

**BLACKROCK®**

# INVESTMENT STEWARDSHIP REPORT: AMERICAS

**Q2 2018**

JUNE 30, 2018



# Contents

|   |    |
|---|----|
| Engagement and Voting Highlights .....            | 2  |
| Engagement and Voting Statistics.....             | 7  |
| Active Ownership and Responsible Leadership ..... | 8  |
| Market Developments and Trends .....              | 10 |

The BlackRock Investment Stewardship (BIS) team publishes quarterly reports to explain BlackRock’s approach to corporate governance engagement that supports long-term value creation for our clients. The examples reported give a sense of the wide range of issues our engagements and voting analyses cover. We aim to provide examples that highlight particular environmental, social and governance (“ESG”) considerations, emerging practices or issues and notable company-specific developments. We also provide examples of our engagement in the public domain, such as responses to formal policy consultations and presentations or informal discussions at conferences.

# Engagement and Voting Highlights

## Succession planning in the railroad sector

1

Last year, we wrote about our [engagements](#) (in the Americas Q2 2017 Quarterly Report) during an activist situation at a Class 1 US railroad, where an activist investor recruited an esteemed railroading veteran as CEO.

In subsequent months, the company settled with the activist, solidifying a deal that ended in a new CEO and five board seats to the activist and his affiliates. The market reacted positively to the news. However, shareholders were also faced with an interesting situation — a vote on a one-time payment of approximately \$84 MM USD related to the hiring of the new CEO. The payment represented benefits that were forfeited upon departure from his previous company, comprised of income and tax liability.

Ultimately, the payment was approved by nearly 93% of shareholders. During our engagements with the company, we shared several concerns with the company, including the size of the payment to the new CEO, the lack of clawback provisions, as well as the importance of having a talent pipeline of qualified management candidates to appropriately execute the new CEO's "Precision Scheduled Railroading" model.

Unfortunately, after only a few months in the role, the newly-appointed CEO passed away when existing health issues worsened. His untimely death required another leadership change amidst an operational turn-around plan.

The company had identified a successor who had worked with the late CEO at another railroad company. He had been trained there as an appropriate understudy during his tenure as Chief Operating Officer and Chief Marketing Officer. While this individual had never held a CEO role previously, the successful implementation of the precision railroading strategy was contingent on significant structural, operational, and client relationship changes — areas in which this individual had relevant experience.

In light of developments, the company also implemented a new policy to mitigate concerns of 'key man' health issues in the future. As adopted at the 2018 annual meeting, all CEOs are now required to undergo an annual physical and provide documentation to the board. This initiative came in response to a shareholder proposal requesting disclosure of health information. The topic was particularly contentious during the activist situation, as the board sought to find balance between privacy issues and material financial implications for shareholders.

Since the new CEO's appointment, the company has continued to focus on executive management development training and ongoing implementation of the new strategic plan. However, our engagement on succession planning extends beyond this particular company. In an industry with a limited talent pool which can benefit from hands-on operational knowledge, succession planning and human capital management are key engagement issues for us in our conversations with board directors. Several Class 1 railroad companies have long-serving CEOs which may similarly challenge them in the context of finding a CEO successor.

## Cybersecurity risk remediation

**2** Over the past year, we have engaged with a consumer credit reporting agency regarding a cybersecurity incident that occurred summer 2017. While companies within specific sectors require different internal controls with regard to cybersecurity, our aim is to better understand the way in which the board is overseeing risk associated with the specific business operations and managing client/consumer information.

The exposure of sensitive client and consumer data has resulted in material financial losses for the company and its investors, ranging from costs associated with government investigations, civil lawsuits, internal remediation processes, and stock price decline. There have subsequently been changes in leadership, including the retirement of the CEO, the Chief Information Officer, and the Chief Security Officer. From a structural perspective, the company implemented several changes to more appropriately mitigate cyber risk, including the formation of a technology committee to conduct an independent review of the incident and report to the board, the retention of outside consultants, expansion of internal team expertise, and the enhancement of operational protocol.

Additionally, the company made amendments to the executive compensation plan. For 2017, cash bonuses were withheld and enhancements were made to the clawback policy. Specifically, under the revised policy, the board may recover incentive compensation in the event of misconduct or failure of oversight that results in significant financial or reputational harm.

For 2018, the compensation committee added a cybersecurity performance measure as one of the metrics to evaluate employee performance under the annual bonus plan. With regard to long-term equity incentive awards, the company will no longer grant performance shares tied to three-year cumulative adjusted earnings per share to

avoid providing any incentive to limit spending on cybersecurity.

While the company took steps to structurally improve their internal controls and cyber expertise, consumers were left with uncertainty as to the extent of the information breach, and the way in which their personal information may be accessed in the future. The company has been responsive to shareholder feedback regarding disclosure of information to assess the extent to which management and the board are appropriately overseeing these material risks.

## Consideration for investor perspectives during an activist contest

**3** In April 2018, the Americas Stewardship team engaged with a consumer products company that had recently lost five directors in less than two months. The board had been an amalgamation of two companies that merged in 2015. The first three directors who resigned were from the acquired company. They left after unsuccessfully trying to gain control of the merged board, in January 2018.

Shortly afterward, in the wake of the first set of resignations, the company was targeted by an activist investor that had teamed up with the three former directors. The newly-formed alliance then launched a campaign to replace the entire board and change the company's strategic course.

There was a second round of director resignations in March 2018, at which point a second activist fund reported a stake, but provided no commentary on its intentions. The company then announced that it had assigned five seats to the second activist fund, three of whom were employees of the fund. In addition to the board seats, the company announced an accelerated strategic transformation plan. While the company provided little commentary about the settlement agreement, their selection of five directors was an appeasement

with the second activist, as opposed to the complete board replacement that was suggested by the first activist.

We engaged with the company, its board, financial advisors, and the activist fund that had initially targeted the company. We expressed concern about the hasty settlement with the second activist fund, which appeared to be a defensive tactic. We explained that we prefer companies to engage with us on these public situations before unilaterally settling with activists. We also explained our preference for truly independent nominees versus principals or employees of an activist fund.

Ultimately, the company and the second activist fund settled with the first activist fund. Their agreement resulted in three new independent directors being appointed to the board, and two activist-affiliated directors remaining. We will monitor the progress the company makes over the coming year with the hopes that fresh perspectives on the board will result in better governance and performance.

**CEO over-commitment**

**4** As mentioned earlier this year (see our [Americas Q1 Quarterly Report](#)), we updated our US proxy voting guidelines in February 2018.

One substantive change that we made to our US guidelines was the total number of public company boards on which an active CEO of a public company may participate.

**BlackRock’s policy**

|                      | # Outside Public Boards | Total # of Public Boards |
|----------------------|-------------------------|--------------------------|
| Director A – CEO     | 1                       | 2                        |
| Director B – non-CEO | 3                       | 4                        |

Due to concerns about time commitments and adequate participation, our guidelines now stipulate that we may vote against the election of a director who is also a CEO of a public

company, who serves on more than two public company boards including of the company of which he / she is CEO.

A recent National Association of Corporate Directors (NACD) survey revealed that public company directors spend approximately 250 hours per year fulfilling board duties for one company. However, for a CEO, this annual requirement is addition to their full-time, often all-consuming job. The estimated 250 hours per year also doesn’t account for extraordinary circumstances that may require additional board or committee meetings, such as investigations, strategy evaluations, M&A activity, or activist proposals.

According to Spencer Stuart<sup>1</sup>, 24% of companies in the S&P 500 have a policy in place to restrict the number of external public company boards their CEO can sit on with 65% of these boards setting the limit at two external boards and 32% at one external board.

While we have formally updated our policy for 2018, the Americas team has actively been engaging with companies and applying discretion when considering vote decisions with regard to over-committed CEOs. The conversations we have had with companies on the topic have been constructive as there is generally a mutual understanding around the challenges of a CEO managing competing time commitments. For example, a technology company with whom we engaged on the topic decided to amend its governance principles to limit their CEO’s outside board participation.

**Engagements with firearms manufacturers and retailers**

**5** When an event occurs that has the potential to impact all companies in a sector we aim to engage all the companies in the affected sector/s on their response to the event. We generally prefer to engage privately with companies on particular matters and may or may not report on that engagement in our Quarterly Reports.

<sup>1</sup>[https://www.spencerstuart.com/~media/ssbi2017/ssbi\\_2017\\_final.pdf](https://www.spencerstuart.com/~media/ssbi2017/ssbi_2017_final.pdf)

However, the February 14 shooting at a school in Parkland, Florida resulted in widespread speculation about and commentary on the role of investors in companies that manufacture and distribute civilian firearms. On March 2, 2018, BlackRock published a [statement](#) to help clients, companies and others understand how the Investment Stewardship team would engage on the topic.

In our engagements in these event-driven situations, we seek to understand how companies have assessed the impact of the event on their business model and operations, how they conduct their business in compliance with relevant regulations, and the board's and management's respective roles in risk oversight and management. Over the past few months, we have engaged with nearly all thirteen public companies in the US that make or sell civilian firearms. The purpose of the engagement was to follow-up on the questions set out in the statement and to understand each company's approach. We found the engagement overall to be constructive and informative.

In the second quarter of 2018, Investment Stewardship contacted a firearms manufacturing company on multiple occasions, including sending a letter to the company's CEO. The company's existing policy does not allow for shareholder engagement with management or the board. We therefore relied on the company's public response to our letter and prior publicly available disclosures to decide how to vote on a shareholder proposal put to the company's annual shareholder meeting seeking a report on its activities to enhance gun safety measures. From the available information, we were unable to make an appropriate full assessment on three key issues:

- Management and the board's assessment of the company's reputational and financial risks
- How the company monitors firearms distribution channels
- How the company addresses the topic of safety with their employees and contractors who work in their manufacturing operations

As a result, we were not able to fully assess the board's oversight on a variety of key risks, nor its assessment of any potential challenges to the company's long-term prospects. We, therefore, voted in favor of the non-binding shareholder proposal.

## Engaging with an eye toward increasing a merger's offering price

**6** A majority family held insurance company recently proposed a management buy-out from the minority shareholders to take the company private. For the transaction to pass, the family needed support from the "majority of the minority" of shareholders.

A dissident shareholder ran a "Vote No" campaign. In line with our standard practice, we met with both the issuer and dissident to pose questions, understand the different perspectives, and inform our vote decision.

In addition, we worked closely with two of BlackRock's active equity teams (Fundamental and Event Driven) who had been following this issuer for some time.

The issuer has experienced a number of operational challenges this year, including an auditor change, late regulatory filings, depressed earnings, and a falling share price. Their primary rating agency put them on "negative watch" with a ratings downgrade potentially hampering their business further.

A private equity firm approached the family about taking the company private. An independent special committee of the board of directors was formed to negotiate the conditions of the buy-out and make a recommendation to the minority shareholders.

We had concerns regarding the independence of the special committee (given their long-standing history with the controlling family). We also questioned the overall robustness of the initial offering process. In addition, given recent asset sales and a strong underlying business, we determined that the initial price undervalued the company and, accordingly, voted against the transaction. The meeting

was adjourned and, over the following weeks, the special committee negotiated an increased offer price which we supported. Ultimately, the merger transaction was approved with a 9.25% price increase relative to the prior offer.

## Diversity engagements

**7** Earlier this year, we identified approximately 300 US companies in the Russell 1000 as engagement candidates on board diversity. We identified the companies on the basis of having fewer than two women on their board; however, our focus is on the broad spectrum of diversity characteristics including, amongst others, age, gender, education, race, professional experience, and industry expertise. The Americas team wrote to each company explaining our views on board diversity and effectiveness. We have subsequently had many productive engagements in which we explored the companies' views on diversity, approach to board composition, performance evaluation and director succession and commitment to enhancing governance practices.

Companies in the REIT sector were less willing to engage on the topic. We attribute this to a convergence of several factors, particularly the closely-held nature of many of these companies. However, there were notable exceptions, with a number of REITs adding women directors, reportedly as a result of increased investor engagement that had made them more aware of these gaps in their boardroom composition.

According to a recent [study](#), of the 94 newly elected, non-employee/outside REIT directors, 52% are women, representing a doubling from just two years earlier (26% in 2016). This is the first time that men were the minority of new directors in the REIT sector.

Also this quarter, the team held productive engagements with a number of energy and biotechnology sector companies. We noted several instances of companies including women directors on their 2018 slate of candidates.

# Engagement and Voting Statistics

## Americas Engagement Statistics<sup>2</sup>

| Number of engagements | Level of Engagement <sup>3</sup> |          |           | Topics Discussed* |        |            |
|-----------------------|----------------------------------|----------|-----------|-------------------|--------|------------|
|                       | Basic                            | Moderate | Extensive | Environmental     | Social | Governance |
| 352                   | 315                              | 23       | 14        | 31                | 43     | 329        |

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

## Americas Region Voting Statistics<sup>2</sup>

| Country                      | Number of meetings voted | Number of proposals | % of meetings voted against one or more management recommendations | % of proposals voted against management recommendation |
|------------------------------|--------------------------|---------------------|--|--|
| USA                          | 2,793                    | 23,398              | 31%  | 4%   |
| Canada                       | 396                      | 4,266               | 35%  | 4%   |
| Latin and South America      | 397                      | 3,840               | 71%  | 14%  |
| <b>Americas Region Total</b> | <b>3,586</b>             | <b>31,504</b>       | <b>36%</b>   | <b>5%</b>  |

<sup>2</sup>The Americas engagement statistics are sourced from BlackRock and the voting statistics are sourced from ISS Proxy Exchange on July 5, 2018 and both are a reflection of 2nd Quarter 2018.

<sup>3</sup> 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. Source: BlackRock as of 2nd Quarter 2018.

# Active Ownership and Responsible Leadership

## Speaking events

Members of the BIS 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 summary of some of the events team members have spoken at during the quarter:

### **Society for Corporate Governance 2018 National Conference – Washington D.C.**

In June, we presented on a panel on “Evolving Approaches to Environmental, Social and Governance (ESG) Standards for Large Cap Companies”, which provided perspectives from three different practitioners on this topic: a representative of Sustainability Accounting Standards Board (SASB), an investor, and general counsel of a large cap company. The audience was made up of general counsel and corporate secretaries. We discussed how we engage companies with the goal of having them provide standardized disclosures for investors that are both useful and scalable. We posed the question: If certain ESG data providers are only using a company's publicly available information to calculate their ratings half of the time, would companies rethink their reluctance to disclose this information themselves? We also discussed some of the different reporting metrics for companies to use and BIS' involvement in the SASB Investor Advisory Group.

We also participated in a panel on how investors are assessing companies' approach to human capital management and investors' expectations of corporate disclosure on this topic. We highlighted the note that BIS has [published](#) on its website explaining why we see this as an investment issue and how we engage on the topic. The consensus in the audience was that human capital is an important topic, but one where most companies are still evolving their reporting. Investors believe it is important to understand how well management and the board are attracting, retaining, and motivating workers for a number of reasons, including the shortage of talent in tightening labor markets and the dependencies that companies have on human capital to realize their strategy and deliver sustainable long-term financial returns.

### **13D Monitor's Active Passive Annual Conference – New York, New York**

In April, BIS participated in a panel on how mainstream investors engage in activist situations and how we weigh the contrasting positions of management and shareholder activists. The audience included corporate advisors, representatives of activist funds, and corporate representatives. We explained that we make our vote decision based on the outcome that our analysis suggests is in the best economic interests of our clients as long-term shareholders. We also emphasized that where management acknowledges the issues and sets out a clear plan to address them, our preference is to support management and the incumbent board directors. Finally, we explained that we generally meet with the company and the activist as often as necessary to ensure we understand the positions of each and can take an informed vote decision.

**Stanford Directors' College Series – Palo Alto, California**

BIS participated in a panel centered on “Listening to Your Shareholders”, which included the lead director of a publicly-traded financial services company as well as a partner from a major law firm. The conference was attended by directors and executive-level management of publicly-traded companies. We discussed Larry Fink’s 2018 letter to CEOs as well as other topics relevant to the audience such as board diversity, activism and best practices to engage with large institutional shareholders. Our participation allowed us to highlight BIS’ work in the context of Larry Fink’s letter and explain our approach to engagement on corporate purpose, long-term strategy and culture. We hope our participation will drive deeper conversation in the future with corporate directors.

**Ascend Summit – San Francisco, California**

At this event, focused on creating opportunities for Asian corporate directors, we were interviewed by an executive search firm representative on the panel entitled, “Demand Side View of Diversity on Boards.” We discussed BIS’ current focus on gender diversity and how this was only one aspect of look at diversity of the board as a whole. We explained how we engage companies on board succession processes and provided anonymized examples of leaders and laggards. The audience of directors was very engaged and had questions and suggestions for how both BIS and search firms can evolve our approaches over time.

**National Association of Corporate Directors – Boston, Massachusetts**

In June, we participated in a panel, “Activism in the Boardroom: Learn from the Nation’s Most Influential Investors What Directors Need to be Doing Today”, with State Street Global Advisors and a director of a company. Attendees were predominantly directors of publicly-traded companies, and we discussed topics ranging from activism, stewardship, and ESG. Our participation allowed us to engage with directors and highlight BIS’ work engaging directors on corporate governance.

**Roundtable Events for Corporate Directors on Emerging Trends in Governance and Stewardship – New York, New York**

In June, we participated in several small group, private events for corporate directors, hosted by different external parties, to discuss emerging trends and developments in corporate governance and stewardship. Key themes were the rise of environmental and social factors as a board issue, progress on board diversity, how BlackRock engages on corporate purpose, long-term strategy and culture, and hot topics from the 2018 proxy season. We find these types of events a helpful way to have a private dialogue with corporate directors on general governance matters of mutual interest in a format more open than can always be the case in a company-specific engagement.

**2018 Harvard Roundtable on Shareholder Engagement – Cambridge, Massachusetts**

In June, we participated in Harvard’s Shareholder Engagement Roundtable — the event concerned asset managers, proxy advisors, bankers, and lawyers to discuss key issues such as dual-class share structures, environmental and social governance topics, and investor activism. During these discussions, we spoke about the Larry Fink’s 2018 letter to CEOs and the importance of companies having a clearly articulated purpose, and MSCI’s consultation on dual-class share structures.

# Market Developments and Trends

## MSCI dual share class

Companies with dual class structures have emerged in the past two years as a key corporate governance concern. While this share structure has existed for a long time, recent IPOs by technology companies have raised awareness of the issue. Many market participants have expressed concern about the implicit deterioration in corporate governance standards and the lack of accountability to shareholders. One of the major index providers, MSCI, conducted a consultation on the treatment of unequal voting structures in their equity indexes. MSCI has suggested that the weighting of companies in their indexes should match the voting rights of their share structures. As discussed in our [Open Letter Regarding Consultation on the Treatment of Unequal Voting Structures](#), we are advocates of the principle of “one share, one vote”. However; we also understand that other structures may serve a purpose in certain circumstances. Importantly, we believe regulators and policymakers – not index providers – should be the guardians of stock exchange listing standards.

This document is provided for information purposes only and must not be relied upon as a forecast, research, or investment advice. BlackRock is not making any recommendation or soliciting any action based upon the information contained herein and nothing in this document should be construed as constituting an offer to sell, or a solicitation of any offer to buy, securities in any jurisdiction to any person. This information provided herein does not constitute financial, tax, legal or accounting advice, you should consult your own advisers on such matters.

The information and opinions contained in this document are as of July 2018 unless it is stated otherwise and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and non-proprietary sources deemed by BlackRock to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. Although such information is believed to be reliable for the purposes used herein, BlackRock does not assume any responsibility for the accuracy or completeness of such information. Reliance upon information in this material is at the sole discretion of the reader. Certain information contained herein represents or is based upon forward-looking statements or information. BlackRock and its affiliates believe that such statements and information are based upon reasonable estimates and assumptions. However, forward-looking statements are inherently uncertain, and factors may cause events or results to differ from those projected. Therefore, undue reliance should not be placed on such forward-looking statements and information.

Prepared by BlackRock, Inc.

©2018 BlackRock, Inc. All rights reserved.