Concurrent Session: Governance

Thursday, March 31st
11:15am – 12:30pm
Marriott Marquis, Washington DC

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February 1, 2016

Dear ,

Over the past several years, I have written to the CEOs of leading companies urging resistance to the powerful forces of short-termism afflicting corporate behavior. Reducing these pressures and working instead to invest in long-term growth remains an issue of paramount importance for BlackRock's clients, most of whom are saving for retirement and other long-term goals, as well as for the entire global economy.

While we've heard strong support from corporate leaders for taking such a long-term view, many companies continue to engage in practices that may undermine their ability to invest for the future. Dividends paid out by S&P 500 companies in 2015 amounted to the highest proportion of their earnings since 2009. As of the end of the third quarter of 2015, buybacks were up 27% over 12 months. We certainly support returning excess cash to shareholders, but not at the expense of value-creating investment. We continue to urge companies to adopt balanced capital plans, appropriate for their respective industries, that support strategies for long-term growth.

We also believe that companies have an obligation to be open and transparent about their growth plans so that shareholders can evaluate them and companies' progress in executing on those plans.

We are asking that every CEO lay out for shareholders each year a strategic framework for long-term value creation. Additionally, because boards have a critical role to play in strategic planning, we believe CEOs should explicitly affirm that their boards have reviewed those plans. BlackRock's corporate governance team, in their engagement with companies, will be looking for this framework and board review.

Annual shareholder letters and other communications to shareholders are too often backwards-looking and don't do enough to articulate management's vision and plans for the future. This perspective on the future, however, is what investors and all stakeholders truly need, including, for example, how the company is navigating the competitive landscape, how it is innovating, how it is adapting to technological disruption or geopolitical events, where it is investing and how it is developing its talent. As part of this effort, companies should work to develop financial metrics, suitable for each company and industry, that support a framework for long-term growth. Components of long-term compensation should be linked to these metrics.

We recognize that companies operate in fluid environments and face a challenging mix of external dynamics. Given the right context, long-term shareholders will understand, and even expect, that you will need to pivot in response to the changing environments you are navigating. But one reason for investors' short-term horizons is that companies have not sufficiently educated them about the ecosystems they are operating in, what their competitive threats are and how technology and other innovations are impacting their businesses.

Without clearly articulated plans, companies risk losing the faith of long-term investors. Companies also expose themselves to the pressures of investors focused on maximizing near-term profit at the expense of long-term value. Indeed, some short-term investors (and analysts) offer more compelling visions for companies than the companies themselves, allowing these perspectives to fill the void and build support for potentially destabilizing actions.

Those activists who focus on long-term value creation sometimes *do* offer better strategies than management. In those cases, BlackRock's corporate governance team will support activist plans. During the 2015 proxy season, in the 18 largest U.S. proxy contests (as measured by market cap), BlackRock voted with activists 39% of the time.

Nonetheless, we believe that companies are usually better served when ideas for value creation are part of an overall framework developed and driven by the company, rather than forced upon them in a proxy fight. With a better understanding of your long-term strategy, the process by which it is determined, and the external factors affecting your business, shareholders can put your annual financial results in the proper context.

Over time, as companies do a better job laying out their long-term growth frameworks, the need diminishes for quarterly EPS guidance, and we would urge companies to move away from providing it. Today's culture of quarterly earnings hysteria is totally contrary to the long-term approach we need. To be clear, we do believe companies should still report quarterly results – "long-termism" should not be a substitute for transparency – but CEOs should be more focused in these reports on demonstrating progress against their strategic plans than a one-penny deviation from their EPS targets or analyst consensus estimates.

With clearly communicated and understood long-term plans in place, quarterly earnings reports would be transformed from an instrument of incessant short-termism into a building block of long-term behavior. They would serve as a useful "electrocardiogram" for companies, providing information on how companies are performing against the "baseline EKG" of their long-term plan for value creation.

We also are proposing that companies explicitly affirm to shareholders that their boards have reviewed their strategic plans. This review should be a rigorous process that provides the board the necessary context and allows for a robust debate. Boards have an obligation to review, understand, discuss and challenge a company's strategy.

Generating sustainable returns over time requires a sharper focus not only on governance, but also on environmental and social factors facing companies today. These issues offer both risks and opportunities, but for too long, companies have not considered them core to their business – even when the world's political leaders are increasingly focused on them, as demonstrated by the Paris Climate Accord. Over the long-term, environmental, social and governance (ESG) issues – ranging from climate change to diversity to board effectiveness – have real and quantifiable financial impacts.

At companies where ESG issues are handled well, they are often a signal of operational excellence. BlackRock has been undertaking a multi-year effort to integrate ESG considerations into our investment processes, and we expect companies to have strategies to manage these issues. Recent action from the U.S. Department of Labor makes clear that pension fund fiduciaries can include ESG factors in their decision making as well.

We recognize that the culture of short-term results is not something that can be solved by CEOs and their boards alone. Investors, the media and public officials all have a role to play. In Washington (and other capitals), long-term is often defined as simply the next election cycle, an attitude that is eroding the economic foundations of our country.

Public officials must adopt policies that will support long-term value creation. Companies, for their part, must recognize that while advocating for more infrastructure or comprehensive tax reform may not bear fruit in the next quarter or two, the absence of effective long-term policies in these areas undermines the economic ecosystem in which companies function – and with it, their chances for long-term growth.

We note two areas, in particular, where policymakers taking a longer-term perspective could help support the growth of companies and the entire economy:

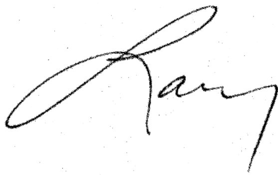
- First, tax policy too often lacks proper incentives for long-term behavior. With capital gains, for example, one year shouldn't qualify as a long-term holding period. As I wrote last year, we need a capital gains regime that rewards long-term investment – with long-term treatment only after three years, and a decreasing tax rate for each year of ownership beyond that (potentially dropping to zero after 10 years).

- Second, chronic underinvestment in infrastructure in the U.S. – from roads to sewers to the power grid – will not only cost businesses and consumers $1.8 trillion over the next five years, but clearly represents a threat to the ability of companies to grow. At a time of massive global inequality, investment in infrastructure – and all its benefits, including job creation – is also critical for growth in most emerging markets around the world. Companies and investors must advocate for action to fill the gaping chasm between our massive infrastructure needs and squeezed government funding, including strategies for developing private-sector financing mechanisms.

Over the past few years, we've seen more and more discussion around how to foster a long-term mindset. While these discussions are encouraging, we will only achieve our goal by changing practices and policies, and CEOs of America's leading companies have a vital role to play in that debate.

Corporate leaders have historically been a source of optimism about the future of our economy. At a time when there is so much anxiety and uncertainty in the capital markets, in our political discourse and across our society more broadly, it is critical that investors in particular hear a forward-looking vision about your own company's prospects and the public policy you need to achieve consistent, sustainable growth. The solutions to these challenges are in our hands, and I ask that you join me in helping to answer them.

Sincerely,



Laurence D. Fink

Proxy voting guidelines for U.S. securities

February 2015

Proxy voting guidelines for U.S. securities

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Proxy voting guidelines for U.S. securities

These guidelines should be read in conjunction with BlackRock's Global Corporate Governance and Engagement Principles, which are available on-line at www.blackrock.com

Introduction

BlackRock, Inc. and its subsidiaries (collectively, "BlackRock") seek to make proxy voting decisions in the manner most likely to protect and promote the economic value of the securities held in client accounts. The following issue-specific proxy voting guidelines (the "Guidelines") are intended to summarize BlackRock's general philosophy on corporate governance matters and approach to issues that may commonly arise in the proxy voting context for U.S. securities. These Guidelines are not intended to limit the analysis of individual issues at specific companies and are not intended to provide a guide to how BlackRock will vote in every instance. Rather, they share our view about corporate governance issues generally, and provide insight into how we typically approach issues that commonly arise on corporate ballots as well as our expectations of boards of directors. They are applied with discretion, taking into consideration the range of issues and facts specific to the company and the individual ballot item.

Voting guidelines

These guidelines are divided into six key themes which group together the issues that frequently appear on the agenda of annual and extraordinary meetings of shareholders.

The six key themes are:

- Boards and directors
- Auditors and audit-related issues
- Capital structure, mergers, asset sales and other special transactions
- Remuneration and benefits
- Social, ethical and environmental issues
- General corporate governance matters

Boards and directors

Director elections

BlackRock generally supports board nominees in most uncontested elections. BlackRock may withhold votes from certain directors on the board or members of particular board committees (or prior members, as the case may be) in certain situations, including, but not limited to:

- The independent chair or lead independent director and members of the governance committee, where a board fails to implement shareholder proposals that receive a majority of votes cast at a prior shareholder meeting, and the proposals, in our view, have a direct and substantial impact on shareholders' fundamental rights or long-term economic interests.

- The independent chair or lead independent director and members of the governance committee, where a board implements or renews a poison pill without seeking shareholder approval beforehand or within a reasonable period of time after implementation.

- The independent chair or lead independent director and members of the governance committee, where a board amends the charter/articles/by-laws such that the effect may be to entrench directors or to significantly reduce shareholder rights. In such cases, in determining whether to withhold support from directors, we will consider in part the company's publicly stated rationale for the changes and whether the board has determined to seek shareholder approval beforehand or within a reasonable period of time after implementation.

- The independent chair or lead independent director, members of the nominating committee, and/or the longest tenured director(s), where we observe a lack of board responsiveness to shareholders on board composition concerns, evidence of board entrenchment, insufficient attention to board diversity, and/or failure to promote adequate board succession planning over time in line with the company's stated strategic direction.

- An insider or affiliated outsider who sits on the board's audit, compensation, nominating or governance committees (the "key committees"), which we believe generally should be entirely independent. However, BlackRock will examine a board's complete profile when questions of independence arise prior to casting a withhold vote for any director. For controlled companies, as defined by the U.S. stock exchanges, we will only vote against insiders or affiliates who sit on the audit committee, but not other key committees.

- Members of the audit committee during a period when the board failed to facilitate quality, independent auditing, for example, if substantial accounting irregularities suggest insufficient oversight by that committee.

- Members of the audit committee during a period in which we believe the company has aggressively accounted for its equity compensation plans.

- Members of the compensation committee during a period in which executive compensation appears excessive relative to performance and peers, and where we believe the compensation committee has not already substantially addressed this issue.

- Members of the compensation committee where the company has repriced options without contemporaneous shareholder approval.

- The chair of the nominating committee, or where no chair exists, the nominating committee member with the longest tenure, where board member(s) at the most recent election of directors have received withhold votes from more than 30% of shares voting and the board has not taken appropriate action to respond to shareholder concerns. This may not apply in cases where BlackRock did not support the initial withhold vote.

- The chair of the nominating committee, or where no chair exists, the nominating committee member with the longest tenure, where the board is not composed of a majority of independent directors. However, this would not apply in the case of a controlled company.

- Where BlackRock obtains evidence that casts significant doubt on a director's qualifications or ability to represent shareholders.

- Where it appears the director has acted (at the company or at other companies) in a manner that compromises his or her reliability in representing the best long-term economic interests of shareholders.

- Where a director has a pattern of poor attendance at combined board and applicable key committee meetings. Excluding exigent circumstances, BlackRock generally considers attendance at less than 75% of the combined board and applicable key committee meetings by a board member to be poor attendance.

- Where a director has committed himself or herself to service on a large number of boards, such that we deem it unlikely that the director will be able to commit sufficient focus and time to a particular company (commonly referred to as "over-boarding"). While each situation will be reviewed on a case-by-case basis, BlackRock is most likely to withhold votes for over-boarding where a director is: 1) serving on more than four public company boards; or 2) is a chief executive officer at a public company and is serving on more than two public company boards in addition to the board of the company where they serve as chief executive officer.

If a board maintains a classified structure, it is possible that the director(s) with whom we have a particular concern may not be subject to election in the year that the concern arises. In such situations, if we have a concern regarding a committee or committee chair, we generally register our concern by withholding votes from all members of the relevant committee who are subject to election that year.

Director independence

We expect that a board should be majority independent. We believe that an independent board faces fewer conflicts and is best prepared to protect shareholder interests. Common impediments to independence in the U.S. may include, but are not limited to:

- Employment by the company or a subsidiary as a senior executive within the previous five years
- Status as a founder of the company
- Substantial business or personal relationships with the company or the company's senior executives
- Family relationships with senior executives or founders of the company
- An equity ownership in the company in excess of 20%

Board composition and effectiveness

We encourage boards to routinely refresh their membership to ensure the relevance of the skills, experience and attributes of each director to the work of the board. To ensure that the board remains effective, regular reviews of board performance should be carried out and assessments made of gaps in skills or experience amongst the members. BlackRock believes it is beneficial for new directors to be brought onto the board periodically to refresh the group's thinking and to ensure both continuity and adequate succession planning. We believe that the nominating committee of the board has the ability to implement such refreshment. In identifying potential candidates, boards should take into consideration the diversity of experience and expertise of the current directors and how that might be augmented by incoming directors. We encourage boards to disclose their views on: the mix of competencies, experience and other qualities required to effectively oversee and guide management; the process by which candidates are identified and selected, including whether professional firms or other sources outside of incumbent directors' networks have been engaged to identify and/or assess candidates; the process by which boards evaluate themselves and any significant outcomes of the evaluation process, without divulging inappropriate and/or sensitive details; the consideration given towards board diversity, including, but not limited to, diversity of gender, race, age, experience, and skills; and other factors taken into account in the nomination process.

While we support regular board refreshment, we are not opposed in principle to long-tenured directors nor do we believe that long board tenure is necessarily an impediment to director independence. We believe that a variety of director tenures within the boardroom can be beneficial to ensure board quality and continuity of experience; our primary concern

is that board members are able to contribute effectively as corporate strategy evolves and business conditions change over time, and that all directors, regardless of tenure, demonstrate appropriate responsiveness to shareholders over time. We acknowledge that each director brings their own unique skills and experiences and that no single person can be expected to bring all relevant skill sets to a board; at the same time, we generally do not believe it is necessary or appropriate to have any particular director on the board solely by virtue of a singular background or specific area of expertise.

As a result of the nominating committee's responsibility for board composition and refreshment over time, we typically oppose shareholder proposals imposing arbitrary limits on the pool of directors from which shareholders can choose their representatives. However, where boards find that age limits or term limits are the most efficient and objective mechanism for ensuring periodic board refreshment, we generally defer to the board's determination in setting such limits.

Board size

We generally defer to the board in setting the appropriate size. We believe directors are generally in the best position to assess what size is optimal to ensure a board's effectiveness. However, we may oppose boards that appear too small to allow for effective shareholder representation or too large to function efficiently.

CEO and management succession planning

There should be a robust CEO and management succession plan in place at the board level that is reviewed and updated on a regular basis. We expect succession planning to cover both long-term planning consistent with the strategic direction of the company and identified leadership needs over time as well as short-term planning in the event of an unanticipated executive departure. We acknowledge that both internal and external management candidates may be considered, as informed by required skill sets and cultural fit considerations and as appropriate to the company's circumstances. We encourage the company to explain its executive succession planning process, including where accountability lies within the boardroom for this task, without prematurely divulging sensitive information commonly associated with this exercise.

Classified board of directors/staggered terms

A classified board of directors is one that is divided into classes (generally three), each of which is elected on a staggered schedule (generally for three years). At each annual meeting, only a single class of directors is subject to reelection (generally one-third of the entire board).

We believe that classification of the board dilutes shareholders' right to evaluate promptly a board's performance and limits shareholder selection of their representatives. By not having the mechanism to immediately address concerns we may have with any specific director, we may be required to register our concerns through our vote on the directors who are subject to election that year (see "Director elections" for additional detail). Furthermore, where boards are classified, director entrenchment is more likely, because review of board service generally only occurs every three years. Therefore, we typically vote against classification and for proposals to eliminate board classification.

Contested director elections

Most director elections are not competitive, but shareholders are sometimes presented with competing slates of director candidates. Generally, such proxy contests are the result of a shareholder (or group of shareholders) seeking to change the company's strategy or address failures in the board's oversight of management. The details of proxy contests are assessed on a case-by-case basis. We evaluate a number of factors, which may include, but are not limited to: the qualifications of the dissident and management candidates; the validity of the concerns identified by the dissident; the viability of both the dissident's and management's plans; the likelihood that the dissident's solutions will produce the desired change; and whether the dissidents represent the best option for enhancing long-term shareholder value.

Cumulative voting for directors

Cumulative voting allocates one vote for each share of stock held, times the number of directors subject to election. A shareholder may cumulate his/her votes and cast all of them in favor of a single candidate, or split them among any combination of candidates. By making it possible to use their cumulated votes to elect at least one board member, cumulative voting is typically a mechanism through which minority shareholders attempt to secure board representation.

We typically oppose proposals that further the candidacy of minority shareholders whose interests do not coincide with our fiduciary responsibility. We may support cumulative voting proposals at companies where the board is not majority independent. We may support cumulative voting at companies that have a controlling shareholder. A cumulative voting structure is not consistent with a majority voting requirement, as it may interfere with the capacity of director candidates to achieve the required level of support. We may not support a cumulative voting proposal at a company that has adopted a majority voting standard.

Director compensation and equity programs

We believe that compensation for independent directors should be structured to align the interests of the directors with those of shareholders, whom the directors have been elected to represent. We believe that independent director compensation packages based on the company's long-term performance and that include some form of long-term equity compensation are more likely to meet this goal; therefore, we typically support proposals to provide such compensation packages. However, we will generally oppose shareholder proposals requiring directors to own a minimum amount of company stock, as we believe that companies should maintain flexibility in administering compensation and equity programs for independent directors, given each company's and director's unique circumstances. As discussed in further detail under the heading "Equity compensation plans" below, we believe that companies should prohibit directors from engaging in transactions with respect to their long-term compensation that might disrupt the intended economic alignment between equity plan beneficiaries and shareholders.

Indemnification of directors and officers

We generally support reasonable but balanced protection of directors and officers. We believe that failure to provide protection to directors and officers might severely limit a company's ability to attract and retain competent leadership. We generally support proposals to provide indemnification that is limited to coverage of legal expenses. However, we may oppose proposals that provide indemnity for: breaches of the duty of loyalty; transactions from which a director derives an improper personal benefit; and actions or omissions not in good faith or those that involve intentional misconduct.

Majority vote requirements

BlackRock generally supports proposals seeking to require director election by majority vote. Majority voting standards assist in ensuring that directors who are not broadly supported by shareholders are not elected to serve as their representatives. We note that majority voting is not appropriate in all circumstances, for example, in the context of a contested election. We also recognize that some companies with a plurality voting standard have adopted a resignation policy for directors who do not receive support from at least a majority of votes cast. Where we believe that the company already has a sufficiently robust majority voting process in place, we may not support a shareholder proposal seeking an alternative mechanism.

Risk oversight

Companies should have an established process for identifying, monitoring and managing key risks, and independent directors should have ready access to relevant management information and outside advice, as appropriate, to ensure they can properly oversee risk management. We encourage companies to provide transparency as to the optimal risk levels, how risk is measured and how risks are reported to the board. We are particularly interested to understand how risk oversight processes evolve in response to changes in corporate strategy and/or shifts in the business and related risk environment. Boards should clearly explain their approach to risk oversight, including where accountability lies within the boardroom for this activity, especially where there are multiple individuals or board committees tasked with oversight of various risks.

Separation of chairman and CEO positions

We believe that independent leadership is important in the board room. In the U.S. there are two commonly accepted structures for independent board leadership: 1) an independent chairman; or 2) a lead independent director. We assess the experience and governance track record of the independent chairman or lead independent director to understand capability and suitability to effectively and constructively lead a board. Our expectations of an individual in this role include, but are not limited to: being available to serve as an advisor to the CEO; contributing to the oversight of CEO and management succession planning; and being available to meet with shareholders when they have highly sensitive concerns about management or corporate governance issues. We generally consider the designation of a lead independent director as an acceptable alternative to an independent chair if the lead independent director has a term of at least one year and has powers to: 1) provide formal input into board meeting agendas; 2) call meetings of the independent directors; and 3) preside at meetings of independent directors. Where a company does not have a lead independent director that meets these criteria, we generally support the separation of chairman and CEO.

Shareholder access to the proxy

We believe that long-term shareholders should have the opportunity, when necessary and under reasonable conditions, to nominate individuals to stand for election to the boards of the companies they own and to have those nominees included on the company's proxy card. This right is commonly referred to as "proxy access". In our view, securing a right of shareholders to nominate directors without engaging in a control contest can enhance shareholders' ability to participate meaningfully in the director election process, stimulate board attention to shareholder interests, and provide shareholders an effective means of directing that attention where it is lacking. Given the complexity of structuring an appropriate proxy access mechanism and the brevity required of shareholder proposals, we generally expect that a shareholder proposal to adopt proxy access will describe general parameters for the mechanism, while providing the board with flexibility to design a process that is appropriate in light of the company's specific circumstances. Proxy access mechanisms should provide shareholders with a reasonable opportunity to use this right without stipulating overly restrictive or onerous parameters for use, and also provide assurances that the mechanism will not be subject to abuse by short-term investors, investors without a substantial investment in the company, or investors seeking to take control of the board. We will review proposals regarding the adoption of proxy access on a case-by-case basis.

Auditors and audit-related issues

BlackRock recognizes the critical importance of financial statements that provide a complete and accurate portrayal of a company's financial condition. Consistent with our approach to voting on boards of directors, we seek to hold the audit committee of the board responsible for overseeing the management of the audit function at a company, and may withhold votes from the audit committee's members where the board has failed to facilitate quality, independent auditing. We look to the audit committee report for insight into the scope of the audit committee's responsibilities, including an overview of audit committee processes, issues on the audit committee's agenda and key decisions taken by the audit committee. We

take particular note of cases involving significant financial restatements or material weakness disclosures, and we expect timely disclosure and remediation of accounting irregularities.

The integrity of financial statements depends on the auditor effectively fulfilling its role. To that end, we favor an independent auditor. In addition, to the extent that an auditor fails to reasonably identify and address issues that eventually lead to a significant financial restatement, or the audit firm has violated standards of practice that protect the interests of shareholders, we may also vote against ratification.

From time to time, shareholder proposals may be presented to promote auditor independence or the rotation of audit firms. We may support these proposals when they are consistent with our views as described above.

Capital structure proposals

Blank check preferred

We frequently oppose proposals requesting authorization of a class of preferred stock with unspecified voting, conversion, dividend distribution and other rights ("blank check" preferred stock) because they may serve as a transfer of authority from shareholders to the board and a possible entrenchment device. We generally view the board's discretion to establish voting rights on a when-issued basis as a potential anti-takeover device, as it affords the board the ability to place a block of stock with an investor sympathetic to management, thereby foiling a takeover bid without a shareholder vote. Nonetheless, where the company appears to have a legitimate financing motive for requesting blank check authority, has committed publicly that blank check preferred shares will not be used for anti-takeover purposes, has a history of using blank check preferred stock for financings, or has blank check preferred stock previously outstanding such that an increase would not necessarily provide further anti-takeover protection but may provide greater financing flexibility, we may support the proposal.

Equal voting rights

BlackRock supports the concept of equal voting rights for all shareholders. Some management proposals request authorization to allow a class of common stock to have superior voting rights over the existing common or to allow a class of common to elect a majority of the board. We oppose such differential voting power as it may have the effect of denying shareholders the opportunity to vote on matters of critical economic importance to them.

When a management or shareholder proposal requests to eliminate an existing dual-class voting structure, we seek to determine whether the cost of restructuring will have a clear economic benefit to our clients' portfolio(s). We evaluate these proposals on a case-by-case basis, and we consider the level and nature of control associated with the dual-class voting structure as well as the company's history of responsiveness to shareholders in determining whether support of such a measure is appropriate.

Increase in authorized common shares

BlackRock considers industry specific norms in our analysis of these proposals, as well as a company's history with respect to the use of its common shares. Generally, we are predisposed to support a company if the board believes additional common shares are necessary to carry out the firm's business. The most substantial concern we might have with an increase is the possibility of use of common shares to fund a poison pill plan that is not in the economic interests of shareholders.

Increase or issuance of preferred stock

These proposals generally request either authorization of a class of preferred stock or an increase in previously authorized preferred stock. Preferred stock may be used to provide management with the flexibility to consummate beneficial acquisitions, combinations or financings on terms not necessarily available via other means of financing. We generally support these proposals in cases where the company specifies the voting, dividend, conversion and other rights of such stock where the terms of the preferred stock appear reasonable.

Stock splits and reverse stock splits

We generally support stock splits that are not likely to negatively affect the ability to trade shares or the economic value of a share. We generally support reverse splits that are designed to avoid delisting or to facilitate trading in the stock, where the reverse split will not have a negative impact on share value (*e.g.* one class is reduced while others remain at pre-split levels). In the event of a proposal to reverse split that would not also proportionately reduce the company's authorized stock, we apply the same analysis we would use for a proposal to increase authorized stock.

Mergers, asset sales, and other special transactions

In reviewing merger and asset sale proposals, BlackRock's primary concern is the best long-term economic interests of shareholders. While these proposals vary widely in scope and substance, we closely examine certain salient features in our analyses. The varied nature of these proposals ensures that the following list will be incomplete. However, the key factors that we typically evaluate in considering these proposals include:

- For mergers and asset sales, we assess the degree to which the proposed transaction represents a premium to the company's trading price. In order to filter out the effects of pre-merger news leaks on the parties' share prices, we consider a share price from multiple time periods prior to the date of the merger announcement. In most cases, business combinations should provide a premium. We may consider comparable transaction analyses provided by the parties' financial advisors and our own valuation assessments. For companies facing insolvency or bankruptcy, a premium may not apply.
- There should be a favorable business reason for the combination.
- Unanimous board approval and arm's-length negotiations are preferred. We will consider whether the transaction involves a dissenting board or does not appear to be the result of an arm's-length bidding process. We may also consider whether executive and/or board members' financial interests in a given transaction appear likely to affect their ability to place shareholders' interests before their own.
- We prefer transaction proposals that include the fairness opinion of a reputable financial advisor assessing the value of the transaction to shareholders in comparison to recent similar transactions.

Poison pill plans

Also known as Shareholder Rights Plans, these plans generally involve issuance of call options to purchase securities in a target firm on favorable terms. The options are exercisable only under certain circumstances, usually accumulation of a specified percentage of shares in a relevant company or launch of a hostile tender offer. These plans are often adopted by the board without being subject to shareholder vote.

Poison pill proposals generally appear on the proxy as shareholder proposals requesting that existing plans be put to a vote. This vote is typically advisory and therefore non-binding. We generally vote in favor of shareholder proposals to rescind poison pills.

Where a poison pill is put to a shareholder vote, our policy is to examine these plans individually. Although we oppose most plans, we may support plans that include a reasonable 'qualifying offer clause.' Such clauses typically require shareholder ratification of the pill, and stipulate a sunset provision whereby the pill expires unless it is renewed. These clauses also tend to specify that an all cash bid for all shares that includes a fairness opinion and evidence of financing does not trigger the pill, but forces either a special meeting at which the offer is put to a shareholder vote, or the board to seek the written consent of shareholders where shareholders could rescind the pill in their discretion. We may also support a pill where it is the only effective method for protecting tax or other economic benefits that may be associated with limiting the ownership changes of individual shareholders.

Reimbursement of expenses for successful shareholder campaigns

Proxy contests and other public campaigns can be valuable mechanisms for holding boards of underperforming companies accountable to their shareholders. However, these campaigns can also lead to unwarranted cost and distraction for boards and management teams, and may be imposed by investors whose interests are not aligned with other investors. Therefore, we generally do not support proposals seeking the reimbursement of proxy contest expenses, even in situations where we support the shareholder campaign, as we believe that introducing the possibility of such reimbursement may incentivize disruptive and unnecessary shareholder campaigns.

Remuneration and benefits

We note that there are both management and shareholder proposals related to executive compensation that appear on corporate ballots. We generally vote on these proposals as described below, except that we typically oppose shareholder proposals on issues where the company already has a reasonable policy in place that we believe is sufficient to address the issue. We may also oppose a shareholder proposal regarding executive compensation if the company's history suggests that the issue raised is not likely to present a problem for that company.

Advisory resolutions on executive compensation ("Say on Pay")

In cases where there is a Say on Pay vote, BlackRock will respond to the proposal as informed by our evaluation of compensation practices at that particular company, and in a manner that appropriately addresses the specific question posed to shareholders. We describe in the Appendix herein ("Our approach to Say on Pay") our beliefs and expectations related to executive compensation practices, our Say on Pay analysis framework, and our typical approach to engagement and voting on Say on Pay.

Advisory votes on the frequency of Say on Pay resolutions ("Say When on Pay")

BlackRock will generally opt for a triennial vote on Say on Pay. We believe that shareholders should undertake an annual review of executive compensation and express their concerns through their vote on the members of the compensation committee. As a result, it is generally not necessary to hold a Say on Pay vote on an annual basis, as the Say on Pay vote merely supplements the shareholder's vote on compensation committee members. However, we may support annual Say on Pay votes in some situations, for example, where we conclude that a company has failed to align pay with performance.

Claw back proposals

Claw back proposals are generally shareholder sponsored and seek recoupment of bonuses paid to senior executives if those bonuses were based on financial results that are later restated or were otherwise awarded as a result of deceptive business practices. We generally favor recoupment from any senior executive whose compensation was based on faulty

financial reporting or deceptive business practices, regardless of that particular executive's role in the faulty reporting. We typically support these proposals unless the company already has a robust claw back policy that sufficiently addresses our concerns.

Employee stock purchase plans

An employee stock purchase plan ("ESPP") gives the issuer's employees the opportunity to purchase stock in the issuer, typically at a discount to market value. We believe these plans can provide performance incentives and help align employees' interests with those of shareholders. The most common form of ESPP qualifies for favorable tax treatment under Section 423 of the Internal Revenue Code. Section 423 plans must permit all full-time employees to participate, carry restrictions on the maximum number of shares that can be purchased, carry an exercise price of at least 85 percent of fair market value on grant date with offering periods of 27 months or less, and be approved by shareholders. We will typically support qualified ESPP proposals.

Equity compensation plans

BlackRock supports equity plans that align the economic interests of directors, managers and other employees with those of shareholders. We believe that boards should establish policies prohibiting use of equity awards in a manner that could disrupt the intended alignment with shareholder interests, for example: use of the stock as collateral for a loan; use of the stock in a margin account; use of the stock (or an unvested award) in hedging or derivative transactions. We may support shareholder proposals requesting the board to establish such policies.

Our evaluation of equity compensation plans is based on a company's executive pay and performance relative to peers and whether the plan plays a significant role in a pay-for-performance disconnect. We generally oppose plans that contain "evergreen" provisions allowing for the unlimited increase of shares reserved without requiring further shareholder approval after a reasonable time period. We also generally oppose plans that allow for repricing without shareholder approval. We may also oppose plans that provide for the acceleration of vesting of equity awards even in situations where an actual change of control may not occur. We encourage companies to structure their change of control provisions to require the termination of the covered employee before acceleration or special payments are triggered. Finally, we may oppose plans where we believe that the company is aggressively accounting for the equity delivered through their stock plans.

Golden parachutes

Golden parachutes provide for compensation to management in the event of a change in control. We generally view golden parachutes as encouragement to management to consider transactions that might be beneficial to shareholders. However, a large potential payout under a golden parachute arrangement also presents the risk of motivating a management team to support a sub-optimal sale price for a company.

We may support shareholder proposals requesting that implementation of such arrangements require shareholder approval. We generally support proposals requiring shareholder approval of plans that exceed 2.99 times an executive's current salary and bonus, including equity compensation.

When determining whether to support or oppose an advisory vote on a golden parachute plan ("Say on Golden Parachutes"), we normally support the plan unless it appears to result in payments that are excessive or detrimental to shareholders. In evaluating golden parachute plans, BlackRock may consider several factors, including:

- whether we believe that the triggering event is in the best interest of shareholders;
- an evaluation of whether management attempted to maximize shareholder value in the triggering event;

- the percentage of total transaction value that will be transferred to the management team, rather than shareholders, as a result of the golden parachute payment;
- whether excessively large excise tax gross up payments are part of the payout;
- whether the pay package that serves as the basis for calculating the golden parachute payment was reasonable in light of performance and peers; and/or
- whether the golden parachute payment will have the effect of rewarding a management team that has failed to effectively manage the company.

It may be difficult to anticipate the results of a plan until after it has been triggered; as a result, BlackRock may vote against a Say on Golden Parachute proposal even if the golden parachute plan under review was approved by shareholders when it was implemented.

Option exchanges

BlackRock may support a request to exchange underwater options under the following circumstances: the company has experienced significant stock price decline as a result of macroeconomic trends, not individual company performance; directors and executive officers are excluded; the exchange is value neutral or value creative to shareholders; and there is clear evidence that absent repricing the company will suffer serious employee incentive or retention and recruiting problems. BlackRock may also support a request to exchange underwater options in other circumstances, if we determine that the exchange is in the best interest of shareholders.

Pay-for-Performance plans

In order for executive compensation exceeding $1 million to qualify for federal tax deductions, the Omnibus Budget Reconciliation Act (OBRA) requires companies to link that compensation, for the company's top five executives, to disclosed performance goals and submit the plans for shareholder approval. The law further requires that a compensation committee comprised solely of outside directors administer these plans. Because the primary objective of these proposals is to preserve the deductibility of such compensation, we generally favor approval in order to preserve net income.

Pay-for-Superior-Performance

These are typically shareholder proposals requesting that compensation committees adopt policies under which a portion of equity compensation requires the achievement of performance goals as a prerequisite to vesting. We generally believe these matters are best left to the compensation committee of the board and that shareholders should not set executive compensation or dictate the terms thereof. We may support these proposals if we have a substantial concern regarding the company's compensation practices over a significant period of time, the proposals are not overly prescriptive, and we believe the proposed approach is likely to lead to substantial improvement.

Supplemental executive retirement plans

BlackRock may support shareholder proposals requesting to put extraordinary benefits contained in Supplemental Executive Retirement Plans ("SERP") agreements to a shareholder vote unless the company's executive pension plans do not contain excessive benefits beyond what is offered under employee-wide plans.

Social, ethical and environmental issues

Our fiduciary duty to clients is to protect and enhance their economic interest in the companies in which we invest on their behalf. It is within this context that we undertake our corporate governance activities. We believe that well-managed companies will deal effectively with the social, ethical and environmental ("SEE") aspects of their businesses.

BlackRock expects companies to identify and report on the material, business-specific SEE risks and opportunities and to explain how these are managed. This explanation should make clear how the approach taken by the company best serves the interests of shareholders and protects and enhances the long-term economic value of the company. The key performance indicators in relation to SEE matters should also be disclosed and performance against them discussed, along with any peer group benchmarking and verification processes in place. This helps shareholders assess how well management is dealing with the SEE aspects of the business. Any global standards adopted should also be disclosed and discussed in this context.

We may vote against the election of directors where we have concerns that a company might not be dealing with SEE issues appropriately. Sometimes we may reflect such concerns by supporting a shareholder proposal on the issue, where there seems to be either a significant potential threat or realized harm to shareholders' interests caused by poor management of SEE matters. In deciding our course of action, we will assess whether the company has already taken sufficient steps to address the concern and whether there is a clear and material economic disadvantage to the company if the issue is not addressed.

More commonly, given that these are often not voting issues, we will engage directly with the board or management. The trigger for engagement on a particular SEE concern is our assessment that there is potential for material economic ramifications for shareholders.

We do not see it as our role to make social, ethical or political judgments on behalf of clients. We expect investee companies to comply, at a minimum, with the laws and regulations of the jurisdictions in which they operate. They should explain how they manage situations where such laws or regulations are contradictory or ambiguous.

General corporate governance matters

We believe that shareholders should have the right to vote on key corporate governance matters, including on changes to governance mechanisms and amendments to the charter/articles/by-laws. We may vote against certain directors where changes to governing documents are not put to a shareholder vote within a reasonable period of time, in particular if those changes have the potential to impact shareholder rights (see "Director elections" herein). In cases where a board's unilateral adoption of changes to the charter/articles/by-laws promotes cost and operational efficiency benefits for the company and its shareholders, we may support such action if it does not have a negative effect on shareholder rights or the company's corporate governance structure.

When voting on a management or shareholder proposal to make changes to charter/articles/by-laws, we will consider in part the company's and/or proponent's publicly stated rationale for the changes, the company's governance profile and history, relevant jurisdictional laws, and situational or contextual circumstances which may have motivated the proposed changes, among other factors. We will typically support changes to the charter/articles/by-laws where the benefits to shareholders, including the costs of failing to make those changes, demonstrably outweigh the costs or risks of making such changes.

Adjourn meeting to solicit additional votes

We generally support such proposals unless the agenda contains items that we judge to be detrimental to shareholders' best long-term economic interests.

Bundled proposals

We believe that shareholders should have the opportunity to review substantial governance changes individually without having to accept bundled proposals. Where several measures are grouped into one proposal, BlackRock may reject certain positive changes when linked with proposals that generally contradict or impede the rights and economic interests of shareholders.

Corporate political activities

Companies may engage in certain political activities, within legal and regulatory limits, in order to influence public policy consistent with the companies' values and strategies, and thus serve shareholders' best long-term economic interests. These activities can create risks, including: the potential for allegations of corruption; the potential for reputational issues associated with a candidate, party or issue; and risks that arise from the complex legal, regulatory and compliance considerations associated with corporate political activity. We believe that companies which choose to engage in political activities should develop and maintain robust processes to guide these activities and to mitigate risks, including a level of board oversight.

When presented with shareholder proposals requesting increased disclosure on corporate political activities, we may consider the political activities of that company and its peers, the existing level of disclosure, and our view regarding the associated risks. We generally believe that it is the duty of boards and management to determine the appropriate level of disclosure of all types of corporate activity, and we are generally not supportive of proposals that are overly prescriptive in nature. We may determine to support a shareholder proposal requesting additional reporting of corporate political activities where there seems to be either a significant potential threat or actual harm to shareholders' interests and where we believe the company has not already provided shareholders with sufficient information to assess the company's management of the risk.

Finally, we believe that it is not the role of shareholders to suggest or approve corporate political activities; therefore we generally do not support proposals requesting a shareholder vote on political activities or expenditures.

Other business

We oppose giving companies our proxy to vote on matters where we are not given the opportunity to review and understand those measures and carry out an appropriate level of shareholder oversight.

Reincorporation

Proposals to reincorporate from one state or country to another are most frequently motivated by considerations of anti-takeover protections, legal advantages, and/or cost savings. We will evaluate, on a case-by-case basis, the economic and strategic rationale behind the company's proposal to reincorporate. In all instances, we will evaluate the changes to shareholder protection under the new charter/articles/by-laws to assess whether the move increases or decreases shareholder protections. Where we find that shareholder protections are diminished, we may support reincorporation if we determine that the overall benefits outweigh the diminished rights.

IPO governance

We expect boards to consider and disclose how the corporate governance structures adopted upon initial public offering ("IPO") are in shareholders' best long-term interests. We also expect boards to conduct a regular review of corporate governance and control structures, such that boards might evolve foundational corporate governance structures as company circumstances change, without undue costs and disruption to shareholders.

We will typically apply a one-year grace period for the application of certain director-related guidelines (including, but not limited to, director independence and over-boarding considerations), during which we expect boards to take steps to bring corporate governance standards in line with our expectations.

Further, if a company qualifies as an emerging growth company (an "EGC") under the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"), we will give consideration to the NYSE and NASDAQ governance exemptions granted under the JOBS Act for the duration such a company is categorized as an EGC. We expect an EGC to have a totally independent audit committee by the first anniversary of its IPO, with our standard approach to voting on auditors and audit-related issues applicable in full for an EGC on the first anniversary of its IPO.

Shareholders' right to act by written consent

In exceptional circumstances and with sufficiently broad support, shareholders should have the opportunity to raise issues of substantial importance without having to wait for management to schedule a meeting. We therefore believe that shareholders should have the right to solicit votes by written consent provided that: 1) there are reasonable requirements to initiate the consent solicitation process in order to avoid the waste of corporate resources in addressing narrowly supported interests; and 2) support from a minimum of 50% of outstanding shares is required to effectuate the action by written consent. We may oppose shareholder proposals requesting the right to act by written consent in cases where the proposal is structured for the benefit of a dominant shareholder to the exclusion of others, or if the proposal is written to discourage the board from incorporating appropriate mechanisms to avoid the waste of corporate resources when establishing a right to act by written consent. Additionally, we may oppose shareholder proposals requesting the right to act by written consent if the company already provides a shareholder right to call a special meeting that we believe offers shareholders a reasonable opportunity to raise issues of substantial importance without having to wait for management to schedule a meeting.

Shareholders' right to call a special meeting

In exceptional circumstances and with sufficiently broad support, shareholders should have the opportunity to raise issues of substantial importance without having to wait for management to schedule a meeting. We therefore believe that shareholders should have the right to call a special meeting in cases where a reasonably high proportion of shareholders (typically a minimum of 15% but no higher than 25%) are required to agree to such a meeting before it is called, in order to avoid the waste of corporate resources in addressing narrowly supported interests. However, we may oppose this right in cases where the proposal is structured for the benefit of a dominant shareholder to the exclusion of others. We generally believe that a right to act via written consent is not a sufficient alternative to the right to call a special meeting.

Simple majority voting

We generally favor a simple majority voting requirement to pass proposals. Therefore, we will support the reduction or the elimination of supermajority voting requirements to the extent that we determine shareholders' ability to protect their economic interests is improved. Nonetheless, in situations where there is a substantial or dominant shareholder, supermajority voting may be protective of public shareholder interests and we may support supermajority requirements in those situations.

Appendix: Our Approach to Say on Pay

We describe herein our beliefs and expectations related to executive compensation practices, our Say on Pay analysis framework, and our typical approach to engagement and voting on Say on Pay. We provide our views on this issue in somewhat more detail than other issues covered in these Guidelines because of the particular focus on executive compensation matters in the U.S. Although we expect proxy disclosures to be the primary mechanism for companies to explain their executive compensation practices, we may engage with members of management and/or the compensation committee of the board, where concerns are identified or where we seek to better understand a company's approach to executive compensation. We may also decline opportunities to engage with companies where we do not have any questions or concerns or believe that these Guidelines already cover the issues at hand.

Beliefs and Expectations Related to Executive Compensation Practices

- We believe that compensation committees are in the best position to make compensation decisions and should maintain significant flexibility in administering compensation programs, given their knowledge of the strategic plans for the company, the industry in which the company operates, the appropriate performance measures for the company, and other issues internal and/or unique to the company.
- Companies should explicitly disclose how incentive plans reflect strategy and incorporate long-term shareholder value drivers; this discussion should include the commensurate metrics and timeframes by which shareholders should assess performance.
- We support incentive plans that foster the sustainable achievement of results. Although we believe that companies should identify those performance measures most directly tied to shareholder value creation, we also believe that emphasis should be on those factors within management's control to create economic value over the long-term, which should ultimately lead to sustained shareholder returns over the long-term. Similarly, the vesting timeframes associated with incentive plans should facilitate a focus on long-term value creation, as appropriate to that particular company.
- While we do support the concept of compensation formulas that allow shareholders to clearly understand the rationale for compensation decisions, we do not believe that a solely formulaic approach to executive compensation necessarily drives shareholder value. BlackRock believes that compensation committees should use their discretion in designing incentive plans, establishing pay quanta, and finalizing compensation decisions, and should demonstrate how decisions are aligned with shareholder interests.
- BlackRock does not discourage compensation structures that differ from market practice. However, where compensation practices differ substantially from market practice, *e.g.* in the event of unconventional incentive plan design or extraordinary decisions made in the context of transformational corporate events or turnaround situations, we expect clear disclosure explaining how the decisions are in shareholders' best interests.
- We understand that compensation committees are undertaking their analysis in the context of a competitive marketplace for executive talent. We acknowledge that the use of peer group evaluation by compensation committees can help ensure competitive pay; however we are concerned about the potential ratchet effect of explicit benchmarking to peers. We therefore believe that companies should use peer groups to maintain an awareness of peer pay levels and practices so that pay is market competitive, while mitigating potential ratcheting of pay that is disconnected from actual performance.
- We expect companies to select peers that are broadly comparable to the company in question, based on objective criteria that are directly relevant to setting competitive compensation; we evaluate peer group selection based on factors including, but not limited to, business size, relevance, complexity, risk profile, and/or geography.

- We do not believe that arbitrary limits on potential compensation are necessarily in shareholders' best interests if those limits have the potential to cap performance. However, we expect compensation committees to ensure that incentive plans do not incentivize excessive risk taking beyond the company's determined risk appetite and that rewards are reasonable in light of returns to shareholders.
- We do not set forth a preference between cash, restricted stock, performance based equity awards, and stock options, amongst other compensation vehicles. We acknowledge that each may have an appropriate role in recruiting and retaining executives, in incentivizing behavior and performance, and in aligning shareholders' and executives' interests. Compensation committees should clearly disclose the rationale behind their selection of pay vehicles and how these fit with intended incentives. We also observe that different types of awards exhibit varying risk profiles, and the risks associated with pay plan design should be in line with the company's stated strategy and risk appetite.
- We expect compensation committees to consider and respond to the shareholder voting results of relevant proposals at previous years' annual meetings, and other feedback received from shareholders, as they evaluate compensation plans. At the same time, compensation committees should ultimately be focused on incentivizing long-term shareholder value creation and not necessarily on achieving a certain level of support on Say on Pay at any particular shareholder meeting.

Say on Pay Analysis Framework

- We analyze the compensation practices in the context of the company's stated strategy and identified value drivers and seek to understand the link between strategy, value drivers and incentive plan design.
- We examine both target and realizable compensation in order to understand the compensation committee's intended outcomes, to judge the appropriateness and rigor of performance measures and hurdles, and to assess the pay plan's sensitivity to the performance of the company.
- We review the pay and performance profiles of the company's disclosed peer companies, as applicable, to identify relative outliers for potential further analysis. We supplement our analysis of the company's stated peers with an independent review of peer companies as identified by third party vendors and our own analysis; part of this analysis includes an assessment of the relevance of the company's stated peers and the potential impact the company's peer selection may have on pay decisions.
- We conduct our analysis over various time horizons, with an emphasis on a sustained period, generally 3-5 years; however we consider company-specific factors, including the timeframe the company uses for performance evaluation, the nature of the industry, and the typical business cycle, in order to identify an appropriate timeframe for evaluation.
- We review key changes to pay components from previous years and consider the compensation committee's rationale for those changes.
- We examine extraordinary pay items (including but not limited to actual or contractual severance payments, inducement grants, one-time bonus and/or retention awards) to understand the compensation committee's rationale and alignment with shareholder interests.
- We may engage with members of management and/or the compensation committee of the board, where concerns are identified or where we seek to better understand a company's approach to executive compensation.
- We consider BlackRock's historical voting decisions (including whether a concern that led to a previous vote against management has been addressed, or whether we determined to support management at previous shareholder meetings with the expectation of future change), engagement activity, other corporate governance concerns at the company, and the views of our portfolio managers.

- We assess the board's responsiveness to shareholder voting results of relevant proposals at previous years' annual meetings, and other feedback received from shareholders.

Engagement and Voting on Say on Pay

- In many instances, we believe that direct discussion with issuers, in particular with the members of the compensation committee, can be an effective mechanism for building mutual understanding on executive compensation issues and for communicating any concerns we may have on executive compensation.
- In the event that we determine engagement is not expected to lead to resolution of our concerns about executive compensation, we may consider voting against members of the compensation committee, consistent with our preferred approach to hold members of the relevant key committee of the board accountable for governance concerns. As a result, our Say on Pay vote is likely to correspond with our vote on the directors who are compensation committee members responsible for making compensation decisions.
- We may determine to vote against the election of compensation committee members and/or Say on Pay proposals in certain instances, including but not limited to when:
    - We identify a misalignment over time between target pay and/or realizable compensation and company performance as reflected in financial and operational performance and/or shareholder returns;
    - We determine that a company has not persuasively demonstrated the connection between strategy, long-term shareholder value creation and incentive plan design;
    - We determine that compensation is excessive relative to peers without appropriate rationale or explanation, including the appropriateness of the company's selected peers;
    - We observe an overreliance on discretion or extraordinary pay decisions to reward executives, without clearly demonstrating how these decisions are aligned with shareholders' interests;
    - We determine that company disclosure is insufficient to undertake our pay analysis; and/or
    - We observe a lack of board responsiveness to significant investor concern on executive compensation issues.

Boardroom Accountability Project
2016 Company Focus List

Company	New/Refile	Largest Holdings	Diversity	Fossil Fuel	Pay	Other Governance*	Withdrawn
3M Company[1]	N	X					Yes
AbbVie Inc.	N	X	X				
Ameren Corporation	N			X			Yes
American Airlines Group Inc.	N		X				
American Tower Corporation	N				X		
Amgen Inc.	N	X					
Bed Bath & Beyond Inc.	N	X			X		
Boeing Company, The	N	X					Yes
Caterpillar Inc.	N	X			X		Yes
Cerner Corporation	N		X				
CMS Energy Corporation	N			X			
Colgate-Palmolive Company	N	X					
Dominion Resources, Inc.	N			X			Yes
Express Scripts Holding Company	N	X	X				
Home Depot, Inc., The	N	X					
Honeywell International Inc.	N	X			X		Yes
Intel Corporation	N	X					
Intercontinental Exchange, Inc.	N		X				
Johnson & Johnson	N	X					
Macerich Company, The	N				X		
NiSource Inc.	N			X			
NRG Energy, Inc.	N			X			
O'Reilly Automotive, Inc.	N		X				
PepsiCo, Inc.	N	X					
Pfizer Inc.	N	X					Yes
Praxair, Inc.	N				X		
salesforce.com, inc.	N	X			X		
SL Green Realty Corp.	N				X		
U.S. Bancorp	N	X					
Union Pacific Corporation[1]	N	X	X				Yes
Universal Health Services	N		X				
Unum Group	N				X		
WEC Energy Group, Inc.	N			X			
Wells Fargo & Company	N	X					Yes
Xcel Energy Inc.	N			X			
Zoetis Inc.	N		X				
AES Corporation, The	R			X			Yes
Alexion Pharmaceuticals, Inc.	R		X				
Alliance Data Systems Corporation	R		X				
Apartment Investment and Management Company	R				X		
Avon Products, Inc.	R				X		
Cabot Oil & Gas Corporation	R		X	X			
Chipotle Mexican Grill, Inc.	R				X		
CONSOL Energy Inc.	R			X			
Devon Energy Corporation	R			X			
Duke Energy Corporation	R			X			Yes
eBay Inc.	R		X				
Electronic Arts Inc.	R				X		
Exelon Corporation	R				X		
Exxon Mobil Corporation	R			X			
Fidelity National Financial, Inc.	R		X				
FirstEnergy Corp.	R			X			
FleetCor Technologies, Inc.	R		X		X		
Freeport-McMoRan Inc.	R			X	X		Yes
HCP, Inc.	R				X		
Monster Beverage Corporation	R		X				
Murphy Oil Corporation	R			X			
Nabors Industries Ltd.	R		X		X		
Netflix, Inc.	R					X	
New York Community Bancorp, Inc.	R				X		
Noble Energy, Inc.	R			X			
NVR, Inc.	R		X				
PACCAR Inc	R		X				
Peabody Energy Corporation	R			X			Yes
PPL Corporation	R			X			Yes
Precision Castparts Corp.	R		X				
Roper Technologies, Inc.	R		X				Yes
SBA Communications Corporation	R		X				
Southern Company, The	R			X			
Urban Outfitters, Inc.	R		X				
Vertex Pharmaceuticals Incorporated	R				X		
Visteon Corporation	R		X				

*Other governance includes companies that received proxy access or other governance proposals from NYC Funds in 2014

[1]Enactment already underway upon receipt of NYC Funds' proposal

Company information accurate as of January 9, 2016

REIT ALERT

February 4, 2015

Barbarians at the (REIT) Gates: REITs Should Be Prepared for a New World Order of Shareholder Activists, Hostile Overtures and Proxy Fights

SPEED READ

Publicly traded REITs today face an increased risk of potential shareholder activism, proxy fights and otherwise hostile overtures. In response to this growing trend, public REITs should examine their corporate governance profiles and evaluate their takeover preparedness. While substantive changes may not be in order, regular reviews of these important internal governance features can better prepare board members and management when a threat materializes and/or when the REIT otherwise receives shareholder proposals relating to governance matters.

For over 20 years from the dawn of the modern REIT era in the early 1990s, hostile takeovers, proxy fights and shareholder activists – the stuff of everyday business in many other sectors – were few and far between in the world of publicly traded REITs. While the REIT sector was an able and willing participant in M&A activity during this period, the overwhelming majority of deals were negotiated, friendly transactions. That is to say, with some notable exceptions,[1] suitors and concerned investors generally pressed their case through and with the participation of the target's board of directors, rather than by going over or around them directly to shareholders.

In thinking about why this has historically been the case for REITs, industry experts have offered a number of reasons:

- Public REITs tend to trade within a generally predictable band above and below their NAV (net asset value). As such, given the relative transparency of the asset class and of the REIT model, an acquiror or activist is less likely to be able to unlock sufficient value to justify the cost and effort of a hostile takeover or proxy fight.
- Many REITs are and were incorporated in Maryland, a jurisdiction where the actions of directors in the face of unwanted overtures may be given more deference by the courts and where the so-called Revlon duties requiring maximization of shareholder value may be less stringently applied.
- Virtually all public REITs have ownership limitation provisions in place that restrict, to greater and lesser degrees, the ability of any one person (or group of persons) to acquire a meaningful amount of the REIT's equity capital without prior board approval (for most REITs, the threshold is 9.8%).

The validity of these rationales has been a matter of academic debate from time to time[2] but activity in the marketplace in recent years demonstrates that the constraints to hostile overtures and activist campaigns in the public REIT sector, whatever they may have been, are no longer sufficient deterrents. To the contrary, REITs large and small have seen a flurry of hostile and activist activity over the past two years, which has served, and should continue to serve, as a wake-up call for the industry as a whole. A non-exhaustive list of hostile and activist activity that has appeared in the press or in public filings during this period includes:

- the disclosure by Lakewood Capital Management of a 5.8% state in Select Income REIT and its subsequent announcement of its intent to file a preliminary proxy statement to solicit votes for the election of a competing trustee (January 2015);
- the disclosure by Corvex Capital Management of a 7.1% stake in American Realty Capital (December 2014);
- issuance of public letters by Land and Buildings to the management of Pennsylvania REIT calling for the disposal of certain assets and other changes (October 2014);
- unsolicited offer letters from Land and Buildings to Associated Estates Realty Corp. (June 2014) and to BRE Properties (June 2013);
- the disclosure by each of Blue Mountain Capital and HG Vora Capital Management of respective 4.9% stakes in Chatham Lodging Trust and subsequent unsolicited offer letter from Blue Mountain to acquire the company (November 2013);
- the disclosure by Corvex Capital Management and Related Fund Management of a collective 9.8% stake in Commonwealth REIT and their subsequent successful campaign to remove and replace the entire board of trustees (February 2013); and
- letters received by dozens of public REITs in recent years from large institutional investors requesting corporate governance changes, such as destaggering of boards and adoption of a majority voting standard in uncontested elections.

In some of these instances, the REIT has been successful in rebuffing unsolicited overtures or activism, while in others the REIT ultimately underwent a change of control or adopted changes to its corporate structure and governance. The common denominator is that a sitting public REIT and its incumbent board came under direct public pressure from investors, competitors and/or other would-be suitors for matters ranging from changes in corporate governance (such as adoption of majority voting) all the way through to complete changes of control.

The merits of shareholder activism and unsolicited hostile overtures continue to be topics of extensive debate among market participants and commentators. The one thing that is clear, however, is that no public REIT should assume that it is immune from the forces at work in the current marketplace. Rather, REITs would be well served to undertake thorough reviews of their current corporate governance profiles to ensure that both the company and the board are optimally prepared to successfully navigate possible hostile activity for the benefit of all stockholders. Just as critically, if not more so, a public REIT must "know its stockholders" – that is, spend time understanding who the company's stockholders are and how they view the REIT's current business plan and prospects for growth.

REIT Anti-Takeover Protections

Takeover protections in the strictest sense have historically been identified with preventing, delaying or discouraging a party from acquiring a controlling interest in a company, unless the company's board of directors approves the acquisition. The array of takeover protections in use or available today also have the effect of preventing or delaying an array of corporate actions short of a change of control, such as charter and bylaw amendments, nominations and appointments to the board of directors.

The table below provides summary statistical data on a number of corporate governance provisions currently available and in use in the public REIT market, which may be useful under certain circumstances in the event of a hostile overture or threatened proxy fight. *Data is as of December 31, 2014 and based on a sample of over 50 NYSE-listed equity REITs of multiple enterprise values selected across multiple sectors, including both older and newer entrants to the market.*

PROVISION/STATUTE	PUBLICLY TRADED REITS*
Ownership limitation provision in charter [3]	100%
Blank check preferred	96%
No opt out of Maryland unsolicited takeover act (Subtitle 8)	85%**
Supermajority vote to remove directors	73%
Shareholders may not take action by (less than unanimous) written consent	73%
Majority of shareholders necessary to call special meeting	73%
Supermajority vote to amend certain provisions in the charter	72%
Only board permitted to fill vacant director positions	69%
Only board can amend bylaws [4]	69%
Directors may be removed only for cause	52%
Supermajority vote required to approve extraordinary transactions	24%
No opt out of business combination statute	24%
Classified board with staggered terms	12%
Exclusive forum selection bylaw	12%
No opt out of control share acquisition statute	12%
Active poison pill/shareholder rights plan	2%

———————

** Percentages are rounded.*

*** Percentage shown is a percentage of only those REITs incorporated in Maryland.*

Opponents of takeover protections believe that their principal purpose is to enable a company's board and management to entrench themselves, or enable management to extract significant personal concessions, such as employment agreements or severance payments, as a condition to agreeing to a proposed change of control. Proponents believe that, when properly used by boards discharging their fiduciary duties to all stockholders, these types of takeover protections give a board the ability to maximize stockholder value. Proponents believe that these devices help in the following ways:

- they give a board time and flexibility to consider whether a proposed action or transaction is in the best interests of the company, which otherwise could be difficult to assess in a crisis situation created by a hostile proxy fight or unsolicited offer;
- they discourage the accumulation of stakes in the company or other activist initiatives designed to generate volatility in the stock price and trading profits for the activist(s);
- they deter potential acquirors from engaging in and benefiting from coercive tactics to the detriment of other stockholders; and
- they help protect stockholders from the costs associated with the distraction to management and employees, and the loss of valuable employees, caused by the hostile overture and/or other proposals.

As indicated by the data above, a majority of public REITs, both those organized in Maryland and otherwise, will typically have most of the takeover defenses listed in the table above available, either as embedded in charters and/or bylaws, or as adopted by the board of directors. Boards of directors, particularly in Maryland, may also have available more general defenses against unsolicited overtures, including (i) the "just say no" defense permitting the board of a company that is not "in play" to reject any acquisition offer involving a change of control regardless of the nature of the consideration offered, and (ii) a presumption that an act of a director of a corporation satisfies the director's standard of conduct under Maryland law. It is particularly worth noting that Maryland does not have a parallel to Delaware's *Unocal* standard under which defensive actions taken by the board of directors in response to a hostile threat can be subject to a stricter level of scrutiny than ordinary business actions.

Nevertheless, recent history has demonstrated that the availability of takeover defenses is in-and-of-itself not always going to be sufficient in the face of a determined activist or hostile actor.[5] For example, even a fully classified board can see a majority of incumbent directors voted off the board in the course of two consecutive annual elections. Moreover, in recent years a growing number of influential corporate governance advocates in the REIT sector, including several of the largest institutional stockholders sector-wide, have brought substantial pressure to bear on the boards of many REITs to irrevocably surrender important takeover defenses, such as permanently opting-out of

Maryland's statutory anti-takeover protections generally, or at least foregoing the ability to unilaterally classify the board.

Again, there is robust debate across the industry and beyond on the relative merits of these efforts and whether or not a company and its stockholders are ultimately helped or harmed by foreclosing the board's ability to deploy defensive measures in the face of a perceived threat – but it is clear that before voluntarily and permanently surrendering an otherwise available defense, a REIT's board should first fully consider the totality of defensive measures available to it and the relative efficacy of these measures in confronting a perceived threat to the company and its stockholders.[6]

Being prepared for a coercive bid or other hostile activity is not a one-size-fits-all proposition, and we do not recommend any particular set or subset of defenses as a blunderbuss approach for all public REITs. For example, a REIT that has the ability to unilaterally stagger its board at any time under the Maryland Unsolicited Takeover Act may feel less threatened by the specter of an activist campaign to take control of the board; a REIT whose ownership limitation provision is drafted so as to restrict accumulation of large blocks of stock by investors not approved by the board – even if the accumulation does not present a REIT qualification concern from a U.S. income tax perspective – may feel less of a need to have the ability to unilaterally adopt a shareholder rights plan. Conversely, REITs whose governing documents impose a mandatory sunset on duly adopted shareholder rights plan (e.g., after one year) may need to rely on other defenses once the rights plan expires.

We recommend that each public REIT take stock of its current corporate governance profile and state of its takeover preparedness (including the interconnectedness of takeover defenses and the way the efficacy of some may depend on the availability or structure of others). An evaluation of governance and takeover preparedness need not necessarily precipitate substantive changes, or any changes, and need not be undertaken with a particular threat in mind or on the horizon. Rather, periodic reviews of these important internal governance features can help the board and management be better prepared when a perceived threat does materialize and/or when the REIT otherwise receives shareholder proposals relating to governance matters. The review and evaluation process can help the board of directors determine whether the company's overall governance and preparedness profile is one that is responsive to the overarching duty of the board to be able to maximize stockholder value for the long term and in line with the corporate governance standards the board believes are appropriate for the company.

---

[1] Some notable exceptions include the 1998 proxy battle waged by hedge funds led by Gotham Partners against the board of First Union Real Estate Investments; Simon/Westfield's hostile bid for Taubman in 2003; and Public Storage's hostile bid for Shurgard in 2005.
[2] For example, there have been pockets of time during which many REITs traded at relatively significant discounts to NAV. Likewise, the ability to take an initial ownership stake of nearly ten percent will often be more than sufficient for a determined hostile bidder or activist to gain the attention of a target and other shareholders.
[3] While beyond the scope of this article, note that ownership limitation provisions are not created equal and that the particular wording and definitions of each charter will generally determine the scope of the ownership limitation's perceived anti-takeover effect. For example, some charters impose the ownership limitation only on actual individuals as required to strictly comply with the relevant REIT qualification provisions under the Internal Revenue Code, while other charters impose the ownership limitation on entities and groups as well.
[4] Note that in some jurisdictions, such as Delaware, the board may not make substantive amendments to the bylaws without shareholder approval.
[5] In an extreme example, Commonwealth REIT in 2013 had in place essentially every possible takeover defense available, including a staggered board, a shareholder rights plan, draconian advance notice bylaw provisions, supermajority voting requirements and an affirmative "opt in" to Maryland's Unsolicited Takeover Act – yet determined activist investors were still able to remove the entire board of trustees without cause in 2014.
[6] See, e.g., "*Getting Nothing for Something*" by James J. Hanks, Jr., REIT Zone Publications, September 3, 2014 ("[W]hy give up, for no economic benefit to the REIT, an option that may provide some protection against an effort by investors or activists with goals other than those typically held by long-term shareholders to seize control of the company on a short-term basis in what may be temporarily unfavorable market conditions?")

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GOODWIN PROCTER

REIT ALERT

June 1, 2015

Why Green Street Should Rethink Its One-Size-Fits-All Position on Corporate Governance

SPEED READ

Research firm Green Street Advisors recently announced a revamping of its corporate governance scoring that penalizes all Maryland REITs that do not permanently opt out of the Maryland Unsolicited Takeover Act ("MUTA"). We are not certain that this "blunt instrument" approach to MUTA is appropriate. There may be scenarios where the protections available under MUTA — either alone or when used in conjunction with other available governance arrangements — can prove critical in enabling a board to act in good faith to maximize long-term shareholder value.

In our February 4, 2015 REIT Alert, "Barbarians at the (REIT) Gates: REITs Should Be Prepared for a New World Order of Shareholder Activists, Hostile Overtures and Proxy Fights," we addressed the increased risk faced by publicly-traded REITs today from potential shareholder activism, proxy fights and otherwise hostile overtures. We concluded that the boards of public REITs would be well served to regularly evaluate their companies' corporate governance profiles in an effort to help the board determine whether the company's overall governance and preparedness profile is one that provides the board of directors with the tools and flexibility to fulfill their overarching duty to maximize stockholder value for the long term. While our Alert discussed a variety of possible approaches to governance, we took care to point out that governance is not a "one-size-fits-all" proposition and that we do not recommend any particular set or subset of defenses as a blunderbuss approach for all public REITs. In particular, we did not recommend that every Maryland REIT rush to permanently opt out of the Maryland Unsolicited Takeover Act, or "MUTA",[1] since there may be scenarios in which the protections available under MUTA — either alone or when used in conjunction with other available governance arrangements — can prove critical in permitting a board acting in good faith to maximize long-term shareholder value.

In its recent "Heard on the Beach" column of May 28, 2015, entitled "Bush League Governance", Green Street Advisors announced a revamping of its corporate governance scoring that penalizes all Maryland REITs across the board if they do not permanently opt out of MUTA. Whereas under current scoring a REIT that had opted out of MUTA would earn 6 more points than a peer that had not done so, the revised scoring would increase this difference to 25 points.[2] All other things being equal, a Maryland REIT that has not permanently opted out of MUTA will receive a significantly lower corporate governance score relative to non-Maryland REITs and/or Maryland REITs that have permanently opted out of MUTA.

We are not certain that this "blunt instrument" approach to MUTA is appropriate for every Maryland REIT, without regard to the REIT's specific facts and circumstances. MUTA exists, indeed all corporate governance measures with possible anti-takeover effects exist, because legislatures and/or other actors in the investment community believe that the good faith exercise of protective measures in the face of a hostile bid may in many cases be the correct response by a target board seeking to fulfill its fiduciary duties to stockholders, as opposed to, say, promptly embracing a short-term premium that may undervalue the company's long-term business prospects. In particular, as stated in Goodwin Procter's February REIT Alert, the availability of one or more of the protections under MUTA can serve to:

- give the board time and flexibility to consider whether a proposed action or transaction is in the best interests of the company, which otherwise could be difficult to assess in a crisis situation created by a hostile proxy fight or unsolicited offer;
- discourage the accumulation of stakes (whether actual or through use of lower-cost derivatives) in the company or other activist initiatives designed to generate volatility in the stock price and trading profits for the activist(s);
- deter potential acquirors from engaging in and benefiting from coercive tactics to the detriment of other stockholders; and
- help protect stockholders from the costs associated with the distraction to management and employees, and the loss of valuable employees, caused by the hostile overture and/or other proposals.

Of course this is not to say that every REIT should arm itself with every takeover defense not prohibited by law or its governing documents. In the vast majority of cases, we believe the very best takeover defense is a management team that regularly and meaningfully engages with stockholders.

At a recent lunch panel hosted by Michael Bilerman, Head of Citi Research's Real Estate and Lodging team, at which corporate governance in the REIT Industry was discussed, one panelist noted that in hostile situations you need good actors, you need good rules and that it is important to keep in mind what are you solving for.[3] We think most parties would agree with this formulation. First and foremost, you need "good actors," a board of directors that is genuinely and in good faith seeking to maximize stockholder value in furtherance of its fiduciary duties to the company and is not seeking to entrench itself or management. Second, you need "good rules," a corporate governance structure that is both conducive to the board's exercising that duty in a deliberate and informed manner and that does not make necessary change unattainable by stockholders. Third, the board and stockholders need to keep in mind the ultimate goal, which is neither immediate capitulation nor indefinite entrenchment — it is identifying and implementing the solution that is ultimately the right one for stockholders, even if it takes a little longer until the right solution becomes clear.

So while the stated goal of activists and bidders generally is getting to a place where target boards are compelled to engage in a process instead of "just saying no," the thoughtful activist or bidder would also agree that it is not prudent for the board to be compelled to immediately throw all caution to the wind and immediately accept any bid that crosses the transom. Instead, during the Citi Research event, all of the panelists expressed support for a structure under which a target board would have the ability to impose a temporary "stay" on an activist or other hostile campaign, creating the critical space and time in which the board could work in good faith on formulating and executing on whatever plan is ultimately determined to be in the best interests of stockholders. If stockholders disagree with the board's

approach, they will have their full say as soon as the “stay” expires but at least the board would have been given a realistic opportunity to demonstrate why its chosen plan was in the best interests of stockholders. The appropriate duration of a “stay” can and should be the topic of debate among interested parties in a given situation, but the essential notion that a board should be given time to fulfill its fiduciary duties appears to be accepted by all but those with the most short-term interests. Conversely, the one-size-fits-all approach now recommended by Green Street appears to be based on the assumption that not only can duly elected boards not be trusted to make the right decision in the face of a hostile bid, they shouldn’t even be given the chance without being immediately forced to take the matter to the ballot box. This approach undervalues the benefits that boards can and do provide as fiduciaries for public company stockholders, irrespective of whether the board’s actions are governed by Maryland, Delaware or another state’s law.

The key to preserving the ability to carefully and deliberately go about getting to the right solution for stockholders is to ensure the right mix of available corporate governance provisions, paying particular attention to the interconnectedness of some provisions and the way the efficacy of some may depend on the availability or structure of others. For example, an effective takeover measure employed by many public companies in the face of an actual or threatened hostile bid is the adoption of a limited duration stockholder rights plan (a “poison pill”).[4] In general, only the board of directors is given the power to redeem the rights or amend the plan so a rights plan, by its adoption, deters coercive takeover tactics by making them unreasonably expensive to the bidder and thus encourages prospective acquirors to negotiate rather than to attempt a hostile takeover.

More modern varieties of these plans typically have a hardwired sunset provision that causes the plan to automatically terminate in a year or less, unless otherwise approved by stockholders. In theory, this provides the temporary “stay” period in which the incumbent board can focus on the best course for maximizing stockholder value without a proverbial gun to its head. In practice, however, if a majority of the board can be replaced by stockholders at the next upcoming annual meeting or removed by stockholders without cause at a duly called special meeting to be held even earlier — then the incoming board can simply redeem the rights and/or amend or terminate the plan entirely and guarantee that the original’s board’s alternative business plan is never given an opportunity to succeed. This would bring us back to square one, a situation in which the board simply may not have the ability to properly evaluate a hostile bid versus its alternatives or the leverage to negotiate with a hostile bidder, which would be to the detriment of all stockholders.[5]

Indeed, this is when having the ability to stagger the board under MUTA for a limited duration would close the gap, working in tandem with the stockholder rights plan to impose the temporary “stay” that would benefit all stockholders. For example, if the board voted to adopt a limited duration stockholder rights plan, say for one year, and also to stagger its board under MUTA for that same one-year period,[6] then the two of these together effectively implement a one-year “stay” on the ability of an activist, raider or coercive bidder (or more likely a coalition of them), to either accumulate a significant amount of stock or to amend or eliminate the rights plan to permit an accumulation of stock. If, as urged by Green Street, the REIT had previously permanently opted out of the MUTA, then it would also knowingly have opted out of the ability to ensure its board had breathing room when evaluating strategic alternatives and the leverage to negotiate a better price for all stockholders. Some Maryland REITs in light of the total mix of facts and circumstances unique to that REIT may conclude that they do not want the benefits that MUTA provides, but we believe MUTA can be an important tool for boards to use to protect and enhance stockholder value in the face of a hostile bid when it is used responsibly.

---

1 MUTA permits a Maryland corporation with a class of equity securities registered under the Securities Exchange Act of 1934 and at least three independent directors to elect to be subject, by provision in its charter or bylaws or a resolution of its board of directors and notwithstanding any contrary provision in the charter or bylaws, to any or all of five provisions:

(i) a classified board;

(ii) a two-thirds stockholder vote requirement for removing a director;

(iii) a requirement that the number of directors be fixed only by vote of the directors;

(iv) a requirement that a vacancy on the board be filled only by the remaining directors and for the remainder of the full term of the class of directors in which the vacancy occurred; and

(v) a majority requirement for the calling of a special meeting of stockholders.

2 Green Street will implement the new scoring by awarding only 5 out of 30 potential points to a Maryland REIT that does not have a staggered board but that has not opted out of MUTA. REITs organized in states other than Maryland will receive the full 30 points if they do not have a staggered board, presumably where applicable state law also does not permit staggering of the board without stockholder approval.

3 Citi Research, Weekly REIT and Lodging Strategy report, April 24, 2015.

4 A stockholder rights plan establishes a level of stock ownership (typically 10% or 15%) which a stockholder cannot exceed without incurring significant dilution to its holdings. A typical rights plan provides for a distribution to existing stockholders of rights that (a) in the event of an acquisition of more than a certain percentage (generally 10% to 25%) of the common stock, entitle the stockholder to purchase additional common stock at a significant discount (the “flip-in” feature) and (b) in the event of a squeeze-out transaction, entitle the stockholder to purchase the acquiring person’s equity at a significant discount (the “flip-over” feature).

5 As noted during the Citi Research event, corporate governance rules in Canada are a useful reference point. Until only recently, Canadian public companies were generally significantly more vulnerable to hostile buyers and activist investors than their American peers, due primarily to blunderbuss statutory provisions that curbed use of corporate governance measures that could have an anti-takeover effect. Canadian law does not provide for staggered boards, any 5% shareholder may call a special meeting and investors can amass up to a 10% stake under the radar before public disclosure is required. Likewise, poison pills adopted by a target board were generally quickly done away with, often within two months. As a result, boards of target Canadian companies often had very little time to properly develop, let alone execute on, strategic alternatives to a hostile bid. Regulators and market participants alike did not view this state of affairs as necessarily positive for Canadian business as a whole. In an effort towards somewhat rebalancing the playing field, the Canadian Securities Administrators have proposed various new rules in recent years to give target company boards greater time to respond to hostile bids and flexibility. See, e.g., “Amendments Proposed to Significantly Change Take-Over Bid Rules” by Goodmans LLP, April 1, 2015.

6 While MUTA does not on its face provide for temporary staggering of the board, any opt in by the board can be accompanied by a formal commitment to de-stagger at the end of the year (or at the next annual meeting of stockholders).

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Rep. Maxine Waters, Ranking Member

Press Releases

Brown, Waters Lead Call For SEC To Strengthen Disclosure Of Corporate Board Diversity

Coalition of Democratic Lawmakers Urge Faster Review of Board Diversity Proposal

Washington, DC, Mar 2
Leading Democratic lawmakers today urged the Securities and Exchange Commission to speed up its review of a proposal that would require companies to provide more specific details about the diversity of their corporate boards. The proposal, which nine public pension fund administrators submitted to the SEC almost a year ago, encourages the agency to require companies to disclose board nominees' gender, racial, and ethnic diversity.

In a letter to SEC Chair Mary Jo White, the lawmakers pressed the SEC to act on the proposal without any further delay. Sen. Sherrod Brown (D-OH) and Rep. Maxine Waters (D-CA), the senior

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Democrats on the Senate Banking and House Financial Services Committees, respectively, led the letter, which was also signed by Sens. Robert Menendez (D-NJ), Jeff Merkley (D-OR), and Cory Booker (D-NJ), and Reps. Marcy Kaptur (D-OH), Carolyn Maloney (D-NY), Tim Ryan (D-OH), Marcia Fudge (D-OH), and Joyce Beatty (D-OH).

The Ohio Public Employees Retirement Systems (OPERS) and eight other public pension fund administrators – including the California Public Employees' Retirement System and the New York State Common Retirement Fund – submitted their rulemaking petition for more board diversity disclosure on March 31, 2015.

"While we applaud your decision to have SEC staff review OPERS' petition, we are disappointed with the amount of time the SEC is taking to examine and seek public comment on this important and widely supported proposal," the lawmakers wrote in their letter to White.

"Investment advisors, shareholders, policymakers, and other stakeholders have been telling the SEC and others for decades now that the diversity characteristics of board nominees and directors is information they need to make informed investment and voting decisions. Similarly, stakeholders have been explaining for decades that enhanced diversity disclosures may promote sociodemographic diversity on corporate boards, which in turn may promote better business strategy and corporate results," the lawmakers added.

The SEC adopted a rule change in 2009 that required publicly-traded companies to disclose more information on director selection and diversity. In their letter, the lawmakers outlined the new rule's limitations, noting that companies have taken a variety of different approaches to disclosing board nominees' qualifications and skills. And since the rule does not define diversity, the lack of a standard makes it difficult for shareholders and investors to make informed decisions when voting for directors.

To strengthen the quality of disclosures, the rulemaking petition encourages the SEC to require companies to indicate in a chart or matrix the qualifications, skills, and racial and gender composition of their board nominees.

"Such a requirement, with minimal burden and cost on companies, would aid in everyone's understanding, including the SEC's understanding, of each company's approach," the lawmakers wrote.

Women, who make up half the American workforce, hold just 16 percent of seats on corporate boards, and it could be decades before the gender gap in boardrooms closes, according to a recent **Government Accountability Office report**. The report, which Rep. Maloney requested in May 2014, found that it may take 40 years or

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2h

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more to reach a 50-50 gender balance on corporate boards.

The full text of the letter is below. A signed copy can be found online here.

March 2, 2016

The Honorable Mary Jo White
Chair
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Dear Chair White:

We are writing to urge the Commission to seek public comment, without any further delay, on a proposed amendment submitted nearly a year ago by the Ohio Public Employees Retirement Systems (OPERS) and several leading public fund administrators on behalf of public fund fiduciaries.[1] While we applaud your decision to have SEC staff review OPERS' petition, we are disappointed with the amount of time the SEC is taking to examine and seek public comment on this important and widely supported proposal.

Investment advisors, shareholders, policymakers, and other stakeholders have been telling the SEC and others for decades now that the diversity characteristics of board nominees and directors is information they need to make informed investment and voting decisions. Similarly, stakeholders have been explaining for decades that enhanced diversity disclosures may promote sociodemographic diversity on corporate boards, which in turn may promote better business strategy and corporate results.[2] In 2009, the SEC partly acknowledged these stakeholders and their concerns when it required publicly-traded companies to disclose more information on director selection and diversity. Specifically, the SEC required reporting on **(1)** the companies' minimum qualifications, if any, for all directors, and any specific qualities or skills that at least one director must possess; and **(2)** whether and, if so, how the board considers diversity in identifying board nominees and if a diversity policy exists, how it is implemented and judged effective. The SEC did not define diversity.[3]

The 2009 rule change, however, fell short of providing stakeholders the information they need on board diversity. First, company disclosures now describe with varying levels of specificity the minimum qualifications and skills they use to identify directors. Yet many disclosures lack the clarity and detail needed for stakeholders to judge easily and accurately whether **(1)** the company's approach to

and accurately whether **(1)** the company's approach to director qualifications and skills are appropriate in light of the company's overall business strategy and **(2)** the slate of board nominees is suitable. These disclosures could be improved, as OPERS explains, by also requiring a chart or matrix that visually depicts the company's approach to director qualifications and skills. Such a requirement, with minimal burden and cost on companies, would aid in everyone's understanding, including the SEC's understanding, of each company's approach.

Second, while companies now provide disclosure on the consideration of diversity in the board selection process, these disclosures often do not describe the concept of diversity with reference to sociodemographic characteristics such as gender, race, or ethnicity, or provide the sociodemographic characteristics of the board nominees.[4] These disclosures could be improved, yet again with minimal burden and cost on companies, by using a chart or matrix that lists whatever information each board nominee provides to the company about his or her gender, race, and ethnicity. Indeed, many companies already use charts or matrices to communicate biographical information about board nominees; for those companies, this change may be as simple as adding new columns to an existing chart.

In addition to being minimally burdensome, these types of improvements to board diversity disclosure are widely supported. Fifteen of 19 stakeholders told the U.S. Government Accountability Office last year that they support improving SEC rules to require more specific information from public companies on board diversity. Twelve stakeholders explicitly supported the SEC requiring companies to disclose the number of women on the board. [5] Moreover, the Council of Institutional Investors has endorsed the use of charts and matrices as "especially useful" disclosure tools for evaluating board candidates.[6]

Again, we strongly urge the Commission to avoid any further delay on seeking public comment on this straightforward proposal.

Thank you for considering our views on this important matter.

Sincerely,

Sen. Sherrod Brown, Ranking Member, Senate Committee on Banking, Housing, and Urban Affairs
Rep. Maxine Waters, Ranking Member, House Financial Services Committee
Sen. Robert Menendez
Sen. Jeff Merkley
Sen. Cory Booker

Sen. Cory Booker
Rep. Marcy Kaptur
Rep. Carolyn Maloney
Rep. Tim Ryan
Rep. Marcia Fudge
Rep. Joyce Beatty

Cc: The Honorable Michael Piwowar
The Honorable Kara Stein

---

[1] Leaders from the following entities signed the Petition for Amendment of Proxy Rule Regarding Board Nominee Disclosure – Chart / Matrix Approach (File No. 4-682): the California Public Employees Retirement System; the California State Teacher's Retirement System; the Connecticut Retirement Plans and Trust Fund; the Illinois State Board of Investment; New York City; the New York State Common Retirement Fund; the North Carolina Department of State Treasurer; the Ohio Public Employees Retirement Systems; and the Washington State Investment Board.

[2] See U.S. Glass Ceiling Commission, A Solid Investment: Making Full Use of the Nation's Human Capital (Washington, D.C.: U.S. Government Printing Office, 1995), at 42-43.

[3] Item 407(c)(2)(v)-(vi) of Regulation S-K.

[4] Dhir, Aaron, Challenging Boardroom Homogeneity: Corporate Law, Governance, and Diversity (Cambridge University Press, 2015), at 175-76.

[5] Corporate Boards: Strategies to Address Representation of Women Include Federal Disclosure Requirements, GAO-16-30 (Dec. 2015), at 24-25.

[6] See, e.g., Council of Institutional Investors, Best Disclosure: Director Qualifications & Skills (Feb. 2014).

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UNITED STATES

BOARD OF DIRECTORS- VOTING ON DIRECTOR NOMINEES IN UNCONTESTED ELECTIONS

Unilateral Bylaw/Charter Amendments

Current General Recommendation: Generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if the board amends the company's bylaws or charter without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders, considering the following factors, as applicable:

- The board's rationale for adopting the bylaw/charter amendment without shareholder ratification;
- Disclosure by the company of any significant engagement with shareholders regarding the amendment;
- The level of impairment of shareholders' rights caused by the board's unilateral amendment to the bylaws/charter;
- The board's track record with regard to unilateral board action on bylaw/charter amendments or other entrenchment provisions;
- The company's ownership structure;
- The company's existing governance provisions;
- Whether the amendment was made prior to or in connection with the company's initial public offering;
- The timing of the board's amendment to the bylaws/charter in connection with a significant business development;
- Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders.

Key Changes:

- Separate the methodology for evaluating adoptions of bylaw or charter provisions made prior to or in connection with a company's initial public offering from the methodology for evaluating unilateral board amendments to the bylaws or charter made following completion of a company's initial public offering, and
- Explicitly state that ISS will consider both such actions in determining vote recommendations for director nominees until such time as the actions are reversed or submitted to a binding vote of public shareholders.

New General Recommendation:

1.17. Generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if the board amends the company's bylaws or charter without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders, considering the following factors:

- The board's rationale for adopting the bylaw/charter amendment without shareholder ratification;
- Disclosure by the company of any significant engagement with shareholders regarding the amendment;
- The level of impairment of shareholders' rights caused by the board's unilateral amendment to the bylaws/charter;
- The board's track record with regard to unilateral board action on bylaw/charter amendments or other entrenchment provisions;
- The company's ownership structure;
- The company's existing governance provisions;
- The timing of the board's amendment to the bylaws/charter in connection with a significant business development; and,
- Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders.

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Unless the adverse amendment is reversed or submitted to a binding shareholder vote, in subsequent years vote case-by-case on director nominees. Generally vote against (except new nominees, who should be considered case-by-case) if the directors:

- Classified the board;
- Adopted supermajority vote requirements to amend the bylaws or charter; or
- Eliminated shareholders' ability to amend bylaws.

1.18. For newly public companies, generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if, prior to or in connection with the company's public offering, the company or its board adopts bylaw or charter provisions adverse to shareholders' rights, considering the following factors:

- The level of impairment of shareholders' rights caused by the provision;
- The company's or the board's rationale for adopting the provision;
- The provision's impact on the ability to change the governance structure in the future (e.g., limitations on shareholder right to amend the bylaws or charter, or supermajority vote requirements to amend the bylaws or charter);
- The ability of shareholders to hold directors accountable through annual director elections, or whether the company has a classified board structure; and,
- A public commitment to put the provision to a shareholder vote within three years of the date of the initial public offering.

Unless the adverse provision is reversed or submitted to a vote of public shareholders, vote case-by-case on director nominees in subsequent years.

Rationale for Update:

This update clarifies ISS policy and aligns ISS' approach to evaluating unilateral bylaw and charter amendments by pre-IPO companies and post-IPO company board members with feedback received from institutional investors. This update also establishes separate methodologies to evaluate adoptions of bylaw or charter provisions made prior to or in connection with a company's initial public offering and unilateral board amendments made to the bylaws or charter following completion of a company's initial public offering. This bifurcation reflects the differing expectations that investors may have for the governance structures of a newly-public company versus a company that has been public for some period of time.

At companies that are already public, investors have seen a marked increase in moves by boards to circumvent votes by unilaterally amending their companies' governing documents—usually the bylaws—to reduce shareholders' rights. While ISS tracked 10 such cases in 2013 (the historic norm in terms of volume), unilateral adoptions jumped to 64 in 2014, and there have been 62 thus far in 2015.

A majority of investor respondents to the ISS 2015–2016 policy survey favor adverse vote recommendations for director nominees when a board unilaterally adopts bylaw or charter amendments that "materially diminish" shareholders' rights until such time as the rights are restored. Both investor and non-investor respondents identify "classifying the board" and "establishing supermajority vote requirements for bylaw/charter amendments" as the unilateral actions for which continuing adverse vote recommendations would be most appropriate.

A significant percentage of recent IPOs have included provisions that limit board accountability to post-IPO investors and make it difficult for shareholders to amend the company's governing documents or take other corporate actions. While some pre-IPO boards argue that these governance structures will benefit investors over the long run, few of them provide opportunities for post-IPO shareholders to ratify these provisions. Notably, the lion's share of recent IPO firms have limited directors' accountability to shareholders by staggering board terms (via classified boards) and adopting supermajority vote provisions to amend the firms' governing documents. A law firm analysis of governance

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practices at more than 400 “emerging growth companies” that completed their IPOs in the period from Jan. 1, 2013, through Dec. 31, 2014, for example, found that 69 percent of these firms went public with classified boards and nearly three-quarters had supermajority vote requirements in place.[1] A separate law firm analysis of large IPOs at 46 non-controlled companies for the Sept. 1, 2001, to Oct. 31, 2013, period, found that 70 percent of the boards had staggered terms and 70 percent of the firms required supermajority votes to amend their bylaws.[2]

Overboarded Directors

Current General Recommendation: Vote against or withhold from individual directors who:

- Sit on more than six public company boards; or
- Are CEOs of public companies who sit on the boards of more than two public companies besides their own—withhold only at their outside boards[3].

Key Changes:

- In 2016, ISS will note in its analysis if a director is serving on more than five (5) public company boards.
- Starting in February of 2017, ISS will recommend against directors who sit on more than five (5) public company boards.

New General Recommendation: Vote against or withhold from individual directors who:

- Sit on more than six public company boards; for meetings on or after Feb. 1, 2017[4], sit on more than five public company boards; or
- Are CEOs of public companies who sit on the boards of more than two public companies besides their own—withhold only at their outside boards[3].

Rationale for Update:

More than a decade ago, in response to rising investor concerns about over-boarding and academic research questioning the performance of “busy” directors, ISS set limits of six directorships for most board members and three total board memberships (service on the home company board and two outside directorships) for sitting CEOs.

Since these limits were adopted, the average time commitment for board service has exploded. According to the National Association of Corporate Directors’ (NACD) 2014-2015 Public Company Governance Survey, respondent directors of public companies now spend an average of 242 hours a year (or more than 30 eight-hour work days annually) on board service. This typical time commitment jumps up to 278 hours (or nearly five more eight-hour work days) when you add in the survey respondents’ estimates of additional time spent in informal meetings/conversations with management. In contrast, the average annual director time commitment reported by NACD’s survey respondents in 2005 was 190 hours (or fewer than 24 eight-hour work days).

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[1] Morrison & Foerster, Getting the Measure of EGC Corporate Governance Practices: A survey and related resources, 2015.
[2] Davis Polk &Wardwell, Corporate Governance Practices in U.S. Initial Public Offerings (Excluding Controlled Companies, Jan, 2014.
[3] Although all of a CEO’s subsidiary boards will be counted as separate boards, ISS will not recommend a withhold vote from the CEO of a parent company board or any of the controlled (>50 percent ownership) subsidiaries of that parent, but may do so at subsidiaries that are less than 50 percent controlled and boards outside the parent/subsidiary relationships.
[4] This policy change includes a 1-year transition period to allow time for affected directors to address necessary changes if they wish.

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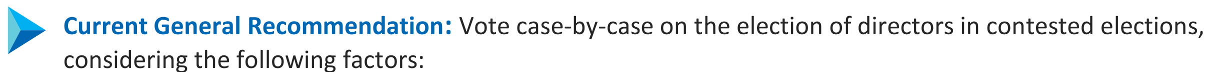
Recent academic research generally shows a negative association between board "busyness" and firm performance and director attendance at board meetings[5]. Notably, the authors of most of these studies define a "busy" director's workload as three or more boards.

Many boards have responded to concerns about overboarding by placing limits on the number of public company directorships that that their members may hold. Some boards appear to address time commitment concerns via their nominating panels. Spurred by these policies and common sense, most board members limit their board seats to four or fewer directorships.

ISS has periodically updated its overboarding policy since it was implemented in 2004, to incorporate the evolving market realities. The new policy aligns with feedback and research received from institutional investors as well as the issuer community (via our 2015-2016 policy survey and roundtable discussions) regarding the ability of a director to devote sufficient time to each board commitment. Based on that feedback as well as draft policy comments, ISS will continue evaluating the optimal level of directorships for individuals who are CEOs of public companies.

Proxy Contests/Proxy Access — Voting for Director Nominees in Contested Elections



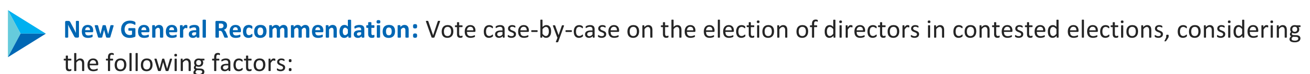
Current General Recommendation: Vote case-by-case on the election of directors in contested elections, considering the following factors:

- Long-term financial performance of the target company relative to its industry;
- Management's track record;
- Background to the proxy contest;
- Nominee qualifications and any compensatory arrangements;
- Strategic plan of dissident slate and quality of critique against management;
- Likelihood that the proposed goals and objectives can be achieved (both slates);
- Stock ownership positions.

When the addition of shareholder nominees to the management card ("proxy access nominees") results in a number of nominees on the management card which exceeds the number of seats available for election, vote case-by-case considering the same factors listed above.

Key Changes:

- Clarifying a policy analysis framework to evaluate candidates nominated pursuant to proxy access as well as nominees in a proxy contest.
- While several factors may be similar in each evaluation, there may be factors that are unique to analyzing proxy access nominations.



New General Recommendation: Vote case-by-case on the election of directors in contested elections, considering the following factors:

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[5] Cashman, George D. and Gillan, Stuart and Jun, Chulhee, Going Overboard? On Busy Directors and Firm Value (March 1, 2012). Available at SSRN: http://ssrn.com/abstract=2044798 or http://dx.doi.org/10.2139/ssrn.2044798; Falato, Antonio and Kadyrzhanova, Dalida and Lel, Ugur, Distracted Directors: Does Board Busyness Hurt Shareholder Value? (December 10, 2013). Available at SSRN: http://ssrn.com/abstract=2272478 or http://dx.doi.org/10.2139/ssrn.2272478; Jiraporn, Pornsit and Davidson, Wallace N. and Ning, Yixi and DaDalt, Peter J., Too Busy to Show Up? An Analysis of Directors' Absences (January 21, 2008). Available at SSRN: http://ssrn.com/abstract=1254642 or http://dx.doi.org/10.2139/ssrn.1254642

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- Long-term financial performance of the target company relative to its industry;
- Management's track record;
- Background to the contested election;
- Nominee qualifications and any compensatory arrangements;
- Strategic plan of dissident slate and quality of critique against management;
- Likelihood that the proposed goals and objectives can be achieved (both slates); and
- Stock ownership positions.

In the case of candidates nominated pursuant to proxy access, vote case-by-case considering any applicable factors listed above or additional factors which may be relevant, including those that are specific to the company, to the nominee(s) and/or to the nature of the election (such as whether or not there are more candidates than board seats).

Rationale for Update:

This policy revision provides an analytical framework for evaluating candidates nominated pursuant to proxy access. ISS has a policy for evaluating director nominees in contested elections, which currently applies to proxy contests as well as proxy access nominations. However, the circumstances and motivations of a proxy contest and a proxy access nomination may differ significantly. Therefore, it is necessary to create adequate analytical latitude for evaluating candidates nominated through proxy access.

Proxy access rights have grown into a high-visibility corporate governance issue for US-listed companies. In 2014, ISS evaluated 18 shareholder proposals seeking proxy access rights. That number rose to more than 90 in 2015. Further, while five of the proposals received majority support in 2014, 52 have received majority support so far in 2015. Moreover, following the 2015 US proxy season, numerous companies have unilaterally adopted proxy access rights, even in the absence of majority-supported shareholder proposals.

While it is unlikely that many (or perhaps any) proxy access nominees will materialize in 2016, ISS believes it is prudent to update its framework for evaluating candidates nominated via proxy access right. In some cases, the nominating shareholder's views on the current leadership or company strategy may be opposed to the existing board's views. Alternatively, a shareholder nominator may generally agree with the company's strategy or have no specific critiques of incumbent directors, but may propose an alternative candidate to address a specific concern, such as board diversity or boardroom skills gaps.

COMPENSATION

Advisory Votes on Executive Compensation— Problematic Pay Practices

Insufficient Executive Compensation Disclosure by Externally Managed Issuers

Currently, insufficient disclosure regarding compensation arrangements for executives at an externally-managed issuer (EMI) is not considered a problematic pay practice under ISS policy. Absent any other significant concerns identified, ISS has generally not issued adverse say-on-pay recommendations on this basis. ISS does raise concerns, however, regarding the lack of transparency resulting when an EMI provides a say-on-pay proposal without information that enables investors to make an informed voting decision on the proposal.

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Key Changes: Update the Problematic Pay Practice policy, add "Insufficient Executive Compensation Disclosure by Externally Managed Issuers (EMIs)" to the list of practices that may result in an adverse recommendation on the advisory vote on executive compensation. This refers to an EMI's failure to provide sufficient disclosure to enable shareholders to make a reasonable assessment of compensation arrangements for the EMI's named executive officers.

New General Recommendation: For externally-managed issuers (EMIs), generally vote against the say-on-pay proposal when insufficient compensation disclosure precludes a reasonable assessment of pay programs and practices applicable to the EMI's executives.

Rationale for Update:

Lack of Disclosure Precludes a Reasonable Assessment of Executive Compensation Arrangements

Like most U.S. public companies, EMIs are subject to periodic, advisory say-on-pay vote requirements. However, an EMI typically does not directly compensate its executives. Instead, executives are compensated by the external manager, which is reimbursed by the EMI through a management fee.

EMIs typically do not disclose any details about their compensation arrangements or payments made to executives by external managers. Many EMIs do not provide even basic disclosure regarding executive compensation arrangements and payments between the external manager and the EMI's executives. When “executive compensation information” is disclosed, it is usually limited to the aggregate management fee paid by the EMI to its manager. Without adequate information, shareholders are unable to conduct a reasonable assessment of executive compensation arrangements in order to identify potentially problematic aspects of those arrangements and to make an informed decision when voting on the EMI's say-on-pay proposal.

Some EMIs provide disclosure about the value and nature of NEOs' compensation arrangements in sufficient detail to enable shareholders to reasonably assess the arrangements and cast an informed vote on the EMI's say-on-pay proposal. Some EMIs, for example, disclose the aggregate portion of such fees that is allocable to executive compensation expenses. A small number of EMIs disclose detailed information on behalf of their external managers. This enhanced transparency demonstrates that such information can be made available within the constraints of company agreements with external managers.

As such, ISS will consider insufficient disclosure regarding compensation arrangements between executives and the external manager to be a problematic practice that warrants an AGAINST recommendation on the say-on-pay proposal.

2015-2016 Policy Survey

Based on 2015-2016 ISS Policy Survey results, 71% of investor respondents indicated that, in the event an EMI does not provide disclosure on the compensation paid to management by the eternal manager, ISS should recommend an AGAINST vote on the say-on-pay proposal, given that the level of disclosure does not meet shareholders' informational needs. Even a sizable minority (24%) of non-investor respondents (companies and advisors) responded that an AGAINST recommendation would be warranted.

U.S. Compensation Roundtables

At the 2015 ISS U.S. Compensation Roundtable held on Sept. 22, 2015, nearly all participants expressed their support for a policy update in which ISS would recommend AGAINST the say-on-pay proposals for EMIs that do not provide sufficient executive compensation disclosure. No participant expressed a preference for continuation of ISS' current approach of supporting the say-on-pay proposals in such cases. At the 2014 ISS U.S. Compensation Roundtable held on Sept. 16, 2014, participants similarly indicated that they considered an EMI's lack of compensation disclosure to inhibit shareholders' ability to fully assess the merits of the company's pay program and practices.

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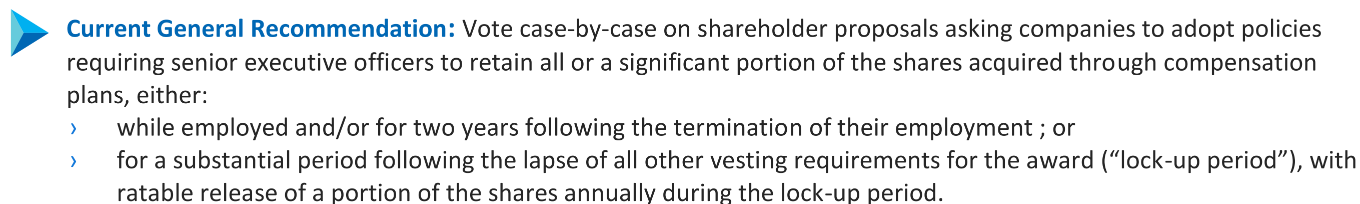
Hold Equity Past Retirement or for a Significant Period of Time



Current General Recommendation: Vote case-by-case on shareholder proposals asking companies to adopt policies requiring senior executive officers to retain all or a significant portion of the shares acquired through compensation plans, either:

- while employed and/or for two years following the termination of their employment ; or
- for a substantial period following the lapse of all other vesting requirements for the award ("lock-up period"), with ratable release of a portion of the shares annually during the lock-up period.

The following factors will be taken into account:

- Whether the company has any holding period, retention ratio, or officer ownership requirements in place. These should consist of:
  - Rigorous stock ownership guidelines;
  - A holding period requirement coupled with a significant long-term ownership requirement; or
  - A meaningful retention ratio;
- Actual officer stock ownership and the degree to which it meets or exceeds the proponent's suggested holding period/retention ratio or the company's own stock ownership or retention requirements;
- Post-termination holding requirement policies or any policies aimed at mitigating risk taking by senior executives;
- Problematic pay practices, current and past, which may promote a short-term versus a long-term focus.

A rigorous stock ownership guideline should be at least 10x base salary for the CEO, with the multiple declining for other executives. A meaningful retention ratio should constitute at least 50 percent of the stock received from equity awards (on a net proceeds basis) held on a long-term basis, such as the executive's tenure with the company or even a few years past the executive's termination with the company.

Vote case-by-case on shareholder proposals asking companies to adopt policies requiring Named Executive Officers to retain 75% of the shares acquired through compensation plans while employed and/or for two years following the termination of their employment, and to report to shareholders regarding this policy. The following factors will be taken into account:

- Whether the company has any holding period, retention ratio, or officer ownership requirements in place. These should consist of:
  - Rigorous stock ownership guidelines, or
  - A holding period requirement coupled with a significant long-term ownership requirement, or
  - A meaningful retention ratio,
- Actual officer stock ownership and the degree to which it meets or exceeds the proponent's suggested holding period/retention ratio or the company's own stock ownership or retention requirements.
- Problematic pay practices, current and past, which may promote a short-term versus a long-term focus.

A rigorous stock ownership guideline should be at least 10x base salary for the CEO, with the multiple declining for other executives. A meaningful retention ratio should constitute at least 50 percent of the stock received from equity awards (on a net proceeds basis) held on a long-term basis, such as the executive's tenure with the company or even a few years past the executive's termination with the company.

Generally vote against shareholder proposals that mandate a minimum amount of stock that directors must own in order to qualify as a director or to remain on the board. While ISS favors stock ownership on the part of directors, the company should determine the appropriate ownership requirement.

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Key Changes:

- Broaden policy to encompass executive equity retention proposals more generally, eliminating the need for a separate policy covering proposals seeking retention of 75% of net shares.
- Clarify that the proposed retention ratio and the required duration of retention are some of the several factors that will be considered in ISS' case-by-case analysis.

New General Recommendation: Vote case-by-case on shareholder proposals asking companies to adopt policies requiring senior executive officers to retain a portion of net shares acquired through compensation plans. The following factors will be taken into account:

- The percentage/ratio of net shares required to be retained;
- The time period required to retain the shares;
- Whether the company has equity retention, holding period, and/or stock ownership requirements in place and the robustness of such requirements;
- Whether the company has any other policies aimed at mitigating risk taking by executives;
- Executives' actual stock ownership and the degree to which it meets or exceeds the proponent’s suggested holding period/retention ratio or the company’s existing requirements; and
- Problematic pay practices, current and past, which may demonstrate a short-term versus long-term focus.

Rationale for Update:

This policy update clarifies the factors considered in ISS' case-by-case analysis. It also broadens the policy to encompass equity retention proposals more generally, thereby eliminating the need for a separate policy tied to a specified retention ratio.

Specifically, the revised policy clarifies that the proponent's suggested retention percentage/ratio and the required retention duration are two of the several factors to be assessed under ISS' case-by-case approach. This change eliminates the need for separate policies tied to specified retention ratios (i.e. a separate policy for proposals requesting 75% net share retention), since the retention ratio is a factor to be considered for every proposal. In more clearly identifying the factors and eliminating repetitive language, the new policy is more streamlined and easier to understand.

ENVIRONMENTAL AND SOCIAL ISSUES

Animal Welfare

Current General Recommendation: Generally vote for proposals seeking a report on a company’s animal welfare standards, unless:

- The company has already published a set of animal welfare standards and monitors compliance;
- The company’s standards are comparable to industry peers; and
- There are no recent, significant fines or litigation related to the company’s treatment of animals.

Key Changes:

- Add "or animal welfare-related risks" to introductory sentence;
- Add "controversies" to last bullet point; and
- Add "and/or its suppliers’" to the last bullet point.

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New General Recommendation: Generally vote for proposals seeking a report on a company's animal welfare standards, or animal welfare-related risks, unless:

- The company has already published a set of animal welfare standards and monitors compliance;
- The company's standards are comparable to industry peers; and
- There are no recent significant fines, litigation, or controversies related to the company's and/or its suppliers' treatment of animals.

Rationale for Update:

In 2014, some proponents began submitting shareholder proposals requesting reports on the risks associated with the use of certain methods of animal housing (e.g. gestation crates and battery cages) and other animal welfare practices deemed inhumane in a company's supply chain. The updated policy clarifies that proposals requesting a report on animal welfare-related risks, including the aforementioned resolutions on supply chain risks, are analyzed under this policy. The inclusion of controversies, along with fines and litigation, provides for consistent language across the Environmental and Social Issues policies, and ensures consistent evaluation and incorporation of relevant information.

Pharmaceutical Pricing, Access to Medicines, and Prescription Drug Reimportation

Current General Recommendation: Vote case-by-case on proposals requesting that a company report on its product pricing or access to medicine policies, considering:

- The nature of the company's business and the potential for reputational and market risk exposure;
- Existing disclosure of relevant policies;
- Deviation from established industry norms;
- Relevant company initiatives to provide research and/or products to disadvantaged consumers;
- Whether the proposal focuses on specific products or geographic regions; and
- The potential burden and scope of the requested report.

Key Changes:

- Add "regulatory" to the risk exposure bullet point; and
  Add a bullet point for "recent signficiant controveries, litigation, or fines at the company."

New General Recommendation: Vote case-by-case on proposals requesting that a company report on its product pricing or access to medicine policies, considering:

- The potential for reputational, market, and regulatory risk exposure;
- Existing disclosure of relevant policies;
- Deviation from established industry norms;
- Relevant company initiatives to provide research and/or products to disadvantaged consumers;
- Whether the proposal focuses on specific products or geographic regions;
- The potential burden and scope of the requested report;
- Recent significant controversies, litigation, or fines at the company.

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Rationale for Update:

This update codifies ISS' current practice. When evaluating resolutions that request a report on a company's policies related to product pricing and access to medicine, ISS considers the potential for regulatory risks and the company's exposure to controversies, litigation, or fines.

The addition of the controversies bullet point reflects the increased criticism regarding the pricing of pharmaceutical products, in particular specialty drugs. This criticism has not only resulted in media coverage, but also Senate and U.S. Department of Justice investigations at some companies. Additionally, a growing number of states have either passed or have presented legislation aiming to cap pricing for certain products or to require drug manufacturers to provide increased disclosure on the cost of drug research and production, resulting in additional regulatory risks for the pharmaceutical industry.

Climate Change/Greenhouse Gas (GHG) Emissions

Current General Recommendation: Generally vote for resolutions requesting that a company disclose information on the impact of climate change on its operations and investments, considering:

- Whether the company already provides current, publicly-available information on the impacts that climate change may have on the company as well as associated company policies and procedures to address related risks and/or opportunities;
- The company's level of disclosure is at least comparable to that of industry peers; and
- There are no significant controversies, fines, penalties, or litigation associated with the company's environmental performance.

Key Changes:

Add "such as financial, physical, or regulatory risks" to the introductory sentence.

New General Recommendation: Generally vote for resolutions requesting that a company disclose information on the risks related to climate change on its operations and investments, such as financial, physical, or regulatory risks, considering:

- Whether the company already provides current, publicly-available information on the impact that climate change may have on the company as well as associated company policies and procedures to address related risks and/or opportunities;
- The company's level of disclosure is at least comparable to that of industry peers; and
- There are no significant controversies, fines, penalties, or litigation associated with the company's environmental performance.

Rationale for Update:

During the 2015 proxy season, proponents filed new shareholder proposals addressing companies' capital expenditure strategies as they relate to investments in fossil fuel and stranded carbon asset risk (investment in high-cost, high-carbon assets could be stranded, as global demand for fossil fuels slows in the coming years and/or potential climate change regulations make them unburnable). These resolutions asked companies to either report on the consistency of their capital expenditure strategies with policymakers' goals to limit greenhouse gas emissions, or a company's strategy

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to address the risk of stranded assets presented by global climate change and associated demand reductions for oil and gas.

The revisions to the current policy clarify the types of risks related to climate change that can impact a company's operations and investments. It also clarifies that the capital expenditure strategy and stranded carbon asset resolutions are evaluated pursuant to this policy.

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CANADA

BOARD OF DIRECTORS- VOTING ON DIRECTOR NOMINEES IN UNCONTESTED ELECTIONS

Overboarded Directors –TSX

Current General Recommendation: Generally vote withhold for individual director nominees if:

- Irrespective of whether the company has adopted a majority voting policy, the director is overboarded[6] AND the individual director has attended less than 75 percent of his/her respective board and committee meetings held within the past year without a valid reason for these absences.

Cautionary language will be included in ISS reports where directors are overboarded regardless of attendance.

Key Changes:

- Change the definition of "overboarded" from more than 2 outside public company boards to more than 1 in the case of CEOs, and from more than 6 total public company boards to more than 4 in the case of non-CEOs.
- Commencing as of February 2017 meeting dates, the new policy definition will be implemented under the ISS Canada TSX Overboarded Directors policy.

New General Recommendation: Generally vote withhold for individual director nominees if:

- Irrespective of whether the company has adopted a majority voting policy, the director is overboarded[6,7] AND the individual director has attended less than 75 percent of his/her respective board and committee meetings held within the past year without a valid reason for these absences.

Cautionary language will be included in ISS reports where directors are overboarded regardless of attendance.

Rationale for Update:

Directors need sufficient time and energy in order to be effective representatives of shareholders' interests. Directors' responsibilities are increasingly complex as board and key committee memberships demand greater time commitments.

In a 2014 study, 120 board chairs, directors and CEOs across Canada were surveyed regarding their annual time commitment per board on which they served. The survey found that the average annual time commitment per board for a Canadian director was 304 hours. This number was higher for directors of companies with assets of more than CA$5 billion (388 hours) and also higher for those with assets between CA$1 billion and CA$5 billion (335 hours). There

[6] "Overboarded" is defined as: a CEO of a public company who sits on more than 2 outside public company boards in addition to the company of which he/she is CEO (withholds would only apply on outside boards these directors sit on), OR the director is not a CEO of a public company and sits on more than 6 public company boards in total.

[7] Starting February 1, 2017, "overboarded" will be defined as: a CEO of a public company who sits on more than 1 outside public company board in addition to the company of which he/she is CEO (withholds would only apply on outside boards these directors sit on), OR the director is not a CEO of a public company and sits on more than 4 public company boards in total.

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was also a correlation between the role of a director and average annual time commitment. As expected, being a board chair is the most time consuming role; however, being a committee chair can be almost as time consuming.

While it appears that no comparable studies were conducted for previous years in Canada, according to a 2014-2015 US survey conducted by the National Association of Corporate Directors (NACD), directors of US public companies spent an annual average of 278 hours on board-related matters.

Based on the results of the 2015-16 ISS Global Policy Survey, a plurality of investor responses indicated that four total board seats is an appropriate limit for directors who are not active CEOs, and that a total of two board seats (a CEO's "home board" plus one outside board) is an appropriate limit for directors who are active CEOs.

ISS also obtained feedback in one-on-one discussions with institutional investors, the results of which indicate that a majority of those canvassed support maximum limits of four and two total board seats for non-CEO directors and CEO directors, respectively. These limits are reasonable in light of the "double-trigger" approach of jointly evaluating both number of board seats and attendance under Canadian policy.

Externally-Managed Issuers (EMIs) –TSX and TSXV

Current General Recommendation: None.

Key Changes:

Provide a framework for reviewing board accountability at EMIs, in cases where disclosure is limited or insufficient with respect to the management services agreement and how senior management is compensated.

New General Recommendation: Vote case-by-case on say-on-pay resolutions where provided, or on individual directors, committee members, or the entire board as appropriate, when an issuer is externally-managed and has provided minimal or no disclosure about their management services agreements and how senior management is compensated. Factors taken into consideration may include but are not limited to:

- The size and scope of the management services agreement;
- Executive compensation in comparison to issuer peers and/or similarly structured issuers;
- Overall performance;
- Related party transactions;
- Board and committee independence;
- Conflicts of interest and process for managing conflicts effectively;
- Disclosure and independence of the decision-making process involved in the selection of the management services provider;
- Risk mitigating factors included within the management services agreement such as fee recoupment mechanisms;
- Historical compensation concerns;
- Executives' responsibilities; and
- Other factors that may reasonably be deemed appropriate to assess an externally-managed issuer's governance framework.

Rationale for Update:

Externally-managed issuers (EMIs) typically pay fees to outside firms in exchange for management services. In most cases, some or all of the EMI's executives are directly employed and compensated by the external management firm.

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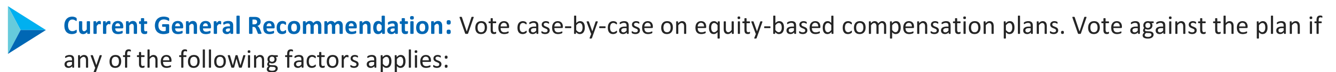
EMIs typically do not disclose details of the management agreement in their proxy statements and only provide disclosure on the aggregate amount of fees paid to the manager, with minimal or incomplete compensation information.

Say-on-pay resolutions are voluntarily adopted in Canada, and none of the currently identified Canadian EMIs had a say-on-pay resolution on ballot this past year. Additionally, all non-controlled TSX-listed issuers are required to adopt majority voting director resignation policies which could result in a director being required to resign from a board if he or she receives more 'withhold' than 'for' votes at the shareholders' meeting. Some investor respondents to ISS' 2015-16 ISS Global Policy Survey indicated that in cases where an externally managed company does not have a say-on-pay proposal (i.e., 'withhold' votes may be recommended for individual directors), factors other than disclosure should be considered, such as performance, compensation and expenses paid in relation to peers, board and committee independence, conflicts of interest, and pay-related issues. Policy outreach sessions conducted with Canadian institutional investors resulted in identical feedback.

COMPENSATION

Equity Compensation Plans–TSX



Current General Recommendation: Vote case-by-case on equity-based compensation plans. Vote against the plan if any of the following factors applies:

- **Cost of Equity Plans:** The total cost of the company’s equity plans is unreasonable;
- **Dilution and Burn Rate:** Dilution and burn rate are unreasonable, where the cost of the plan cannot be calculated due to lack of relevant historical data.
- **Plan Amendment Provisions:** The provisions do not meet ISS guidelines regarding those amendments that should require shareholder approval..
- **Non-Employee Director Participation:** Participation of directors is discretionary or unreasonable.
- **Pay for performance:** There is a disconnect between CEO pay and the company’s performance.
- **Repricing Stock Options:** The plan expressly permits the repricing of stock options without shareholder approval and the company has repriced options within the past three years.
- **Problematic Pay Practices:** The plan is a vehicle for problematic pay practices.

Key Changes:

Similar to the model introduced in the United States for the 2015 proxy season, ISS is adopting a "scorecard" model (Equity Plan Scorecard – "EPSC") for Canadian TSX equity plans that considers a range of positive and negative factors to evaluate equity incentive plan proposals. In concert with ISS' longstanding Canadian policies for TSX equity plans (relating to non-employee director participation, amendment provisions, and repricing without shareholder approval), the total EPSC score will determine whether ISS recommends for or against the proposal.

EPSC factors will fall under three categories ("EPSC pillars"): Plan Cost, Plan Features, and Grant Practices.

As part of the new approach, the updated policy will:

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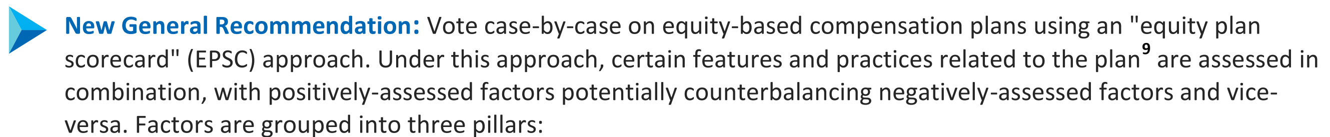
- Utilize two index groups to determine certain thresholds and factor weightings: [8]
  - S&P/TSX Composite Index; and
  - Non-Composite TSX-listed Issuers.
- Utilize individual scorecards for both index groups, as well as Special Cases versions of these scorecards where certain historic data are unavailable;
- Measure plan cost (Shareholder Value Transfer or SVT) through both of the following:
  - The company's total new and previously reserved equity plan shares plus outstanding grants and awards ("A+B+C shares"); and
  - Only the new request plus previously reserved but ungranted shares ("A+B shares");
- Incorporate a wide range of new factors for consideration, both positive and negative, in determining how to recommend for a given equity plan.



New General Recommendation: Vote case-by-case on equity-based compensation plans using an "equity plan scorecard" (EPSC) approach. Under this approach, certain features and practices related to the plan[9] are assessed in combination, with positively-assessed factors potentially counterbalancing negatively-assessed factors and vice-versa. Factors are grouped into three pillars:

- **Plan Cost**: The total estimated cost of the company's equity plans relative to industry/market cap peers, measured by the company's estimated Shareholder Value Transfer (SVT) in relation to peers and considering both:
  - SVT based on new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised grants; and
  - SVT based only on new shares requested plus shares remaining for future grants.

- **Plan Features:**
  - Absence of problematic change-in-control (CIC) provisions, including:
    - Single-trigger acceleration of award vesting in connection with a CIC; and
    - Settlement of performance-based equity at target or above in the event of a CIC-related acceleration of vesting regardless of performance.
  - No financial assistance to plan participants for the exercise or settlement of awards;
  - Public disclosure of the full text of the plan document; and
  - Reasonable share dilution from equity plans relative to market best practices.

- **Grant Practices:**
  - Reasonable three-year average burn rate relative to market best practices;
  - Meaningful time vesting requirements for the CEO's most recent equity grants (three-year lookback);
  - The issuance of performance-based equity to the CEO;
  - A clawback provision applicable to equity awards; and
  - Post-exercise or post-settlement share-holding requirements (S&P/TSX Composite Index only).

Generally vote against the plan proposal if the combination of above factors, as determined by an overall score, indicates that the plan is not in shareholders' interests. In addition, vote against the plan if any of the following unacceptable factors have been identified:

- Discretionary or insufficiently limited non-employee director participation;

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[8] Additional Special Cases versions of both models will also be developed for companies that have recently IPO'd or emerged from bankruptcy and where the burn-rate factor would therefore not apply.
[9] In cases where certain historic grant data are unavailable (e.g. following an IPO or emergence from bankruptcy), Special Cases models will be applied which omit factors requiring these data.

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- An amendment provision which fails to adequately restrict the company's ability to amend the plan without shareholder approval;
- A history of repricing stock options without shareholder approval (three-year look-back);
- The plan is a vehicle for problematic pay practices or a significant pay-for-performance disconnect under certain circumstances; or
- Any other plan features that are determined to have a significant negative impact on shareholder interests.

Rationale for Update:

As issues around cost transparency and best practices in equity-based compensation have evolved in recent years, ISS has determined to update its Canadian Equity Plans policy in order to provide for a more nuanced consideration of equity plan proposals.

Currently, the Canadian policy for equity plans comprises a series of pass/fail tests relating to plan cost and to three key concerns of Canadian investors:

- Non-employee director participation;
- Plan amendment provisions; and
- Repricing without shareholder approval.

While the three policy cornerstones above will continue to be overriding negative factors under the new policy, the pass/fail test for plan cost will be replaced with a scorecard approach designed to provide a robust overview of an equity plan's strengths and weaknesses.

Feedback obtained through ongoing consultation with institutional investors since the 2013-2014 ISS policy cycle indicates strong support for the new approach, which incorporates the following key goals:

1. Consider a range of factors, both positive and negative, in determining vote recommendations;
2. Select factors based on institutional investors' concerns and preferences and on best practices within the Canadian market established through regulation, disclosure requirements, and best practice principles;
3. Establish factor thresholds and weightings which are cognizant of the Canadian governance landscape (separate scorecards for the S&P/TSX Composite Index and the broader TSX);
4. Ensure that key concerns addressed by policy continue to hold paramount importance (institution of overriding negative factors).

The EPSC policy for equity plan proposals significantly iterates ISS' current Canadian policy by providing a full-spectrum overview of plan cost, plan features, and historic grant practices. This allows shareholders greater insight into rising governance concerns, such as the implementation of risk-mitigating mechanisms, the strength of vesting provisions, and the use of performance-based equity, while also providing added assessments of longstanding concerns relating to equity plans such as burn rate and dilution.

By assessing these factors in combination, the EPSC is designed to facilitate a more holistic approach to vote recommendations. For example, a plan where cost is nominally higher than a company's allowable cap may receive a favourable recommendation if sufficient positive factors are present. Conversely, a plan where cost is nominally lower than the allowable cap may ultimately receive a negative recommendation if a preponderance of scorecard factors demonstrates adverse qualities. Plans will, however, continue to be subject to the scrutiny of overriding negative factors reflecting ISS' current policies regarding problematic non-employee director participation, insufficient plan amendment provisions, repricing without shareholder approval, and other egregious practices. Plans permitting these unacceptable practices will continue to receive an "against" recommendation.

A scorecard approach will enable the evaluation of equity plan proposals in consideration of a range of best practices. Weightings for the three scorecard pillars applicable to S&P/TSX Composite Index constituents and non-Composite TSX-

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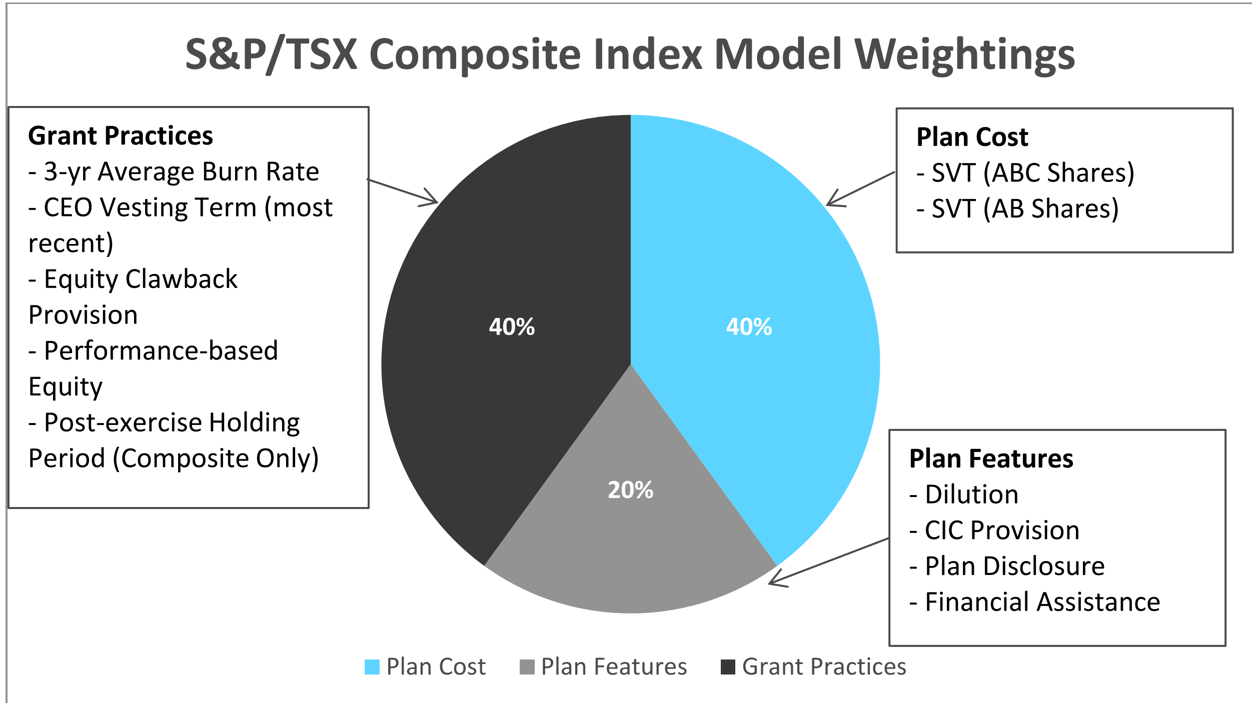
listed issuers are shown below, along with the factors within each pillar. More information about the policy and weightings will be included in ISS' EPSC FAQ to be published in December.



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BRAZIL

BOARD OF DIRECTORS - DIRECTOR ELECTIONS

Election of board and fiscal council nominees presented by minority ordinary and preferred holders under separate election items

Current General Recommendation: Vote against the election of directors nominated by non-controlling shareholders presented as a separate voting item if the nominee names are not disclosed in a timely manner prior to the meeting.

The policy is silent regarding the election of fiscal council members (statutory auditors) nominated by non-controlling shareholders, presented as separate voting items, as allowed by the Brazilian Corporate Law.

Key Changes:

- Recommend an abstain vote in the absence of timely disclosure regarding the names of the minority shareholders' director nominees (both ordinary minority nominee and/or preferred minority nominee, as applicable), when presented under a separate election; and
- Add the provision of an abstain vote recommendation in the absence of timely disclosure regarding the names of minority shareholders' fiscal council nominees and alternates (both ordinary and preferred minority nominees, as applicable), when presented under a separate election.

New General Recommendation: Vote abstain on the election of directors and fiscal council members nominated by non-controlling shareholders presented as a separate voting item if the nominee names are not disclosed in a timely manner prior to the meeting.

Rationale for Update:

The current recommendation to vote against the election of directors nominated by non-controlling shareholders presented as a separate voting item if the nominee names are not disclosed in a timely manner prior to the meeting is part of the Brazilian policy carved out from the Americas Regional policy mid-2013, effective as of Feb. 1, 2014, but was not fully implemented by the Latin America Research team due to the evolving processes in the voting operations chain regarding minority elections presented under separate items in the Brazilian market.

Minority nominees are generally considered independent and, as they can legally be presented up to the time of the meeting, a vote against would disenfranchise minority shareholders who could benefit from greater independent representation. Nonetheless, a vote for minority nominees in the absence of the disclosure of such names is inconsistent with ISS transparency principles and the overall policy framework for the Latin America region.

As such, an abstain vote is the most effective (and neutral) way to address minority shareholder election items when adequate disclosure is not provided in a timely manner. The policy update maintains the current practice of recommending a for vote if the names of the minority nominees are disclosed, and, in the absence of timely disclosure, to recommend an abstain vote for all minority election items, including directors and fiscal council nominees (ordinary and preferred shareholder meeting).

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Combined Chairman/CEO

Current General Recommendation: None specific to the combination of Chair/CEO.

Key Changes:
Introduce policies for voting on directors at companies listed under the differentiated corporate governance segments in Brazil that maintain a combined Chair/CEO structure

New General Recommendation: Vote against the bundled election of directors of companies listed under the differentiated corporate governance segments of the Sao Paulo Stock Exchange (BM&FBovespa)--Novo Mercado, Nivel 2, and Nivel 1-- if the company maintains or proposes a combined chairman/CEO structure, after three (3) years from the date the company's shares began trading on the respective differentiated corporate governance segment.

Vote against the election of the company's chairman, if the nominee is also the company's CEO, when it is presented as a separate election at companies listed under the differentiated corporate governance segments of the Sao Paulo Stock Exchange (BM&FBovespa)–Novo Mercado, Nivel 2, and Nivel 1-- after three (3) years from the date the company's shares began trading on the respective differentiated corporate governance segment.

Rationale for Update:

The policy update is consistent with the current regulatory requirements of the Brazilian differentiated corporate governance listing segments (Novo Mercado, Nivel 2, and Nivel 1) adopted by the BM&FBovespa in 2010, which established the following:

No Accumulation of Positions. The offices of chairman of the board of directors and the chief executive officer or major executive officer of the Company shall not be accumulated in a single person, except in case of vacancy, in which event the circumstance will be disclosed to the market and action will be taken within the subsequent one hundred and eighty (180) days to fill in the positions.

However, accumulation of positions of chairman of the board of director and chief executive officer or major executive officer of the Company will be permitted on an exceptional and transitional basis for a maximum period of three (3) years starting from the date the Company shares begin to trade on the Novo Mercado, the Nivel 2 and Nivel 1.

Conflicts of Interest (Policy change applies to Americas Regional policy as well)

Current General Recommendation: Under extraordinary circumstances, vote against individual directors, members of a committee, or the entire board, due to:

- Material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

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Key Changes:
Include the provision to recommend against an individual nominee, committee members, or the entire board in light of a conflict of interest that raises significant risk, which has not yet materialized (forward looking), in the absence of mitigating measures.

New General Recommendation: Under extraordinary circumstances, vote against individual directors, member(s) of a committee, or the entire board, due to:

- Material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

Vote against individual directors, members of a committee, or the entire board due to a conflict of interest that raises significant potential risk, in the absence of mitigating measures and/or procedures.

Rationale for Update:

The current policy framework refers to conflicts of interest that raise concern in specific transactions. The update addresses a conflict of interest that raises potential significant risk in terms of future possible actions or transactions that could be adverse to shareholders' interests, when the company does not disclose policies and procedures that would mitigate such risk.

COMPENSATION

Management Compensation

Current General Recommendation: Generally vote for management compensation proposals that are presented in a timely manner and include all disclosure elements required by the Brazilian Securities Regulator (CVM).

Vote against management compensation proposals when:

- The company fails to present a detailed remuneration proposal or the proposal lacks clarity; or
- The company does not disclose the total remuneration of its highest-paid executive; or
- The figure provided by the company for the total compensation of its highest-paid administrator is not inclusive of all elements of the executive's pay.

Key Changes:
Include a provision that a significant increase in the proposed remuneration cap on a year-over-year basis will trigger further scrutiny of the company's remuneration proposal, providing a framework for a more qualitative remuneration analysis.

New General Recommendation: Generally vote for management compensation proposals that are presented in a timely manner and include all disclosure elements required by the Brazilian Securities Regulator (CVM).

Vote against management compensation proposals when:

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- The company fails to present a detailed remuneration proposal or the proposal lacks clarity; or
- The company does not disclose the total remuneration of its highest-paid executive; or
- The figure provided by the company for the total compensation of its highest-paid administrator is not inclusive of all elements of the executive's pay.

Vote case-by-case on global remuneration cap (or company's total remuneration estimate, as applicable) proposals that represent a significant increase of the amount approved at the previous AGM (year-over-year increase). When further scrutinizing year-over-year significant remuneration increases, jointly consider some or all of the following factors, as relevant:

- Whether there is a clearly stated and compelling rationale for the proposed increase;
- Whether the remuneration increase is aligned with the company's long-term performance and/or operational performance targets disclosed by the company;
- Whether the company has had positive TSR for the most recent one- and/or three-year periods;
- Whether the relation between fixed and variable executive pay adequately aligns compensation with the company's future performance.

Rationale for Update:

In Brazil, shareholders are asked to approve the aggregate remuneration of directors and executive officers annually through a binding resolution presented at a shareholder meeting. Regulatory changes implemented late 2009, effective as of January 2010 (Instructions 480 and 481), provided the framework of full disclosure of the proposed remuneration, including detailed information of executive remuneration (not individualized), which has now been in place for several years. While current policy has based recommendations solely on companies' compliance with the disclosure requirements, this update provides for a more qualitative analysis when a significant year-over-year increase signals that further scrutiny of remuneration practices is warranted.

Compensation Plans

Current General Recommendation: ISS will generally support reasonable equity pay plans that encourage long-term commitment and ownership by its recipients without posing significant risks to shareholder value.

Practically all of the plans presented since the implementation of the 2009 CVM guidelines have included reasonable dilution limits and adequate vesting conditions. Performance criteria, meanwhile, are rarely disclosed. ISS' assessments of these plans have generally hinged on the presence of discounted exercise prices (which are common in Brazil), particularly in the absence of specific performance criteria.

Vote against a stock option plan, or an amendment to the plan, if:

- The plan lacks a minimum vesting cycle of three years; and/or
- The plan permits options to be issued with an exercise price at a discount to the current market price, in the absence of explicitly stated, challenging performance hurdles related to the company's historical financial performance or the industry benchmarks; and/or
- The maximum dilution exceeds ISS guidelines of 5 percent of issued capital for a mature company and 10 percent for a growth company. However, ISS will support plans at mature companies with dilution levels up to 10 percent if the plan includes other positive features such as challenging performance criteria and meaningful vesting periods, as these features partially offset dilution concerns by reducing the likelihood that options will become exercisable unless there is a clear improvement in shareholder value; and/or
- Directors eligible to receive options under the scheme are involved in the administration of the plan.

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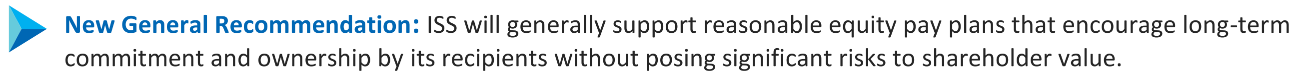
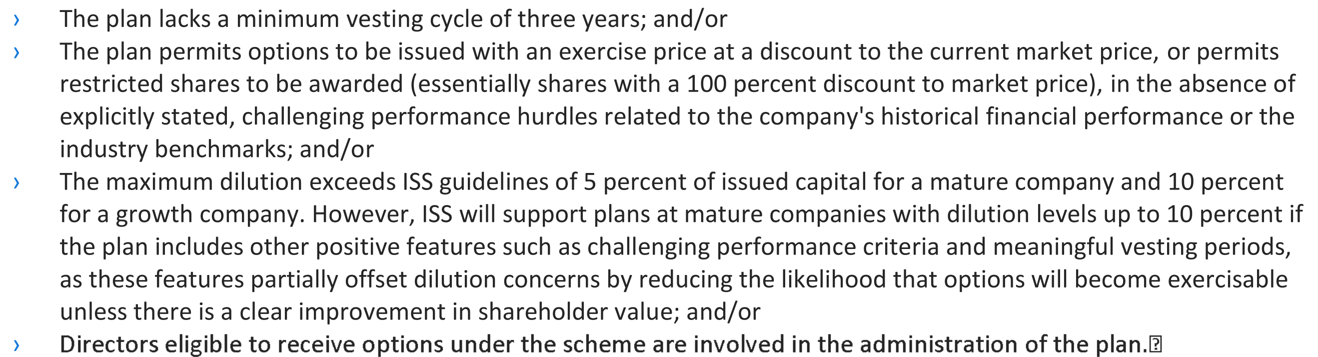
Key Changes:
Reference restricted share plans to clarify that ISS will recommend against such plans based on the proposal of full-value shares (which essentially represent a 100-percent discount to market price) in the absence of publicly disclosed performance targets and hurdles.



New General Recommendation: ISS will generally support reasonable equity pay plans that encourage long-term commitment and ownership by its recipients without posing significant risks to shareholder value.

Practically all of the plans presented since the implementation of the 2009 CVM guidelines have included reasonable dilution limits and adequate vesting conditions. Performance criteria, meanwhile, are rarely disclosed. ISS' assessments of these plans have generally hinged on the presence of discounted exercise prices (which are common in Brazil), particularly in the absence of specific performance criteria.

Vote against a stock option plan and/or restricted share plan, or an amendment to the plan, if:



- The plan lacks a minimum vesting cycle of three years; and/or
- The plan permits options to be issued with an exercise price at a discount to the current market price, or permits restricted shares to be awarded (essentially shares with a 100 percent discount to market price), in the absence of explicitly stated, challenging performance hurdles related to the company's historical financial performance or the industry benchmarks; and/or
- The maximum dilution exceeds ISS guidelines of 5 percent of issued capital for a mature company and 10 percent for a growth company. However, ISS will support plans at mature companies with dilution levels up to 10 percent if the plan includes other positive features such as challenging performance criteria and meaningful vesting periods, as these features partially offset dilution concerns by reducing the likelihood that options will become exercisable unless there is a clear improvement in shareholder value; and/or
- Directors eligible to receive options under the scheme are involved in the administration of the plan.

Rationale for Update:

Currently, ISS Brazil policy does not address restricted share plans, only stock option plans, although the latter have been seen more frequently in the last couple of years. As such, this policy update includes specific reference to restricted share plans under the current policy framework already adopted for stock options plans.

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Speech

Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility"

Chair Mary Jo White

Washington, DC

Dec. 9, 2015

Good morning. Thank you, Bridgette [Hodges], for that kind introduction.

It is a pleasure to be here to speak to you about our shared and weighty responsibility to maintain high-quality, reliable financial reporting. This audience – preparers, auditors, audit committee members, and their advisors – is a very important one for the SEC. Investors, issuers, and the markets all depend on the work you do and the judgments you make – and how well you do both. You, together with the standard setters and the regulators, have a vital stake in ensuring that our capital markets remain the safest and strongest in the world – and we all share the responsibility.

Key to our mutual success is maintaining high-quality reporting of reliable and relevant financial information that investors can use to make informed investment decisions. If there is even one weak link in the financial reporting chain, investors and the integrity of our markets suffer. We must all work together in order to fulfill the high expectations investors rightly set for financial reporting.

This morning, I will talk about our respective responsibilities and some challenges I see for each of us. In the course of my remarks, I will touch on some of the current work we are doing at the SEC, including our disclosure effectiveness review, our concept release on audit committee disclosure, and the status of the Commission's consideration of the further use of International Financial Reporting Standards (IFRS). Over the next three days, our Chief Accountant Jim Schnurr, Director of Corporation Finance Keith Higgins, and Director of Enforcement Andrew Ceresney – and members of their staffs – will address each of the topics I cover in more detail.

The Responsibility of Preparers

Let me start with the role of preparers because you really are the lynchpin of high-quality, reliable financial reporting. You are the ones who make the often difficult and nuanced decisions and judgments required to meet the objectives and principles of U.S. Generally Accepted Accounting Principles (GAAP) or IFRS – from revenue recognition to impairments to fair value determinations. We rely on those of you in the trenches of finance and internal audit to press and challenge management on questions you have on transactions, judgments, and risk areas. It is not an easy job, and we all need to do whatever we can to support you – whether through strong external audits; through standard setters and Commission staff providing clarity in the implementation of new standards; or through our Whistleblower Office protecting you if you do find and report violations to us.

Preparers must recognize that management's ability to fulfill its financial reporting responsibilities significantly depends on the design and effectiveness of internal control over financial reporting (ICFR) – controls designed to provide reasonable assurance that the company's financial statements are prepared in accordance with GAAP.[1] While some initially questioned the value of such controls, we now generally hear from stakeholders – especially following new guidance and auditing standards issued in 2007[2] – that the ICFR requirements of the Sarbanes-Oxley Act have resulted in improved controls and financial reporting. And we see the improvement ourselves.

But, as you know, debate persists about whether companies and auditors are being required to perform documentation and testing of controls that is unnecessary – and, if so, the reasons why. There are useful, ongoing discussions about these issues among the Public Company Accounting Oversight Board (PCAOB), investors, the audit profession, and preparers, which the SEC staff has been keenly observing. I will not get ahead of those discussions, but I will say that it is hard to think of an area more important than ICFR to our shared mission of providing high-quality financial information that investors can rely on. We need to be frank about any challenges in the operation and assessments of ICFR and address them to the extent appropriate. But at the end of the day, ICFR must remain the strong bulwark of reliable financial reporting that it has become.

Another financial reporting topic of shared interest and current conversation is the use of non-GAAP measures. This area deserves close attention, both to make sure that our current rules are being followed and to ask whether they are sufficiently robust in light of current market practices. Non-GAAP measures are allowed in order to convey information to investors that the issuer believes is relevant and useful in understanding its performance. By some indications, such as analyst coverage and press commentary, non-GAAP measures are used extensively and, in some instances, may be a source of confusion.

Like every other issue of financial reporting, good practices in the use of non-GAAP measures begin with preparers. While your chief financial officer and investor relations team may be quite enamored of non-GAAP measures as useful market communication devices, your finance and legal teams, along with your audit committees, should carefully attend to the use of these measures and consider questions such as: Why are you using the non-GAAP measure, and how does it provide investors with useful information? Are you giving non-GAAP measures no greater prominence than the GAAP measures, as required under the rules? Are your explanations of how you are using the non-GAAP measures – and why they are useful for your investors – accurate and complete, drafted without boilerplate? Are there appropriate controls over the calculation of non-GAAP measures?

The Responsibility of Auditors

Preparers, of course, are not solely responsible for maintaining the strength of financial reporting. It also depends on thorough and objective audits performed by independent, knowledgeable, and skeptical public accountants. Indeed, while preparers are the lynchpin of high-quality financial reports, auditors are the key gatekeepers for those reports, protecting shareholders by ensuring that issues are promptly identified and addressed. As with other parts of the chain in financial reporting, there is both encouraging news and also some areas of concern.

In the encouraging column, investor confidence in audited financial statements and independent auditors is high.[3] We have also seen a general reduction in the number and severity of restatements of financial statements since the implementation of the Sarbanes-Oxley Act, although there are some specific areas

that could benefit from a redoubling of efforts.[4] The positive signs are attributable, at least in part, to improvements in audit quality and the enhanced role that auditors generally now discharge in providing an essential check in the financial reporting process.

Significant credit for the increase in audit quality should be given to the PCAOB's inspection program and the enhancements it has made to some of the auditing standards. The PCAOB's inspection findings on individual audit engagements and firm quality controls have resulted in many audit firms making significant improvements, which in some cases included structural or systems changes beyond the specific remedial actions required.

In the worrisome column, we still observe too many instances where companies and their auditors have not discharged their responsibilities adequately under the securities laws and professional standards. Recent PCAOB inspections, for example, have found significant deficiencies in auditing the effectiveness of ICFR; assessing and responding to risks of material misstatement; auditing accounting estimates; and work performed by audit firms other than the signing firm in cross−border audits.[5] And as I will discuss later, we have also just recently brought two enforcement cases against national accounting firms and their partners for missing or ignoring red flags. Such failures are totally unacceptable.

The Responsibility of Audit Committees

The audit committee is another critical gatekeeper in the chain responsible for high-quality, reliable financial reporting. Listing requirements and SEC rules, as well as how companies address various enterprise risks, are placing heavy demands on audit committees. We must all ensure that they have the tools and the abilities to perform their important functions.

As I have said before, being a director of a public company is not "for the faint of heart." [6] Members of audit committees particularly need to be strong. Having served on the audit committee of a public company, I know first-hand how much work and responsibility the job requires. And, since my service, even more is being demanded, with many audit committees now being charged with overseeing additional risks, including incredibly important areas such as cybersecurity.

I have growing concerns about the amount of work required of some audit committees. The increasing workload may dilute an audit committee's ability to focus on its core responsibilities: selecting and overseeing the independent auditors; internal controls and auditing; setting up an appropriate system for the receipt and treatment of complaints about accounting; and reporting to shareholders.[7] And when directors serve on multiple boards, including multiple audit committees, we must question whether they can do the job effectively.

Companies and directors should carefully choose who serves on their audit committee, selecting only those who have the time, commitment, and experience to do the job well. Just meeting the technical requirements of financial literacy may not be enough to fully understand the financial reporting requirements or to challenge senior management on major, complex decisions. Nor is experience necessarily transferable. While independent directors should have diversified backgrounds, a director with financial reporting experience limited to manufacturing firms, for example, may not be able to adequately oversee the reporting of a large financial services firm.

Audit committees of every company must be entirely committed to their oversight of financial reporting. They must, for example, be able to adequately review how management is designing and implementing ICFR and how it is using non-GAAP measures. They must ask questions about their auditor's work and satisfy themselves of the job the auditors are doing, particularly when it is time to select the right auditor and recommend to shareholders that they ratify the company's choice.

Audit committees must also take seriously their reporting to shareholders, a critical responsibility on which the SEC is closely focused. Deputy Chief Accountant Brian Croteau will discuss the responses we have received on the concept release we issued in July on possible revisions to audit committee disclosure requirements. My only observation for now is that the audit committee report serves as a place for engaging with shareholders on important subjects, and the report must continue to meet the needs of investors as their interests and expectations evolve with the marketplace.

The Responsibility of Standard Setters

Let me now turn to the importance of standard setters to high-quality, reliable financial reporting. In a fundamental sense, good financial reporting cannot occur without strong, first-rate accounting standards established by independent standard setters. The quality and value of financial reporting would be seriously diminished if based on – and audited against – subpar accounting standards.

Confidence in financial reporting cannot exist without confidence in the underlying accounting standards and how and for what purpose they were developed. Accounting standards, with their potentially significant ramifications for companies, are often the subject of intense debates among policymakers, companies, investors, and other market participants. Setting a standard must be informed by all relevant viewpoints, but the standard must ultimately provide objective, accurate, and credible information about relevant economic activities useful for investor decisions, without regard to how it might change the behavior of market participants or regulators.

As you know, while the Commission retains the ultimate standard-setting authority for financial reporting in the United States, it has consistently looked to the private sector for leadership in establishing and improving high-quality accounting standards. Since the 1970s, the Financial Accounting Standards Board (FASB) has been the private sector standard setter for GAAP, and its structure and operations have been designed to preserve its independence and maintain a focus on strong standards.[8]

Since 2002, the FASB has also worked jointly with the International Accounting Standards Board (IASB) to develop converged, high-quality globally accepted accounting standards.[9] While several priority projects did not result in a common standard, the two boards have made significant progress in converging GAAP and IFRS in several major areas and are continuing to cooperate on other important projects. Too often, these successes are not sufficiently recognized, with the public discussion emphasizing instead the differences between GAAP and IFRS.

The new revenue recognition standard that Deputy Chief Accountant Wes Bricker will be talking about, for example, addresses one of the most fundamental financial statement metrics for investors. It is a prime example of how the cooperation between the two boards can produce high-quality standards that now will be globally consistent. Other success stories include reporting for business combinations and fair value measurements.

As both boards shift to agendas not dominated by joint projects, I urge them to continue, wherever possible, to build on these successes and maintain their commitment to collaboration in support of the objective of a single set of high-quality, globally accepted accounting standards.

I want to pause here to briefly mention the question of the use of IFRS by domestic issuers in the United States. As you know, since 2007, the Commission has permitted foreign private issuers to include financial statements prepared in accordance with IFRS, as issued by the IASB, in filings with the SEC without requiring reconciliation to U.S. GAAP.[10] And today, over 500 issuers representing trillions of dollars in aggregate market capitalization report to the Commission using IFRS. The Commission staff monitors and reviews the application of those standards in filings with the SEC in the same manner that it monitors and reviews the application of GAAP, making IFRS very much a focus in the SEC's work.

With respect to the issue of possible further use of IFRS in the United States, as I have said in the past, I believe it is important for the Commission, as a Commission, to make a further statement about its general views on the goal of a single set of high-quality global accounting standards – a topic that the Commission itself has not spoken on since 2010.[11]

At this conference last year, Jim Schnurr discussed the possibility of allowing domestic issuers to provide IFRS-based information as a supplement to GAAP financial statements without requiring reconciliation.[12] This proposal has the potential to be a useful next step, and the staff has now developed a recommendation for the Commission's consideration, which staff will be discussing with all of the Commissioners so that we can determine the path forward.

The Responsibility of Regulators

I will finish today with a brief discussion of the role of regulators. As with the other parties I have addressed, our vigilance and commitment too is essential for preserving high-quality, reliable financial reporting.

Let me first return briefly to the PCAOB. We work closely and collaboratively with the board to achieve our shared goals on behalf of investors and it is an extraordinarily important partnership.

One of my responsibilities since becoming Chair has been to attend board meetings of the International Organization of Securities Commissions (IOSCO), which oversees a number of important workstreams, including one dedicated to audit quality. Discussions around that workstream return again and again to how strong a contributor the PCAOB is in the United States to raising audit quality – through their inspections, standard setting, enforcement, and other initiatives. That is certainly my view, and I want to commend Chairman Doty and the PCAOB board and staff for the important work they have done – and continue to do – in raising the bar for auditors and audit quality.

For the Commission's part, our staff works closely with the PCAOB and all of the parties in the financial reporting chain to ensure that reports continue to serve to protect investors and build confidence in our markets. This work, of course, reflects the work of our Office of the Chief Accountant, expertly led by Jim Schnurr, who you will hear from shortly, and includes the extensive and very impressive work of the Division of Corporation Finance in reviewing and commenting on the financial reports of over 4,000 registrants each year. It also includes a strong enforcement program that prioritizes financial reporting cases.

One important area of mutual interest is the staff's work on its disclosure effectiveness initiative. As you know, at my direction, the Division of Corporation Finance is spearheading a comprehensive review of our disclosure regime, beginning with a review of Regulations S-K and S-X. In September, the Commission issued the first public product from that review – a request for comment on certain Regulation S-X

requirements.[13] I anticipate further output in the coming year on Regulation S-K, as well as on various technical changes related primarily to financial statement disclosures and improvements to the presentation of information and tools on sec.gov.

There is also news from Congress on this front. Last week, a transportation bill was enacted that contained a number of SEC-related provisions, including one for disclosure modernization and simplification.[14] Among other provisions, the Commission is required to study the requirements in Regulation S-K, report the findings to Congress, and issue a proposed rule to implement the recommendations of the study.

Momentum on disclosure effectiveness is also occurring at companies. We have seen concrete progress by companies working to make disclosures clearer and more understandable, in particular by removing redundancies or unnecessary information.

But there is more work to do, both from our perspective and yours. The goal of the staff's initiative is to make disclosure more effective, which is not only about reducing volume and complexity, but also considering whether investors need more information in certain areas. While in some cases it may be beneficial to reduce volume and complexity to help investors better focus on important matters, you will hear from our staff in Corporation Finance that there are other areas – foreign tax disclosure is one – where the staff believes that more disclosure would help investors. The staff is considering all of these issues in its review, and I encourage companies to continue to undertake their own efforts to enhance disclosures for the benefit of their investors.

One of the ultimate tools to ensure high-quality, reliable financial reporting is strong enforcement when the rules are not followed. Since I became Chair in April 2013, the staff has reinvigorated its investigative and enforcement efforts in this area, with a focus on issuers and gatekeepers. The Commission has more than doubled the number of issuer reporting and disclosure actions it has brought – from 53 actions in fiscal year 2013 to 114 actions in fiscal year 2015, not counting cases based on delinquent filings and follow-on proceedings.

We have also been closely scrutinizing the gatekeepers of financial reporting, continuing to hold accountants, auditors, and audit committees accountable in appropriate circumstances. In the fiscal year that just ended, the Commission charged 76 respondents – 57 individuals and 19 firms – under Rule 102 (e) of the Commission's Rules of Practice. In September, we also charged a national audit firm for dismissing red flags and issuing false and misleading audit opinions about the financial statements of an audit client.[15] This was the Commission's first non-independence case against a national audit firm since 2009,[16] and the first case where we obtained admissions from a national audit firm.

Just last week, a second national audit firm admitted wrongdoing, and the firm and two of its partners agreed to settle charges that they ignored red flags and fraud risks while conducting deficient audits of two publicly-traded companies that wound up facing accounting-related enforcement actions.[17] In the past fiscal year, we also charged a former audit committee chair for substituting his incorrect interpretation of SEC rules requiring the disclosure of executive perks for the views of experts the company had hired, resulting in incomplete disclosures.[18]

The financial reporting area will continue to be a high priority for our enforcement program. Investors depend on comprehensive and accurate financial reporting, and so our fundamental objective is to raise the bar of compliance by issuers and their auditors and we will use all of our tools to do so.

Conclusion

Let me conclude on that note. In our time this morning, I have tried to give you an overview of how the SEC views our shared responsibility for strong financial reporting and to highlight some of the reporting issues that have our attention. Senior staff will talk more about these and other issues over the next three days.

As you listen to the discussion of specific financial reporting issues, it is important to keep in mind that regulators are not just preaching to you, although it may seem like that at times. What we are trying to do is engage proactively with you on our shared responsibility for high-quality, reliable financial reporting. It is a weighty responsibility that constantly requires the very best efforts of all of us. Investors and our capital markets deserve and demand no less.

Thank you.

[1] *See* Section 404 of the Sarbanes-Oxley Act of 2002, Securities Exchange Act Rules 13a-15 and 15d-15 and Item 308 of Regulation S-K.

[2] *See Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934,* Release No. 33-8810 (June 20, 2007), *available at* https://www.sec.gov/rules/interp/2007/33-8810.pdf and AS 2201: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, *available at* http://pcaobus.org/Standards/Auditing/Pages/AS2201.aspx (originally adopted in June 2007 as Auditing Standard No. 5).

[3] *See* The Center for Audit Quality's Ninth Annual Main Street Investor Survey, Investor of the Future (September 2015), *available at* http://www.thecaq.org/docs/default-source/reports-and-publications/caq2015mainstreetinvestorsurvey.pdf?sfvrsn=4.

[4] *See* Center for Audit Quality, "Financial Restatement Trends in the United States: 2003-2012," *available at* http://www.thecaq.org/docs/reports-and-publications/financial-restatement-trends-in-the-united-states-2003-2012.pdf .

[5] *See* Audit Committee Dialogue, PCAOB Release No. 2015-003 (May 2015), *available at* http://pcaobus.org/sites/digitalpublications/Documents/AuditCommitteeDialogue.pdf.

[6] Mary Jo White, Chair, U.S. Securities and Exchange Commission, *A Few Things Directors Should Know About the SEC* (June 23, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542148863.

[7] *See Standards Relating to Listed Company Audit Committees,* Release No. 33-8220 (April 9, 2003), *available at* https://www.sec.gov/rules/final/33-8220.htm.

[8] *See Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, Release No. 33-8221 (April 25, 2003), *available at* https://www.sec.gov/rules/policy/33-8221.htm.

[9] The FASB's objective for participating is to increase the international comparability and the quality of standards used in the United States. *See* http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220079468.

[10] *See Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP,* Release No. 33-8879 (December 21, 2007), *available at* http://www.sec.gov/rules/final/2007/33-8879.pdf.

[11] Mary Jo White, Chair, U.S. Securities and Exchange Commission, Remarks at the Financial Accounting Foundation Trustees Dinner (May 20, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370541872065.

[12] James Schnurr, Chief Accountant, U.S. Securities and Exchange Commission, Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments (December 8, 2014), *available at,* http://www.sec.gov/News/Speech/Detail/Speech/1370543609306.

[13] *See Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant,* Release No. 33-9929 (September 25, 2015), *available at*http://www.sec.gov/rules/other/2015/33-9929.pdf.

[14] *See* the "Fixing America's Surface Transportation Act", or "FAST Act," *available at* http://transportation.house.gov/uploadedfiles/fastact_xml.pdf.

[15] Press Release No. 2015-183, *SEC Charges BDO and Five Partners in Connection With False and Misleading Audit Opinions* (September 9, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-184.html.

[16] Press Release No. 2009-271, *SEC Charges Ernst & Young and Six Partners for Roles in Accounting Violations at Bally Total Fitness* (December 17, 2009), *available at* http://www.sec.gov/news/press/2009/2009-271.htm.

[17] Press Release No. 2015-272, *SEC: Grant Thornton Ignored Red Flags in Audits* (December 2, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-272.html.

[18] Press Release No. 2015-179, *SEC Charges Sports Nutrition Company With Failing to Properly Disclose Perks for Executives* (September 8, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-179.html.

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U.S. Securities and Exchange Commission

Division of Corporation Finance
Securities and Exchange Commission

Shareholder Proposals

Staff Legal Bulletin No. 14H (CF)

Action: Publication of CF Staff Legal Bulletin

Date: October 22, 2015

Summary: This staff legal bulletin provides information for companies and shareholders regarding Rule 14a-8 under the Securities Exchange Act of 1934.

Supplementary Information: The statements in this bulletin represent the views of the Division of Corporation Finance (the "Division"). This bulletin is not a rule, regulation or statement of the Securities and Exchange Commission (the "Commission"). Further, the Commission has neither approved nor disapproved its content.

Contacts: For further information, please contact the Division's Office of Chief Counsel by submitting a web-based request form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive.

A. The purpose of this bulletin

This bulletin is part of a continuing effort by the Division to provide guidance on important issues arising under Exchange Act Rule 14a-8. Specifically, this bulletin contains information about the Division's views on:

- the scope and application of Rule 14a-8(i)(9); and
- the scope and application of Rule 14a-8(i)(7) in light of *Trinity Wall Street v. Wal-Mart Stores, Inc.*[1]

You can find additional guidance about Rule 14a-8 in the following bulletins that are available on the Commission's website: SLB No. 14, SLB No. 14A, SLB No. 14B, SLB No. 14C, SLB No. 14D, SLB No. 14E, SLB No. 14F and SLB No. 14G.

B. Rule 14a-8(i)(9)

1. Background

Rule 14a-8(i)(9) is one of the substantive bases for exclusion of a shareholder proposal in Rule 14a-8. It permits a company to exclude a proposal "[i]f the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting."

During the most recent proxy season, questions arose about the Division's interpretation of Rule 14a-8(i)(9). In light of these questions, Chair Mary Jo White directed the Division to review the proper scope and application of the rule.[2] As part of this review, we reviewed, among other things, Commission and Division statements and other materials, and considered approaches suggested by commenters.

2. History of Rule 14a-8(i)(9)

This exclusion was first adopted in 1967. At that time, the Commission amended Rule 14a-8(a), which already stated that Rule 14a-8 did not apply to elections to office, to codify the Commission's view that Rule 14a-8 "does not apply ... to counter proposals to matters to be submitted by the management."[3]

In 1976, the Commission renumbered and amended the exclusion. As adopted, Rule 14a-8(c)(9) provided that management could omit a proposal and any statement in support thereof from its proxy statement and form of proxy "[i]f the proposal is counter to a proposal to be submitted by the management at the meeting."[4] The Commission stated in the adopting release that "subparagraph (c)(9) of the revised rule merely restates a ground for omission already set forth in the existing rule. That is, a proposal that is counter to a proposal to be presented by the management may be omitted from an issuer's proxy materials."[5]

In 1982, the Commission characterized the exclusion as one of the substantive bases under Rule 14a-8 designed to permit omission of a shareholder proposal that "constitute[s] an abuse of the security holder proposal process."[6]

In 1998, the Commission revised Rule 14a-8 into its current Q&A, plain English format. In connection with these amendments, the Commission replaced the language in Rule 14a-8(c)(9) with Rule 14a-8(i)(9)'s current language, which allows the exclusion of a proposal that "directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting."[7] The Commission also added a note to the rule stating that a "company's submission to the Commission under this section should specify the points of conflict with the company's proposal."[8] In proposing this revision, the Commission stated that the amended rule would "reflect the Division's long-standing interpretation permitting omission of a shareholder proposal if the company demonstrates that its subject matter directly conflicts with all or part of one of management's proposals."[9] At adoption, the Commission clarified that "by revising the rule we do not intend to imply that proposals must be identical in scope or focus for the exclusion to be available."[10]

3. The Division's application of Rule 14a-8(i)(9)

Based on our review of the history of the exclusion, we believe that it was intended to prevent shareholders from using Rule 14a-8 to circumvent the proxy rules governing solicitations. When a shareholder solicits in opposition to a management proposal, the Commission's proxy rules contain additional procedural and disclosure requirements that are not required by Rule 14a-8.[11] We do not believe the shareholder proposal process should be used as a means to conduct a solicitation in opposition

without complying with these requirements. Several commenters agreed with this view.[12]

Many of the Division's response letters granting no-action relief under the exclusion have expressed the view that a shareholder proposal was excludable if including it, along with a management proposal, could present "alternative and conflicting decisions for the shareholders" and create the potential for "inconsistent and ambiguous results."[13] The response letters have used variations of this language for decades to articulate when a shareholder proposal may be excluded.[14] This language focused on the potential for shareholder confusion and inconsistent mandates, instead of more specifically on the nature of the conflict between a management and shareholder proposal.

After reviewing the history of Rule 14a-8(i)(9) and based on our understanding of the rule's intended purpose, we believe that any assessment of whether a proposal is excludable under this basis should focus on whether there is a direct conflict between the management and shareholder proposals. For this purpose, we believe that a direct conflict would exist if a reasonable shareholder could not logically vote in favor of both proposals, *i.e.*, a vote for one proposal is tantamount to a vote against the other proposal. While this articulation may be a higher burden for some companies seeking to exclude a proposal to meet than had been the case under our previous formulation, we believe it is most consistent with the history of the rule and more appropriately focuses on whether a reasonable shareholder could vote favorably on both proposals or whether they are, in essence, mutually exclusive proposals.[15]

In considering no-action requests under Rule 14a-8(i)(9) going forward, we will focus on whether a reasonable shareholder could logically vote for both proposals. For example, where a company seeks shareholder approval of a merger, and a shareholder proposal asks shareholders to vote against the merger, we would agree that the proposals directly conflict. Similarly, a shareholder proposal that asks for the separation of the company's chairman and CEO would directly conflict with a management proposal seeking approval of a bylaw provision requiring the CEO to be the chair at all times.

We will not, however, view a shareholder proposal as directly conflicting with a management proposal if a reasonable shareholder, although possibly preferring one proposal over the other, could logically vote for both. For example, if a company does not allow shareholder nominees to be included in the company's proxy statement, a shareholder proposal that would permit a shareholder or group of shareholders holding at least 3% of the company's outstanding stock for at least 3 years to nominate up to 20% of the directors would not be excludable if a management proposal would allow shareholders holding at least 5% of the company's stock for at least 5 years to nominate for inclusion in the company's proxy statement 10% of the directors. This is because both proposals generally seek a similar objective, to give shareholders the ability to include their nominees for director alongside management's nominees in the proxy statement, and the proposals do not present shareholders with conflicting decisions such that a reasonable shareholder could not logically vote in favor of both proposals.

Similarly, a shareholder proposal asking the compensation committee to implement a policy that equity awards would have no less than four-year

annual vesting would not directly conflict with a management proposal to approve an incentive plan that gives the compensation committee discretion to set the vesting provisions for equity awards. This is because a reasonable shareholder could logically vote for a compensation plan that gives the compensation committee the discretion to determine the vesting of awards, as well as a proposal seeking implementation of a specific vesting policy that would apply to future awards granted under the plan.

In the preceding examples, the board of directors may have to consider the effects of both proposals if both the company and shareholder proposals are approved by shareholders. We do not believe, however, that such a decision represents the kind of "direct conflict" the rule was designed to address.[16]

Commenters generally agreed that Rule 14a-8(i)(9) is designed to ensure that Rule 14a-8 is not used as a means to circumvent the Commission's proxy rules governing solicitations,[17] and suggested several alternatives for administering the exclusion going forward. We agree that proponents should not be able to use Rule 14a-8 to circumvent the proxy rules governing solicitations and believe that focusing on whether a reasonable shareholder could logically vote for both proposals effectively addresses such concerns.

Some commenters suggested that the Division should take the view that precatory proposals do not directly conflict with management proposals because they are not binding.[18] We believe that a precatory shareholder proposal, while not binding, may nevertheless directly conflict with a management proposal on the same subject if a vote in favor is tantamount to a vote against management's proposal. Other commenters suggested that the exclusion should not apply when a shareholder submits his or her proposal before the company approves its proposal.[19] This approach would not necessarily prevent a shareholder from submitting a proposal opposing a management proposal, in contravention of the proxy rules governing solicitations. Finally, other commenters suggested that the Division either continue its historic application of the exclusion[20] or adopt a broader, subject matter exclusion.[21] We believe that these approaches do not take full account of the language of the exclusion because they may allow the exclusion of proposals that propose different means of accomplishing an objective, but do not directly conflict. In our view, granting no-action relief only if a reasonable shareholder could not logically vote in favor of both proposals is more appropriately rooted in the exclusion's intended purpose and language, and better helps companies, proponents and the staff determine when two proposals "directly conflict."[22]

C. Rule 14a-8(i)(7)

In *Trinity Wall Street v. Wal-Mart Stores, Inc.*, the U.S. Court of Appeals for the Third Circuit addressed the application of Rules 14a-8(i)(3) and 14a-8(i)(7).[23] Reversing a decision by the U.S. District Court for the District of Delaware which ruled that a shareholder proposal could not be excluded, a three-judge panel held that a shareholder proposal submitted to Wal-Mart Stores, Inc. ("Wal-Mart") was excludable under Rules 14a-8(i)(3)[24] and 14a-8(i)(7). The staff had previously agreed that Wal-Mart could exclude the proposal under Rule 14a-8(i)(7).[25]

In analyzing whether the proposal was excludable under Rule 14a-8(i)(7), the Third Circuit concluded that the proposal's subject matter related to Wal-Mart's ordinary business operations - specifically, "a potential change in the way Wal-Mart decides which products to sell." This conclusion was the same as our conclusion when responding to Wal-Mart's no-action request. We believe our analysis in this matter is consistent with the views the Commission has expressed on how to analyze proposals under the ordinary business exclusion, *i.e.*, the analysis should focus on the underlying subject matter of a proposal's request for board or committee review regardless of how the proposal is framed.[26]

The panel also considered whether the significant policy exception to the ordinary business exclusion applied. The majority opinion employed a new two-part test, concluding that "a shareholder must do more than focus its proposal on a significant policy issue; the subject matter of its proposal must 'transcend' the company's ordinary business."[27] The majority opinion found that to transcend a company's ordinary business, the significant policy issue must be "divorced from how a company approaches the nitty-gritty of its core business."[28] This two-part approach differs from the Commission's statements on the ordinary business exclusion and Division practice.

In contrast, the concurring judge analyzed Rule 14a-8(i)(7) in a manner consistent with the approach articulated by the Commission and applied by the Division, including in Wal-Mart's no-action request. Summarizing the Commission's history on this exclusion, the judge noted that "whether a proposal focuses on an issue of social policy that is sufficiently significant is not separate and distinct from whether the proposal transcends a company's ordinary business. Rather, a proposal is sufficiently significant 'because' it transcends day-to-day business matters."[29] The judge also explained that the Commission "treats the significance and transcendence concepts as interrelated, rather than independent."[30]

Although we had previously concluded that the significant policy exception does not apply to the proposal that was submitted to Wal-Mart, we are concerned that the new analytical approach introduced by the Third Circuit goes beyond the Commission's prior statements and may lead to the unwarranted exclusion of shareholder proposals. Whereas the majority opinion viewed a proposal's focus as separate and distinct from whether a proposal transcends a company's ordinary business, the Commission has not made a similar distinction. Instead, as the concurring judge explained, the Commission has stated that proposals focusing on a significant policy issue are not excludable under the ordinary business exception "*because* the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote."[31] Thus, a proposal may transcend a company's ordinary business operations even if the significant policy issue relates to the "nitty-gritty of its core business." Therefore, proposals that focus on a significant policy issue transcend a company's ordinary business operations and are not excludable under Rule 14a-8(i)(7).[32] The Division intends to continue to apply Rule 14a-8(i)(7) as articulated by the Commission and consistent with the Division's prior application of the exclusion, as endorsed by the concurring judge, when considering no-action requests that raise Rule 14a-8(i)(7) as a basis for exclusion.

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[1] 792 F.3d 323 (3d Cir. 2015).

[2] *See* Statement from Chair White Directing Staff to Review Commission Rule for Excluding Conflicting Proxy Proposals (Jan. 16, 2015), *available at* http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html.

[3] Release No. 34-8206 (Dec. 14, 1967).

[4] Release No. 34-12999 (Nov. 22, 1976).

[5] *Id*.

[6] Release No. 34-19135 (Oct. 14, 1982).

[7] Release No. 34-40018 (May 21, 1998).

[8] *Id*.

[9] Release No. 34-39093 (Sept. 18, 1997).

[10] Release No. 34-40018.

[11] The Commission defined "solicitation in opposition" in Exchange Act Rule 14a-6. *See* Note 3 to Rule 14a-6(a). The discussion in this section is not intended to apply outside of the Division's application of Rule 14a-8(i)(9).

[12] *See* letters from (i) Faegre Baker Daniels LLP dated March 6, 2015 ("Faegre"); (ii) the Society of Corporate Secretaries & Governance Professionals dated March 25, 2015 (the "Society"); (iii) Gibson, Dunn & Crutcher LLP, Sidley Austin LLP, Wilmer Cutler Pickering Hale and Dorr LLP, Morrison & Foerster LLP and Skadden, Arps, Slate, Meagher & Flom LLP dated June 10, 2015 (the "Law Firms"); (iv) Business Roundtable dated June 10, 2015 ("Business Roundtable"); (v) Domini Social Investments LLC dated June 22, 2015 ("Domini"); (vi) US SIF: The Forum for Sustainable and Responsible Investment dated July 6, 2015 ("US SIF"); and (vii) Adrian Dominican Sisters, *et al.*, dated June 18, 2015 (the "Proponents").

[13] *See*, *e.g.*, *SBC Communications, Inc.* (Feb. 2, 1996). This articulation of the scope and application of the exclusion evolved over time. In the 1970s, some of the Division's response letters referenced the potential for inconsistent mandates if shareholders approved both proposals. *See*, *e.g.*, *General Mills, Inc.* (Jul. 6, 1979). Response letters in the early 1980s occasionally stated that inclusion of the proposal "may cause shareholder confusion," *see*, *e.g.*, *Ehrenreich Photo-Optical Industries, Inc.* (May 5, 1981), or "would be the source of shareholder confusion," *see*, *e.g.*, *Executive Industries, Inc.* (Jun. 26, 1981). By the 1990s, these concepts came together in the Division's most recent articulation of what constitutes a direct conflict, which references "alternative and conflicting decisions" and "inconsistent and ambiguous results." Two commenters highlighted the different language the staff has used over the years. *See* letters from

Domini dated June 22, 2015 and Professor J. Robert Brown, Jr. dated June 30, 2015.

[14] *See id.*

[15] We remind companies that the staff may need a complete copy of a company's proposal to evaluate a no-action request under Rule 14a-8(i)(9) and that the staff may not be able to agree that the company has met its burden of demonstrating that a shareholder proposal is excludable if those materials are not included with the company's no-action request. This same principle applies when the staff evaluates no-action requests under Rule 14a-8(i)(10).

[16] We recognize, however, that there may be instances in which a binding shareholder and management proposal would directly conflict. We do not believe that a reasonable shareholder would logically vote for two proposals, each of which has binding effect, that contain two mutually exclusive mandates. However, consistent with the Division's practice under Rule 14a-8(i)(1), our no-action response may allow proponents to revise a proposal's form from binding to nonbinding. If revised within a specified time, and a reasonable shareholder could otherwise logically vote for both proposals, the shareholder proposal would not be excludable under Rule 14a-8(i)(9). In addition, a binding shareholder proposal on the same subject as a binding management proposal may be excludable under Rules 14a-8(i)(1) or 14a-8(i)(2) to the extent a company demonstrates that it is excludable under one of those bases.

[17] *See supra*, note 12.

[18] *See* letters from (i) The Marco Consulting Group dated January 9, 2015; (ii) the Council of Institutional Investors dated January 9, 2015 and March 25, 2015; (iii) the New York City Comptroller dated January 15, 2015 and June 17, 2015; (iv) the California Public Employees Retirement System and the California State Teachers' Retirement Systems dated May 21, 2015; (v) James McRitchie dated June 8, 2015 ("McRitchie"); (vi) Domini; (vii) US SIF; (viii) the Proponents; (ix) the New York State Comptroller dated July 7, 2015; (x) John Chevedden dated July 14, 2015 ("Chevedden"); (xi) Steve Nieman dated July 14, 2015 ("Nieman"); and (xii) the State Board of Administration of Florida dated August 7, 2015.

[19] *See* letters from (i) McRitchie; (ii) Domini; (iii) the Proponents; (iv) US SIF; (v) Chevedden; and (vi) Nieman.

[20] *See* letters from (i) American Bankers Association, *et al*., dated February 24, 2015;(ii) the Law Firms; and (iii) Business Roundtable.

[21] *See* letters from Faegre and the Society.

[22] Where a shareholder proposal is not excluded and companies are concerned that including proposals on the same topic could potentially be confusing, we note that companies can, consistent with Rule 14a-9, explain in the proxy materials the differences between the two proposals and how they would expect to consider the voting results. As always, we expect companies and proponents to respect the Rule 14a-8 process and encourage them to find ways to constructively resolve their differences.

[23] Rule 14a-8(i)(3) permits a company to exclude a shareholder proposal "[i]f the proposal or supporting statement is contrary to ... [Rule] 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials" and Rule 14a-8(i)(7) permits a company to exclude a shareholder proposal "[i]f the proposal deals with a matter relating to the company's ordinary business operations."

[24] Two judges concluded that the proposal could be excluded under Rule 14a-8(i)(3). The Division was not asked to express a view on the application of Rule 14a-8(i)(3) to this proposal in the no-action process and therefore we do not express a view in this bulletin.

[25] *Wal-Mart Stores, Inc.* (Mar. 20, 2014). In our view, the proposal was excludable because it related to the company's ordinary business operations and did not focus on a significant policy issue.

[26] Release No. 34-20091 (Aug. 16, 1983).

[27] *Trinity*, 792 F.3d at 346-347.

[28] *Id*. at 347.

[29] *Id*. at 353 (Schwartz, J., concurring).

[30] *Id*.

[31] Release No. 34-40018 (emphasis added).

[32] Whether the significant policy exception applies depends, in part, on the connection between the significant policy issue and the company's business operations. *See* Staff Legal Bulletin No. 14E (Oct. 27, 2009) (stating that a proposal generally will not be excludable "as long as a sufficient nexus exists between the nature of the proposal and the company").

http://www.sec.gov/interps/legal/cfslb14h.htm

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A Report by UNITE HERE
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Improving corporate governance at hospitality REITs:

Year 3 Progress Report

UNITE HERE has recently concluded the third season of a focused program to improve corporate governance at lodging and hospitality REITs. Working together with a range of institutional investors, we are seeing a new, higher standard of corporate governance emerging in the sector.

Why Hospitality REITs?

We believe that transparent, accountable, stable and well-run companies are in the interest of shareholders and stakeholders alike. Our contribution to efforts to improve corporate governance has focused on a segment of the hospitality industry – the industry we best understand.

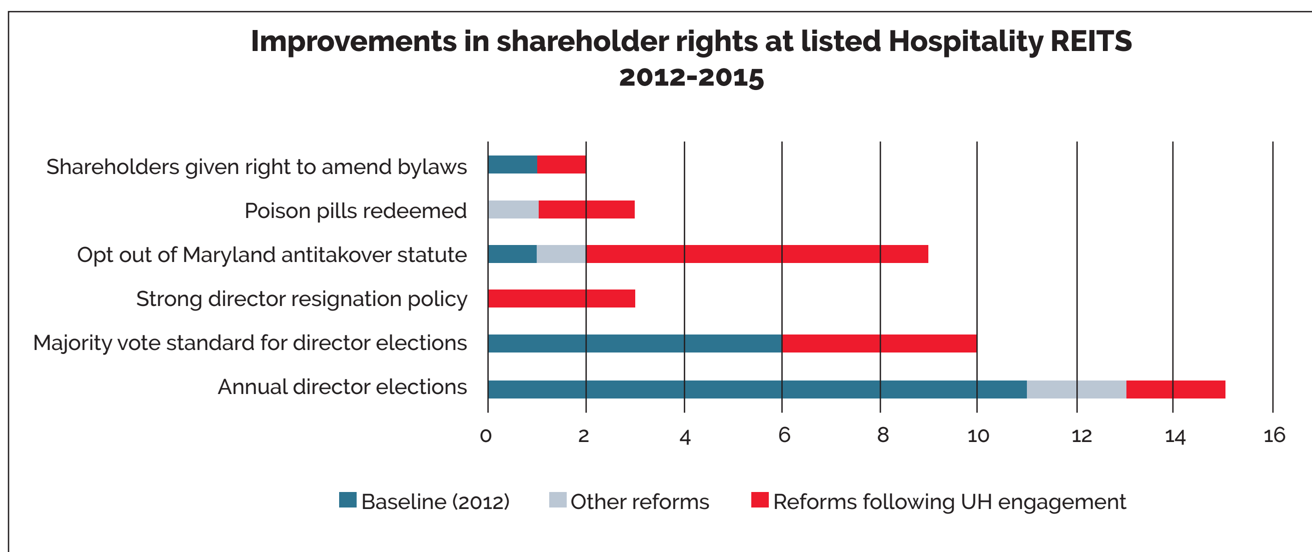
The small- and mid-cap companies in the lodging REIT sector have not typically benefited from the shareholder activism that has transformed corporate governance practices in S&P 500 companies. When we started our program, several companies had classified boards, and almost every company remained subject to potent state anti-takeover statutes.

UNITE HERE's program seeks to give hospitality REIT shareholders a voice in the use of statutory anti-takeover devices, as well as the myriad defenses put in place by companies themselves: staggered board terms, supermajority voting requirements, plurality vote standards in director elections and poison pills. Strengthening shareholder rights at lodging REITs, moreover, should help shareholders preserve strategic opportunities in a highly cyclical industry.

Tangible progress for lodging REIT shareholders since 2012

Working with a range of institutional investors, we've seen concrete improvements to shareholder rights at listed lodging REITs, with **18 separate reforms adopted at 11 of 17 listed lodging REITs.**

Our progress at a glance:



Classified boards

Between 2013 and 2015, the number of hospitality REITs with classified boards sank from 6 to 2. Two companies initiated board declassification following the submission of shareholder proposals by UNITE HERE (Felcor Lodging Trust and Lasalle Hotel Properties), while a majority of shareholders voted in support of our proposal to declassify the board of Gaming and Leisure Properties, the first US gaming REIT. Hospitality Properties Trust began declassifying its Board after a five year campaign led by an institutional investor.

Requiring majority support for director elections

Four REITs adopted majority vote thresholds for uncontested director elections upon receiving our shareholder proposals, bringing the total of hospitality REITs adhering to this standard to ten.

In the course of engagement with UNITE HERE, three REITs (Strategic Hotels, Chesapeake Lodging Trust, RLJ Lodging Trust) took the additional step of adopting strong director resignation policies, which stipulate that no director can be reappointed after receiving less than majority support in two consecutive uncontested elections.

Giving shareholders a say in the use of antitakeover statutes

Maryland's Unsolicited Takeovers Act (MUTA) allows REIT boards to unilaterally adopt numerous takeover defenses, such as a classified board, without shareholder approval.

In 2012, only one lodging REIT had opted out of the statute's provisions. Today, nine lodging REITs opt out of provisions of MUTA, seven of which opted out in response to shareholder proposals by UNITE HERE.

Only those companies opting out as a result of our engagement have agreed to require prior shareholder approval before opting back into MUTA – an essential step in truly opting out.

Five of six shareholder proposals to opt out of MUTA received the support of a majority of votes cast. The average level of support was 70%.

Strengthening right to amend bylaws

Shareholders of most listed lodging C-Corps have the right to initiate bylaw amendments, but this right is not common at lodging REITs. Without it, corporate governance reform can take years, and can be unilaterally reversed by the Board. Shareholders at one REIT (Sunstone Hotel Investors) gained the right to initiate bylaw amendments after the board unanimously recommended adopting UNITE HERE's proposal. Shareholders at three additional REITs receiving the same proposal (Host Hotels, Diamondrock Hotels and RLJ Lodging Trust) voted to recommend extending to shareholders the right to initiate bylaw amendments (49% of votes at Chesapeake Lodging Trust were cast in support of this proposal).

Shareholder approval of poison pills

Strategic Hotels decided to redeem its poison pill, and require shareholder approval of future poison pills (within 12 months of adoption), as recommended by UNITE HERE's shareholder proposal.

Continued engagement

The majority (14/18) of reforms we've seen put in place to date have been accomplished through engagement – shareholder proposals were withdrawn before a vote.

Fourteen of our proposals pursuant to SEC Rule 14a-8 have proceeded to a shareholder vote. Twelve of the fourteen (86%) received the support of a majority of votes cast, with an average of 67% of votes cast in favor. To date, four of the majority-supported proposals (33%) have been implemented. A more complete report of voting results can be found on our website, www.hotelcorpgov.org.

Next steps

While we have achieved tangible improvements in shareholder rights at lodging and hospitality REITs, much work remains to be done. At several REITs, proposals supported by majority votes have not been implemented; many companies still have potent takeover defenses, limits to shareholders' ability to hold directors accountable and/or limits to shareholder rights.

UNITE HERE represents hospitality workers and is a member of the Council of Institutional Investors. Its members are beneficiaries of pension funds with over $60 billion in assets. Since 2012, UNITE HERE has pursued a program of improving shareholder rights at hospitality REITs (see www.hotelcorpgov.org.

UNITE HERE

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Stock buybacks by lodging REITs:

Do they work in the down cycle?

In 2015, lodging REIT stock prices lost more than a quarter of their value after six consecutive years of steady gains. The NAREIT lodging REIT index plummeting -27.3% over the course of the year.[1] At the same time, the private market value of hotel assets continued to climb, leading to steeply discounted company valuations.

Lodging REITs have taken divergent responses to these developments. Strategic Hotels initiated a search for strategic alternatives in the summer and announced a sale to Blackstone in September, at a 13% premium to its pre-offer price. Another REIT recently announced it would distribute the proceeds from an asset sale to shareholders via a special dividend. However, seven other lodging REITs have authorized share repurchases worth just over $2 billion, a range of 4% to 22% of company stock.[2]

Company	Share repurchases authorized ($000s)	Estimated Market Cap (1/22/16, 000s)	Approximate % of market cap repurchased
CHSP	$ 100,000	$ 1,400,000	7.1%
DRH	$ 150,000	$ 1,630,000	9.2%
HT	$ 200,000	$ 916,590	21.8%
HST	$ 1,000,000	$ 10,380,000	9.6%
RLJ	$ 400,000	$ 2,290,000	17.5%
RHP	$ 100,000	$ 2,330,000	4.3%
XHR	$ 100,000	$ 1,530,000	6.5%

Are share buybacks by lodging REITs a good use of capital at this point in the cycle? Because IRS regulations limit REITs' ability to retain earnings, buybacks tend to be funded by debt or asset sales – and to a limited degree, cash reserves. But lodging REITs play in a more volatile space, and are subject to liquidity challenges during cyclical downturns – to an extent not shared by other REITs.

Using an analysis of stock buybacks during the previous lodging cycle, we argue that lodging REIT shareholders may be better served at this point in the cycle by other strategies, such as special

dividends financed by asset sales or an outright business sale. We argue that in the previous downturn, buybacks were not effective in stabilizing share prices or protecting dividends:

> *In the last downturn, modest stock buybacks were wiped out by large share issuances in short order as the end of the upcycle turned quickly into the downcycle.* In 2008, several lodging REITs who were not sold to private equity bought back stock as prices began to decline. However, stock prices continued their descent until the second quarter of 2009. Most lodging REITs were forced to issue large volumes of shares at declining prices to raise cash, wiping out the impact of the 2008 buybacks. On average, REITs issuing buybacks subsequently issued greater volumes of stock.
>
> *In the last downturn, stock buybacks may have accelerated lodging REITs' cash crunch.* To the extent that buybacks were financed by drawing down cash reserves and increasing debt, they pushed REITs into a more precarious position at the worst possible time. Most lodging REITs halted distributions entirely; some also requested permission from the IRS to issue distributions in stock rather than cash.
>
> *Could stock buybacks act as M&A deterrents?* Investors should carefully evaluate the impact of proposed stock buyback plans on the REIT's ability to pursue other strategic alternatives. Would a change in EPS or price/FFO impact executive compensation? Would buybacks be offset by stock issued to executives? Would a leverage-funded buyback discourage potential takeover offers by increasing the cost of an acquisition?

Management teams are appropriately considering how to exploit the gap between high real estate values on the one hand, and depressed share prices on the other. But investors should urge management teams to consider other ways to make this gap work for shareholders. By distributing the proceeds of asset sales to shareholders as special dividends, for example, management teams allow shareholders to choose whether to plough their funds back into the company.

Further, past cycles suggest that lodging REITs take a beating in terms of share prices and dividends for years, suggesting lodging REITs should consider an outright sale of the company. Roughly half of lodging REITs successfully executed business sales at or around the peak of the last cycle, achieving on average a 20% premium for shareholders.

Is the timing right for share repurchases?

After reaching a cyclical high on or around the end of 2014, lodging REIT shares lost over a quarter of their value, on average, in 2015. Some management teams have begun using capital to repurchase their own shares at these lower prices.

In fact, the price of lodging REIT stocks indicates some skepticism in the market about a rebound in the near term. On average, the lodging up-cycle lasts 7 years.[3] Lodging REIT stock prices have been steadily increasing since Q2 2009. One analyst sees the hotel industry entering the final third of the current cycle.[4]

While industry fundamentals remain decent, analysts and investors see storm clouds on the horizon. U.S. supply growth is picking up, particularly in key markets, approaching the 2% long term average growth level.[5] Interest rates have begun to increase after being frozen at historic lows. Events such as Paris and San Bernadino attacks may impact travel plans and intentions. Indeed, the market strongly punished lodging REITs for missing revenue and EBITDA projections even slightly in the second half of 2015.

A Merrill Lynch analyst told *The Wall Street Journal* in August 2007: "And there's always the possibility that the bottom of this REIT bear market hasn't been reached, Mr. Sakwa [Merrill Lynch] said. If the credit panic spreads, stocks could tumble further, making buybacks poor investments."[6]

How will REITs finance share repurchases?

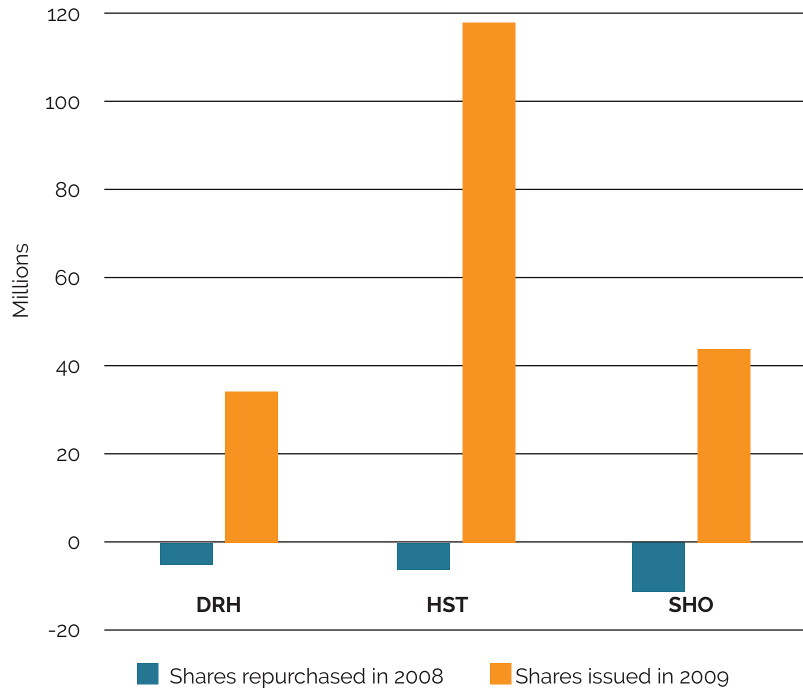
REITs typically have less free cash flow than corporations, as they must distribute most of their income to shareholders via dividends. Funds for buybacks can also be raised by selling assets or levering up.[7]

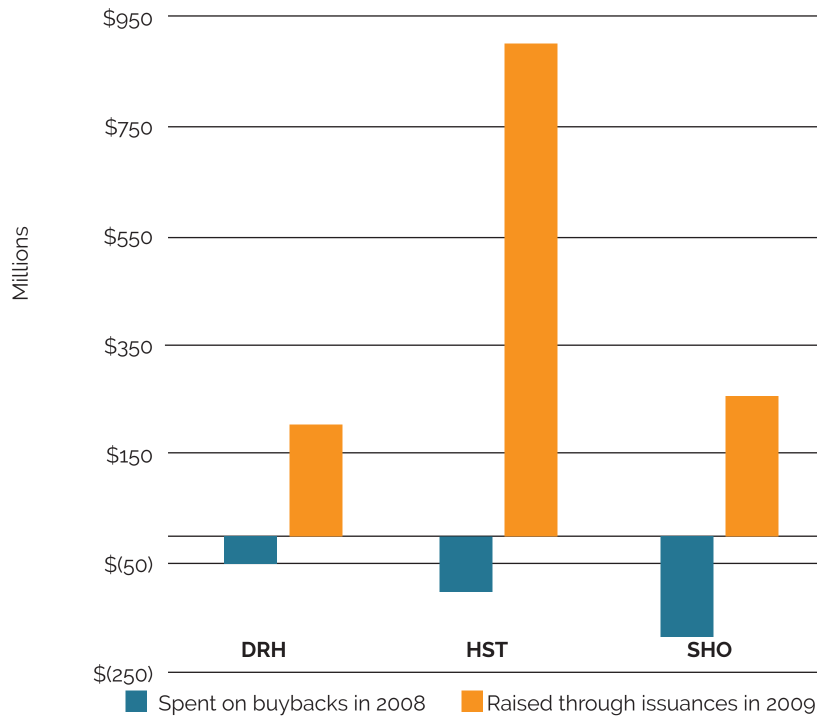
'Share repurchases may be a plus for REIT net asset values in the short-term, but over time the resultant increase in leverage could impair credit quality,' according to Fitch Director Reinor Bazarewski. 'It is important to note that current REIT leverage is above levels seen at the end of 2006, just before share buybacks spiked sharply during the last credit cycle.'[8] As we will see, in 2009, many lodging REITs had to reduce or suspend dividends due to a cash crunch.

Of the seven REITs announcing share repurchase programs in 2015, four have provided information about how these buybacks may be funded. Of these four, three include cash and financing as possible funding sources, while one (Host) announced plans to fund repurchases through asset sales.

Lessons from the Past, 1: Buybacks were followed swiftly by share issuances

Diamondrock (DRH), Host (HST) and Sunstone (SHO), three of the four veteran lodging REITs pursuing share repurchase programs in 2008, completed share issuances the very next year that were 3 to 18 times the volume of shares repurchased the previous year.[9]


Volume of stock buybacks and issuances by lodging REITs, 2008-2009 (millions of shares)
Millions
120
100
80
60
40
20
0
-20
DRH
HST
SHO
Shares repurchased in 2008
Shares issued in 2009


Cost of stock buybacks and issuances by lodging REITS, 2008-2009 ($000)
Millions
$950
$750
$550
$350
$150
$(50)
$(250)
DRH
HST
SHO
Spent on buybacks in 2008
Raised through issuances in 2009

Moreover, REITs that had executed share buybacks in 2008 increased their share volumes by an average of 26% by the end of 2009, while lodging REITs with no repurchase programs in 2008 increased their share volumes by an average of 13%.

Lessons from the Past, 2: Buybacks did not save dividends

In the last downturn, lodging REITs not only saw share prices lose upwards of 80% of their value; they also saw dividends dry up, or, in most cases, cease. On average, lodging REITs suspended periodic dividends for an average of 2.7 years.[10]

Company	Per share dividend mid-2008	Per share dividend mid-2009	Dividends stopped	Regular dividends resumed	Years without dividends
AHT	0.13	0	26-Sep-08	27-Mar-11	2.50
BEE	0.24	0	26-Sep-08	12/11/2015	7.21
DRH	0.25	0	3-Sep-08	23-Mar-11	2.55
FCH	0.35	0	10-Oct-08	13-Jan-14	5.26
HPT	0.77	0	16-Jan-09	21-Jan-10	1.01
HST	0.196	0	29-Dec-08	4-Nov-09	0.85
HT	0.72	0.2			0.00
LHO	0.175	0.01			0.00
SHO	0.35	0	17-Dec-08	26-Sep-13	4.78

At the time, the IRS attempted to ease the cash crunch REITs were experiencing by allowing them to issue up to 90% of their dividends in stock.[11] At least three lodging REITs elected to distribute stock in place of dividends pursuant to this ruling during the downturn; all had repurchased stock in 2008.[12] Strategic Hotels was not able to resume paying dividends after the last downturn at all.

Who benefits?

Critics of stock buybacks note they do not actually create value — by, for instance, repositioning or renovating assets — but instead may be a way to engineer improved performance metrics, at least in the short term. Investors should evaluate:

- How the volume of stock repurchased compares to the volume of stock issued for executive compensation. Is the share buyback a means of moving capital from shareholders to executives?

- Whether share repurchases have an impact on executive compensation. Some shareholders have filed shareholder proposals asking boards to factor out the impact of share repurchases when calculating per-share operating metrics for the purposes of determining executive compensation.

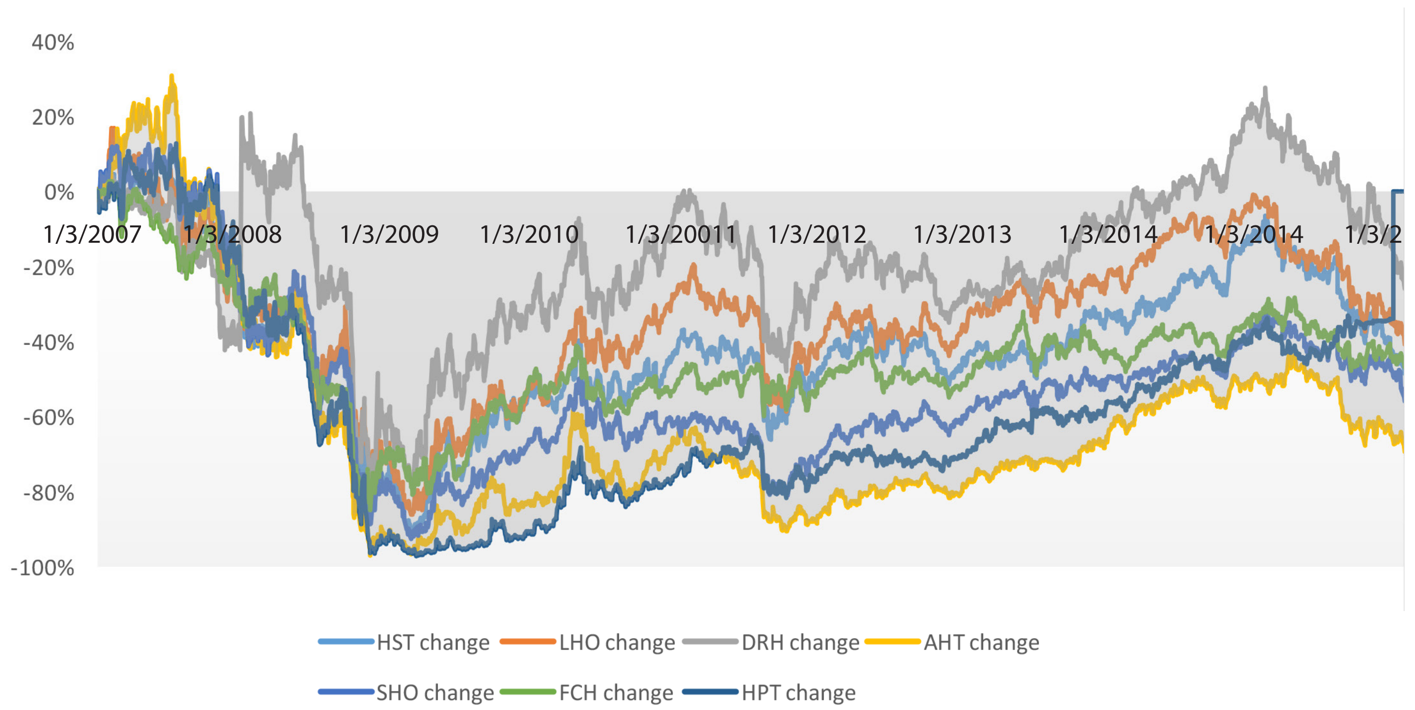
Alternative to Buybacks: #1 Issue dividends

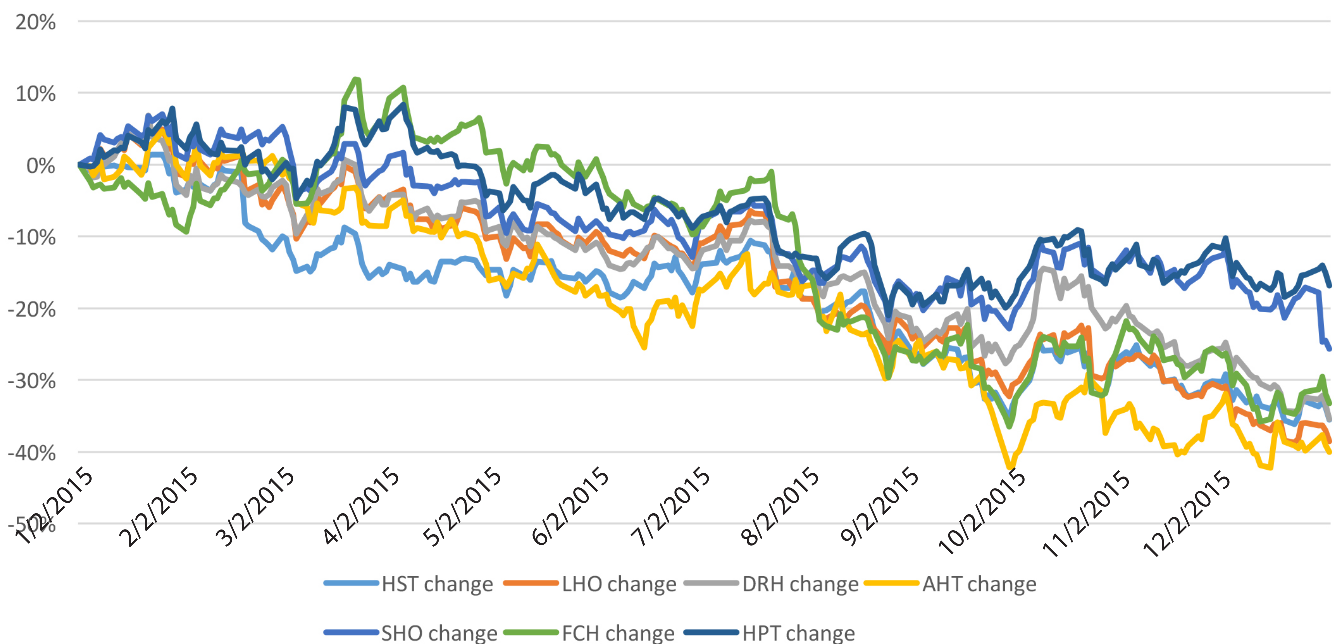
Proceeds from asset sales and excess cash can be distributed to shareholders as dividends, rather than being ploughed back into share repurchases. Special dividends preserve investor choice – if investors have confidence that lodging stocks will recover quickly, they can reinvest these dividends into company stock. But if they are skeptical about the near-term fortunes of lodging stocks – and share prices suggest that many are – they can reinvest elsewhere.

If the three lodging REITs that completed share repurchase programs in 2008 had instead distributed funds of the same value to shareholders, shareholders would have realized between $0.189 and $2.88 per share in special distributions.[13]

Alternative to Buybacks: #2 Sell company

Near the peak of the last lodging cycle, approximately half of listed lodging REITs were taken private through a company sale. At least one additional lodging REIT reports that a planned sale was interrupted by the tightening of the credit markets in the second half of 2007.[14] The average pre-announcement premium received by shareholders was approximately 20%.[15] One prominent lodging REIT, Strategic Hotels & Resorts, agreed to be acquired on September 8, 2015 to Blackstone; the offer price represented a 13% premium to the stock's trading price the day before Strategic announced its intention to pursue a sale on July 23, 2015.[16] Strategic, which announced an exploration of strategic alternatives in the summer of 2015, is the only listed lodging REIT whose shares showed a gain in 2015.


Veteran Lodging REIT share prices from January 2007 to January 2016
40%
20%
0%
-20%
-40%
-60%
-80%
-100%
1/3/2007
1/3/2008
1/3/2009
1/3/2010
1/3/20011
1/3/2012
1/3/2013
1/3/2014
1/3/2014
1/3/2
HST change
LHO change
DRH change
AHT change
SHO change
FCH change
HPT change


Veteran lodging REITs see stock prices slide in 2015
(Average decline -32%)
20%
10%
0%
-10%
-20%
-30%
-40%
-50%
1/2/2015
2/2/2015
3/2/2015
4/2/2015
5/2/2015
6/2/2015
7/2/2015
8/2/2015
9/2/2015
10/2/2015
11/2/2015
12/2/2015
HST change
LHO change
DRH change
AHT change
SHO change
FCH change
HPT change

Endnotes

1 Dow Jones US Hotel & Lodging REIT Index, https://www.google.com/finance?cid=15591941 1-year returns, accessed January 26, 2016
2 Third quarter market cap estimates obtained from Google Finance profiles for listed companies, accessed January 25, 2016. Share repurchase authorizations: Q3 10-Q reports for CHSP, DRH, RLJ; Press releases for HT (October 5, 2015), Host (November 16, 2015), RHP (August 20, 2015) and Xenia (December 10, 2015).
3 http://www.hotel-online.com/News/PR2007_1st/Feb07_AverageMarket.html
4 Lodging, 2016 Outlook, JP Morgan, January 6, 2016, p. 3
5 Lodging, 2016 Outlook, JP Morgan, January 6, 2016, p. 2
6 http://www.wsj.com/articles/SB118713051419697771
7 http://www.wsj.com/articles/SB118713051419697771
8 http://www.reuters.com/article/fitch-more-share-buybacks-and-risk-may-b-idUSFit69718020140429#74OiSQ6ARbqjX0xT.97
9 Ashford Hospitality Trust completed a stock-financed merger towards the end of 2007, leading to pronouncedly different stock dynamics in the following years, and has therefore been excluded from this analysis. Shares repurchased and issued do not include equity awards; the shares issued total for Host includes shares issued as dividends in 2009. Source: Diamondrock 10-K, "Consolidated Statements of Stockholders' Equity, Years Ended December 31, 2009, 2008 and 2007," p. F-7, filed with the SEC on February 26, 2010; Host 2010 10-K "Consolidated Statements of Equity and comprehensive Income (Loss), Years Ended December 31, 2009, 2008 and 2007," p. 92, filed with the SEC on March 1, 2010; Sunstone Hotel Investors, Inc. 10-K "Consolidated Statements of Stockholders' Equity, 2009, 2008 and 2007," F-5 to F-7, filed with the SEC on February 23, 2010;
10 Yahoo Finance historical dividend reports for listed stocks, accessed 1/26/2016
11 http://www.forbes.com/2009/04/15/reits-stock-dividend-markets-real-estate.html
12 Diamondrock and Sunstone: See http://www.forbes.com/2009/04/15/reits-stock-dividend-markets-real-estate.html ; Host: See 2010 10-K "Consolidated Statements of Equity and comprehensive Income (Loss), Years Ended December 31, 2009, 2008 and 2007," p. 92, filed with the SEC on March 1, 2010.
13 Value of 2008 share repurchases as reported in company 10-ks, divided by shares outstanding as of 12/31/2008: Host: See 2010 10-K "Consolidated Statements of Equity and comprehensive Income (Loss), Years Ended December 31, 2009, 2008 and 2007," p. 92, filed with the SEC on March 1, 2010; Sunstone Hotel Investors, Inc. 10-K "Consolidated Statements of Stockholders' Equity, 2009, 2008 and 2007," F-5 to F-7, filed with the SEC on February 23, 2010; Diamondrock 10-K, "Consolidated Statements of Stockholders' Equity, Years Ended December 31, 2009, 2008 and 2007," p. F-7, filed with the SEC on February 26, 2010
14 See Diamondrock 2008 Proxy Statement, p. 12: http://www.sec.gov/Archives/edgar/data/1298946/000104746908003255/a2183487zdef14a.htm
15 See discussion in the DEFC14A, filed by UNITE HERE for Chesapeake Lodging Trust on 4/21/15: http://www.sec.gov/Archives/edgar/data/1034426/000103442615000046/chspdefc14aedgar042115.htm
16 http://www.streetinsider.com/Corporate+News/Blackstone+to+Acquire+Strategic+Hotels+%26+Resorts+(BEE)+in+~$6B+Deal/10872768.html