

M O R R O W S O D A L I

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GETTING ALONG WITH BLACKROCK

AMERICA'S MOST INFLUENTIAL INVESTOR WANTS COMPANIES TO ENGAGE,
OPEN THE BOARDROOM DOOR AND DO A BETTER JOB TELLING THEIR STORY.

BY JOHN C. WILCOX, CHAIRMAN, MORROW SODALI

“What is the significance of having BlackRock as our largest shareholder?” This question is being asked by corporations around the world as they prepare for annual meetings and plan to engage with shareholders.

BlackRock, with more than \$5 trillion of assets under management, is the world's largest investor. They appear at the top of the share register of listed companies around the world. They are also one of the most engaged and influential global shareholders – they provide detailed information about their policies, views and activities on their website, deliver advice to CEOs in an annual letter from Chairman and CEO Larry Fink, and are regularly seen providing insights in the business and financial media about corporate governance, sustainability, shareholder rights and board accountability.

Given the firm's importance and high visibility, it seemed logical to go directly to BlackRock and ask how it would answer the question of its significance as a shareholder. I arranged to meet with Michelle Edkins (Global Head of BlackRock's Investment Stewardship team) and Zach Oleksiuk (Head of the Americas of BlackRock's Investment Stewardship team) – two of the primary decision-makers responsible for stewardship in relation to BlackRock's portfolio companies – i.e., how BlackRock thinks and behaves as a shareholder. Michelle and Zach are on the front line of BlackRock's day-to-day relationships with portfolio companies. Their team of over 30 specialists operates as an integral part of the firm's investment function. Their decisions in monitoring portfolio companies and voting proxies are made in collaboration with the firm's 125 investment teams, whether the holding is in active or passive portfolios. Over the course of a year they cast votes at about 17,000 shareholder meetings and meet with more than 1,500 companies annually.

Michelle opened the conversation with a definitive statement about BlackRock:

As indexed investors, we are patient long-term capital. We operate at scale. Our focus is heavily on governance and board oversight. We do not react to short-term earnings and we do not practice corporate governance box-ticking.

This statement contains several important messages for portfolio companies:

First, it confirms that BlackRock expects to be treated as a long-term owner on behalf of its clients, not as a trader, activist, or market opportunist. BlackRock sees itself as a de facto “permanent” shareholder of the companies in the indexes they track.

Second, the BlackRock stewardship team gives priority to understanding portfolio companies' long-term strategies and policies relating to ESG – the environmental, social, and governance factors relevant to their businesses. These issues, which are a responsibility of corporate boards, will be among the top priorities for institutional investors during the 2018 annual meeting season.

Third, because BlackRock is a fiduciary to its clients, the stewardship team's policies and actions are taken with a view to protecting the underlying economic interests of the beneficial owners whose assets BlackRock has been entrusted to manage. This fiduciary responsibility underlies the stewardship team's focus on governance, sustainability and long-term financial performance.

Fourth, indexing (often referred to as “passive investing”) does not mean that BlackRock takes a passive approach to proxy voting or that voting decisions are outsourced to proxy advisory firms. On the contrary, the BlackRock team sees proxy voting as an essential shareholder right they must exercise with fiduciary care.

Finally, Michelle’s statement reveals why “stewardship” has become the term favored by BlackRock and other major institutional investors. It describes an engagement process that integrates financial and investment analysis with oversight of the governance, societal, environmental and sustainability practices of portfolio companies. This holistic approach to evaluating companies from both financial and “extra-financial” perspectives has long-term implications for companies’ disclosure and engagement practices.

With this explanation of the fundamentals of indexed investing and stewardship, Michelle and Zach addressed what could be considered three pillars that support their team’s stewardship work in relation to portfolio companies: *engagement*, *access to directors* and *disclosure*.

ENGAGEMENT

Engagement has been described by attorney Martin Lipton as “the nexus between corporate governance and investor stewardship.”* Engagement programs are now generally recognized as an essential supplement to companies’ statutory disclosure documents, investor relations programs and other forms of corporate communication.

Based on discussion with the BlackRock team, here are some thoughts about how effective engagement programs should work.

- **Do it now.** Surprisingly, Michelle stated categorically that she would like to see every portfolio company get in touch with the BlackRock team by email at least once a year. She calls this “engagement light.” Despite having the industry’s largest and most global investment stewardship team, BlackRock does not have the time or resources to meet with every company. Nevertheless, an engagement-light knock on the door is one of the best ways for a company to initiate and maintain a relationship with BlackRock. Michelle pleaded for routine engagement unrelated to a voting issue not to be initiated during the annual meeting season, when her team is fully focused on analysis and dialogue to inform voting decisions. A calendar-based approach to engagement can be timed by companies to align with investor relations meetings, strategic announcements, or disclosure filings. It can also help management contribute feedback into board discussions about any changes being considered to governance processes.
- **Be prepared.** The BlackRock team will initiate engagements on its own when conditions warrant. These initiatives occur most commonly when companies have failed to satisfy BlackRock’s informational needs. Michelle and Zach pointed out that BlackRock’s Investment Stewardship priorities require companies to provide “...sufficient information in their disclosures to fully inform our assessment of the quality of governance, including the exposure to and management of environmental and social factors.” If this high threshold is not met, companies can sooner or later expect a knock on the door. Even in these cases, the ensuing discussions with BlackRock will be more credible and constructive if a pattern of engagement is already in place.
- **Follow up.** When engagement meetings do occur, whether initiated by the company or by BlackRock, Michelle and Zach emphasize that “there has to be a clear and anticipated outcome.” In other words, engagements should have an objective, a timetable, key performance indicators and either a resolution or an explanation of why the expected outcome has not been achieved. Companies that fail to fulfill a commitment made during an engagement, or let it slide with no follow-up, will lose credibility and risk becoming vulnerable to more public forms of engagement.

*Comments made by Martin Lipton on September 13, 2017, The Conference Board Governance Center 2017 Fall Meeting, New York, NY

- **Don't let an activist or crisis set the agenda.** The BlackRock team advises companies not to wait for an activist or crisis to trigger a substantive engagement about business strategy. In Michelle's words, "It doesn't make sense for companies to put themselves on the defensive. Companies are expected to do their own continuous self-examination and monitoring of business strategy, performance goals, governance and risk factors. Strategic questions are basic to managing a business. Do you have the right capital structure? Are you using assets efficiently? Are you number one in each of your business lines? How is your board performing? If these issues are addressed only in response to an activist, investors are likely to conclude that the business isn't being run effectively."
- **Talk to shareholders before agreeing to a settlement with an activist.** The BlackRock team wants companies targeted by activists to engage directly with shareholders. According to Michelle and Zach, there is a real concern among investors that standard negotiated settlements – such as giving board seats to a dissident or announcing a stock buyback – may favor short-term gains at the expense of long-term performance. They urge target companies and their boards to engage with shareholders directly, listen to their views and disclose their own detailed strategic plan to create value over the long term. This approach will enable shareholders to evaluate the merits of the proposals put forward by both sides and provide the company with informed feedback on its perspective of the best way forward.

ACCESS TO DIRECTORS

In 2017 the BlackRock stewardship team issued the following public statement in explanation of its decision to cast a negative vote at a portfolio company's annual meeting:

... [W]e have repeatedly requested to meet with independent board directors over the past two years to better understand the board's oversight of the company's long-term strategy and capital allocation priorities... The company declined to make directors available, citing a non-engagement policy between independent board members and shareholders.

As a result, we have not been able to fully assess the board's oversight of a range of key risks and its decision-making process pertaining to long-term strategy and capital allocation. In line with our expectations that the lead independent director should be available to shareholders, we voted against the re-election of the lead independent director and the chair of the committee responsible for setting this policy...

Clearly, being willing to provide access to directors is a sine qua non for companies that want to engage substantively with BlackRock. Where the situation warrants, Michelle and Zach expect to be able to meet and engage directly with their elected representatives in the boardroom. Because their focus is on governance and a wide range of board-related matters, it is essential for BlackRock to be able to meet with directors as well as executive management. In their view, directors are in the best position to explain how they set policy, fulfill their core governance responsibilities and exercise oversight of risk and long-term strategy.

Given the increasing pressure for boards to take an active role in shareholder engagement programs, companies should consider some of the following suggestions raised in discussion with the BlackRock team:

- **Review your company disclosures relating to board composition.** A complaint heard often from institutional investors, including BlackRock, is that they are asked to vote for directors without having sufficient information to make an informed judgment about their skills, experience and the process by which they were selected. The BlackRock team wants companies to provide more detailed and qualitative information about board members on their web site and in annual meeting materials. Many companies have adopted a board skills matrix, which explains the specific skill sets and personal characteristics of each director in the framework of overall board criteria. Companies are also adding detail to director biographies, committee reports and board policy statements relating to ESG and risk.

- **Educate your board members about shareholder expectations.** Board members should receive periodic reports from the corporate secretary, the investor relations team and outside experts that provide data and information about the company's shareholder profile, ownership changes, market activity, buy-side and sell-side reports, media coverage and feedback from investor relations (IR) and governance roadshows. The directors should be briefed on intelligence from proxy solicitations, investor engagement campaigns and voting results at the annual meeting. In addition to this internal data, board members should have access to professional education programs and should be briefed periodically by experts on ESG issues and risk factors such as technology and cyber security that are high on the list of shareholder concerns. At times, representatives from the BlackRock team participate in director education programs to provide a shareholder perspective; this also provides an opportunity to build relationships outside of the formal engagement process. Board members may also be assigned to participate in the company's IR and governance road shows, either in a listening capacity or to give the board's perspective on governance, risk and long-term strategy.

From BlackRock's perspective access to directors is a no-brainer: it allows companies to showcase the board's capabilities, explain board processes and clarify how policies relate to strategy and performance goals. Nevertheless, seen from the company perspective director access, if unchecked, can give rise to significant risks: duplicative or contradictory messages, selective disclosure, market confusion, diminished CEO authority, legal liability, loss of board confidentiality and collegiality. To deal with these risks, executive management and the board must work closely together to develop a well-planned and coordinated approach to shareholder engagement and board access that will meet shareholder expectations and provide insights to the company without exposing it to unreasonable risk.

DISCLOSURE

The BlackRock Investment Stewardship Engagement Priorities for 2017-2018, published earlier this year, states:

In our view, companies that report only to meet the regulatory disclosure requirements are missing a prime opportunity to more comprehensively engage new and existing investors about how effectively a business is led and managed.

This statement challenges companies to "tell their story" in a holistic way that integrates financial performance and operating results together with the specific board-level responsibilities that BlackRock includes on its list of current "engagement priorities":

- Governance (including board composition, effectiveness and accountability);
- Corporate strategy for the long term (including strategic goals management, milestones that will demonstrate progress, obstacles anticipated or incurred and capital allocation priorities);
- Compensation that promotes long-termism (including performance metrics and hurdles);
- Disclosure of climate risks;
- Human capital management.

Zach suggested that the "missed opportunity" to provide a comprehensive narrative results in part from U.S. securities regulations that require companies to prepare a separate proxy statement and annual report. This practice, together with concerns about potential legal liability for disclosure that goes beyond regulatory mandates, results in a split-screen, piecemeal approach: business operations and financial performance are disclosed in the annual report, while board composition, corporate governance, compensation and board policies are disclosed in the proxy statement. The problem is compounded when environmental, safety and other sustainability policies are disclosed in separate reports.

Nevertheless, Zach pointed out that in actual practice the straightjacket U.S. disclosure rules have not proven to be an obstacle when companies are operating in crisis mode. When activists present a strategic challenge or criticize poor governance, companies respond with detailed rebuttals in defense of their business strategy and policies. Zach asks a fair question: Why can't the comprehensive approach taken during a crisis become the norm for basic corporate disclosure? Instead of following advice to "think like an activist," wouldn't companies be better off if they learned to "think like an indexed investor"?

Michelle expressed an additional concern that separate narrative lines may have a negative impact on the "organizational ecosystem" of companies, with compliance-based disclosure having the unwanted effect within the company of encouraging siloed responsibilities and decision-making rather than centralized thinking and a holistic approach to managing the enterprise. Companies should consider whether the integrated reporting principles developed by the International Integrated Reporting Council would be appropriate in the context of boardroom transparency and shareholder engagement.

We discussed several emerging ideas that could enable boards to tell their story substantively, beyond compliance with regulatory disclosure requirements:

- Companies could add more detail to the Management's Discussion and Analysis (MD&A) section of the annual report to include a narrative summarizing the board's responsibilities and explaining how board "oversight" works in practice, how management implements board policies through internal controls and how board actions supported strategy during the past year. Former SEC Chair Elisse Walter stated in a recent article, "SEC regulations set the stage, telling companies what, at a minimum, should be covered, but it's up to the company to *make sure the story gets told*. That's where the MD&A becomes a real opportunity for the company to tell shareholders what's going on."** [Italics added]
- When ESG and sustainability reports are published separately, companies could include an introduction or commentary from the board of directors to demonstrate that the policies are linked to business strategy. Walter also comments on this topic: ". . . sustainability factors increasingly impact the financial condition and operating performance of companies. As such, these factors have a heightened potential to be *material* to investment decisions." And she says further, ". . . sustainability issues are business issues." It seems clear that the BlackRock stewardship team as well as many other large institutional investors would agree with these views. In particular, they would agree with Walters' statement: "In my view, companies should address investors like they are business partners. . ."
- Companies could include in the proxy statement a letter to shareholders from the board, the board chair or the lead director discussing the board's activities and decisions during the year. In some cases, a board letter could focus on a relevant topical issue – say on pay, succession planning, shareholder access, changes in board composition.
- Companies could expand the scope of the annual board evaluation process to address ESG topics and to consider the board's performance from the perspective of shareholders and other important constituencies. A board evaluation report reflecting this approach could include substantive commentary explaining how the board's actions serve the interests of these constituents. [Last year's client memo]
- Over the long term, companies and boards should consider whether it would be appropriate to publish an annual Director's Discussion & Analysis (either published separately or as a section of the MD&A in the annual report) that would provide shareholders with greater transparency about issues for which the board has primary responsibility.

**Sustainability Disclosure, by Elisse Walter, in IRUpdate, September 2017, pp. 15-16.

CONCLUSION

Think like an indexed investor.

Companies that want to know the significance of having BlackRock as their largest shareholder are asking an important question. Given its size, voting power and long-term investment horizon, BlackRock and its peer institutional investors will have an increasingly dominant influence on the future of communications and relations between companies and shareholders.

BlackRock sees itself as a provider of patient long-term capital, a permanent shareholder on behalf of its clients. It prefers private dialogue over public action. It is willing to evaluate portfolio companies individually case-by-case, on the merits rather than by one-size-fits-all standards. The price of these stabilizing attributes is a set of demands for significant change in the behavior of companies. BlackRock expects companies to engage openly, it wants direct access to board members, it wants a transparent rather than a cloistered boardroom and it wants companies to tell their story in a comprehensive holistic narrative.

For companies willing to meet the challenge, the three stewardship pillars provide a blueprint for how to align with shareholders.

Engagement – *establish and maintain a relationship before a crisis arises;*

Access – *open the boardroom door (just to let directors out, not to bring shareholders in);*

Disclosure – *open the boardroom windows and tell the company's whole story.*