Beyond the Numbers | DFIN orrick

A Q&A with DFIN and Orrick

To provide additional perspective on the trends uncovered in *Corporate Governance Outlook 2022*, Equilar spoke with contributors at DFIN and Orrick to discuss the state of the governance environment and what to expect in 2022. Below is a snapshot of the conversation. Commentary from both DFIN and Orrick can be found throughout the publication.

Equilar: How does the current landscape of corporate governance differ from this time last year? Have companies become more proactive in addressing shareholder concerns after almost two years of the pandemic?

Ron Schneider, DFIN: Companies, employees, investors and other affected stakeholders, unfortunately, have had two years to observe the pandemic's impact, company responses, and subsequent performance. Looking back to 2019, investor focus on ESG, corporate social responsibility (CSR), sustainability and the related topic of human capital management (HCM) had been rapidly intensifying. Previously endorsed primarily by a small but vocal group of "social investors," many companies tried to ignore, due to their relatively small ownership, ESG in its various forms increasingly being adopted by large, long-term mainstream investors. In fact, fully one third of all actively managed U.S. investments now apply some form of ESG considerations in their investment selection process. As for the large (and growing) "passive" (i.e., indexed) investors, these considerations have been elevating among their "stewardship" priorities for engagement with their portfolio companies. Blackrock CEO Larry Fink clearly summarized this investor view that "climate risk is investment risk."

In "year one" of the pandemic, many companies and even industries literally went into survival mode, and investors and proxy advisors appear to have given these companies a fair amount of forbearance, apparently accepting pauses in their sustainability (and related reporting) journeys as they struggled with rapidly unfolding events impacting their companies, workforces, customers and suppliers.

That said, the pandemic has served to galvanize investor resolve that their pre-existing focus on ESG and sustainability, and related focus on human capital, are correct, and they have renewed pressure on portfolio companies to either initiate—or resume——their ESG and reporting journeys, and address investor desire for material, quantitative, decision-useful information.

Regarding ESG, investors are increasingly focused on the "G" of the ESG program itself. Pending anticipated SEC rulemaking on climate disclosure, investors still expect the primary reporting on company ESG risks and opportunities to occur at the website, either in searchable information, or in more robust sustainability reports and fact sheets. They also like to see relevant highlights of these programs in the proxy. What they particularly need to see in the proxy, is the role of board oversight over ESG. Is it the responsibility of the full board, or of a particular committee? Have the relevant charters been updated to include these responsibilities? Are the qualifications and competencies of directors to effectively provide this oversight clearly delineated in the board bios and skills matrices?

In short, what's transpired is that clear, credible, useful ESG disclosures (which may evolve significantly from year to year), as well as of the program's oversight—have moved from "nice to have" to "must have."

J.T. Ho, Orrick: This past year has sharpened companies' focus on ESG and led to a greater appreciation that stakeholder expectations are real and require specific actions, not just from policies and boilerplate public disclosures. Four trends are driving this:

1. Institutional Investor Focus: We saw a surge in support from large institutional investors with respect to shareholder proposals and activist campaigns related to ESG matters, including most notably, the Engine No.1 campaign, in which shareholders such as BlackRock, Vanguard and State Street elected three new board members to the Exxon board with the goal of pushing Exxon to reduce its carbon footprint. Support for climate change and human capital management proposals is also on the rise. With the new SEC guidance on no action letters, companies can expect to face more ESG-related proposals in 2022.
2. Signals From the SEC: We also saw the SEC issue comment letters (and follow-up comment letters, in many cases) to a number of issuers, seeking detailed information relating to how they determined what climate change-related disclosure was necessary. More prescriptive guidance from the SEC is anticipated in 2022. In addition, the SEC has stated that they are working on new guidance related to human capital and cybersecurity matters, which will likely require further disclosure from companies, including specific disclosure on topics like employee retention, worker health and safety, and cybersecurity hygiene.
3. Other Stakeholder Scrutiny: Companies are also experiencing increasing scrutiny from other stakeholders, including customers and business partners about their ESG practices (driven by these stakeholder's own ESG policies), with an increasing number of business-to-business contracts containing ESG commitments. Companies are having to find ways to address these increased, and increasingly specific, contractual demands and to track them internally to ensure they are being followed.
4. Data and Disclosure Risk: Companies are also reevaluating how they are collecting and analyzing ESG data, and the processes they are undergoing to make sure that their representations about that data are accurate, and their decisions based on it are reliable and defensible. More companies are using, or are considering using, third parties to provide assurance. Many of these third parties are not traditional auditors.

These dynamics have led companies both to be more proactive with stakeholders about ESG, but also more careful. Few companies can afford not to have a well-developed and well-informed approach to stakeholder engagement on ESG.

Equilar: Are there any issues that have flown under the radar that companies should seek to address in 2022? How can companies stay ahead of the curve on governance practices?

Carolyn Frantz, Orrick: Two emerging corporate governance issues that companies should consider addressing in 2022 are increased rigor in, and disclosure about, board assessments, and the integration of ESG into their internal controls processes.

Traditionally, companies have given very limited disclosure about their board assessment processes. Practices have also varied, with even companies known for excellent corporate governance engaging in very informal assessment processes—often nothing more formal than a discussion of specific questions in annual executive sessions by the board and each committee. And, indeed, for a well-functioning board, an informal process may work quite well, and avoid risks that can be associated with more formal approaches—in particular, the risk that survey responses or other outputs from the

assessment process might ultimately be discoverable in litigation.

But shareholders are increasingly pushing for more transparency about board assessment processes. ISS's Governance QualityScore, for instance, considers a company's disclosure about board assessment, favoring disclosure that demonstrates an annual process that includes assessments of individual directors and the use of an external evaluator at least every three years. As some companies plan to increase their disclosures, they are also considering altering their processes to address shareholder priorities.

Another factor likely to drive increased enhancements of board assessment processes is widespread re-evaluation of board composition. The new Nasdaq board diversity requirements, as well as state-specific board diversity requirements like those in California and Washington, are drivers for many companies. Even beyond specific legal and listing requirements, companies are thinking about board diversity as the result of feedback from multiple stakeholders: shareholders, customers, employees, and existing and potential directors. Additionally, increased shareholder focus on particular director skills, such as information security expertise and experience with ESG, is causing many boards to rethink whether changes to their boards are necessary.

Director refreshment can be challenging, and a board assessment process that effectively facilitates difficult discussions about whether existing directors have the right mix of skills and experiences can help. For some companies, instituting individual director assessments can be an important part of this process, as well as involving a third party, who can help process and deliver sensitive results (and in the case of a third-party attorney, with the potential benefit of attorney-client privilege).

With respect to ESG, 2022 will be the year when many companies incorporate ESG more deeply into their general internal controls processes. As the rigor around ESG issues increases, financial reporting, internal audit and enterprise risk management will need clearly defined roles in ESG initiatives, goals, and disclosures. Compliance professionals may also benefit from considering what their role in their companies' ESG program should be. Compliance professionals have broad experience in creating and administering company-wide programs designed to advance corporate values, and their expertise should be invaluable as ESG continues to mature.

Equilar: Given the cross-department collaboration necessary in the creation of the proxy, how can companies remain committed to a singular vision and effectively communicate that vision to shareholders?

Ron Schneider, DFIN: The proxy, or "14A" filing, is a serious regulatory document and as such, should remain primarily controlled by legal. Over the past two decades, based primarily on investor demand, mature company proxies increasingly contain greater amounts of non-SEC required, voluntary or "contextual" information—the "why" as well as the "what" about corporate governance, compensation and sustainability. As ESG highlights sections illustrate, proxies increasingly are "one-stop shops" to give investors the "big picture" prior to voting (while referring them to other documents and locations where they can learn more about these ancillary topics).

As proxies, annual reports and even sustainability reports increasingly discuss company strategy and performance and there is "crossover" in content, it can be striking how different these documents—often located adjacent to each other at company websites—may be in branding and design. This is an understandable result of these documents often being drafted by different teams operating under different budgets and time frames. In response, many of our clients are asking for our help in correcting and harmonizing the look and feel of these increasingly interrelated documents, and more consistently reflect their "one brand."

What is more concerning is inconsistent or even conflicting messaging, which investors can be quick to spot. We suggest that all three of these (and

other) documents and information channels receive a fresh review to ensure consistency in message as well as in brand.

One tactic to mitigate this problem is to have more crossover between the various drafting or review teams. Irrespective of the unique technical and informational requirements of each document, investor relations and corporate communications—perhaps with disclosure committee involvement—deserve a seat at all tables. This can help ensure that unified strategic messaging resonates through all channels.

From our perspective, this is resulting in rapidly growing use of our secure, collaborative disclosure management platform Active Disclosure, which permits multiple users to collaborate securely on the same document.

Equilar: What are the critical issues companies will look to address in their upcoming proxy statements? Which topics will require the most attention and detail?

Ron Schneider, DFIN: Perennial, as well as emerging, issues need to be addressed. Content-wise, the "big three" issues investors focus on are:

1. Board diversity, skills and qualifications, including those necessary to provide effective oversight of ESG and HCM issues. Nasdaq companies will have to comply with its new board diversity disclosure requirements, effective as of August 8 for most companies. This is not a proxy disclosure requirement per se, but many of our Nasdaq clients that already meet the standards are indicating they intend to include this in the spring 2022 proxy.
2. Executive compensation and the "pay for performance" story. As part of this, many companies are discussing compensation in the context of the business strategy—how the program, its vehicles and any metrics and weightings support the current business strategy.
3. As discussed earlier, ESG and human capital highlights (not the full story) increasingly are desired in the proxy by a range of investors and other readers. Rather than be just a "check the box" exercise, the desired end state of this ESG and reporting focus is for ESG to become instilled throughout the organization, its strategies and operations, to help give the company a sustainable advantage.

A related content consideration is the increasing ownership of large, indexed investors, who may not be as fully attuned to a company's ongoing IR communications as are the "active" managers, yet who seek to vote thoughtfully. As a convenience to them, we recommend including a brief company, strategy and performance overview. This may be contained in substantive cover letters or a proxy summary at the start of the document, or alternatively, at the start of the CD&A. Essentially, it is repurposing existing IR disclosures.

In addition to content, we also focus on:

- Appropriate use of the company brand in document covers and even throughout the document
- Humanizing board and executive leadership, including through robust cover letters featuring half or full profile photography
- Given the focus on human capital and diversity, equity, and inclusion, many companies are including photography of actual employees throughout the document
- As proxies increasingly become longer and more complex, efficient navigation is essential. This can be enabled via one (or more) detailed tables of contents, consistent hierarchy and flow of primary, secondary, and tertiary section headings, page headers and footers and similar devices.
- With more readers viewing the proxy online, many companies are adding additional color to the SEC-filed and web-hosted version (digital color having little, if any, cost impact compared to the printed version), links to company and director videos, and additional interactive and engaging features.

Equilar: With the approval of Nasdaq's new listing rules, along with legislative efforts in states like California, board diversity has become a crucial governance issue. How have companies responded to these calls for action, and will more requirements emerge in 2022?

J.T. Ho, Orrick: The approval of Nasdaq's new listing rules, along with legislative efforts in states like California, have led many companies to reassess the composition of their boards and add or replace board members to meet these requirements. However, adding new diverse board members and/or replacing board members can be challenging. Many companies want to continue to recruit from the traditional pool of candidates (for example, former CEOs or CFOs of public companies) but are finding it difficult to identify diverse candidates from those pools, particularly those who also have industry expertise. There are also concerns that diverse candidates who have traditional qualifications will be "overboarded" because they currently serve on a number of other company boards. Tensions and challenges can also arise from board refreshment, with some long-standing directors who are knowledgeable about the company and well-connected to other directors needing to step aside to change the overall board composition.

To overcome these issues, a number of companies are looking to more non-traditional candidates, such as candidates who fall within the C-suite but were not CEOs or CFOs, and leaders of major business or functional groups who may not have been in the C-suite at all. Human resources and information security leaders can be particularly in demand, given the rising prominence of those issues in ESG. Some companies are also looking more closely at candidates who haven't served in a corporate role at all but bring other valuable, relevant skills to the boardroom, such as former government officials, corporate lawyers and other advisors. Consistent with this practice, companies also are recognizing that the skill sets needed in the boardroom evolve over time and warrant continual review and revisiting to ensure the right mix of backgrounds among board members.

Companies have also adjusted their recruiting practices. They are moving beyond traditional third-party search firms and instead are partnering with organizations whose mission centers around placing diverse board candidates. Another strategy is leaning on diverse contacts and colleagues to make introductions to people who might be qualified for board roles.

Companies are beginning to recognize the importance of building diversity into their board succession planning, as losing even one diverse board member can make a significant difference. Strategic board succession planning can be a tool for adding new diverse board members without having to expand the board.

Finally, to encourage board refreshment and avoid entrenchment, some companies are adopting mandatory director retirement age guidelines or other tenure-related requirements.

California's state board diversity laws are facing challenges in enforcement, as well as legal challenges. This may dissuade individual states from passing similar statutes. Even without legal requirements, however, the interest of listing agencies, proxy advisors and shareholders seems likely to continue to increase at least in the short term.