I. Recent Developments in Virginia corporate law.

Here is a summary of the principal recent court decisions, legislative changes and related developments for Virginia corporations.

1. Exclusive Forum Bylaws. Code Section 13.1-624 has been amended to provide that the bylaws can establish an exclusive forum for derivative suits and other claims relating to the corporation’s internal affairs. A circuit court or federal district court in the Commonwealth or in the jurisdiction in which the corporation has its principal office can be designated as the sole and exclusive forum. A sample exclusive forum bylaw is attached as Exhibit A. Because Virginia law will be applied in any claim involving the internal affairs of a Virginia corporation, adoption of an exclusive forum bylaw may be desirable.

2. Virtual Shareholder Meetings. In 2017 Code Section 13.1-660.2 was amended to state that unless otherwise provided in the articles of incorporation or bylaws, the board of directors has authority to decide that an annual or special meeting of shareholders will not be held at a place, and instead, be conducted solely by means of remote communication. Significant debate continues regarding the advantages and disadvantages of virtual shareholder meetings. Boards and management get concerned that virtual meetings could be used by dissident shareholders to cause disruption. Some shareholders argue that remote participation will lead to more shareholders attending and participating. Other shareholders believe that shareholders can engage more effectively with the Board and management when the meeting is held at a place and not just remotely. Note that the Code leaves to the discretion of the Board of Directors whether to have a virtual meeting of shareholders and to establish the participation procedures that will be followed for the meeting. The shareholders cannot, even with a bylaw amendment, require that meetings be held remotely.

3. Shareholder Action By Less Than Unanimous Consent. Legislation that has just been adopted in 2018 further refines Virginia’s approach to shareholder action by less than unanimous consent. While shareholders of publicly traded corporations, with the support of ISS
and others, often have sought authorization to take action by less than unanimous consent, opponents have pointed to the special meeting of shareholders as a more appropriate way for shareholders to exercise their authority. Since 2007 Code Section 13.1-657 has permitted all corporations to authorize shareholder action by less than unanimous consent in the articles of incorporation. The consent provision was revised in 2012 to provide the corporation early warning of a shareholder consent solicitation. Code Section 13.1-657 provides that corporations must have received notice of the proposed action before holders of more than 10 percent of the shares have executed the consent. In addition, the Code Section was changed for public corporations to increase the vote required to amend the articles of incorporation to authorize the use of such a consent to the greater of (i) the vote required in the articles of incorporation to amend the articles and (ii) more than two thirds of the shares entitled to vote for each voting group entitled to vote on the amendment.

Code Section 13.1-657 was further amended in the 2018 session of the General Assembly to draw a direct link between the authorization of shareholder action by less than unanimous consent and the corporation’s failure to authorize shareholders to call a special shareholders meeting. As amended, Section 13.1-657 provides that for any public corporation whose articles of incorporation did not provide for action by less than unanimous consent as of April 1, 2018, shareholders could only act by less than unanimous consent if (i) the corporation did not permit holders of 30 percent or fewer shares entitled to vote to call a special shareholders meeting and (ii) the articles of incorporation were amended subsequent to April 1, 2018 with shareholder approval satisfying the requirements described in the preceding paragraph. See H.B. 1559 attached hereto as Exhibit B.

4. Judicial Review of Disputed Governance Decisions. Code Section 13.1-669.1, which used to just address judicial review of contested elections of directors, was revised in 2015 to follow a new Model Act provision that broadens the scope of authorized judicial review to include (i) the validity of the election, removal or resignation of any director or officer, (ii) the result or validity of any other shareholder vote, (iii) the right of any director to be on a committee or board of directors and (iv) the right of any individual to nominate, or to be nominated as, a director. The new provision addresses the proper parties to any such action as well as what qualifies as acceptable process for serving any necessary party to the action. It is not likely that this judicial review will be invoked often. Notwithstanding, it is helpful to have a process in
place including provisions addressing issues such as proper parties and acceptance service of process.

5. **Duration of Voting Trusts and Shareholder Agreements.** Code Section 13.1-670, which addresses voting trusts, and Code Section 13.1-671.1, which covers agreements among shareholders, both have been amended to provide a means to extend the trust or the agreement beyond 10 years. These changes permit the parties to voting trusts or shareholder agreements to continue their effectiveness notwithstanding that when they were created the Virginia Act restricted their duration to 10 years.

6. **Derivative Suits.** In recent years a number of fiduciary duty claims have been made that bring into play Virginia’s code provisions relating to derivative suits. In several trial court decisions, courts have shown a willingness to accept complaints by shareholders as satisfying the statutory requirement that any derivative claim must start with a demand for the board of directors to take action. See [O'Brien v. Midgett](https://www.courtlistener.com/opinion/675906/), 2016 Va. Cir. LEXIS 25 (Norfolk Cir. Ct., Apr. 5, 2016); [Williams v. Stevens](https://www.courtlistener.com/opinion/675907/), 86 VA. Cir. 385, 2013 Va. Circ. LEXIS 28 (Norfolk C.T. Ct., Apr. 1, 2013). In both of these circuit court decisions, the court concluded that shareholder complaints satisfied the statutory requirement of a demand for board action even though the complaints made no reference to the statutory demand requirement or to the Article in the Virginia Act addressing derivative suits.

In an important decision, the Federal District Court for the Eastern District provided helpful guidance with respect to the weight to be given to the findings of a special litigation committee of the Board that has investigated a shareholder demand on behalf of the corporation. [Luzak v. Light](https://www.courtlistener.com/opinion/675906/), 2016 U.S. Dist. LEXIS 88992 (E.D. Va. 2016), [affirmed without opinion](https://www.courtlistener.com/opinion/675907/), 2017 U.S. App. LEXIS 4175 (4th Cir. March 9, 2017). The Luzak court accepted the special committee’s conclusion that a derivative suit was not in the corporation’s best interest. It determined the special committee was a properly constituted committee of “disinterested directors” that were adequately informed to determine whether the litigation was in the best interest of the corporation. In reaching this conclusion, the court rejected claims that the directors who appointed the committee were not disinterested and that the committee members were not disinterested. The court also rejected claims that the committee was not adequately informed, noting that the statutory mandate is to understand the specific nature of the factual basis for the claim, rather than conduct a particular level of substantive inquiry into the merits of
the allegations. The court also concluded that whether the litigation would be in the best interests of the corporation involved multiple considerations including cost and the ongoing disruption to operations and not just the merits of the allegations.

Having Luzak as precedent is extremely helpful for Virginia corporations. In addressing whether the committee was disinterested, whether the committee was adequately informed and whether the rejection of the demand was in the best interest of the corporation, the court appeared to recognize that some deference to the Board of Directors and to the committee was appropriate and, accordingly, did not accept challenges that, if a more demanding standard had been applied, could have caused the court to refuse to accept the committee’s recommendation. Giving deference to a committee of disinterested Board members that has engaged in an informed and deliberative decision-making process is consistent with the fundamental assumption underlying the Virginia Act that it is best to minimize the situations in which judicial intervention is necessary. Luzak should be especially helpful for closely held corporations which may well have a harder time complying precisely with the prerequisites for dismissal of a derivative suit demand under the Virginia Act. For example, closely held corporations are less likely to have directors who are totally disinterested in the matters that are the subject of the dispute.

7. **Director Exposure to Liability.** While the Virginia Act was designed to respect the business judgment of the typical director and to provide broad protection to directors from liability except in extreme cases, it is important to recognize that recent years have witnessed not only an increase in derivative litigation but also an increase in the number of claims that have led to some form of settlement.


You also wonder whether the toxic environment for corporations and businesses today, coupled with the increased risks associated with instantaneous and negative publicity put directors at increased risk. Deference to the judgment of the corporation and its decision-makers seems to be long gone, driven in part by high profile failures and repeated instances of excessive executive compensation.
Recent years also have seen a significant increase in attention to the Board’s oversight role, especially with respect to the assessment and control of risks to the Company and its business. In years past the directors’ exposure to liability was tied to their decision-making role, and, absent major red flags, directors were not deemed accountable for the manner in which they performed their oversight role. There have not been any especially troublesome court decisions over the last several years that have shifted the landscape for directors with respect to their exposure for lack of oversight. Notwithstanding, there is reason to believe that the exposure has increased. The risk of action by a regulator has grown as has the likelihood and magnitude of an adverse development that may signal a failure of oversight. In today’s rapidly changing global environment, corporations are exposed to a diversity of risks, an increase in the materiality of some risks, and challenges in understanding and controlling risks, some of which are not only hard to detect, but also constantly changing. Cybersecurity risks are an obvious example. While one could argue that the law in this area continues to provide directors with plenty of protection, caution seems appropriate. Put yourself in the shoes of a director of Wells Fargo or of Equifax.

8. **Indemnification; Advancement of Expenses.** With the ever-increasing cost of defending against a claim of breach of duty, it is extremely important for directors to know that the corporation will advance or reimburse their legal and other defense costs. In 2015 Virginia amended Code Section 13.1-699 to eliminate an important prerequisite to advancement or reimbursement. Following the lead of the Model Act, the General Assembly eliminated the requirement that an applicant for advancement or reimbursement provide the corporation a written statement of his or her good faith belief that he or she has met the standard of conduct that is the prerequisite for indemnification. In a close case this requirement could put both the applicant and the corporation in a difficult position. While this change is advantageous, many corporations may face an argument that they cannot take advantage of it because of the widespread practice of including indemnification provisions in the articles of incorporation that track the language of the Virginia Act and most of those provisions were adopted before the 2015 amendment. While we have concluded that indemnification rights under the articles are separation and distinct from indemnification under the Indemnification Article of the Virginia Act, we are not aware of any court decision that has addressed that distinction.
9. **A New Approach to Combinations.** A 2015 addition to Code Section 13.1-718 provides a new way for a public company that is a party to a merger or share exchange to consummate the transaction without the necessity of a shareholder vote and the related time and expense of having to comply with the SEC’s proxy rules and to hold a meeting of shareholders. Section 13.718 G provides for a merger or share exchange without a vote of the target company’s shareholders following a tender offer or exchange offer for all of the outstanding shares, if the number of shares tendered would be sufficient to approve a plan of merger or share exchange and any shares not acquired in the tender offer or exchange offer will be acquired in the merger or share exchange for the same amount and kind of per share consideration as was paid in the tender offer or exchange offer.

II. **THE 2016 REVISION OF THE MODEL BUSINESS CORPORATION ACT.**

If all goes well, we will introduce in the General Assembly next January a revision of the Virginia Act that is built on the revision of the Model Act published in 2016. The following is a summary of the principal changes that will be discussed as we develop the draft legislation to conform the Virginia Act more closely to the 2016 Revision. While each of these changes will be discussed, at this point we do not know which changes will be included in the Virginia Act.

1. **Correcting Corporate Errors.** Following Delaware’s lead, the 2016 Revision includes a very detailed provision that gives a corporation the means to undo or correct technical failures to comply with applicable corporate law requirements long after the mistake was made. See 2016 Revision §§ 1.45-1.52. The Virginia Act currently has a process for addressing mistakes made in connection with a document filed with the State Corporation Commission. While that provision is helpful, it has a very short time period in which it can be used (within 90 days after the document’s effective date). While the provision in the 2016 Revision is complicated, it can be invoked when the error is not identified promptly. It also addresses the correction of errors that are not associated with documents filed with the SCC. An example of a situation in which the correction mechanism could be used is when a corporation issues more shares than are authorized by the charter. Having a mechanism to correct such a fundamental error seems to make sense.

2. **Combinations with Unincorporated Entities.** The Virginia Act currently permits corporations to combine with limited liability companies. The 2016 Revision establishes processes for corporations to combine with a broader range of non-corporate entities including
limited and general partnerships and business trusts. As a result, the 2016 Revision includes in a number of places protection for shareholders who as a result of the transaction would be exposed to liabilities beyond the possible loss of their investment. These types of transactions are likely to be rare, which raises the question whether adding additional complexity to the Virginia Act is justified.

3. **Shareholder Approval of Significant Issuances of Shares.** The 2016 Revision includes a requirement that any issuance of shares that would result in an increase in the number of outstanding shares by 20% or more must have shareholder approval. Publicly traded Virginia corporations likely are subject to that requirement under NYSE or NASDAQ rules. In addition, the Virginia Act currently has the 20% voting threshold requirement in effect in the case of a merger or share exchange.

4. **Notice of Shareholder Meetings.** The 2016 Revision now only requires at least 10 days’ notice of any meeting of shareholders while Virginia still requires at least 25 days’ notice for shareholder action on significant transactions such as a merger or a sale of substantially all of the assets.

5. **Election of Directors; The Holdover Rule.** The 2016 Revision eliminates the director holdover rule. Under that rule, a director serves until his or her successor is elected and qualified, or following the expiration of his or her term, the number of directors is reduced. The holdover rule comes into play when the bylaws require a majority vote to elect directors and a director fails to get a majority of the votes cast. Under the current Virginia law, even though the director has not been reelected, he or she continues to serve until the Board selects a replacement or reduces the size of the Board. The current rule is statutory and cannot be changed in the articles of incorporation or bylaws.

6. **Judicial Authority to Remove a Director.** The 2016 Revision gives a court authority to remove a director in a case of fraudulent or abusive conduct. 2016 Revision § 8.09. Such authorization might be helpful when there is a rogue director and the director owns sufficient shares to block removal.

7.
7. **Force the Vote.** The 2016 Revision includes a provision that confirms that a corporation can include in an agreement that is subject to shareholder approval, such as a plan of merger, that the board of directors will submit the transaction to the shareholders even if the board of directors changes its position and recommends that shareholders vote against the transaction. 2016 Revision § 8.26. There are differing views among Virginia practitioners as to the current validity of a force the vote provision under current Virginia law.

8. **Director’s Duty of Disclosure.** The directors standard of conduct in the 2016 Revision includes a requirement that a director who has material information with respect to a matter that the board is considering must disclose that information to the rest of the board unless he or she is subject to a confidentiality agreement that precludes such disclosure. At this time it is not clear that a director of a Virginia corporation would have such a disclosure obligation.

9. **Books and Records; Limits on Inspection Rights.** The 2016 Revision confirms that a shareholder’s right to inspect the corporation’s books and records, including the annual financial statements, can be made subject to reasonable restrictions on the confidentiality, use and distribution of such records. See 2016 Revision §§ 16.02 (d), 16.20 (d)(1). Over the last five years we have seen increasing use of books and records demands by shareholders of Virginia corporations.

10. **Standard of Conduct for Officers.** For a number of years the Model Act has had a statutory standard of conduct for officers similar to its standard for directors. 2016 Revision § 8.42. In 1984 the Virginia Code Commission elected not to include a provision for officers. It seems appropriate to revisit that decision, especially since we provide that officers can have the benefit of mandatory indemnification, as well as exculpation.

11. **Conflicting Interest Transactions.** For a number of years the Model Act has had an elaborate series of provisions addressing directors’ conflicting interest transactions. See 2016 Revision §§ 8.60 – 8.63. In 1985 Virginia elected to stay with the less complex Virginia approach to those types of transactions. See Va. Code Ann. § 13.1-691. Careful consideration of the more complex Model Act approach seems appropriate.
Note that in addition to the foregoing list of the principal possible changes to the Virginia Act that may come from the 2016 Revision, the process of conforming the Virginia Act to the 2016 Revision will include consideration of more technical changes to essentially every Code section. While we hope to pursue a review process that will allow introduction of a revised Virginia Act in the 2019 Session of the General Assembly, that will take a lot of work.

III. Trends in Corporate Governance.

If you look back over 50 years you see a very significant change in the prevailing standards of corporate governance including a significant shift in who are the decision-makers, changes in the composition and size of the typical board, the evolution of the directors’ oversight role, accompanied by dramatic changes in the risk exposure associated with an increasingly complex, rapidly changing global economy, the rise to power of the financial shareholder activists, a resulting increased focus on the role of the corporation with respect to the interest of constituencies other than the shareholders and on social, environmental and governance issues, accompanied by lots of attention to the “culture” of a corporation and, as a consequence of the foregoing, significant changes in the relationship between boards and large shareholders.

Fifty years ago, the balance of power was heavily weighted in management’s favor. The vast majority of shares were owned by individuals who could be expected to consistently follow management’s recommendations. Board members were typically selected with lots of input from the chief executive officer, and often were closely connected to the chief executive officer. Any major transaction needed Board approval before the shareholders had a shot at it. That time might best be referred to as the time of the imperial CEO. Since then, there has been a steady evolution of the power of institutional shareholders. Today many publicly traded companies confront the reality that a handful of institutional holders own a controlling block of the outstanding shares.

This shift in ownership, combined with the negative effect of unanticipated major failures, including Enron’s collapse and the 2008 financial crisis, and high profile and repeated examples of excessive executive compensation often in connection with unsatisfactory performance have led to the significant changes in corporate governance best practices today, including in the following areas.
1. **Board Composition.** One of the most significant changes has been in the composition of the Board of the typical publicly traded company.

Today's board likely will be smaller – with between 9 and 11 directors being a typical range. The chief executive will be a director, but the rest likely will be independent directors. Other changes include an increasing emphasis on diversity, and with the complex current operating environment, Board members with a variety of desired expertise including financial and accounting experience, international experience, technological experience, marketing expertise and experience directly related to the company's businesses. Board tenure also has become a significant issue. For example, some look askance at any director who has served for 10 or more years. Others take objection to directors who serve on too many boards.

2. **The Ascendancy of Financial Shareholder Activists.** While the financial shareholder activists have been around since the mid-1970s, when the all cash hostile tender offer was developed to permit an activist to bypass the management and the Board, the influence of these activists grew dramatically in the last several years as the activists have turned to the proxy contest for Board representation as the attack vehicle and institutional shareholders have shown an increased willingness to support them.

We should recognize that when these types of activists succeed, an increase in shareholder value may be the end result. At the same time the activist typically focuses on the short term and on increasing value by taking out costs. Cost take-outs may be appropriate. On the other hand, they may have an adverse impact on long term value. For example, if you are a drug company, research is key to long-term value, but research also is expensive. Other capital expenditures present the same challenge. See Exhibit C hereto. Cost cuts also implicate the corporation’s other constituencies - its employees, its suppliers, its customers and the communities in which it operates. While corporate governance historically – at least in Virginia and Delaware – has not taken those constituencies directly into account, that may be changing, as is discussed in the following section.

3. **Other Constituencies.** The Virginia Act states that a director shall act in the best interest of the corporation. In day to day matters, management and the Board are not precluded from considering the impact of proposed action on other constituencies as they try to act in the
corporation’s best interest. But it is at this juncture that shareholder activist have been able to successfully promote the interest of the shareholders as the true meaning of the “best interest of the corporation.”

In contrast to Virginia and Delaware, Indiana, Ohio and Pennsylvania have for a number of years expressly provided that the Board of Directors can consider the interests of the corporation’s other constituencies. While there has not been a lot of interest in this issue in Virginia over the years, there is reason to believe that more focus is on the horizon. For the period following the 2008 financial crisis, top line growth for many corporations has come solely from cost takeouts, often triggered by pressure from financial shareholder activists. The negative effect on employees and other constituencies is demonstrable and appears to be one source for the low regard in which corporations are held today, which, in turn, is feeding the increased interest in other constituencies. For example, in 2017 the Massachusetts Supreme Judicial Court found that the directors could consider the interest of employees and any regional impacts of their proposed decision, notwithstanding the absence of statutory authorization similar to that found in Illinois, Ohio and Pennsylvania. Int’l Bhd. of Elec. Workers Local 29 Benefit Funds v. Tucci, 70 N.E. 3d 918 (Mass. Sup. Jud. Ct. 2017). Of perhaps greater significance, in January 2018 the head of BlackRock surprised the corporate world when he wrote to chief executive officers a cautionary letter that included: “Companies must benefit all of the stakeholders, including shareholders, employees, customers and the communities in which they operate.” See Exhibit D hereto.

4. Environmental, Social and Corporate Governance Issues. Related to the other constituency issue is the recent surge in interest in environmental, social and corporate governance (“ESG”) issues. Institutional holders are showing growing interest in these issues that are, at best, indirectly related to shareholder value. With climate change being a prime concern, institutional shareholders have been pursuing energy companies for several years. More recently the focus has been, for obvious reasons, on gun manufacturers and, because of social media concerns, Facebook, Apple and other technology companies. Board diversity is another component of the ESG focus. In his well-publicized January 2018 letter, the head of BlackRock emphasized that “every company must not only deliver financial performance, but also show how it makes a positive contribution to society.” See Exhibit D hereto.

11.
While there may be links between ESG issues and financial performance over the long term, it seems clear that some ESG benefits will have little or no real impact on financial performance and may, in fact, adversely impact financial performance. Of significance is the recent announcement from the Department of Labor cautioning fiduciaries of 401K plans and defined benefit pension plans that they may not sacrifice returns or assume greater risks to promote collateral ESG policy goals when making investment decisions. See Exhibit E hereto. Also of note, a recent NASD survey found that boards of directors do not put a lot of emphasis on ESG issues, see Exhibit F hereto, and a recent Wall Street Journal article cited a study that found that a CEO’s commitment to socially responsible initiatives increases the likelihood that the CEO will be fired in bad times. See Exhibit G hereto.

There is little doubt that in today’s hostile political environment with capitalism held in such low regard, boards will be pushed to sacrifice financial results for the common good. That seems like a fundamental challenge to bedrock concepts of corporate governance. Stay tuned.

5. Corporate Culture. Closely related to the focus on other constituencies and ESG issues is a developing interest in the “culture” of the company. Once gain the interest in a corporation’s culture is driven in part by high profile failures, with Wells Fargo being a prime example. As discussed in Exhibit H hereto, General Electric’s recent struggles are being attributed to some extent to cultural challenges.

Another source for the increased focus is the recognition that the rapidly and constantly changing environment puts pressure on an entity’s culture. Focusing on the challenge faced by Facebook relating to the unauthorized use of its data, one commentator stated:

“Values are more vital now than ever because sustainable values are what anchor us in a storm, and because values propel and guide us when our lives are profoundly disrupted. They help us make the hard decisions. Hard decisions abound because everything is now connected. The world is fused. So there is no place anymore to stand on the side and claim neutrality – to say ‘I am just a businessperson’ or ‘I am just running a platform.’ No way…The business of business is now society. And therefore, how you take or don’t take responsibility for what your technology enables or for what happens on your platform is
inescapable. This is the emerging expectation of users – real people – who have entrusted so much of their inner lives to these powerful companies.” Thomas Friedman, NYT, March 28, 2018 (quoting Dov Seidman).

Few would argue that culture is not important. But a meaningful evaluation of a corporation’s culture is hard to achieve. The task is hard for a corporate board and even harder for a significant institutional shareholder. Some have emphasized the importance of developing and using a series of non-financial metrics to measure culture. See Exhibit I hereto. Also helpful are a series of recommendations of the 2017 NACD Blue Ribbon Commission. See Exhibit J hereto.

Relationship Between Directors and Large Shareholders.

We close by noting that all of the foregoing trends in corporate governance also have led to a significant change in the relationship between Boards and the corporation’s largest shareholders. Until recently any communication between the company and any of its shareholders was considered to be the sole province of the CEO and his or her management team. Corporations typically had a policy in place that any inquiries to a director were to be referred to the CEO as the sole spokesperson for the company.

Today, most publicly traded boards recognize that there are some issues in which institutional shareholders have an interest and for which the appropriate company voice is the lead director or another independent director rather than the CEO. For example, if a large shareholder has concerns about the CEO’s compensation or the CEO’s performance, the CEO is not the appropriate spokesperson for the company. A company’s plan of succession is another example of an issue that is best left to the lead director rather than the CEO.

More recently some boards have recognized that, in light of the power that the company’s larger shareholders possess, ongoing contact between the board and the largest shareholders should be the norm and should be initiated by the company. Regular contact with a large shareholder can instill confidence in the company and its strategic plan that can be of significant value if the company ever needs to seek the shareholder’s support in the context of a proxy fight or other emergency. While the traditional links between the management team and its largest
institutional shareholders has value, more now recognize that also having a link between independent directors and the institutional shareholder's governance representatives is desirable. Note, in this regard, that establishing that contact is easier said than done. Most established shareholders do not have the staff to have regular contact with the many companies in which they invest. As a result, the shareholder's governance representatives naturally focus on companies and situations that require immediate attention.
Sample Exclusive Forum Bylaw for Virginia Corporations

Unless the Corporation consents in writing to the selection of an alternative forum, the [United States District Court for the Eastern District of Virginia, Richmond Division,] [or] [in the event that court lacks jurisdiction to hear such action,] [the Circuit Court of the County of Henrico, Virginia,] shall be the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of duty owed by any current or former director, officer, employee or agent of the Corporation to the Corporation or the Corporation's shareholders, (iii) any action asserting a claim against the Corporation or any current or former director, officer, employee or agent of the Corporation arising pursuant to any provision of the Virginia Stock Corporation Act (as it may be amended from time to time) or the Articles of Incorporation or these Bylaws (as either may be amended from time to time), or (iv) any action asserting a claim against the Corporation or any current or former director, officer, employee or agent of the Corporation governed by the internal affairs doctrine, in all cases subject to one of the courts having personal jurisdiction over the indispensable parties named as defendants. Any person or entity purchasing or otherwise acquiring any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to the provisions of this Article [__]. If any action the subject matter of which is within the scope of this Article [__] is filed in a court other than a court located within the Commonwealth of Virginia (a "Foreign Action") by or in the name of any shareholder, such shareholder shall be deemed to have consented to (i) the personal jurisdiction of the state and federal courts located within the Commonwealth of Virginia in connection with any action brought in any such court to enforce the provisions of this Article [__] and (ii) having service of process made upon such shareholder in any such action by service upon such shareholder's counsel in the Foreign Action as agent for such shareholder. Failure to enforce the foregoing provisions would cause the Corporation irreparable harm and the Corporation shall be entitled to equitable relief, including injunctive relief and specific performance, to enforce the foregoing provisions.
VIRGINIA ACTS OF ASSEMBLY -- 2018 SESSION

CHAPTER 267

An Act to amend and reenact § 13.1-657 of the Code of Virginia, relating to stock corporations; action by shareholders without meeting.

Approved March 9, 2018

[H 1559]

Be it enacted by the General Assembly of Virginia:

1. That § 13.1-657 of the Code of Virginia is amended and reenacted as follows:


A. Action required or permitted by this chapter to be adopted or taken at a shareholders’ meeting may be adopted or taken without a meeting if the action is adopted or taken by all the shareholders entitled to vote on the action, in which case no action by the board of directors shall be required. The adoption or taking of the action shall be evidenced by one or more written consents describing the action taken, signed by all the shareholders entitled to vote on the action, bearing the date of each signature, and delivered to the corporation for inclusion in the minutes or filing with the corporate records.

B. The articles of incorporation may authorize action by shareholders by less than unanimous written consent provided that the taking of such action is consistent with any requirements that may be set forth in the corporation’s articles of incorporation, the bylaws, or this section. For such action, however, unless the articles of incorporation of a public corporation authorize action by shareholders by less than unanimous written consent as of April 1, 2018, the shareholders of the public corporation shall not be entitled to act by less than unanimous written consent even if so authorized by the articles of incorporation if the articles of incorporation or bylaws of such public corporation allow the holders of 30 percent or fewer of all votes entitled to be cast to demand the calling of a special meeting of shareholders. For action by shareholders by less than unanimous written consent to be valid:

1. It shall be an action that this chapter requires or permits to be adopted or taken at a shareholders’ meeting;

2. The corporation’s articles of incorporation shall authorize action by shareholders by less than unanimous written consent and, if a public corporation at the time of such authorization and in addition to the other limitations in this subsection B, the inclusion of the authorization in the articles of incorporation shall be approved by each voting group entitled to vote by the greater of:

   a. The vote of that voting group required by the corporation’s articles of incorporation to amend the articles of incorporation; and

   b. More than two-thirds of all votes that the voting group is entitled to cast on the amendment;

3. Before the holders of more than 10 percent of the outstanding shares of any voting group entitled to vote on the action to be adopted or taken have executed the written consent, the corporation’s secretary shall have received a copy of the form of written consent setting forth the action to be adopted or taken; and

4. The holders of not less than the minimum number of outstanding shares of each voting group entitled to vote on the action that would be required to adopt or take the action at a shareholders’ meeting at which all shares of each voting group entitled to vote on the action were present and voted shall have signed written consents setting forth the action to be adopted or taken.

The written consent shall bear the date on which each shareholder signed the consent and be delivered to the corporation for inclusion in the minutes or filing with the corporate records.

C. If not otherwise fixed under § 13.1-656 or 13.1-660 and if prior board action is not required respecting the action to be adopted or taken without a meeting, the record date for determining the shareholders entitled to adopt or take action without a meeting shall be the first date on which a signed written consent is delivered to the corporation. If not otherwise fixed under § 13.1-656 or 13.1-660 and if prior board action is required respecting the action to be adopted or taken without a meeting, the record date shall be the close of business on the day the resolution of the board taking such prior action is adopted. No written consent shall be effective to adopt or take the action referred to therein unless, within 60 days of the earliest date on which a consent delivered to the corporation as required by this section was signed, written consents signed by the holders of shares having sufficient votes to adopt or take the action have been delivered to the corporation. A written consent may be revoked by a writing to that effect delivered to the corporation before unrevoked written consents sufficient in number to adopt or take the action are delivered to the corporation.

D. A consent signed pursuant to the provisions of this section has the effect of a vote at a meeting and may be described as such in any document. Unless the articles of incorporation, bylaws or a resolution of the board of directors provides for a reasonable delay to permit tabulation of written
consents, the action adopted or taken by written consent shall be effective when (i) written consents signed by the holders of shares having sufficient votes to adopt or take the action are delivered to the corporation or (ii) if an effective date is specified therein, as of such date provided such consent states the date of execution by the consenting shareholder.

E. Any person, whether or not then a shareholder, may provide that a consent in writing as a shareholder shall be effective at a future time, including the time when an event occurs, but such future time shall not be more than 60 days after such provision is made. Any such consent shall be deemed to have been made for purposes of this section at the future time so specified for the consent to be effective, provided that (i) the person is a shareholder at such future time and (ii) the person did not revoke the consent prior to such future time. Any such consent may be revoked, in the manner provided in subsection C, prior to its becoming effective.

F. If this chapter requires that notice of a proposed action be given to nonvoting shareholders and the action is to be adopted or taken by written consent of the voting shareholders, the corporation shall give its nonvoting shareholders written notice of the action not more than 10 days after (i) written consents sufficient to adopt or take the action have been delivered to the corporation, or (ii) such later date that tabulation of consents is completed pursuant to an authorization under subsection D. The notice shall reasonably describe the action adopted or taken and contain or be accompanied by the same material that under any provision of this chapter would have been required to be sent to nonvoting shareholders in a notice of a meeting at which the proposed action would have been submitted to the shareholders for action.

G. If action is adopted or taken by less than unanimous written consent of the voting shareholders, the corporation shall give its nonconsenting voting shareholders written notice of the action not more than 10 days after (i) written consents sufficient to adopt or take the action have been delivered to the corporation or (ii) such later date that tabulation of consents is completed pursuant to an authorization under subsection D. The notice shall reasonably describe the action adopted or taken and contain or be accompanied by the same material that under any provision of this chapter would have been required to be sent to voting shareholders in a notice of a meeting at which the action would have been submitted to the shareholders for action.
2. Shareholder Activism Exacerbates the Short-Term Performance Pressure Felt by Boards.

The impact of short-term performance pressure continues to be acutely felt by boards and management teams. Seventy-four percent of respondents report that management's focus on long-term strategic goals has been compromised by pressure to deliver short-term results, either slightly, somewhat, or to a great extent. This is consistent with last year's findings, when 75% of respondents felt that the impact of short-term pressure undermined a long-term focus, demonstrating that short-termism continues to be a significant driver in today's business environment.

This year's survey reveals that companies which feel the heat of activist investors are more likely to report that short-term pressure compromised their long-term strategic goals compared to organizations that did not receive activist attention. Eighty-five percent of respondents who were approached by an activist over the last 12 months indicate that short-term pressure from external sources compromised management's focus on long-term strategic goals, versus 73% of respondents who did not report an activist approach.

Boards are trying to reduce the threat of excessive management risk-taking to meet or exceed short-term performance targets. Eighty-four percent of respondents report that their compensation committees now balance short- and long-term performance metrics in executive-compensation design, and 83% say they review overall compensation approaches to ensure they drive the right risk-taking behaviors.

At your organization, to what extent has short-term pressure from external sources compromised management's focus on long-term strategic goals?
Client Alert

January 2018

Corporate Governance Update: BlackRock’s Sense of Purpose

On January 16, 2018, BlackRock CEO Larry Fink released his annual letter to CEOs.¹ Mr. Fink traditionally has used this letter to advocate for the governance practices he and BlackRock believe will maximize the long-term value of their clients’ investments. In addition to discussing the key governance issues on which BlackRock will focus its attention in 2018, however, Mr. Fink’s most recent letter argues that companies must “serve a social purpose” and show how they make a “positive contribution to society.” This is a significant change from the traditional, shareholder-centric view of corporate purposes, but BlackRock, as the world’s largest investment firm, is uniquely positioned to ensure companies consider its concerns.

BlackRock’s Evolving View of Corporate Governance and Corporate Purposes

BlackRock—along with other prominent institutional investors like Vanguard and State Street—views good corporate governance practices as critical to protecting the perpetual investments it holds in its index funds. In addition, index fund investors often have long-term investment horizons, such as saving for retirement or their children’s education. Active managers can sell the stock of poorly governed companies, but index funds generally must remain invested in all companies comprising the relevant index. For this reason, BlackRock and other institutional investors believe that effective corporate governance is a key component of maximizing long-term shareholder value and investor returns.

In his 2017 letter, Mr. Fink identified certain environmental, social, and governance factors that BlackRock views as important, such as “sustainability of the business model and its operations, attention to external and environmental factors that could impact the company, and recognition of the company’s role as a member of the communities in which it operates.” In this year’s letter, however, Mr. Fink goes a small but significant step further. He now argues that:

Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

The New York Times recently wrote that Mr. Fink’s letter may be “[a] watershed moment on Wall Street, one that raises all sorts of questions about the very nature of capitalism.”² This is because Mr. Fink’s focus on societal contributions departs from the traditional view that corporations exist to maximize

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shareholder value. Consider, for example, the following explanation of corporate purposes from one notable court decision:

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.3

As a result of this and many other decisions over the last century,4 corporations and their directors typically focus on a single goal: to maximize shareholder value. Of course, they can take actions to benefit their employees, communities, or other constituencies, which are typically protected by the business judgment rule. But such actions are generally taken on the basis that they ultimately help increase shareholder value. Beyond providing the public with a valuable good or service, for-profit corporations generally do not try to serve a particular social purpose.5

Because BlackRock’s view of corporate governance and corporate purposes—at least as set forth in Mr. Fink’s recent letter—has diverged from the traditional view, companies and their boards will need to consider carefully how to address this important shareholder’s demands.

Developing a Strategy to Achieve Long-Term, Sustainable Financial Performance

To be clear, BlackRock’s goal remains to generate returns for its clients by investing in companies on their behalf. BlackRock therefore is not dismissing the importance of financial performance. Instead, BlackRock is asserting its belief that companies should focus on long-term, sustainable financial performance, which companies can achieve only when they understand the impact of their business on society and the effects that impact can have on their potential for growth. BlackRock expects companies to develop and disclose publicly their “strategic framework for long-term value creation and explicitly affirm that it has been reviewed by [their] board of directors.” BlackRock presumably believes that any such framework should identify the positive impact on society resulting from a company’s operations.

Like other prominent institutional investors,6 BlackRock believes that companies are best served by having a diverse board of directors. The board should be diverse in terms of gender, ethnicity, career experience, and “ways of thinking,” which, Mr. Fink argues, will result in a board less likely to “succumb to groupthink or miss new threats to a company’s business model” and “better able to identify opportunities that promote long-term growth.” Diverse boards will also help companies address environmental, social, and governance matters, which “demonstrates the leadership and good governance that is so essential to sustainable growth.”

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4 E.g., eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010) ("Having chosen a for-profit corporate form, the [company's] directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders.").

5 Benefit corporations, a recently developed twist on the traditional corporate form for companies that intended to produce a public benefit that is identified specifically in their articles of incorporation, are a notable exception to this general rule.

6 See, e.g., Press Release, New York City Comptroller, Comptroller Stringer, NYC Pension Funds Launch National Boardroom Accountability Project Campaign — Version 2.0 (Sept. 8, 2017), available at https://comptroller.nyc.gov/newsroom/press-releases/comptroller-stringer-nyc-pension-funds-launch-national-boardroom-accountability-project-campaign-version-2-0/ (describing a new campaign to "ratchet up the pressure on some of the biggest companies in the world to make their boards more diverse, independent, and climate-competent, so that they are in a position to deliver better long-term returns for investors").
Developing a strategic framework to address environmental, social, and governance matters and to describe a company’s social purpose and positive contribution to society will require careful deliberation by management and boards of directors. Open issues to consider include, among others:

- how BlackRock may apply its new view across different industries, particularly where companies have a naturally shorter (e.g., technology companies) or longer (e.g., utility companies) investment horizon;
- how much patience BlackRock will have if a company’s short-term financial performance suffers while the company focuses on long-term value creation;
- whether BlackRock will, in practice, vote consistently in support of companies taking a long-term outlook;
- whether BlackRock will be able to monitor compliance with its new expectations; and
- what BlackRock will view as an acceptable social purpose or positive contribution to society.

Importance of BlackRock’s New View

Mr. Fink’s letter cannot be dismissed as mere rhetoric. With assets under management approaching $6.3 trillion at the end of 2017, BlackRock is the world’s largest investment firm. A majority of its assets are invested in index funds and, as a result, BlackRock is one of the largest investors in most U.S. public companies. And importantly, it seems clear from Mr. Fink’s letter that BlackRock intends to hold companies accountable if they fail to address its demands.

"Without a sense of purpose," Mr. Fink writes, companies "will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives." He goes on to argue that "companies who have not already developed and explained their plans will find it difficult to defend against [activist] campaigns." This is a not-so-subtle threat that companies without a clearly articulated strategy for long-term value creation—as publicly disclosed and affirmatively endorsed by the board—may find BlackRock supporting an activist investor who can explain its plan to generate returns for shareholders. Last year, for example, BlackRock reportedly voted in favor of 18% of all activist-led proposals in proxy fights, which included supporting activist hedge funds in proxy contests at Procter & Gamble and ADP, and also voted in favor of a proposal to enhance climate change disclosure after a company failed to provide sufficient information regarding its long-term strategy and risks related to that issue.?

Conclusion

Although BlackRock and other institutional investors have often emphasized the importance of a long-term outlook, Mr. Fink’s most recent letter demands that companies also address how their business practices affect society. This is a small but significant change that will require management and boards to consider not just how to maximize shareholder value, but also how to demonstrate the contribution to society made by their company as it pursues long-term, sustainable financial performance. Companies and directors should be prepared to address these matters as they engage with BlackRock and other long-term institutional shareholders.

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WASHINGTON, DC – The U.S. Department of Labor's Employee Benefits Security Administration (EBSA) today released a Field Assistance Bulletin (FAB) providing guidance to EBSA's national and regional offices regarding proxy voting, shareholder engagement, and economically targeted investments by fiduciaries of private-sector employee benefit plans covered by the Employee Retirement Income Security Act (ERISA).

The FAB clarifies earlier interpretations set forth in Interpretive Bulletins (IB) 2015-01 and 2016-01. In IB 2015-01, the Department held that fiduciaries may not sacrifice returns or assume greater risks to promote collateral environmental, social, or corporate governance (ESG) policy goals when making investment decisions. In IB 2016-01, the Department addressed issues surrounding written statements of investment policy, proxy voting, and other exercises of shareholder rights by fiduciaries when managing plan assets that are corporate stock.

ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. The FAB announced today advises that fiduciaries of ERISA-covered plans must avoid too readily treating ESG issues as being economically relevant to any particular investment choice. It further advises that ERISA does not necessarily require plans to adopt investment policy statements with express guidelines on ESG factors. The FAB addressed issues that arise in the use of ESG-themed investment alternatives in 401(k)-type plans, and as qualified default investment alternatives. The FAB also clarifies that plan fiduciaries (including investment managers) may not routinely incur significant plan expenses to pay for the costs of shareholder resolutions or special shareholder meetings, or to initiate or actively sponsor proxy fights on environmental or social issues.

The FAB is part of the Department's ongoing compliance assistance program to help employers, plan officials, service providers, and others comply with ERISA. All FABs are publicly available at www.dol.gov/ebsa.

EBSA News Release: 04/23/2018
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Memorandum For: Mabel Capolongo, Director of Enforcement
Regional Directors

From: John J. Canary
Director of Regulations and Interpretations

Subject: Interpretive Bulletins 2016-01 and 2015-01

This Field Assistance Bulletin provides guidance to the Employee Benefits Security Administration's national and regional offices to assist in addressing questions they may receive from plan fiduciaries and other interested stakeholders about Interpretive Bulletin 2016-01 (relating to the exercise of shareholder rights and written statements of investment policy), and Interpretive Bulletin 2015-01 (relating to "economically targeted investments" (ETIs)).

Background

Title I of the Employee Retirement Income Security Act of 1974 (ERISA) establishes minimum standards that govern the operation of private-sector employee benefit plans, including fiduciary responsibility rules. The Department's longstanding position is that the fiduciary act of managing plan assets that involve shares of corporate stock includes making decisions about voting proxies and exercising shareholder rights. To assist plan fiduciaries in understanding their obligations under ERISA, the Department issued IB 2016-01. The Department has a similarly longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals. IB 2015-01 contains the Department's interpretation of ERISA sections 403 and 404 as applied to employee benefit plan investments in economically targeted investments (that is, investments selected for the economic benefits they create apart from their investment return to the employee benefit plan).

ESG Investment Considerations

In General

In IB 2015-01, the Department reiterated its longstanding view that, because every investment necessarily causes a plan to forego other investment opportunities, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals. IB 2015-01 also reiterated the view that when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral considerations as tie-breakers for an investment choice. The preamble of IB 2015-01 added: "If a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from environmental, social and governance [(ESG)] factors, the fiduciary may make the investment without regard to any collateral benefits the investment may also promote."

In making that observation, the Department merely recognized that there could be instances when otherwise collateral ESG issues present material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories. In such situations, these ordinarily collateral issues are themselves appropriate economic considerations, and thus should be considered by a prudent fiduciary along with other relevant economic factors to evaluate the risk and return profiles of alternative investments. In other words, in these instances, the factors are more than mere tie-breakers. To the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors.

Fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision. It does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors. Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives.

In IB 2016-01, the Department noted that investment policy statements are permitted to include policies concerning the use of ESG factors to evaluate investments, or on integrating ESG-related tools, metrics, or analyses to evaluate an investment's risk or return. That discussion in the IB does not reflect a view that investment policy statements must contain guidelines on ESG investments or integrating ESG-related tools to comply with ERISA. Moreover, the IB does not imply that if an investment policy statement contains such guidelines then fiduciaries managing plan assets, including appointed ERISA section 3(38) investment managers, must always adhere to them. A statement of investment policy is part of the "documents and instruments governing the plan" within the meaning of ERISA section 404(a)(1)(D), and an investment manager or other plan fiduciary to whom such an investment policy applies is required to comply with the policy, but only so far as the policy is consistent with Titles I and IV of ERISA (including the core fiduciary obligations of prudence and loyalty). Thus, if it is imprudent to comply with the investment policy statement in a particular instance, the manager must disregard it.

Investment Alternatives in 401(k)-Type Plans and Qualified Default Investment Alternatives

The Department explained in the preamble to IB 2015-01 that the standards set forth in sections 403 and 404 of ERISA apply to a fiduciary's selection of an investment fund as a plan investment or, in the case of an ERISA section 404(c) plan or other individual account plan, a designated investment alternative under the plan. In the case of an investment platform that allows participants and beneficiaries an opportunity to choose from a broad range of investment alternatives, adding one or more funds to a platform in response to participant requests for an investment alternative that reflects their personal
values does not necessarily result in the plan forgoing the placement of one or more other non-ESG themed investment alternatives on the platform. Rather, in such a case, a prudently selected, well managed, and properly diversified ESG-themed investment alternative could be added to the available investment options on a 401(k) plan platform without requiring the plan to remove or forgo adding other non-ESG-themed investment options to the platform. In the case of a qualified default investment alternative (QDIA), however, selection of an investment fund is not analogous to merely offering participants an additional investment alternative as part of a prudently constructed lineup of investment alternatives from which participants may choose. Nothing in the QDIA regulation suggests that fiduciaries should choose QDIAs based on collateral public policy goals. In the QDIA context, the decision to favor the fiduciary’s own policy preferences in selecting an ESG-themed investment option for a 401(k)-type plan without regard to possibly different or competing views of plan participants and beneficiaries would raise questions about the fiduciary’s compliance with ERISA’s duty of loyalty. Even if consideration of such factors could be shown to be appropriate in the selection of a QDIA for a particular plan population, however, the plan’s fiduciaries would have to ensure compliance with the guidance in IB 2015-01. For example, the selection of an ESG-themed target date fund as a QDIA would not be prudent if the fund would provide a lower expected rate of return than available non-ESG alternative target date funds with commensurate degrees of risk, or if the fund would be riskier than non-ESG alternative available target date funds with commensurate rates of return.

Shareholder Engagement Activities

The Department’s longstanding view is that plan fiduciaries should engage in traditional and customary proxy voting activities in discharging their fiduciary obligation to prudently manage plan investments. The Department observed in the preamble to IB 2016-01 that, in most cases, proxy voting and other shareholder engagement does not involve a significant expenditure of funds by individual plan investors because the activities are undertaken by institutional investment managers that are appointed as the responsible plan fiduciary pursuant to ERISA sections 402(c)(3), 403(a)(2), and 3(38). The IB noted further that investment managers often engage consultants, including proxy advisory firms, to further reduce individual plan costs of researching proxy matters and exercising shareholder rights.

In IB 2016-01, the Department stated that an investment policy that contemplates engaging in shareholder activities that are intended to monitor or influence the management of corporations in which the plan owns stock can be consistent with a fiduciary’s obligations under ERISA, if the responsible fiduciary concludes there is a reasonable expectation that such activities (by the plan alone or together with other shareholders) are likely to enhance the economic value of the plan’s investment in that corporation after taking into account the costs involved. In fact, it is increasingly common for investment managers to include proxy voting and shareholder engagement guidelines in their investment policy statements. IB 2016-01 further states that, in various circumstances, plans may have a reasonable expectation that such activities are likely to enhance the value of the plan’s investments after taking into account the costs. For example, investment managers often engage with companies to learn about corporate governance practices, or company actions to manage its environmental risks, human capital, facilities, stakeholder relations, and long-term access to critical resources. Other common communications are to share significant concerns about board profiles, related-party transactions, executive compensation, the corporation’s long-term business plans, or to discuss overarching principles that the investment manager applies to proxy voting decisions.

All that language in the IB should be read in the context of the Department’s observation that proxy voting and other shareholder engagement typically does not involve a significant expenditure of funds by individual plan investors because the activities are generally undertaken by institutional investment managers that are appointed as the responsible plan fiduciary pursuant to ERISA sections 402(c)(3), 403(a)(2), and 3(38). The IB was not intended to signal that it is appropriate for an individual plan investor to routinely incur significant expenses to engage in direct negotiations with the board or management of publicly held companies with respect to which the plan is just one of many investors. Similarly, the IB was not meant to imply that plan fiduciaries, including appointed investment managers, should routinely incur significant plan expenses to, for example, fund advocacy, press, or mailing campaigns on shareholder resolutions, call special shareholder meetings, or initiate or actively sponsor proxy fights on environmental or social issues relating to such companies.

The Department noted in the IB that there may be circumstances, for example involving significantly indexed portfolios and important corporate governance reform issues, or other environmental or social issues that present significant operational risks and costs to business, and that are clearly connected to long-term value creation for shareholders with respect to which reasonable expenditure of plan assets to more actively engage with company management may be a prudent approach to protecting the value of a plan’s investment. But, as stated in the preamble to IB 2016-01, “[t]he Department has rejected a construction of ERISA that would render ERISA’s tight limits on the use of plan assets illusory and that would permit plan fiduciaries to expend trust assets to promote myriad public policy preferences. Rather, plan fiduciaries may not increase expenses, sacrifice investment returns, or reduce the security of plan benefits in order to promote collateral goals.”

If a plan fiduciary is considering a routine or substantial expenditure of plan assets to actively engage with management on environmental or social factors, either directly or through the plan’s investment manager, that may well constitute the type of “special circumstances” that the IB 2016-01 preamble described as warranting a documented analysis of the cost of the shareholder activity compared to the expected economic benefit (gain) over an appropriate investment horizon.

You may direct any questions about this Field Assistance Bulletin to the Division of Fiduciary Interpretations, Office of Regulations and Interpretations at (202) 693-8510.

Footnotes

1. Interpretive Bulletin 2016-01 (IB 2016-01), including a preamble, was published in the Federal Register at 81 FR 95379 (Dec. 29, 2016), and is codified at 29 CFR § 2509.2016-01. In 1994, the Department of Labor issued its first Interpretive Bulletin 94–2 (IB 94–2) on this subject which collected and summarized views the Department previously expressed in several interpretive letters. In 2008, the Department replaced IB 94–2 with Interpretive Bulletin 2008–2 (IB 2008-2). The Department’s intent was to clarify and update the guidance in IB 94–2, and to reflect interpretive positions issued after 1994 on shareholder activism and socially-directed proxy voting initiatives. In 2016, the Department replaced IB 2008-2 with IB 2016-01.
2. Interpretive Bulletin 2015-01 (IB 2015-01), including a preamble, was published in the Federal Register at 80 FR 65135 (Oct. 28, 2015), and is codified at 29 CFR § 2509.2015-01. The Department's guidance in this area went through a similar iterative process as IB 2016-01. Specifically, the Department issued its first Interpretive Bulletin in 1994, Interpretive Bulletin 94–1 (IB 94–1). In 2008, the Department replaced IB 94–1 with Interpretive Bulletin 2008–1 (IB 2008-01). In 2015, the Department replaced IB 2008-1 with IB 2015-01.

3. 80 FR 65135, 65136.

4. Investment policy statements are frequently adopted by plans, often as part of the plan's engagement of an ERISA section 3(38) investment manager. An investment policy is a written statement that provides investment managers and other plan fiduciaries responsible for plan investments with guidelines or general instructions concerning investment management decisions, including proxy voting. The creation and adoption of an investment policy is itself an exercise of fiduciary responsibility, which is subject to ERISA's fiduciary duties.

5. ERISA section 404(a)(1)(D) provides that plan fiduciaries shall discharge their duties in accordance with the "documents and instruments governing the plan" as such documents and instruments are consistent with the provisions of Titles I and IV of ERISA.

6. In other words, in deciding whether and to what extent to make a particular fund available as a designated investment alternative, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to designate an investment alternative may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value, would be equal to or superior to alternative available investments. For example, a plan fiduciary could adopt an investment policy statement with prudent criteria for selection and retention of designated investment alternatives for an individual account plan that were based solely on economic factors, and apply that policy to all investment options, including potential ESG-themed funds. See also Advisory Opinion 98-04A (regarding application of predecessor to IB 2015-01 to the selection of a "socially responsible" mutual fund as an investment alternative in a 401(k) plan).

7. The Department's QDIA regulation at 29 CFR § 2550.404c-5 establishes conditions under which a participant or beneficiary in a participant-directed individual account plan will be deemed to have exercised control over assets in his or her account when, in the absence of investment directions from the participant or beneficiary, the plan invests all or part of a participant's or beneficiary's account in a QDIA. When a plan complies with the regulation, plan fiduciaries are not liable under Part 4 of ERISA for any loss or by reason of any breach which results from such participant's or beneficiary's exercise of control, but the plan fiduciaries remain responsible for the prudent selection and monitoring of the QDIA. The QDIA regulation describes the attributes necessary for an Investment fund, product, model portfolio, or managed account to be a QDIA. Each of the QDIA categories requires that the investment fund, product, model portfolio, or investment management service apply generally accepted investment theories, be diversified so as to minimize the risk of large losses, and be designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures.

8. For purpose of this bulletin, ESG-themed funds (e.g., Socially Responsible Index Fund, Religious Belief Investment Fund, or Environmental and Sustainable Investment Fund), should be distinguished from non-ESG-themed investment funds in which ESG factors may be incorporated in accordance with IB 2015-01 and IB 2016-01 as one of many factors in ordinary portfolio management and shareholder engagement decisions.

9. 81 FR 95879, 95881.

10. Id. at 95881. As noted above, a statement of investment policy, including policies on proxy voting or shareholder engagement, is part of the "documents and instruments governing the plan" within the meaning of ERISA section 404(a)(1)(D), and an investment manager or other plan fiduciary to whom such an investment policy applies is required to comply with the policy, but only insofar as the policy is consistent with Titles I and IV of ERISA (including the core fiduciary obligations of prudence and loyalty). Thus, if it is imprudent to comply with a proxy voting or shareholder engagement policy in a particular instance, the plan fiduciary must disregard it and act in accordance with fiduciary obligations under ERISA. ERISA does not shield investment managers or other fiduciaries from liability for imprudent actions taken in compliance with a statement of investment policy.
MAJOR FINDINGS

Highlights of the 2017–2018 Public Company Governance Survey


Significant industry change was selected by 58% of respondents as one of the five trends likely to have the greatest impact on their companies in 2018. When asked to break down the key drivers of change in their industries, respondents most frequently mentioned technology disruption, industry consolidation, and shifting regulations. In light of major industry change, it is notable that industry experience is the most desirable attribute that boards look for in new director candidates. They will need to carefully assess if the past industry experience of candidates is still relevant for the company’s future needs.

Business model disruption and competition for increasingly scarce talent—which contribute to major industry upheaval—are also ranked among the top five 2018 trends, suggesting boards are concerned about a dramatic transformation in how enterprise value is created and their companies’ ability to effectively adapt.

Perhaps not unexpectedly in light of the Trump administration’s focus on repealing or softening federal regulations, respondents’ concerns about the impact of the regulatory burden dropped significantly, from 58% in 2016 to just 29%. However, a lower regulatory burden in the United States may be offset by proliferating compliance requirements and heightened regulatory enforcement in other markets—specifically, in the European Union and China.

Similar to the results in last year’s survey, very few boards consider social and environmental issues as top trends that will impact business performance over the next 12 months. Just 6% of respondents selected climate change as a top-five trend for 2018, while only 2% believe the changing role of business in society is a key trend impacting their company. This suggests that most boards continue to see these challenges as peripheral to near-term business success, despite increased expectations about corporate sustainability from investors and declining trust in business among the broader public. In fact, only 24% of respondents consider it important or very important that their board improve oversight of ESG matters in 2018.

What five trends do you foresee having the greatest effect on your company over the next 12 months? (Respondents could select five of the 17 issues below.)

- Significant industry change: 58%
- Business model disruption: 46%
- Changing global economic conditions: 46%
- Cybersecurity threats: 38%
- Competition for talent: 36%
- Political uncertainty in the United States: 35%
- Technology disruption: 33%
- Corporate tax reform in the United States: 30%
- Increased regulatory burden: 29%
- Rise in M&A: 24%
- Shift in consumer spending and behaviors: 22%
- Investor activism: 14%
- Global security threats: 13%
- Deregulation: 8%
- Climate change: 6%
- Shifting workforce demographics: 6%
- The role of business in society: 2%
When The Good Goes Bad For CEOs

BY VANESSA FURMANSKI

CEOs beware: Being a do-gooder could get you fired.
Many corporate chiefs argue companies should be good corporate citizens. From Starbucks Corp. Chairman Howard Schultz to Unilever PLC Chief Executive Paul Polman, leaders variously promote efforts to reduce company carbon footprints, work with sustainable suppliers, and produce healthier products.

"My personal mission is to galvanize our company to be an effective force for good," Mr. Polman says on his LinkedIn page.
But a new study shows that socially responsible initiatives can be a double-edged sword for CEOs, helping to shield them from being ousted during more prosperous times but increasing the likelihood they would be fired in bad times.
Examing the exits of Fortune 500 company bosses over several years, researchers found that those who heavily invested company resources in good corporate citizenship were 84% more likely to be fired amid sluggish financial results than CEOs at poor-performing companies that spent less on do-good initiatives.
On the flip side, spending on corporate social responsibility acted as a protective buffer for company chiefs who presided over robust profitability. They were 53% less likely to be ousted than other leaders of high-performing companies that didn't invest so much in measures to bolster social welfare, according to the study, published in the November issue of Strategic Management Journal.
‘Success Theater’
Masked Rot at GE

Under Immelt, disdain for bad news led to overoptimistic forecasts, botched strategies

Jeffrey Immelt, the longtime boss at General Electric Co., was a polished presenter who held court each year at a waterfront resort off Sarasota, Fla., where industrial executives and Wall Street listened for his outlook on the conglomerate.

“This is a strong, very strong company,” Mr. Immelt said at the event last May. On that Wednesday morning, he looked shaky to some people in attendance, quickly going through highlights of 27 slides in the ballroom of the Resort at Longboat Key Club. He defended his long-held 2018 profit goal, an optimistic benchmark Wall Street had long abandoned.

“It’s not crap. It’s pretty good really,” he told the skeptical room, referring to GE’s recent financial performance. “Today, when I think about where the stock is compared to what the company is, it’s a mismatch.”

It was a mismatch. On that day, GE shares were trading near $28. They would go on to collapse over the next six months while the stock market set fresh records. Today, they trade below $15.

Please see GE page A8.
GE

GE’s precarious fall, following years of treading water while the overall economy grew, was exacerbated, some insiders say, by the fact that they call “success thievery.” Mr. Immelt and his top deputies projected an optimism about GE’s business and its future that did not always match the reality of its operations or its markets, according to more than a dozen current and former executives, investors and people close to the company.

This culture of confidence trickled down from the top, yet even affected how those gaining to succeed Mr. Immelt ran their business units, some of these people said, with consequences that led to more than a dozen massive financial targets, missed bets on markets and sometimes poor decisions on how to deploy cash.

“The issue for GE is to selectively provide enough information,” said Deutsche Bank analyst John Inch, who has a “sell” rating on the stock. “There is a growing gap between what they say and the reality of what is going on.”

Within weeks of the May meeting, Mr. Immelt announced his retirement. By year-end, GE’s under a new leader had cut its dividend in half and triggered a restructuring that is expected to eliminate thousands of jobs and cost off more than $20 billion of assets. Today, federal regulators are reviewing GE’s accounting for certain transactions, and new CEO John Flannery is breaking up the 125-year-old company.

The tumble is stark for a company that embodied the managerial success of American business and its industrial might. Few knew how badly selling the oil business and other key assets to buy more oil businessGE’s former CEO Mr. Immelt said he didn’t realize the depth of problems in the biggest division. GE Power and Water, which had 51,000 employees as of last quarter, GE reported lower revenue and was charged to a related reserve for its industrial sector, a loss of nearly $2 billion.

“Many of us are in some level of shock,” said Mark Lowey, the company’s general counsel and director. Investigations are under way inside GE seeking to find out how it all happened.

“GE through multiple initiatives has taken the lead, in energy, in the global financial crisis. Our leadership team always focused on the task at hand,” Mr. Immelt, 63 years old, said in a written statement. “Because we had a culture of debate and external competitiveness. GE built a set of industrial businesses that lie in their market share.”

At a conference in November, Mr. Immelt said he was “fully confident that this company is going to thrive in the future.”

A spokesman for the former CEO pointed to his decision to purchase $8 million worth of GE shares in 2016 and 2017. That included 100,000 shares in May at a price roughly twice current levels. Former GE Chief Financial Officer Keith Sherin said Mr. Immelt would “continue to approach a problem with his team, consider multiple viewpoints and communicate regularly with the board.” “I never felt

A Bleak Stretch

GE sales, profitability and shares all fall during Jack Immelt’s 13-year tenure as CEO. Its stock-market value has plunged.

<table>
<thead>
<tr>
<th>Total revenue</th>
<th>Net income</th>
<th>Stock price</th>
<th>Market cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>$200 billion</td>
<td>$7 billion</td>
<td>$17 dollar</td>
<td>$200 billion</td>
</tr>
</tbody>
</table>

Mr. Immelt’s predecessor, Jack Welch, delivered steady profit growth in the 1980s and 1990s. He built a huge leveraged business called GE Capital that generated endless profits—but nearly sank the company during the financial crisis on Mr. Welch’s watch.

When GE later said some of GE Capital, Mr. Immelt laid out a strategy in which industrial businesses would grow enough to offset the cash flow from the financial unit, so that long-term financial projections and the dividend were sustainable. Instead, free cash flow wasn’t enough to cover dividends for years.

Mr. Immelt ramped up research and hiring $5 billion of programmers to develop software for GE machinery. Results were weak at sales and cash-plummeted at the oil and power units. Acquiring companies that help drillers pump transmission

A $10 billion deal for a turbine business just as that market was cooling.

Mr. Immelt’s predecessor, Jack Welch, delivered steady profit growth in the 1980s and 1990s. He built a huge leveraged business called GE Capital that generated endless profits—but nearly sank the company during the financial crisis on Mr. Welch’s watch.

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SEC inquiry

The Securities and Exchange Commission is examining its revenue recognition policies under current CEO Jeff Immelt.

The agency is also seeking information about a recent GE review of its insurance business, which reviewed billions of dollars in sales transactions, according to people familiar with the matter.

GE declined to comment on the SEC investigation or the review of its insurance business.

“SEC investigation is ongoing, and we are in discussions with the SEC,” a GE spokeswoman said. Mr. Immelt is expected to retire early next year. It’s unclear whether the SEC is seeking an interview with the new CEO.

Jeff Immelt, left, former power division chief Steve Bolze and

Stock market

Source: Standard & Poor’s, Dealogic, Mergermarket, Greenhill & Co., and Thomson Reuters. pipe turbomachinery, said Mr. Sherin.

Costly buybacks

But Mr. Immelt didn’t like hearing bad news, said several executives who worked with him, and didn’t like delivering bad news, either. He wanted people to make their sales and earnings numbers no matter what, so he thought he could make the numbers, too, they said.

The optimism was evident in how he and the board talked about GE over the past three years. GE spent more than $8 billion on share repurchases, and made a profit of about $80 billion, twice the current level. The company included billions of dollars spent less than a year before. GE’s profits were depressed, strapped for cash last fall.

“Trian Fund Management LP, which invested $5.5 billion in GE in 2015, wanted to buy GE more and activist investor urged the company to borrow $10 billion for repurchases (which it didn’t do), based on a belief that the profits made by Mr. Immelt was promising would send the stock soaring when they arrived. Instead, at GE’s 2017 presentation in August the stock was below its level when it took over 16 years earlier. Including dividends, GE gained 8% with Mr. Immelt at the helm, while the S&P 500 rose 38%. Since he stepped down, the stock has lost about 43%, creating almost $44 billion in market value.

The relationship with Trian deteriorated and the firm successfully pushed for a board seat.

Mr. Immelt’s successor, Mr. Flannery, in November slashed GE’s financial targets. Instead, at $5 a share. Super-pressed $1.07, it now expects to be at the lower end of that range. Given no one is now Mr. Immelt’s team, and employees want us to focus on the future. We are building a stronger, simpler GE,” Mr. Flannery said in a statement. “In the last decade, the GE team built a number of excellent businesses.”

Several directors discussed in November whether the entire board should be fired, according to people familiar with the meeting. Instead, what had been an 18-person board would lose half its members but add three new directors in coming months.

In 2000, GE’s $10 billion deal for a turbine business just as that market was cooling.

Mr. Immelt’s predecessor, Jack Welch, delivered steady profit growth in the 1980s and 1990s. He built a huge leveraged business called GE Capital that generated endless profits—but nearly sank the company during the financial crisis on Mr. Welch’s watch.

When GE later said some of GE Capital, Mr. Immelt laid out a strategy in which industrial businesses would grow enough to offset the cash flow from the financial unit, so that long-term financial projections and the dividend were sustainable. Instead, free cash flow wasn’t enough to cover dividends for years.

Mr. Immelt ramped up research and hiring $5 billion of programmers to develop software for GE machinery. Results were weak at sales and health care unit. But sales and profits slumped at the oil and power units. Acquiring companies that help drillers pump transmission
Nonfinancial metrics are increasing in prevalence and importance. For example, 82 percent of S&P 500 companies published a sustainability report in 2016, and 71 percent of executives in a recent poll said communication to the marketplace about purpose, values, and vision was of equal or greater importance than financial results.¹ In this environment, choosing which nonfinancial measures to use to assess and communicate company performance has become an increasingly critical task for management teams and boards of directors. When carefully selected, monitored, and well understood, nonfinancial metrics that reflect a company's key value drivers can help provide employees, executives, directors, and external stakeholders a fuller picture of performance and progress toward achieving the company's strategic goals, compared with traditional financial metrics alone.

"Given the degree of transformation that virtually every company is facing, tracking progress is increasingly critical for boards and senior management teams. They need information over and above the usual financial data," said Larry Costello, former executive vice president and chief human resources officer at Tyco International. "They need stronger 'surround sound,' and it's nonfinancial metrics that add that dimension."

On October 19, 2017, the National Association of Corporate Directors (NACD), Farient Advisors, Katten Muchin Rosenman LLP, KPMG LLP, and Sidley Austin LLP cohosted a joint meeting of the NACD Audit Committee Chair Advisory Council and the NACD Compensation Committee Chair Advisory Council. At the session, audit and compensation committee chairs from Fortune 500 corporations discussed the key issues and challenges associated with the selection and use of nonfinancial metrics at the board level. Three key takeaways emerged from the discussion.

1. Link nonfinancial metrics to strategic and cultural objectives.
2. Data quality oversight is a challenge; audit committees can leverage internal audit in the oversight of the quality of nonfinancial data.
3. Compensation committees are focusing on the role nonfinancial metrics play in compensation plan design and in eventual payouts.

Link nonfinancial metrics to strategic and cultural objectives.

Meeting participants agreed that, as one director put it, choices about nonfinancial metrics "should arise organically out of discussions about strategy. What do we need, as a company, to support effective execution?" For example, depending on the company’s business and industry, metrics related to talent, product innovation, customer satisfaction, culture, or sustainability might be considered key for measuring performance. (See sidebar below for more on the types of nonfinancial metrics used by boards when setting executive pay. See Appendix A on p. 7 for key questions for the board to ask about the use of nonfinancial metrics.)

“We are seeing the use of non-financial metrics trend up at companies across all industries, as they help to paint a more ‘holistic’ view of performance, says John V. Trentacoste, partner, Farien Advisors. “However, while investors are supportive of these metrics popping up into pay plans, investors require strong disclosure regarding their inclusion and on the payout related to these non-financial metrics.”

**What are the key nonfinancial metrics used by your board to set CEO pay?**

<table>
<thead>
<tr>
<th>Metric</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee engagement/morale</td>
<td>37%</td>
</tr>
<tr>
<td>Risk management effectiveness</td>
<td>34%</td>
</tr>
<tr>
<td>Customer satisfaction</td>
<td>33%</td>
</tr>
<tr>
<td>Maintaining good standing with regulators</td>
<td>28%</td>
</tr>
<tr>
<td>Regulatory compliance record</td>
<td>27%</td>
</tr>
<tr>
<td>Workplace safety</td>
<td>27%</td>
</tr>
<tr>
<td>Product quality</td>
<td>27%</td>
</tr>
<tr>
<td>Measures related to environmental/CSR</td>
<td>11%</td>
</tr>
<tr>
<td>Workplace diversity</td>
<td>11%</td>
</tr>
<tr>
<td>Employee turnover</td>
<td>11%</td>
</tr>
<tr>
<td>Other</td>
<td>15%</td>
</tr>
<tr>
<td>Nonfinancial measures not used</td>
<td>20%</td>
</tr>
</tbody>
</table>


3 Italicized comments are from delegates or guests who participated in either the meeting on Oct. 19, 2017, or a related teleconference on Oct. 25, 2017. Discussions were conducted under a modified version of the Chatham House Rule, whereby names of attendees are published but comments are never attributed to individuals or organizations (except cohosts of the event or, in limited special circumstances, when preapproved by a special guest).
Nonfinancial metrics can also be powerful tools to reinforce a healthy corporate culture. The Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset recommends that boards incorporate cultural criteria into discussions with management about strategy and risk and that they build cultural measures into performance evaluations. Further, the commission emphasizes that “the way directors formulate questions during reviews of business results and operating performance sends an important signal ... [A]n excessive focus on quantifiable gains and losses (whether in terms of revenue, profits, market share, or other measures) can obscure or diminish the importance of purpose, values, and behaviors."³

Delegates viewed the task of nonfinancial metric selection as a joint endeavor between the board and senior leadership, with metrics weighted appropriately based on their importance. One director suggested, “[Board members] need to ask management, ‘What nonfinancial metrics did you choose as the critical few, and why—and also what was left out, and why?’” Board-level review and input is especially important with regard to the subset of nonfinancial measures the company chooses to disclose in external reports and communications: in a recent survey of actively managed investment funds and firms, 70 percent of respondents said they place a medium to strong weight on nonfinancial metrics and characteristics in their decisions to buy or sell a company’s shares.⁴

Several directors pointed out that information from sources outside the company can help the board put nonfinancial performance data into context. Examples include information from customers, suppliers, external reviews of the company, independently conducted surveys, industry associations, and third-party indices (the latter are becoming an increasingly prevalent source of data in the environmental and social governance arena). Boards can also leverage the help of external advisors to provide a cross-industry perspective. “Interpretation [of the data] can be important,” said Jason Vigna, partner at Katten Muchin Rosenman LLP. “The board may need secondary perspectives to help it to look beyond top-line results and figure out what the data means.”

Given the increasing popularity of nonfinancial metrics, meeting participants also highlighted the fact that management teams and directors must avoid the temptation to increase information overload at the board level.

“Nonfinancial measures shouldn’t just be more data and reports for the board to review,” said Costello. “They need to provide insight about how the company is performing against specific goals and the resulting impact on the enterprise.”

Data quality oversight is a challenge; audit committees can leverage internal audit in the oversight of the quality of nonfinancial data.

Delegates emphasized that nonfinancial metrics should not be generalized as “soft” data. In other words, “nonfinancial does not mean non-quantitative.” As one director noted, “There’s lots of rigor that can be applied to [nonfinancial metrics] calculation and use.” Rigor notwithstanding, ensuring the quality and integrity of nonfinancial data, including the controls around it, is essential. Just as they do for financial reporting, directors should ask management how nonfinancial metrics are validated, and audit committees should monitor whether the company’s internal controls around the data are sufficiently robust. “Audit committees will want to consider whether management has clearly defined the company’s key nonfinancial metrics and has assessed the adequacy of its disclosure controls and procedures surrounding these metrics,” said Jose Rodriguez, partner in charge and executive director of KPMG’s Audit Committee Institute.

“It can be especially challenging in large, complex global organizations to collect and aggregate this type of data,” one director explained. Several delegates noted that at their companies, internal audit’s vetting process for the nonfinancial measures used in performance management includes reviews and tests of the sources, data controls, and the accuracy of the numbers.

Compensation committees are focusing on the role nonfinancial metrics play in compensation plan design and in eventual payouts.

When nonfinancial metrics are used in pay plans, it’s important that there is a clear line of sight from each metric to the company’s financial goals, and furthermore, that the rationale for those linkages is clear to investors. “Investors are interested in the logic behind the board’s choices. Why is a particular metric appropriate for your company? How does it affect shareholder value?” one delegate said. Participants also suggested that it’s important for the compensation committee to get interim reports on progress against non-
financial metrics throughout the year, as opposed to only at the end of the performance period: "It allows us to have better discussions and has made the committee more confident in the decisions they're making related to the nonfinancial metrics piece of the plan," one director said. And while "discretion can feel like a four-letter word," compensation committees should not be afraid to adjust payouts either upward or downward if they believe circumstances warrant, but they should be prepared to explain to investors why and how such discretion was used. According to one delegate, "In a series of meetings with our top investors, they made it clear that [they think] discretion is okay, as long as it is not exercised in an indiscriminate way."

Like all performance measures, nonfinancial metrics should be included in risk assessments of the compensation plan to avoid any potential unintended consequences and to help ensure that they reinforce, rather than undermine, the company's culture. In the 2017 Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset, one commissioner noted, "Each year we ask our compensation consultant to do a summary report on the incentive programs at all levels of the company, and identify any aspect of those programs that could be problematic by encouraging high-risk behavior or otherwise damaging the culture. It gives the compensation committee a new level of visibility, and also sends a strong message that the board is paying attention."

Delegates also noted that not every nonfinancial metric belongs in the compensation plan. "There's a menu of nonfinancial metrics companies can use in pay plans. Choosing some and leaving some out are equally important," Trentacoste said. (See Appendix B on p. 8 for a set of questions the board could consider when determining appropriate metrics.) Metrics that are not tied to the pay plan but that are important to the business can be used in other ways as appropriate. Some metrics may be used as modifiers to incentive payouts, providing the board with additional flexibility. "For example, if successful execution of the strategy requires a transformation in the R&D function, the board can identify key milestones for progress in that area and to use as governing criteria on the annual bonus payout," Costello said. One delegate said his company ties certain nonfinancial metrics to CEO evaluations: "We use some nonfinancial goals to round out the board's annual evaluation of the CEO. By not including them in the compensation plan, we avoid over-weighting their importance, but can still send a clear message to the CEO that we're paying attention."

"Inside the company, nonfinancial metrics are powerful tools to focus management's attention and drive change on issues the board believes are important."

—DIRECTOR

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Conclusion

Council participants agreed that although the board shouldn’t dictate which nonfinancial metrics are used to assess company performance, directors should have robust discussions with management regarding their selection and the governance of the data and processes used, as well as updates throughout the year to monitor progress toward their achievement. The board should also understand which metrics will be disclosed, as all of the metrics used to manage the business may not be reported. In addition, directors should ensure that the rationale for any nonfinancial metrics used is clearly communicated to investors, particularly any that are included in executive pay plans.

As one director noted, "Inside the company, nonfinancial metrics are powerful tools to focus management's attention and drive change on issues the board believes are important. Externally, they help communicate to shareholders about how the company is making progress in areas such as sustainability and innovation."

For Further Reading

- NACD, Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset (October 2017)
APPENDIX A

Key Questions to Ask About Nonfinancial Metrics


The following questions will help directors narrow the choice of key metrics to track. To be useful, a metric need not meet all the criteria below, but the more criteria it meets, the more important it will be.

- How does this metric reflect and support our strategy?
- Does this metric reflect a key performance driver for our company?
- What aspects of performance does this metric drive?
- Is this metric used in our executive compensation plans?
- Do we as a board understand how this metric is calculated and why it is used?
- Is this metric commonly used in our industry? Do our competitors use this metric, and if so, how do we compare with them?
- What other metrics does our industry use?
- Do we have information about this metric for past performance periods, and if so, what is the pattern?
- Is the company required to disclose this metric to investors (e.g., under the U.S. Securities and Exchange Commission’s Regulation S-K as part of the annual 10-K filing), and if so, what message does it send?
- Is this metric required by executive branch agencies such as the U.S. Department of Labor or the U.S. Environmental Protection Agency? If so, is our score above or below what is considered desirable?
- Will a low score on this metric bring us negative media and/or shareholder attention?
- Is there good news that the company should promote through its website and media channels?
APPENDIX B

Special Considerations of the Compensation Committee


There are many factors to consider when relating incentive compensation with short- and long-term metrics. Compensation committees, chiefly responsible for this activity, should review some of the following questions:

- Do the chosen performance metrics support the basic strategy? Do they measure the key value drivers?
- Does the required performance fall within the scope of industry performance and economic projections?
- Are the performance metrics incentivizing team work or individual merit?
- Have we reviewed performance metrics as disclosed in our competition's proxy statements?
- What are the weights of varying business units? Have we placed too much emphasis on one particular unit?
- Have we placed too much emphasis on a particular individual performance factor? Have we ensured no one metric dominates?
- Are the metrics able to be communicated externally with respect to legal issues and confidential information?
- Are the short-term bonus metrics supportive of and consistent with long-term metrics?
- What are the pros and cons of using relative performance measures?
- Should there be a payout if performance is negative but beats peers?
- Is there sufficient confidence in the integrity of the numbers and the measurement process of the metrics, whether financial or nonfinancial, to be sure that fraud or erroneous reporting would not subject the payments to clawback provisions required under the Dodd-Frank Act?
- Can the performance metrics be skewed inappropriately by non-recurring or nonoperating performance?
PART THREE

Recommendations of the 2017 NACD Blue Ribbon Commission

1. The board, the CEO, and senior management need to establish clarity on the foundational elements of values and culture—where consistent behavior is expected across the entire organization regardless of geography or operating unit—and develop concrete incentives, policies, and controls to support the desired culture.

2. Directors and company leaders should take a forward-looking, proactive approach to culture oversight in order to achieve a level of discipline that is comparable to leading practices in the management and oversight of risk.

3. Because of its significant interdependencies with strategy and risk, active monitoring of the organization's culture is a full-board responsibility, with specific oversight activities housed in committees as appropriate. The nominating and governance committee should ensure that board policy documents and committee charters clearly delineate the allocation of such responsibilities and explain how culture oversight is embedded into the ongoing work of the board.

4. Directors should review the culture of the whole board and its key committees on a regular basis, both formally (via the evaluation process) and informally (by making time for reflective conversation in executive sessions). The results of these reviews should inform board composition, succession planning—especially for leadership roles on the board—and continuous improvement efforts in board operating processes.

5. Directors should assess whether the chief legal officer/general counsel and other officers in key risk-management, compliance, and internal-control roles are well positioned within management and in relationship to the board to support an appropriate culture.

6. Integrate culture into the board's ongoing discussions with management about strategy, risk, and performance, emphasizing that the way in which results are achieved is as important as whether or not a given goal is met.

7. Boards should set the expectation with management that regular assessments of culture will include both qualitative and quantitative information and incorporate data from sources outside the organization.

8. Directors should make culture an explicit criterion in the selection and evaluation of the CEO, and set the expectation that the CEO and senior leaders do the same in their own leadership development and succession-planning activities.

9. Boards and compensation committees should review the company's recognition and reward systems (including incentive compensation as well as promotion decisions and other nonfinancial rewards) to ensure that they reinforce the desired culture and avoid unintended outcomes that could undermine culture.

10. Shareholder communications should include a description of how the board carries out its responsibility for overseeing and actively monitoring the company's culture.