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The Role of Private Ordering in Corporate Governance

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It has been a little over three months since the new administration assumed office and uncertainty still exists around the administration's approach to securities regulations, although deregulation is anticipated. Such uncertainty is compounded as the leadership of the Securities and Exchange Commission (SEC) hangs in the balance. There are currently two Commissioners, Acting Chairman Michael S. Piwowar and Kara M Stein. The new administration's nominee, Walter "Jay" Clayton, a Wall Street lawyer, expected to become the next Chairman of the SEC has yet to be confirmed by the Senate. As public companies await the new Chair, they find themselves expecting opportunities that would come with deregulation. Companies however should not expect that deregulation will completely alter the world of corporate governance. Concerns by shareholders with respect to corporate governance matters may actually gain strength in the wake of deregulation, and thus companies should expect the power of private ordering. We consider in this article that shareholder activism will shape corporate conduct regardless of the new administration, particularly in response to predictions that the new administration will reduce regulations and make it harder for shareholders to police public companies.

Private ordering is not novel and has been initiated over the years by shareholders championing issues that matter to them. As the direction of the securities regulations and the makeup of the SEC are in transition, shareholders continue to inform companies of their priorities with respect to corporate governance matters through no action letter campaigns, shareholder proposals, shareholder activist campaigns and pressure for shareholder engagement. Public companies can expect the current trend in shareholder proposals to continue around the topics related to, among others, board composition and diversity, sustainability and corporate social responsibility issues, clawback provisions with respect to executive compensation, and political contribution disclosures. In order to provide a flavor of the power of private ordering, this article addresses two of these areas, namely board diversity and sustainability as it relates to climate change.

In early March 2017, State Street Global Advisors (State Street) reemphasized the importance of, and its focus on, board diversity. On the eve of International Women's Day and the same day as the placement of the "Fearless Girl" statue in front of the Charging Bull on Wall Street, Ronald P. O'Hanley, President and Chief Executive Officer of State Street, issued a keynote address explaining that State Street has been particularly focused on gender diversity because of the strength of the evidence supporting the correlation between gender diversity and superior company performance. More specifically, State Street found, and the research supported, that not only do those companies that have more gender diverse leadership experience greater financial superiority, but those companies also have fewer instances of bribery, corruption, shareholder battles and fraud. Despite this increased evidence of the utility of diverse boards, Mr. O'Hanley found that there are

still not enough women serving on corporate boards. State Street maintains that all boards need independent female directors and should set the tone at the top for members of senior management to increase gender diversity within senior management and throughout the entire organization.

State Street developed the following framework to assist boards in increasing the amount of female directors. Companies should (1) identify the current levels of board and management gender diversity; (2) develop objectives geared toward increasing the levels of gender diversity on both the board and within senior management; (3) discover those individuals who will advocate for diversity on the board and within senior management and promote certain initiatives to meet those established diversity objectives; (4) concentrate on potential behavioral gender bias that is embedded in the search and nomination process for new directors and attempt to eliminate such bias by, for example, broadening the search for director candidates outside of the bounds of directors' current networks; (5) contemplate females fulfilling director and leadership positions, including on vital board committees; and (6) increase transparency and communication efforts with shareholders concerning the board's view of gender diversity and provide updates concerning the board's advancement in meeting those established diversity objectives.

Where is the private ordering pressure you might ask? State Street has stated that if after attempting to actively engage with a company that the company fails to take action; State Street may use its proxy vote to vote against the Chair of the nominating and/or governance committee.

BlackRock is also spearheading efforts to increase diversity on public company boards. In early March 2017, BlackRock issued its Engagement Priorities for 2017-2018 and explained that it has an objective of safeguarding and increasing the long-term value of its clients' investments and that it will utilize investment stewardship engagement and proxy voting as tools to ensure companies are maintaining comprehensive governance practices and policies. BlackRock developed an Investment Stewardship team, which is comprised of over thirty specialists and has the responsibility of engaging with companies in their portfolios concerning the companies' corporate governance practices and approaches to various issues, including responses to and management of certain environmental and social concerns. BlackRock is currently engaging companies to fully appreciate each company's approach to and progress of increasing board gender diversity. In the event that companies fail to make certain progress in a reasonable amount of time, BlackRock will hold the nominating and/or governance committees responsible for its perceived lack of dedication of achieving board effectiveness. Accordingly, BlackRock will promote such governance structures that will (1) increase board accountability, (2) reduce board entrenchment and (3) properly coordinate voting rights with economic interests.

In addition to board diversity, BlackRock has also focused efforts on improving disclosures concerning climate risk. BlackRock expects that those board members of companies that are particularly vulnerable to climate risk prove that they (1) appreciate the manners in which climate risk can affect the company and (2) have developed an approach to lessening the impact of such risk. In the event that the board fails to handle a material climate risk in a proper manner, BlackRock may utilize its proxy vote to vote against the re-election of those directors that BlackRock believes are responsible for failure to exercise proper oversight.

If a company fails to change its practices concerning board diversity, climate risk or any other priority of BlackRock and BlackRock fails to see any progress in spite of its consistent engagement efforts or companies fail to satisfactorily respond to BlackRock's engagement attempts, BlackRock may use its proxy vote to vote against certain management proposals.

While the SEC has yet to issue any notable regulation, shareholders have spoken and will continue to speak on topics such as board diversity and climate change. Thus, companies should prepare in advance to address shareholder concerns surrounding these topics as well as matters such as executive compensation and political contribution disclosures. Companies should consider the demands of their shareholders as they will continue to guide the actions of their companies amidst a potentially deregulated securities regime.

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