BlackRock®

INVESTMENT STEWARDSHIP REPORT: AMERICAS

Q3 2017

SEPTEMBER 30, 2017

Contents

Engagement and Voting Highlights

Board process engagement in an activist contest

1 BlackRock's Investment Stewardship (BIS) team continually engages with companies to better understand the *process* around board oversight of risk management that may have long term implications for shareholder value. Understanding the board's process has proven particularly important in the context of activist campaigns. Several companies within the industrials and materials sectors which have undergone high profile activist contests have had their processes tested.

As part of our proxy contest engagement due diligence process, BIS engages with both the activist and the company board/management. Each situation is unique; however, our evaluation of the proposal(s) centers on the prospect for long term value creation—for the next 3, 5, or 10+ years. As a fiduciary investor whose clients' investment timelines extend far into the future, our outlook may diverge from activist proposals recommending business strategy for the next 12-18 months. However, our team finds greater merit in proposals that can demonstrate sustained value creation.

The way in which a board prepares for activist involvement and responds to their proposals serves as a litmus test for board quality. The board's response can highlight the strength of their governance structures or pinpoint weaknesses. This applies whether the activist approach is more collegial or antagonistic, as tactics vary by company, proposal, and activist.

A proactive board response was recently on display when an industrial conglomerate received an activist proposal concerning the realignment of the company's portfolio and the potential spin-off of a significant division. In this instance, the board has agreed to report back to shareholders this fall after their thorough review of the proposal. The activist proposal came at an inflection point for the company, with a new CEO having just replaced a former CEO with a successful 15 year legacy.

Preempting any activist headlines, the company engaged with shareholders around its CEO succession plan prior to the slated change at the helm. These investor engagements covered proposed changes to the compensation plan, provided a detailed discussion around business efficiencies, and, perhaps most importantly, the process by which the CEO transition would occur.

In a similar manner, the company also assured investors of its thoughtful approach to evaluating the activist proposal, promising to report the board's findings within a stipulated timeframe. Nearly as important as the critical eye with which the board will consider the activist's proposal, our engagement sheds light on the importance of open and transparent communication with shareholders. These conversations can provide insight as we evaluate the board's quality and effectiveness. BIS will continue to engage with the company upon review of the final report later this fall.

Railroads on track with sustainability efforts

2 As discussion around voluntary investment decision-relevant ESG reporting standards evolve, to include those by the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD), we recently engaged with several companies in the railroad sector. In particular, we sought to learn more about how these boards are considering the risks that may be associated with a changing climate, marketplace, and client base.

In particular, these engagements with railroads have revealed an innovative approach to incorporating sustainability into long term business success. Pioneers in transforming American and Canadian commerce, railroads today are often overlooked as contemporary innovators. However, railroads stand as an example of an industry that is thoughtfully integrating innovation and efficiency to cut waste, streamline processes, and plan for the future. Moreover, these changes are materially impacting shareholder value.

As industrials, railroads are subject to many of the cyclical market trends of their peers. In addition, they also must consider the business cycles of their cargo—agriculture, coal, freight shipments, etc. Recent engagements have revealed a set of unique scenarios that one company board considers—detailing the price of fuel, analyzing a potentially changing mix of cargo, and discussing the impact of various environmental pressures on the bottom line. Furthermore, the board is considering waste reduction and efficiency from a big picture standpoint.

For example, feedback from employees and locomotive engineers revealed an opportunity for improved efficiency that materially affected the business—reduction of engine idling. For quick background, the paraffin wax in diesel fuel that the trains use begins to solidify, or "gel" in colder weather when it drops below a certain temperature, which can ultimately cause clogs and engine damage.

In order to prevent this "gelling" process without leaving the engine idling in train yards in the winter, the company introduced the use of a mechanism to effectively keep the fuel at an appropriate temperature, while saving fuel in the idling process and avoiding damage from the gelling process.

In another example, the company has brought the conversion of older locomotives to like-new models in house. The repairs are significantly more cost effective than the purchase of new trains and prudent from a waste-reduction standpoint. Additionally, the installation of newer technology in the trains is able to extend the life of the machinery and facilitate increased safety and efficiency through updated software.

These efforts demonstrate that certain companies are looking at sustainability from an environmental and business perspective, and incorporating processes that support the long term health of the company.

Classified board / dual class

3

We engaged with a U.S.-based investment bank after our analysis revealed that the company has a number of problematic practices. The bank lacks majority board independence, has non-independent directors on key committees, a classified board, and a dual class (10 to 1) voting structure.

In our engagement meeting, the company explained its rationale for these governance provisions. Until recently, the company was a privately held bank that had long-standing success. When the company decided to go public the board opted for governance provisions that would limit any sudden impact to the way it had previously been successfully structured and run. To offset these provisions, the company opted to introduce various mechanisms to improve the structure over time, such as increasing the number of independent directors as a large shareholder sells down its position and sun-setting dual class shares as employee shares vest. On the basis of this information, BIS decided to support the company and will stay closely engaged to ensure the governance structures continue to improve over time.

Voting rights and index inclusion

4

BlackRock is a strong advocate for equal voting rights for all shareholders. However, we disagree with index providers' recent decisions to exclude certain companies from broad market indices due to governance concerns. Those decisions could limit our index-based clients' access to the investable universe of public companies and deprive them of opportunities for returns.

Policymakers, not index providers, should set equity investing and corporate governance standards. BlackRock supports the creation of regulatory regimes that increase financial market transparency, protect investors, and facilitate responsible growth of capital markets. The document, entitled "*A Potential Solution* *for Voting Rights and Index Inclusion Issues"*, is available **here**.

Director over boarding in the US

5 In 2011, the BIS Americas team adopted a director over boarding policy for U.S. companies that specifies withholding or voting against directors who serve on more than four public company boards[1]. The policy — which remains in effect — was among the first to establish more restrictive director participation standards on public boards. We will generally vote against an over boarded director at any U.S. company where he or she is up for election.

This is based on a proactive risk assessment; specifically, we are concerned that directors overextended and unable to oversee management effectively. Given the importance of directors' roles in the boardroom, who sit on multiple boards may be particularly in situations where a company is facing a crisis, we continue to believe this is an important safeguard for investors. We have engaged many companies over the course of six years.

According to multiple publications based on director surveys, the number of hours of work for directors has been steadily rising. For example, the 2015 National Association of Corporate Directors (NACD) Public Company Survey reported that directors spent an average of 248 hours on board-related matters, which is a 30% increase since 2005.[2]

Companies themselves have also increasingly placed limits on the number of external directorships their board members can hold. The 2016 Spencer Stuart Board Index states that 74% of S&P 500 boards have some restriction on external directorships. In 2008, 56% of boards had such limits and, in 2006, the number was only 27%.[3]

Looking back at our votes in the U.S. against directors for over boarding, it is clear that the number of individual directors that we have voted against has decreased steadily:

Reported N-PX period	Total number of BIS votes against individual directors on the basis of being over boarded[4]
2016 - 2017	87
2015 - 2016	105
2014 - 2015	137

From our perspective, the directors that serve on many boards tend to be very strong directors. The issue is not necessarily their performance, but rather the time it takes to serve.

According to the 2016 Spencer Stuart Board Index, an S&P 500 director serves on an average of 2 external corporate boards. Although this number has been steady for five years, the number of directors serving on more than four boards has fallen.

In 2011, 165 directors served on more than four boards, which is almost double the 88 directors who do so today.[5] That these directors now tend to serve on fewer boards is likely attributable to the mounting time commitment, coupled with greater investor scrutiny of board effectiveness. Collectively, these trends help to explain the drop in our voting outcomes against directors for over boarding.

While there is some conflicting academic literature on the effect of over boarding on company performance, we continue to believe that there should be a limit on the number of boards that directors can sit on. However, we remain open to having discussions with companies that are affected by our votes in such situations.

[1] We also have a related over boarding policy for CEOs who serve on more than two public company boards in addition to the board of the company where they serve as a CEO.

[2] 2014-2015 NACD Public Company Governance Survey
[3] Spencer Stuart Board Index 2016
[4] Totals exclude CEOs
[5] Spencer Stuart Board Index 2016

In one example of constructive engagement on this topic, we have been engaging a media company with a history of over boarded directors since 2014. One of the directors stepped down from a board in 2016; hence, we supported his re-election this year. During our engagement, the company's representatives told us that the other over boarded director, who currently sits on six public company boards, is also considering a reduction in his board duties. We continue to withhold support for the currently over boarded director and have shared with the company that we are open to continuing our dialogue on this matter.

Engagement and Voting Statistics

Americas Engagement Statistics[6]

	Level of Engagement[7]			Topics Discussed*		
Number of engagements	Basic	Moderate	Extensive	Environmental	Social	Governance
92	60	26	6	15	24	81

*Most engagement conversations cover multiple topics. Our engagement statistics reflect the primary engagement topic for which the meeting was called.

Americas Region Voting Statistics[6]

Country	Number of meetings voted	Number of proposals	% of meetings voted against one or more management recommendations	% of proposals voted against management recommendation
USA	376	2,623	24%	10%
Canada	42	302	40%	16%
Latin and South America	64	208	26%	15%
Americas Region Total	482	3,133	27%	5%

[6] The Americas engagement statistics are sourced from BlackRock and the voting statistics are sourced from ISS Proxy Exchange on October 4, 2017 and both are a reflection of 3rd Quarter 2017.

[7] Basic engagement is generally a single conversation on a routine matter; Moderate engagement is technically more complex and generally involves more than one meeting; Extensive engagement is technically complex, high profile and involves numerous meetings over a longer time frame.

Active Ownership and Responsible Leadership

Speaking Events

Members of the Investment Stewardship Americas team spoke at or participated in a number of events over the past quarter, with the objectives of furthering the debate on matters deemed important to investors and/or promoting an increased understanding of BlackRock's approach to investment stewardship. We target events that enable us to connect with key stakeholders and thought leaders, including corporate directors, senior members of management teams, and other shareholders.

Below is a list of select speaking events from the quarter, and subject matter covered:

- **CECP Strategic Investor Initiative — New York**

BlackRock is a member of the CECP's Strategic Investor Initiative, an effort to work with large companies and investors to focus on long-term value creation and find ways to mitigate short-term pressures. We participated in the second CEO Investor Forum, held at Bloomberg's New York headquarters on September 19. Seven CEOs of major global companies, such as Aetna, Delphi, Allstate and Prudential, presented their long-term strategies and discussed the key drivers of value creation in their business, including the integration of material environmental and social factors into planning and operations. The audience was primarily long-term investors such as BlackRock and it was a valuable opportunity for those investors to ask the type of questions about long-term performance, opportunity and adaptation that are seldom heard on quarterly earnings calls. The event was web-streamed and can be viewed online here.[8]

- **Climate Competent Boards — San Diego and New York**

BlackRock spoke on a panel on Climate Competent Boards at the Council of Institutional Investors (CII) fall meeting in September. We explained our 'engagement first' approach to stewardship and the multi-faceted approach we are taking to climate risk as an investment issue. This includes our active engagement at the market level through, amongst others, membership of the Task Force on Climate-related Financial Disclosures (TCFD) to advance reporting of material climate-related risks and opportunities. As we noted in our 2017/18 engagement priorities, directors' understanding of the impacts of climate risk underpins a board's ability to engage management on its approach to identifying, mitigating and reporting relevant climate impacts on the business. We explained our approach to engaging companies at management and board level to understand the governance process related to material climate risk. We also explained that in our experience it is counterproductive to vote for shareholder proposals when management are either very early on their climate-risk reporting journey or are making reasonable progress, even if there is still room for improvement. As a constructive investor with a long term focus, we prefer to support management as they make the changes we seek to protect the long term value of our clients' assets.

During Climate Week, BlackRock also co-hosted, with the director of a global energy company, an invitation-only meeting of institutional investors and directors of companies with material climate risks inherent in their businesses. The purpose of the meeting was to discuss respective experiences and expectations of climate competent boards and climate-related disclosures. It was a productive and open dialogue that underpinned to both the director and investor parties the importance and value of having a continuing dialogue on these issues as we gain more experience of disclosure relevant to investor decision-making and evolving practices.

---

[8]The event was web-streamed and can be viewed online at: http://www.wsw.com/webcast/cecp2/register.aspx?conf=cecp2&page=index&url=http%3A//www.wsw.com/webcast/cecp2/

Market Development and Trends

SEC Issues Guidance on Pay Ratio Disclosure

On September 21, 2017, the Securities and Exchange Commission's (SEC) Division of Corporate Finance published interpretive guidance to assist companies in preparing their pay ratio disclosures required by Regulation S-K under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Finalized in 2015, the pay ratio rule is designed to allow shareholders to better understand and assess a company's compensation practices. Companies have expressed concern about the imprecision of the pay ratio rule, and the potential for resultant liability. The guidance clarifies that it would not specify precise methods that companies must use to calculate the pay ratio. Rather, it would allow companies to use reasonable estimates, assumptions, methodologies, and statistical sampling to arrive at the necessary disclosure data. In so doing, a company may use its own methodology to decide appropriate existing internal records, such as tax or payroll records, in determinations about the inclusion of non-U.S. employees and in identifying the median employee for reporting purposes. Ultimately, the guidance states that if a company uses reasonable estimates, assumptions or methodologies, the pay ratio and related disclosure that results from such use would not provide the basis for SEC enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith. Under the final rule, companies will begin disclosing CEO to worker pay ratios in early 2018.

BlackRock does not anticipate making vote decisions on the basis of the new disclosure because we view this as one data point in analysis which may or may not impact our view of overall compensation.

PCAOB Adopts New Standards for Auditor's Report

On June 1, 2017, the Public Company Accounting Oversight Board (PCAOB) adopted a new auditing standard (Standard No. 3101) in order to enhance the relevance of auditor reporting to investors. The new standard will require auditors to include a discussion of "critical audit matters (CAMs) in their audit reports. This includes information communicated to the audit committee that is "related to accounts or disclosures that are material to the financial statements, and involved especially challenging, subjective, or complex auditor judgment." The new standard clarifies the auditor's responsibility for obtaining reasonable assurances regarding the accuracy of information provided for the audit and it requires that the auditor disclose its tenure advising the company at issue. The final standard applies to audits conducted under PCAOB standards but will exclude the communication of CAMs for audits of brokers and dealers, investment companies other than business development companies, employee stock purchase, savings, and similar plans, and emerging growth companies. The new standard is intended to elicit more information about the audit directly from the auditor and to provide ongoing insight regarding the state of any material financial matters. Subject to approval by the SEC, provisions related to CAM will take effect for audits for fiscal years ending on or after June 30, 2019 for large accelerated filers (companies with a public float of $700 million or more), and for audits for fiscal years ending on or after December 15, 2020 for all other companies to which the requirements apply. The new auditor's report format, disclosure of tenure and other information will take effect for audits for fiscal years ending on or after December 15, 2017.

Overall, BIS supports the concept of communicating critical audit matters and believes that much of the framework proposed will result in useful information to users of financial statements.

Supreme Court to Decide Securities Fraud Liability Case

On March 27, 2017, the U.S. Supreme Court agreed to hear the case of *Leidos, Inc. v. Indiana Public Retirement System et al*., No. 16-581. The case will be the first time in roughly 30 years that the Supreme Court will be making a decision which may expand the definition of who can be liable for securities fraud under the Securities Exchange Act of 1934, particularly with regard to omissions. The Supreme Court has long taken the position that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5." *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988). As a result, "firms are entitled to keep silent (about good news as well as bad news)" unless there is an affirmative duty to disclose. *Gallagher v. Abbott Labs*., 269 F.3d 806, 808 (7th Cir. 2001). This has protected issuers even in the face of information that "a reasonable investor would very much like to know." *In re Burlington Coat Factory Sec. Litig*., 114 F.3d 1410, 1432 (3d Cir. 1997) (Alito, J.). In *Leidos*, the Court will decide whether a failure to disclose "known trends or uncertainties" under Item 303 of Regulation S-K can give rise to private liability for securities fraud under Section 10(b) of the Exchange Act. The Court will resolve a split between the Third and Ninth Circuits which have concluded that an omission under Item 303 does not give rise to liability under 10(b), and the Second Circuit, which has held that non-disclosure under Item 303, can, in certain instances, give rise to third party claims under Section 10(b).

The Supreme Court case holds great import for public companies who may fear that the Second Circuit approach will open them up to expanded securities fraud liability for speculations made regarding future trends which do not play out as anticipated. Oral argument is set in *Leidos* for November 6, 2017.

Coalition Petitions SEC to Require Disclosures Related to Human Capital Management

On July 6, 2017, the Human Capital Management Coalition (HCMC), a global group of 25 institutional investors representing over $2.8 trillion in assets submitted a rulemaking petition to the SEC urging it to adopt standards requiring listed companies to disclose information on human capital management policies, practices, and performance. The petition argues that current SEC workforce reporting rules only require companies to disclose employee headcount and that the SEC should develop a framework allowing investors to better understand and assess how well the companies in which they invest are managing their talent. The petition states that "[g]iven the key role of human capital, investors under current Commission disclosure requirements cannot adequately assess a company's business, risks and prospects, for investment, engagement or voting purposes, without information about how it is managing its human capital" and that such information is "essential to long-term value creation and therefore material to evaluating a company's prospects." The petition does not define specific metrics for reporting but instead, provides nine broad categories of information it deems as "fundamental to human capital analysis" as a starting point to dialogue. These categories include: workforce demographics, workforce stability, workforce composition, workforce skills and capabilities, workforce culture and empowerment, workforce health and safety, workforce productivity, human rights, and workforce compensation and incentives.

Although the petition may be unlikely to result in SEC rulemaking, it is a mark of the growing importance of these issues to investors. BIS' 2017-18 engagement priorities has identified human capital management as one of its key themes.

Prepared by BlackRock, Inc.