” and “human rights” sub-dimensions, than comparable European firms with zero or more limited Russian operations in the periods leading up to the recent invasion.



A full 12 days after the invasion, a surprisingly high 28% of European firms had not taken even the most modest form of public action, such as the condemnation of Russia’s invasion or even the expression of a soft voice of support for the Ukrainian people. Even after intensified public pressure, as of today (March 15th) only 53% of the 75 firms have publicly announced significant action in the form of ceasing their subsidiary’s operations in Russia.

High overall ESG scores combined with slow (or no) meaningful action by many firms begs the ultimate question—how useful is a firm’s ESG score for predicting its response to the Russian invasion? The answer: not very.

We use duration analyses to investigate whether ESG predicts the timeliness with which companies announce their withdrawal from Russia. After simultaneously considering the firm’s size, profitability, and the amount of sales being generated in Russia, our analyses yield surprising overall conclusions: there is no statistical association between companies’ ESG scores and the timeliness of a meaningful response to the Russian invasion. If you’re an investor who has been picking stocks based on ESG scores under the assumption that your money is likely to

be funding more socially responsible corporate behavior, particularly in periods of extreme crisis such as Russia's invasion of a sovereign country, you should be very disappointed.

Overall, our analyses reveal that the former Ukrainian finance minister, Natalie Jaresko, was fully justified in calling out so-called "virtuous" (high ESG) firms for not walking the talk of socially responsible corporate behavior. Our evidence suggests that Russian-invested European firms that have higher overall ESG scores, and even those with higher "social" and "human rights" scores, do not move more quickly to exit their Russian operations in response to Russia's invasion of Ukraine. If ESG scores are going to remain meaningful and fulfill their promise of enabling socially responsible investing, they need to do a much better job of reflecting the rated firm's activities in suspect countries that are known for widespread corruption and human rights abuses.

V. The Current State of Hedge Fund Activism

Q1 2022 Review of Shareholder Activism

Posted by Rich Thomas, Christopher Couvelier and Leah Friedman, Lazard, on Thursday, April 28, 2022

Editor's note: Rich Thomas is Managing Director, Christopher Couvelier is Director, and Leah Friedman is Vice President at Lazard. This post is based on a Lazard memorandum by Mr. Thomas, Mr. Couvelier, Ms. Friedman, Jim Rossman, and Antonin Deslandes.
Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); Dancing with Activists by Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

Observations on the Global Activism Environment in Q1 2022

Record Pace for Global Activism, Led by U.S.

- 73 new campaigns launched globally in Q1 marks the busiest quarter on record and, when combined with Q4, the busiest six-month period for activism since 2018
- The U.S. continues to account for the largest share of global activity, representing 60% of new campaigns and 55% of capital deployed
    - Q1 activity in APAC accelerated, accounting for 16% of new campaigns vs. 2021's recent low of 11%
- While Icahn and Starboard were both prolific in Q1 (launching four and three new campaigns, respectively), "first timers" and smaller-cap focused funds accounted for a higher proportion of activity than in prior years

Robust Activity in Europe Despite PullBack Since Onset of Ukraine Crisis

- Europe registered 15 new campaigns in Q1, representing a 50% jump in activity compared to Q1 2021
    - French companies were disproportionately targeted in Q1, representing ~27% of European targets—nearly 3x the country's historical share
- Activity has declined following the onset of the Ukraine crisis, particularly from non-European activists; agitation may have pivoted to behind-the-scenes pressure rather than public campaigns

Fewer M&A-Related Campaigns, but Still Common

- 30% of all activist campaigns in Q1 2022 featured an M&A-related thesis, starting the year down slightly vs. the same period last year

    - Scuttle/sweeten campaigns—the most common M&A attacks in recent periods—were down materially, in line with reduced deal volume in Q1 relative to prior quarters
    - With scuttle/sweeten activism less prevalent, demanding an outright sale became the most frequent M&A attack vector, with notable examples including Everbridge/Ancora and Cano Health/Third Point
- The potential for more interplay between PE and activism is drawing attention, with activists partnering with PE to submit bids (Elliott with Vista Equity to buy Citrix and with Brookfield to take Nielsen private), traditional PE engaging in activist behavior (Hellman & Friedman's plans to engage at Splunk) and activists pursuing their own PE strategies (Starboard Value-backed Acacia Research bidding for each of Comtech and Kohl's)

With Proxy Season Looming, Many Seats "In Play"

- 38 Board seats were won by activists in Q1 2022 and Board change was an objective in ~40% of all new campaigns initiated
    - Only one Board seat has been secured by an activist via proxy fight in 2022 thus far (by Voss Capital at Griffon), with the remainder of seats secured via settlement
- Starboard's high-profile proxy fight for four Board seats at Huntsman came to a head in late March, with all ten of the Company's nominees prevailing at the AGM
- 85 seats remain "in play" heading into Q2, including notable potential contests at Kohl's (10 seats), Southwest Gas (10 seats), U.S. Foods (5 seats) and Hasbro (5 seats)

Regulatory Changes Poised to Impact Activist Behavior

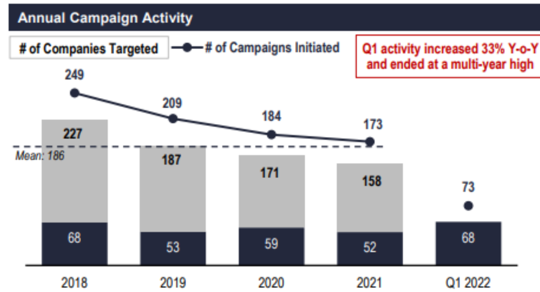
- The SEC's November adoption of a universal proxy rule is poised to lower barriers to entry for nominations from both traditional activists and other constituencies (e.g., climate and labor activists, current/former employees)
    - Although the rule does not officially take effect until August 2022, activists have already requested universal proxy usage in recent campaigns – notably, Huntsman, SpartanNash and LivePerson
- The SEC's proposed 13D and 13G rule amendments—which recently concluded the public comment period—would benefit issuers by bolstering the "early warning" function of these ownership disclosure rules

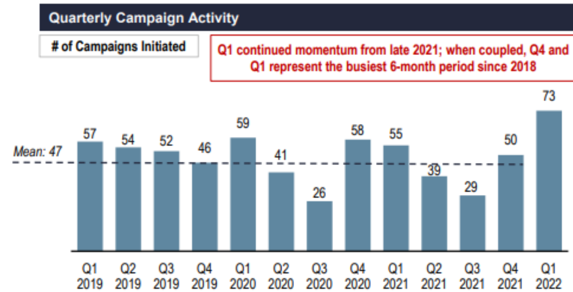
Public Company ESG Pressure Grows

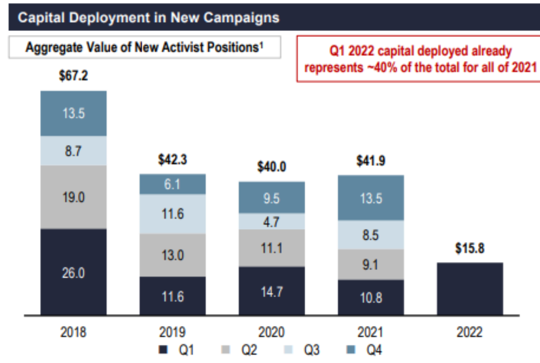
- Between the SEC's long-anticipated climate change disclosure rule and the increasing number of E&S proposals submitted at U.S. AGMs, ESG scrutiny on public companies continues to mount
    - Proposed increased disclosure around long-term emissions goals will, if approved, increase transparency on corporate climate strategies
    - Increased transparency will potentially lead to further ESG proposal action from shareholders, which is already at heightened levels

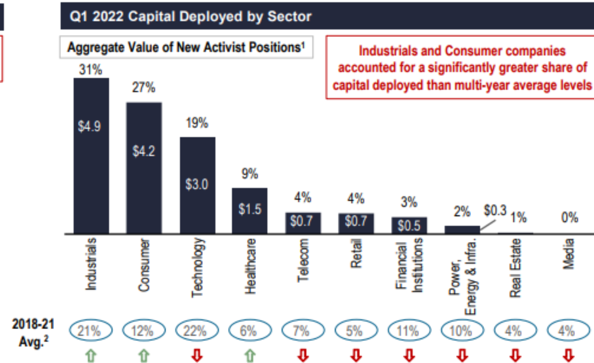
Global Campaign Activity and Capital Deployed

($ in billions)





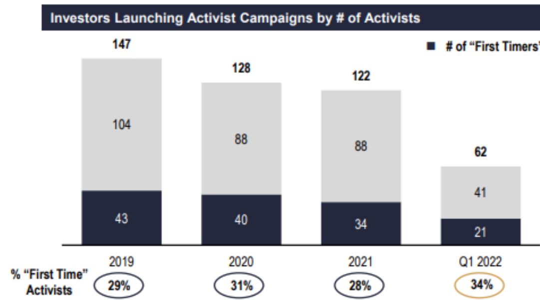


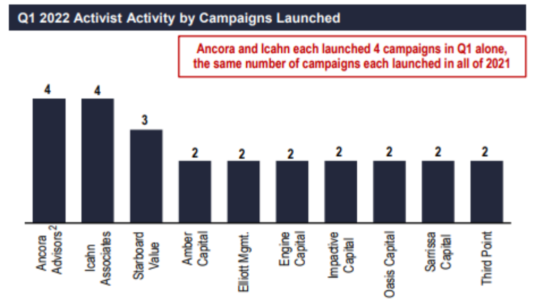


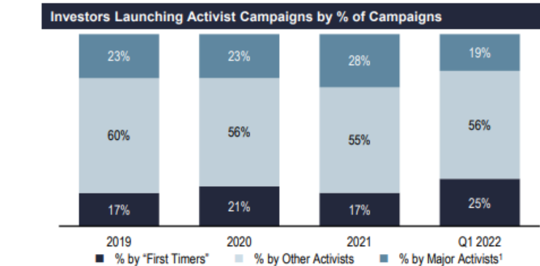
Global Activist Activity in Q1 2022

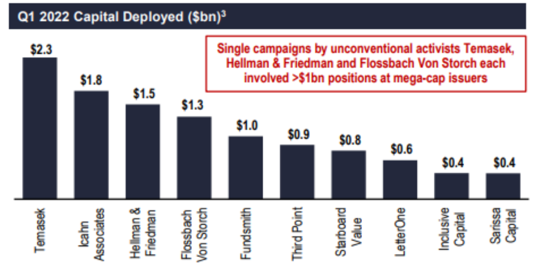
($ in billions)

The number of activists waging campaigns in Q1—many of them "first timers"—is already over half of the number in 2021 as a whole



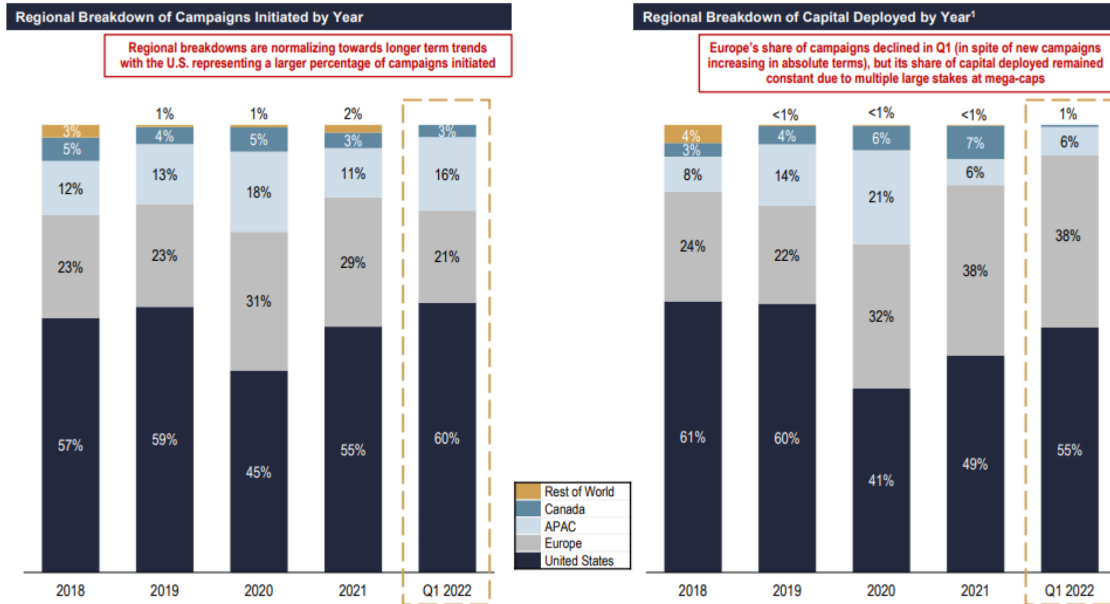






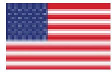
Regional Trends in Global Activity

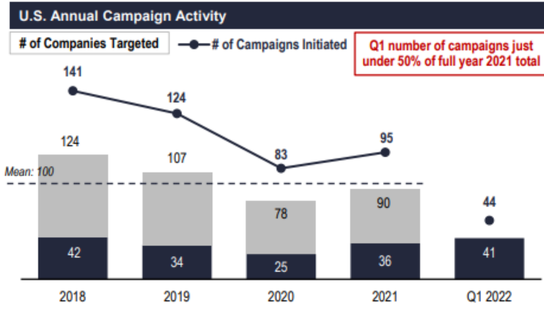
U.S. continued to lead activity in Q1 2022, representing 60% of all global campaigns and 55% of capital deployed; campaign activity in APAC accelerated over the quarter, although capital deployed remained flat vs. 2021 as activists initiated modest positions

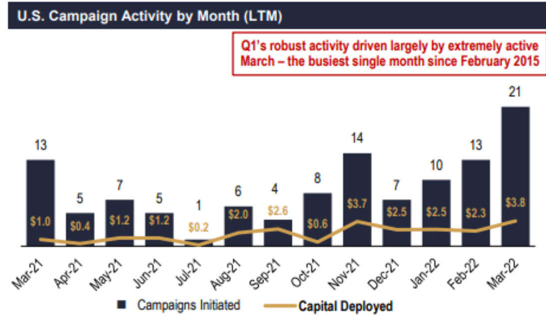


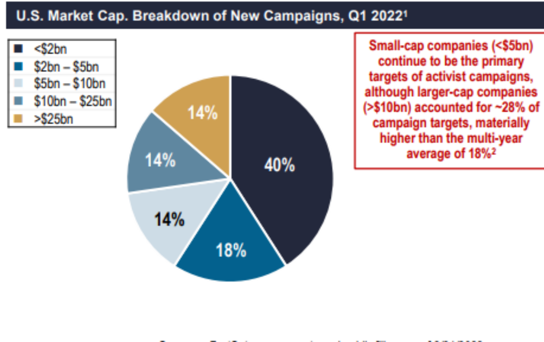
U.S.: Campaign Activity and Capital Deployed

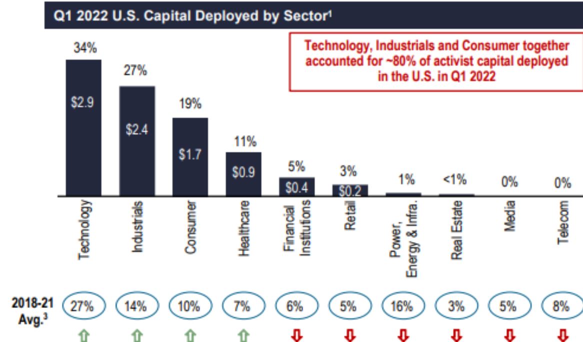
($ in billions)





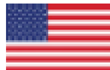






U.S.: Notable Q1 Public Campaign Launches and Developments

($ in billions)



Increased Vocalism From Institutional Investors Turns Into Public Debate

Q1 2022 saw continued willingness from active managers to take public stances on key strategic matters, with shareholders speaking up on both sides of the debate in certain instances

Vocalism Against the Company

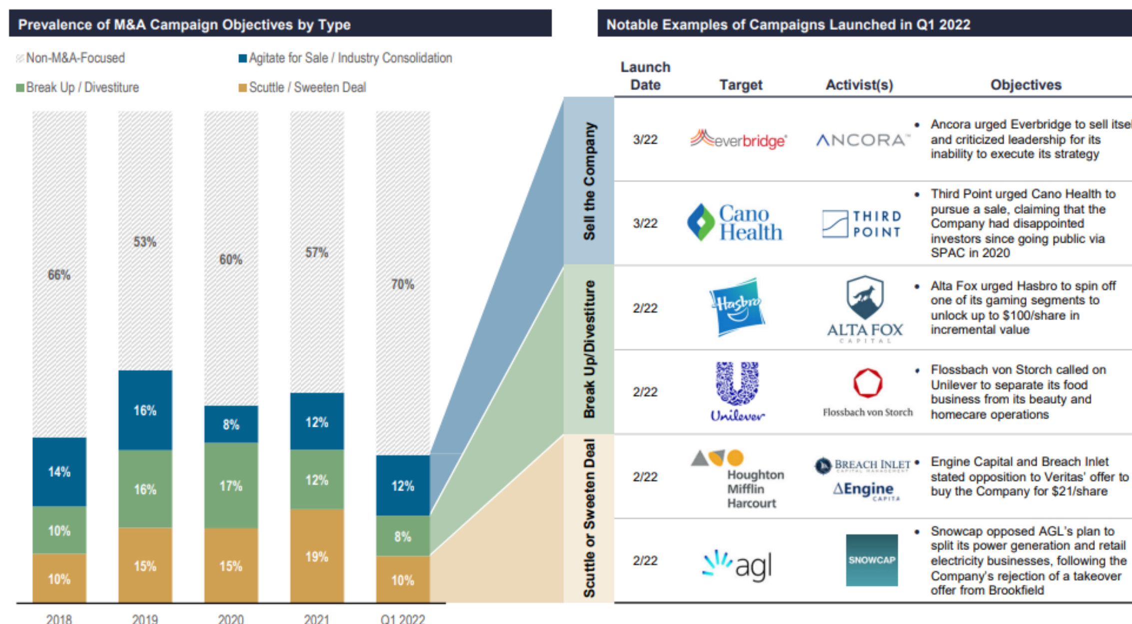
Company	Vocal Investor	Activist	Observations
Bayer	Temasek		• In March 2022, Temasek agitated for the departure of Bayer CEO Werner Baumann, dissatisfied with his performance
Unilever	Candriam, Trinity Health, gmpf	Trian Partners, Flossbach von Storch, Fundsmith Equity Fund	• In January 2022, an international investor coalition including Candriam, Trinity Health and GMPF urged the Company to adopt ambitious targets to increase the proportion of healthy foods in its sales
Vodafone	abrdn, PSAM	Cevian Capital	• In February 2022, Abrdn and PSAM indicated they would back Cevian's campaign at Vodafone, which they believed was "long overdue"
thyssenkrupp	DekaBank	Cevian Capital	• In February 2022, Deka Investment expressed its concerns over Thyssenkrupp's steel unit performance and future without state aid
zendesk	Janus Henderson	JANA	• In January 2022, Janus Henderson criticized the planned combination between Zendesk and Momentive Global, a deal already opposed by activist JANA Partners

Vocalism in Support of the Company

Company	Vocal Investor	Activist	Observations
Bayer	Union Investment	Temasek	• In March 2022, Union Investment opposed Temesek's call to oust Bayer's CEO, contending the Company had made visible progress
Unilever	Lindsell Train	Trian Partners, Flossbach von Storch, Fundsmith Equity Fund	• In February 2022, Lindsell Train expressed support to CEO Alan Jope, stating it "would have been a lot more disappointed if [Unilever] had not considered making the acquisition [of GSK healthcare unit]"
RWE	Association of Municipal RWE Shareholders	Enkraft Capital	• In March 2022, RWE's municipal investors dismissed Enkraft Capital's call for a rapid spin-off of the Lignite division, asserting it would threaten the local economy and jobs
sse	Royal London	Elliott	• In December 2021, Royal London dismissed Elliott's push to break up SSE, stating the activist's strategy would cause "disruption"
Shell	abrdn	Third Point	• In October 2021, Abrdn stated Third Point's call for Shell to split was "too complicated" and that "just because Third Point says it makes compelling financial logic doesn't mean it will happen"

Slight Decline in M&A-Related Campaigns

Coincident with the recent pull-back in the M&A market, campaigns to scuttle/sweeten deals were less prevalent in Q1 2022 as compared to typical annual levels, though transaction-related campaigns still accounted for ~30% of all campaign activity

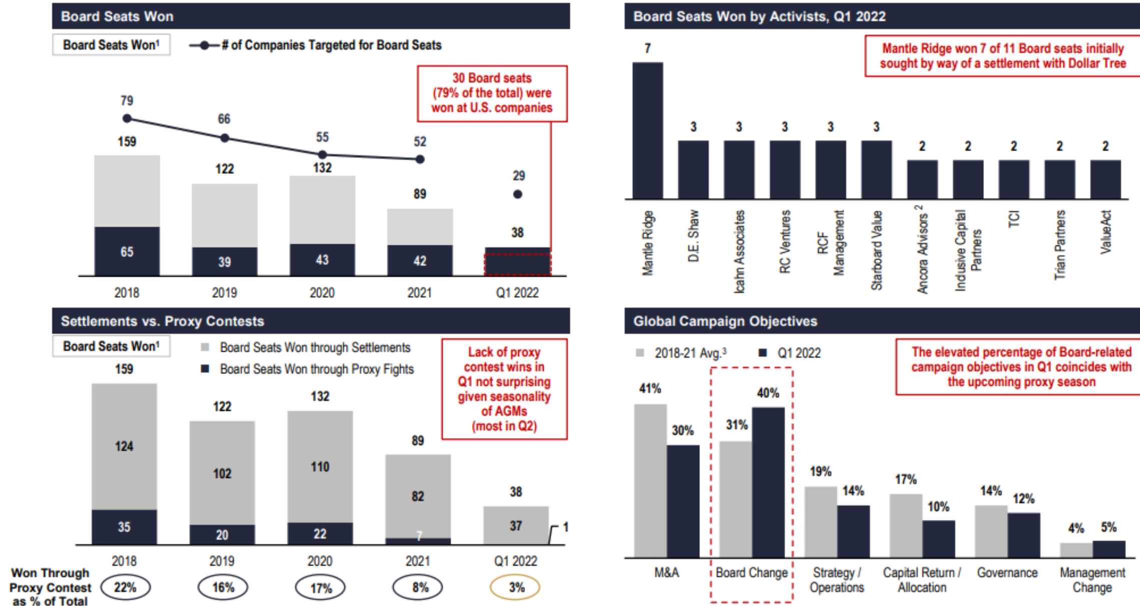


Notable Examples of Campaigns Launched in Q1 2022

Launch Date	Target	Activist(s)	Objectives
3/22	everbridge	ANCORA	• Ancora urged Everbridge to sell itself and criticized leadership for its inability to execute its strategy
3/22	Cano Health	Third Point	• Third Point urged Cano Health to pursue a sale, claiming that the Company had disappointed investors since going public via SPAC in 2020
2/22	Hasbro	Alta Fox Capital	• Alta Fox urged Hasbro to spin off one of its gaming segments to unlock up to $100/share in incremental value
2/22	Unilever	Flossbach von Storch	• Flossbach von Storch called on Unilever to separate its food business from its beauty and homecare operations
2/22	Houghton Mifflin Harcourt	Breach Inlet, Engine Capital	• Engine Capital and Breach Inlet stated opposition to Veritas' offer to buy the Company for $21/share
2/22	agl	Snowcap	• Snowcap opposed AGL's plan to split its power generation and retail electricity businesses, following the Company's rejection of a takeover offer from Brookfield

Global Board Seats Won

Board representation is top of mind heading into proxy season; 38 seats have been won by activists to date, with 37 secured via settlement



Key Development in Focus: Potential Impacts of Universal Proxy

Although the universal proxy does not go into effect until August 2022, certain activists have already requested its use in proxy contests

Overview

- In November 2021, the SEC adopted a rule requiring parties in a contested election to use a universal proxy card listing all available candidates, **allowing investors to pick and choose which combination of candidates to vote for**
  - The change contrasts the existing binary proxy voting regime, in which investors must choose between company and dissenting shareholder proxy cards, which list only their respective nominees
  - The SEC has called this an "important aspect of shareholder democracy," putting investors voting in person and by proxy on "equal footing"
- The new rules require Director nominees' consent to be named and introduce a minimum solicitation requirement in which the activist must solicit the holders of shares representing at least 67% of voting power

Upcoming Nomination Deadlines[1]

The concentration of AGMs in April – June means that ~2/3 of Russell 3000 issuers have nomination deadlines in Q1; 20%+ of Russell 3000 issuers will be required to use the universal proxy for their 2022 AGMs in the event of a contested election

Universal proxy rule goes into effect

	Jan.	Feb.	Mar.	Apri.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
	13%	32%	21%	4%	2%	2%	2%	2%	2%	2%	6%	12%
	Q1			Q2			Q3			Q4		

Key Takeaways

- Lower barriers to entry for nominations from both traditional activists as well as former founders/CEOs, employees and upstart ESG-focused funds
- Solicitation requirement (67% of voting power) is unlikely to be a deterrent given extreme concentration of most shareholder bases
- Individual Directors, rather than just the Company, may become more direct targets of a public activist campaign
- Unclear what the eventual impact on activist election success, or the rate of settlements reached, will be

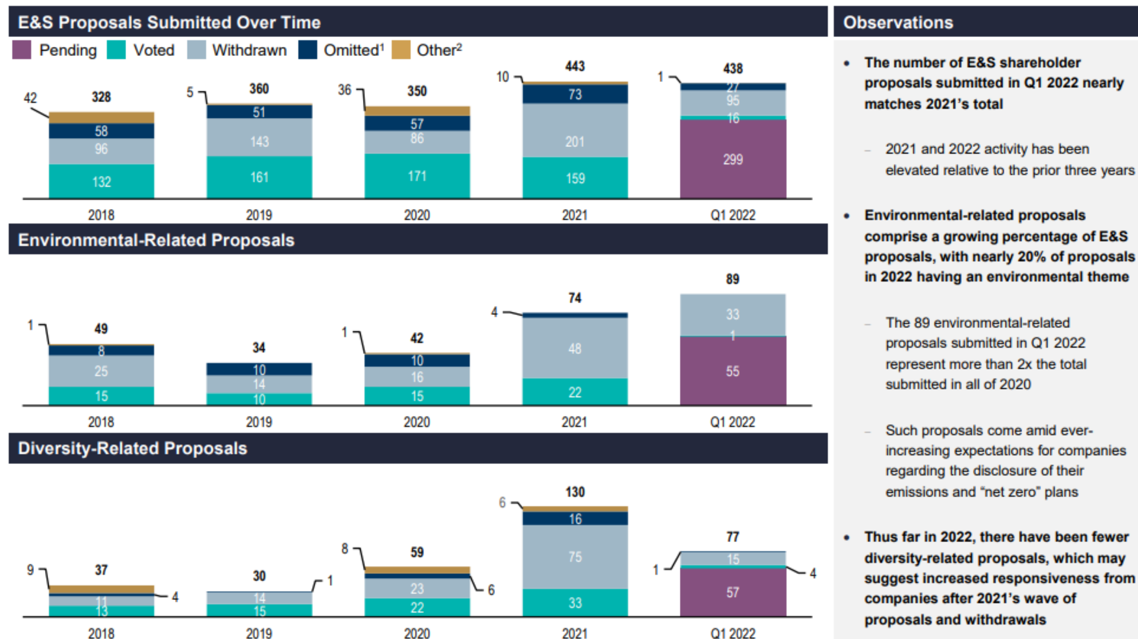
Pressure For Early Adoption

- While the changes will not take effect until Aug. 31, 2022, activists may start demanding use of universal proxies in advance of that date
- Certain companies have successfully availed themselves of final opportunities to decline such requests in the 2022 proxy season, including:

HUNTSMAN SpartanNash

Increasing Number of E&S Proposals

Though how many E&S proposals go to a final vote is yet to be seen, the number of submitted E&S proposals for 2022 AGMs thus far nearly matches 2021's total, fueled in part by the continued growth in environmental-related proposals



The complete publication, including footnotes, is available here.

Annual Meetings and Activism in the Era of ESG and TSR

Posted by Edward D. Herlihy, and Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Thursday, May 19, 2022

Editor's note: Edward D. Herlihy is partner and Martin Lipton is a founding partner at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell memorandum by Mr. Herlihy and Mr. Lipton. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); Companies Should Maximize Shareholder Welfare Not Market Value by Oliver Hart and Luigi Zingales (discussed on the Forum here); Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee by Max M. Schanzenbach and Robert H. Sitkoff (discussed on the Forum here).

During the past five years we have been experiencing: (1) activism seeking greater total shareholder return or a price enhancing transaction or the abandonment of a merger or other financial transaction, (2) activism to achieve a change in management to accomplish the activist's objective, either TSR or ESG, and (3) activism to seek both TSR and ESG with the activist seeking to leverage one to achieve the other. The proxy advisors, Institutional Shareholder Services and Glass Lewis, have taken various positions in proxy solicitations raising these issues, sometimes inconsistent and sometimes using their Say on Pay vote or withholding a vote for one or more directors to show their position on an issue. The major asset managers have also taken various positions and, with increasing frequency, have been supporting activists. In large measure, the proxy advisors and the major asset managers, especially, BlackRock, Vanguard, State Street, Fidelity and T. Rowe Price, together vote or influence the vote in manner sufficient to determine every significant proxy contest.

This proxy season, now coming to an end, has numerous examples of the key ESG issues, climate, environment, diversity, executive compensation, and employee working conditions and compensation and the TSR issues. What is particularly striking is the large number of "surprises" where proxy contests were lost due to failure to effectively present an issue or failure to ascertain, and where appropriate change, the views of the voters in advance of the meeting. Activism will continue to grow. To avoid surprises, careful review of this season's proxy voting and effective engagement, well in advance of next season, with the proxy advisors and asset managers is essential. Also essential is a team of outside advisors and corporate officers to plan the premeeting investor engagement and the presentation of the issues to be voted upon.

How Universal Proxy Card Notices Work

Posted by Michael R. Levin, The Activist Investor, on Wednesday, June 1, 2022

Editor's note: Michael R. Levin is founder and editor of The Activist Investor. Related research from the Program on Corporate Governance includes Universal Proxies by Scott Hirst (discussed on the Forum here).

Like all good and sound SEC regulations, the one on Universal Proxy Cards (UPC) calls for some new notices—to shareholders, from the company, among activist investors, to the SEC, etc. etc.

The new UPC rule has some novel notice requirements for activists. Others are similar to existing notice processes. Complying with these should be straightforward. Yet, it's not hard to miss one or another of these, and then it's difficult and possibly fatal for a proxy contest. Best to know the notice structure and plan ahead well.

Here we explain how these notices work, as simply as we can. Citations below refer to sections, pages, and footnotes in the final regulation. You can find more resources at universalproxycard.com.

Notices serve two purposes

First, UPC means the company and activist (or multiple activists) must present the same list of BoD nominees to shareholders. So, they need to exchange that information far enough ahead of a shareholder meeting to allow each to include all nominees. This is new and unique to the UPC.

Second, the activist needs to inform shareholders about its nominees, which might seem obvious. The particulars of the UPC rule makes it a little tricky. In short, the SEC requires an activist to handle an existing notice (proxy statement) in a new way.

You see, while the SEC requires all nominee *names* on the UPC, that's it. The rule doesn't require anything further, like biographical data. So, shareholders receive a company proxy statement with all the usual information, including glorious detail about the company nominees. They receive a company UPC listing those nominee names.

The company UPC will also list activist names, which of course is the point of this entire exercise. But, the company proxy statement won't provide any more information about the activist nominees. Just the names.

The SEC worries that if a company sends out a UPC with only the *names* of activist nominees, shareholders will look for, want and need, and regret missing information about those activist nominees. Thus, the company (and activist, this whole concept applies equally) proxy statement will include language *referring* shareholders to the activist proxy statement for that information.

The company might state something like, “go find the activist’s proxy statement for information about its nominees, whose names appear on our UPC since we’re required to do that, but since the SEC doesn’t require us to include any other information about those nominees, that’s all you get.”

The SEC further worries that shareholders won’t have the activist nominee information *in time*. The company refers shareholders to the activist proxy statement. The SEC wants shareholders to have that statement with enough time to vote thoughtfully. So now there’s a kind of new-and-improved notice provision for that. This is not strictly new, since activists send out proxy statements anyway.

Notice of nominees, between the company and activist

The activist goes first. It notifies the company of its nominees at least **60 days** before the shareholder meeting.

(Ok, sure, it’s actually 60 days before the anniversary date of last year’s meeting.)

(There are provisions if the company didn’t have a meeting the year before, or if the meeting date moves around more than about a month relative to last year’s meeting (Sec. 14a-19(b)(1), p. 192), that happens seldom enough that we need not cover that right here.)

Some other things about the activist notice:

- The notice includes
    - the names of the activist nominees
    - statement of activist’s intent to solicit at least 67% of the votes
- Don’t file this with the SEC, it’s just a notice to the company, although an activist with 5% or more of the shares might also file a Form 13D
- A simple emailed letter or even just an email message should suffice
- If the activist files its proxy statement at least 60 days before the shareholder meeting, then that filing fulfills this requirement; this seldom happens
- Alas, the letter that complies with company advance notice terms does not by itself fulfill this requirement, although after an activist sends that, sending the UPC notice is relatively simple; with some additional language about the 67% the advance notice letter can likely constitute the needed UPC notice, too.

The SEC thinks this 60 day requirement should be easy to meet. Its economic analysis finds 99% of S&P 500 companies and 95% of Russell 3000 companies have advance notice provisions for BoD nominees (p. 29, fn 73). So, this notice becomes another letter that an activist needs to send to the company, with information it very likely already conveyed.

The company goes next. It sends a list of its nominees to the activist at least **50 days** before the shareholder meeting. All other relevant terms of the activist notice, like how the notice period changes if the anniversary of the annual meeting changes or how filing a proxy statement can meet the requirement, apply equally.

Almost two months before a shareholder meeting should be enough time for an activist to put together a proper UPC with the names of the company nominees.

Notice of activist nominees, to shareholders

To assuage its worry about shareholders having information about activist nominees, the SEC now requires an activist to file its definitive proxy statement at least **25 days** before the shareholder meeting.

This deadline is new. While the SEC requires activists to file proxy statements, it previously has not required doing so on any schedule.

Now the company goes first (specifically, if it wants the activist can wait for the company to file a proxy statement). If the company files its proxy statement within 30 days of the shareholder meeting, then the activist can comply by filing its proxy statement within 5 days after the company filing. Or, if the company files (for example) within 35 days before the shareholder meeting, then the activist can file after the company, say 30 days before the meeting, and still comply with this requirement. Note, this seldom happens, as companies typically file proxy materials more than a short four weeks before the shareholder meeting.

Even though the company goes first, an activist need not wait for the company. You can always file a definitive proxy whenever you like, even before the company. There might be advantages to filing early, too, see below.

This new deadline should not present a problem in most contests. Based on a sample of proxy contests from 2017-2020, 82% of activists filed proxy statements at least 25 days before the shareholder meeting (p. 45, fn 117).

What if someone misses a deadline?

The regulations don't say anything about consequences for late notices between activist and company. They are pretty clear about the 25 day proxy filing requirement.

If an activist misses the filing deadline for notice to the company, it seems the company can at least use the old proxy card listing only company nominees, rather than the new UPC. It's not clear whether that also means the activist cannot proceed with the proxy contest. In other words, while the activist can finish the solicitation, it will do so using only its own proxy card.

If the company misses the filing deadline for notice to the activist, it's really unclear. Maybe the activist need not include company nominees on its proxy card, while the company still must use a UPC with both company and activist nominees.

Suppose the activist fails to file its proxy at least 25 days out? Then it looks like the activist cannot finish the proxy contest: "If a dissident fails to file its definitive proxy statement by the new deadline prescribed, that failure would constitute a violation of Rule 14a-19 and the dissident would face the same liability as if it had violated any other proxy rules." (p. 47)

Tips for complying

An activist would be wise to get as far ahead of they company and other potential activists as it can.

Companies have a natural, long-standing advantage in soliciting shareholders. They can communicate with shareholders as early, often, and in whatever manner they want. So, an activist should put its nominees in front of shareholders as soon as possible. It wants shareholders to learn about the activist candidates when the company communicates about its nominees.

You'll want to get ahead of other activists, too. We expect multiple activist situations to become more frequent. At the very least you want shareholders to know about your candidates before they start to learn about others. Even better, early communication with shareholders might dissuade other activists from nominating candidates.

The 60 day notice and 25 day proxy filing deadline represent the latest dates. An activist can notify the company for UPC as soon as it notifies the company pursuant to advance notice terms, or even within the same notice. An activist can also file a proxy statement long before the 25 day deadline. Sure, you'll need to wait for the company to file its notice to distribute a UPC. Still, once you notify the company and file proxy materials, you can at least start to communicate with shareholders about your nominees.