

**BLACKROCK®**

# INVESTMENT STEWARDSHIP REPORT: AMERICAS

**Q3 2018**

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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

This quarter, the Americas Investment Stewardship team's engagements and voting activities spanned a number of key topics, ranging from board oversight and quality, corporate culture and strategy, climate risk, and human capital management. We were also involved in several ongoing contested situations. The following examples provide insight into these activities and their outcomes.

## The intersection of corporate governance and human capital management (HCM)

**1** Recently, we engaged a restaurant franchise embroiled in a public legal battle with its founder and former CEO in order to understand the background to this situation and the steps the board was taking to address it. Many of the problems apparently stem from lax corporate governance and deference to its former CEO and chairman, a significant shareholder. Recent disparaging comments made by the founder led to his losing his leadership functions on the board. His comments also raised questions about whether the company's culture enables behavior contrary to its code of ethics and business conduct. He has continued to pressure the board and management team in an apparent bid to retain his significant influence.

In response, the company's board took the unusual step of publishing a letter publicly denouncing the founder's pattern of ignoring board decisions and announcing that it would conduct an independent audit and investigation of its corporate culture, focusing on diversity and inclusion.

Consequently, the company management undertook a series of engagements with investors that detailed their new strategic framework which highlighted investing in its people. We believe the company is rightly focused on HCM, especially in a people-oriented industry like restaurants. During our meeting, the company outlined its key efforts:

- establishing an independent audit of its culture
- conducting a multi-week listening tour with its franchisees
- establishing a diversity and inclusion committee
- retaining external resources to develop a strategy to articulate the values they hope will resonate with employees

The company shared that it plans to continue to build on these efforts to further expand HCM into its corporate strategy and to increase diversity within the board, management, and workforce. Investment Stewardship asked that, moving forward, the company publicly disclose more on its HCM strategy and progress on inclusion and diversity.

Recently, an activist investor and a major US pension plan partnered to press the restaurant franchise to improve their governance practices and increase sales. This development reinforces the importance for boards to maintain sound governance and business practices, as well as the cost to companies that fail to do so.

We intend to continue our dialogue with the board to monitor how it is delivering on its new strategic priorities, to include HCM.

## Achieving strategic transformation in the technology sector

**2** During our engagements, we seek to understand companies' strategic framework for long-term value creation—particularly, how boards support management in implementation, and how new business developments are taken into account. Engaging with companies over a

number of years allows us to better assess the effectiveness of the board and management in executing the strategy and its impact on financial results over time. We recently engaged with a technology company in the midst of a strategic transformation from a legacy mainframe hardware business to a provider of next-generation products and services. We met with company management last year on the heels of a Say on Pay vote that garnered only 54% of votes cast and had an encouraging and productive conversation about how the board and management were improving governance. We discussed the future use of one-time pay grants, disclosing more detail on the performance metrics used in the executive compensation plans, and enhanced disclosure on social responsibility initiatives.

When we met this year, the company gave us an update on governance and the business. The management team highlighted that its turnaround plan was beginning to take hold and top-line revenue growth was coming through for the first time in over five years. The company had enhanced disclosure on executive compensation and reduced maximum payouts to executives in response to feedback from BlackRock and other shareholders. The management team shared its views on issues associated with the shift to next-generation technologies (like artificial intelligence), and how these are considered at the board level. The company clearly articulated its purpose and how it engages with its stakeholders in a rapidly shifting business environment. For example, it is also investing in the communities in which it operates by providing apprenticeship-type job opportunities to underserved communities. The top performers in this program are hired by the company and are provided specific support to integrate and develop their careers.

These results are emblematic of how an iterative engagement process can help companies better understand investor expectations and concerns in order to adapt their governance practices and disclosures. We believe this in turn supports more sustainable long-term financial returns, which benefit our clients.

### Engaging on the contested sale of a Real Estate Investment Trust (REIT)

**3** During agreed mergers and acquisitions and contested takeovers, Investment Stewardship engages with both the target company and the bidder to understand the long-term strategic rational and financial benefits of the proposed transaction. Oftentimes our engagement involves our active portfolio management colleagues who hold positions in the companies involved; frequently our analysis requires multiple engagements over an extended period as the situation evolves.

This was the case when a REIT that made an unsolicited offer for another listed REIT which was summarily rejected by the target company's board of directors.

Alongside our active fundamental active equity team, we engaged with management at both the target company and the bidder. After the initial offer was rejected, the bidder improved the terms of its cash-and-stock offer; however, the subsequent offer was also rejected by the target's management team without a substantive explanation to shareholders or the bidder.

The target company ultimately indicated that it was actively pursuing potential acquirers deemed more promising than the bidder. The target company management claimed that the initial rejection was not prejudiced against the unsolicited acquirer but was a tactic to improve the offer.

It took several attempts by Investment Stewardship to secure a meeting to assess whether the board has a thorough process to assess the bid and is taking into consideration the long-term economic interests of shareholders in their deliberations. As part of their evaluation of proposed transactions, market participants are increasingly considering corporate governance practices in order to assess management's ability to act in the interest of their shareholders. We were particularly keen to understand if the proposal to sell to a private equity fund on less favorable terms which, in our view, was detrimental to unaffiliated shareholders.

Just before the special shareholder meeting to vote on the transaction, the target company scrapped the deal with the private equity fund and entered into a merger agreement with the initial unsolicited bidder. This resulted in the company paying a large break fee to the private equity firm.

## Climate risk

**4** Investment Stewardship's climate-related engagements seek to gain a better understanding, through disclosures, of the processes that each company has in place to manage climate risks and to understand how those risks are likely to impact the business. Encouragingly, we have observed that certain companies which previously lagged their peers in providing climate risk disclosure are now disclosing the strategic oversight of climate risks and opportunities potentially impacting their financial performance over the long term.

For instance, we have started to see a change in climate risk reporting at a large American multinational petroleum company whose management team we have engaged with over several years. This company had previously been slow to address what we view as material climate-related risks inherent in its business model.

When we engaged with the company in 2017 to discuss a shareholder proposal that asked the company to produce an assessment of long-term impacts of plausible scenarios that address climate change, the company explained that such reporting was unnecessary given its existing climate risk disclosures. The company also claimed that further reporting could be considered a misuse of corporate resources. The shareholder proposal passed with 67% support, requiring the company to comply with the request made by the proposal.

During our 2018 engagement, the board explained the evolution of their thinking around using the Task Force on Climate-related Financial Disclosures (TCFD) as a reporting framework. The company was initially concerned that broader disclosures would expose them to greater legal and competitive

risk. Over time, as the report evolved, the board started to see the relevance of the framework. The company became more open to reporting and developed an internal group to spearhead their so-called "Low Carbon Ventures." Most notably, the company opted to link a component of its short-term and long-term incentive programs to the advancement of its low carbon business strategy. In our view, this initiative underscores the company's recognition of the importance of climate-related risks to its corporate strategy.

While we expect that the company's climate risk reporting will evolve further, we are supportive of the board's current approach to climate disclosures.

Another major North American energy company also recently improved its climate risk reporting. The company received a shareholder proposal requesting that they 1) report on long-term risks and opportunities related to climate change and 2) provide an analysis of the resilience of its business model to a 2-degree scenario analysis.

Rather than opposing the shareholder resolution, the company recommended shareholders vote in favor. In doing so, the board signaled that it understands that its shareholders desire more information on how the company addresses material climate risks.

The board plans to issue a report on its climate risk analysis in the coming months. At the company's behest, Investment Stewardship had a follow-up engagement with management to explain how we evaluate material environmental, social and governance (ESG) factors at the companies in which we invest on behalf of our clients. The company's proactive approach and openness to improving their disclosure demonstrates a growing recognition of the importance of these factors to investors.

Both of these examples suggest the necessity and value of engagement with shareholders on material environmental factors relevant to a company's business model. They also highlight how more companies are moving towards undertaking disclosure in line with TCFD recommendations, with an eye towards how such disclosure can be strategically useful to the company.

# Engagement and Voting Statistics

## Americas Engagement Statistics<sup>1</sup>

Number of engagements	Level of Engagement <sup>2</sup>			Topics Discussed*		
	Basic	Moderate	Extensive	Environmental	Social	Governance
114	54	48	12	20	25	108

\*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>1</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	379	2,552	35%	7%
Canada	39	300	31%	10%
Latin and South America	56	340	47%	11%
<b>Americas Region Total</b>	474	3,192	36%	8%

<sup>1</sup> The Americas engagement statistics are sourced from BlackRock and the voting statistics are sourced from ISS Proxy Exchange on October 5, 2018 and both are a reflection of 3rd Quarter 2018.

<sup>2</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 3rd Quarter 2018.

# Active Ownership and Responsible Leadership

In August, Investment Stewardship published its [2018 Annual Report](#) detailing BlackRock's approach to corporate governance and stewardship in support of long-term value creation for our clients.

Additionally, our Investment Stewardship team collaborated with BlackRock's Global Public Policy Group to publish a *ViewPoint*: [The Investment Stewardship Ecosystem](#) in which we set out the roles of the different stakeholders in the investment stewardship ecosystem. Among other things, we emphasize in the *ViewPoint* that investment stewardship is a feedback mechanism through which BlackRock, as a long-term investor on behalf of our clients, can help build mutual understanding with companies.

## Speaking Events

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

### **Trends in Corporate Governance: Insights into Institutional Investors' Concerns about Boards – San Francisco, California**

We participated on a panel on critical corporate governance issues and how general counsels should advise their boards on these matters. Attendees were primarily general counsels of publicly traded-companies. We discussed topics ranging from board composition to environmental, social, and governance (ESG) strategies. Our participation allowed us to have a candid conversation with practitioners about how legal teams can support boards with regard to emerging corporate governance issues.

### **National Association of Real Estate Investment Trust (NAREIT): “Dividends through Diversity” Program – Chicago, Illinois**

Investment Stewardship participated on a panel entitled “How Cutting-Edge Institutional Investors View Diversity and What You Can Learn from Their Approach.” The event, which was attended by commercial real estate professionals and corporate members of NAREIT, focused on how institutional investors can support the development of women and minorities in the REIT sector. Our participation provided us with the opportunity to share [our perspective how we engage on diversity](#) and how it can impact long-term corporate performance.

### **Society for Corporate Governance, Eastern Regional Fall Conference – New York, New York**

We spoke on two panels centered on investment stewardship. The audience included governance professionals, corporate secretaries, and business executives. During One panel session was n, entitled “Heightened Scrutiny: Preparing Officers and Directors for this New Era of Accountability.” We emphasized our perspective on topics such as activism and shareholder-director engagement, and our approach to voting and engagement. We also reflected on Larry Fink's 2018 letter to CEOs, as well as the feedback we received on the letter.

In the second panel session, entitled “Board Composition Under Scrutiny – Do You Have What It Takes?” we discussed our views on board composition. Our work has always focused on board

quality and effectiveness, and we frequently take the opportunity to share our views on best practices with companies and contribute to the public debate. We explained that, when applicable, we want to meet with members of the nominating committee to discuss our views on board refreshment and succession planning, as we believe that these are two key responsibilities of the committee.

**2018 Power & Utilities Senior Executive Forum – Pebble Beach, California**

We participated in a roundtable-style event that convened CEOs, CFOs, and senior executives from power and utilities companies to discuss transformations occurring within the industry. We presented our views from an investor perspective, highlighting the role of long-term strategy and the importance of risk management in driving value.



# Market Developments and Trends

## U.S. Proxy Voting Infrastructure

At its September 2018 meeting the Securities and Exchange Commission's (SEC)'s Investor Advisory Committee heard from a panel of market participants discussing the infrastructure behind the proxy voting system (i.e. proxy plumbing).

The SEC is also to hold a staff Roundtable on November 15, 2018 on the proxy process. It is expected that the Roundtable will cover a number of topics, including voting process, retail shareholder participation, shareholder proposals and the role of proxy advisory firms.

## Associação de Investidores no Mercado de Capitais (AMEC) Stewardship Code

In September 2018, Investment Stewardship became a signatory of the AMEC Stewardship Code. AMEC, Brazil's leading investor group, launched the code to drive the adoption of good corporate governance practices, create responsible engagement standards for companies and investors, and foster a culture of "stewardship" within the market. Already a member, Investment Stewardship works closely with AMEC — as noted in our [2018 Annual Report](#). We participate in monthly calls to discuss Brazilian regulatory issues and other pertinent issues impacting the region. Additionally, we took part in regular consultations to facilitate the AMEC Stewardship Code's development and launch.

BlackRock is a signatory of stewardship codes across several jurisdictions, and engages with relevant stakeholders in jurisdictions that are establishing new codes. These forums provide us with the opportunity to share our perspective on corporate governance with our peers and other professionals committed to advancing stewardship practices.

## The Opioid Crisis Response Act of 2018

Congress is considering legislation that will affect opioid manufacturers and others and is an example of the types of risks that companies need to consider in the operations of their business. Specifically, the U.S. Senate passed [the Opioid Crisis Response Act of 2018](#) which contains provisions related to pain management alternatives, tracking opioid prescriptions to prevent misuse and diversion, improve coordination between the FDA and Customs Border Protection to stop illicit drugs, among others. This underscored the necessity for the type of industry-wide engagements Investment Stewardship [has undertaken](#) (see case study 6 of our Americas 2017 Q4 report) to better understanding board oversight and corporate action on this issue.

## IOSCO Consultation on Good Practices for Supporting Audit Quality

The International Organization of Securities Commission (IOSCO) initiated a request seeking feedback on recommended good practices for the audit committees of listed public companies entitled "Consultation Report on Good Practices for Audit Committees in Supporting Audit Quality."

IOSCO suggests that "the quality of a company's financial report, supported by an independent external audit, is key to market confidence and informed investors. The audit committee has an important role in the quality of the financial report, since audit quality relates to an effective and independent audit function that is appropriately supported by the company. While the auditor has primary responsibility for audit quality, the audit committee can promote and support audit quality and thereby contribute to greater confidence in the quality of information in the issuers' financial reports. The good practices report can therefore assist audit committees in considering ways in which they may be able to promote and support audit quality."

Overall, the majority of the practices listed in the consultation are already being undertaken in the U.S. In Investment Stewardship's view, IOSCO's approach to provide good practices at a principles (rather than procedural) level, provides an additional perspective to audit committees on overseeing the quality of the audit.

### **Gender Quotas for Corporate Boards in California**

In September 2018, California became the first state in the nation to mandate a gender quota for corporate boards of directors. The legislation – [SB 826](#) – will require a public company headquartered in California to have a minimum of one female on its board of directors by December 31, 2019. Depending on the size of the company, boards will be required to have a minimum of two or three women by December 31, 2021. Companies that fail to comply could be subjected to a fine of up to \$300,000. The legislation is likely to be challenged on Constitutional grounds.

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