
The Proxy Process

Raising the Investor Voice to Address New Risks

Morningstar Manager Research

8 February 2019

Contents

- 1 Introduction
- 1 Overview of the Proxy Process
- 5 Management Resolutions, Shareholder Governance
- 8 Shareholder Resolutions
- 17 Asset Manager Proxy Voting
- 19 Conclusions

Jackie Cook

Director, Sustainable Stewardship Research
+1 416-489-7074
jackie.cook@morningstar.com

Important Disclosure

The conduct of Morningstar's analysts is governed by Code of Ethics/Code of Conduct Policy, Personal Security Trading Policy (or an equivalent of), and Investment Research Policy. For information regarding conflicts of interest, please visit: <http://global.morningstar.com/equitydisclosures>

Key Takeaways

- ▶ The right of shareholders to file and vote on shareholder resolutions is a central feature of shareholder democracy in the United States.
- ▶ Environmental and social (or E&S) considerations are viewed as material to investment risk and opportunity.
- ▶ Large financial institutions are increasingly voting in support of shareholder-sponsored resolutions on social and environmental issues.

Introduction

Within portfolios and across entire markets, sustainable business practices are fundamental to long-term value creation. Conversely, short-termism is a recipe for financial disaster. The proxy process allows shareholders to ask tough questions about how companies in their portfolios are managing pressing E&S risks, and governing natural and social capital.

How companies treat their stakeholders and the environment can have costly reputational, regulatory, and legal consequences. Strong E&S governance creates value and builds reputational resilience. The evidence is unequivocal: E&S issues are material and are driving investment flows.¹ They are also driving shareholders to file resolutions and engage with corporate management.

This primer introduces the proxy process which, while an important mechanism for giving voice to shareholders, is not well understood among investors, much less the general public. It offers an illustrative walk through the proxy process as the centerpiece of shareholder democracy in the U.S. equities market, focusing on shareholder resolution filing as a powerful channel for communicating concerns about material issues that affect shareholder value and the world we live in.

Overview of the Proxy Process

The term "proxy" refers to how most shareholders exercise their votes. Casting votes via proxy enables shareholders to vote without attending annual meetings in person. More broadly, proxy process has come to refer to the entire annual routine of shareholder meetings — their timing, agenda, required disclosures and voting — all of which falls under the regulatory purview of the SEC.

¹ US SIF Foundation, Report on US Sustainable, Responsible and Impact Investing Trends 2018, November 2018.

Shareholder Voting Rights

The answer to, "What does it mean to own shares in a public company?" seems obvious enough: Share ownership means the shareholder owns a piece of a company. A shareholder is therefore entitled to hold or sell those shares, receive a portion of declared dividends, and realize capital gains (or losses) upon the sale of shares. Capital gains and cash flow rights are the economic rights of share ownership.

Share ownership also confers on shareholders control rights, otherwise known as voting rights. The interests of those managing corporate assets may sometimes diverge from the economic interests of those contributing investment capital. Voting rights allow shareholders, including minority shareholders, to exercise a degree of oversight over governance and incentive structures. Minority shareholder protection via voting rights is one of the mainstays of robust, liquid markets.²

The US equities market operates under the Securities and Exchange Act of 1934. Enacted during the Great Depression, this act created the SEC to administer and enforce the rules that would rebuild investor confidence. It gives effect to a version of democracy that, among other things, allows shareholders to shape governance practices at public companies through filing shareholder resolutions.³

Shareholders in the U.S. equities market have the right to vote on a basic set of issues at least once a year at the annual shareholders meeting. They have a right to informational materials that support informed voting. For almost 80 years, shareholders have also had the right to submit items to be voted on as long as they meet certain basic conditions. Finally, they have a right to know the vote's outcome.

Annual Meetings

Companies are required to hold a general shareholder meeting at least once a year. At these annual general meetings shareholders get to vote on the corporate directors. This much is dictated by state corporate law and applies to both public and private companies.⁴ In addition, public company shareholders must vote on auditors, executive pay, bylaw changes, and changes to the capital structure of the company. For public companies, communications between the company and shareholders about shareholder meetings and shareholder resolution filing are governed by the SEC.

The company is responsible for preparing the proxy materials and distributing them to shareholders before the meeting. These include the proxy card, or proxy ballot, containing the items to be voted on, and the proxy statement containing information relevant to these items. Most companies distribute proxy materials under the SEC's Notice and Access model, which came into effect in 2007 as an alternative to delivering proxy materials in paper format. The model allows companies to notify

² See: The Value of Protecting Minority Shareholders in the Market, October 2015: "Mauro Guillen, director of The Lauder Institute at Penn and professor of management at Wharton, finds that countries that offer a legal framework to protect minority shareholders tend to have more robust markets because investors are more willing to take risks." <http://knowledge.wharton.upenn.edu/article/the-value-of-protecting-minority-shareholders-in-the-market>

³ Tsuk Mitchell, D., Shareholders as Proxies: The Contours of Shareholder Democracy, Washington and Lee Law Review, Vol. 63(4) <https://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1171&context=wlulr>

⁴ Garner, C.M.; Geissinger, C.G. & Woodley, J.T. (2018) Annual Meeting Handbook 2018 Edition, Donnelly Solutions <https://www.lw.com/thoughtLeadership/LW-annual-meeting-handbook>

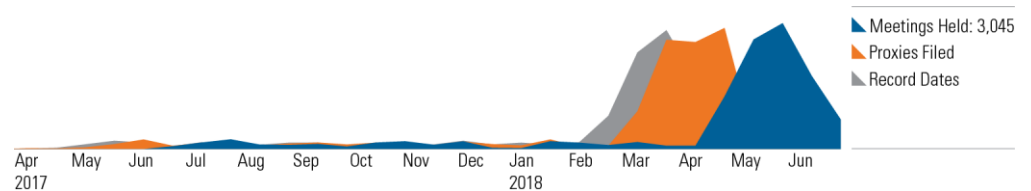
shareholders of an upcoming meeting by sharing a link to online materials. This notice must be sent out at least 40 days prior to the AGM, at which time materials must have been filed with the SEC and be publicly available.⁵

Holders of shares at the company's record date are eligible to vote. The record date is set by a company and marks a point in time, between 60 and 10 days prior to a company's meeting, at which a "snapshot" of the shareholder list, or register, is taken. If a shareholder sells their shares after the record date but before the meeting date, their votes are counted. If a shareholder buys shares after the record date but before the meeting date, they are not eligible to vote.

Most companies hold their annual shareholder meetings within a 10-week window from mid-April to the end of June, a period often referred to as the "proxy season." The timing is dictated by the requirement that meetings must take place within six months of a company's fiscal year-end and no more than 15 months from the previous meeting. For most U.S. companies, the fiscal year ends on December 31, meaning they have to hold their annual meeting prior to June 30.

Exhibit 1 shows the distinctively skewed distribution of key events defining the 2018 proxy calendar for 3,045 large U.S.-listed companies in 2018. The proxy calendar runs from July 1 to June 30. About 75% of annual shareholder meetings take place from mid-April to the end of June.

Exhibit 1 The 2018 Proxy Calendar: Distribution of Key Events



Source: Morningstar Proxy Data as of June 30, 2018.

Anatomy of the Ballot

Every year thousands of U.S. companies hold shareholder meetings, where tens of thousands of ballot items, or proposals⁶, are voted on. These give shareholders a say in the governance of companies whose shares they own.

The range of items up for vote on a proxy ballot affords shareholders an opportunity to weigh in on the governance and direction of a company. Some items are merely advisory, meaning the outcome of the vote is nonbinding on management. Others, such as a bylaw change or amendment to an equity compensation plan, are binding if the vote passes.

⁵ Securities and Exchange Commission (2007). Final Rule: Internet Availability of Proxy Materials. Release Nos: 34-55147; 34-52926; IC-27671; File No.: S7-10-05: <https://www.sec.gov/rules/final/2007/34-55146fr.pdf>

⁶ The terms "ballot item" and "proposal" are used interchangeably throughout this paper and refer to items that appear on proxy ballots and are voted on by shareholders. Proposals that are put forward by shareholders are often referred to as "shareholder resolutions". The terms "shareholder proposal" and "shareholder resolution" are used interchangeably throughout this paper.

All annual meeting proxy ballots contain items proposed by management. Some proxy ballots, mainly those of large companies, contain one or more items that shareholders have submitted. These are referred to as shareholder resolutions or shareholder proposals. Shareholders can vote for, against, or abstain on each ballot item. Each issue presented on the proxy ballot comes with management's recommended vote, which shareholders can choose to follow or ignore. Naturally, these recommendations support management's ballot items. Typically, these recommendations oppose shareholder-sponsored items.

Exhibit 2 Proxy Ballot for Amazon.com's 2018 Annual Meeting of Shareholders

Ballot Item	Resolution	Management's Recommended Vote
1.1	Jeffrey P. Bezos	For
1.2	Tom A. Alberg	For
1.3	Jamie S. Gorelick	For
1.4	Daniel P. Huttenlocher	For
1.5	Judith A. McGrath	For
1.6	Jonathan J. Rubinstein	For
1.7	Thomas O. Ryder	For
1.8	Patricia Q. Stonesifer	For
1.9	Wendell P. Weeks	For
2	Appointment of Ernst & Young LLP as independent public auditor	For
3	Advisory vote to approve executive compensation	For
4	Shareholder proposal regarding diverse board candidates	Against
5	Shareholder proposal regarding a policy to require an independent board chair	Against
6	Shareholder proposal regarding vote-counting practices for shareholder proposals	Against

Source: Amazon.com's DEF 14a Filing; April 18, 2018.

A typical proxy ballot, such as the one issued by Amazon.com **AMZN** for their AGM held on May 30, 2018, is reproduced in Exhibit 2. It contains a list of directors to be voted on, an item requesting shareholders to ratify the auditor selected by the board for the fiscal year ahead, and an item requesting shareholders to vote on the pay earned by the top five executive officers of the company in the previous fiscal year. The latter is colloquially known as "say-on-pay." Shareholders can read about each board candidate; see the history of the relationship with, and fees paid to, the auditor; and look up the details of top executives' compensation in the proxy statement.⁷

About half of U.S. company ballots contain additional items, most often requesting approval of a new or amended equity compensation plan; approval of share issuances, stock splits, and other events affecting the capital structure of the company; approval of mergers or acquisitions; and shareholder approval of corporate bylaw or charter amendments—many of which affect governance via changes to board structure, shareholder meetings, or shareholder voting rights. These items require a minimum level of

⁷ See: Required proxy disclosures: Securities and Exchange Commission (2009). Final Rule: Proxy disclosure enhancements. Release Nos. 33-9089; 34-61175; IC-29092; File No. S7-13-09: <https://www.sec.gov/rules/final/2009/33-9089.pdf>

support from shareholders in order to pass. Usually a majority is required; however, bylaw amendments often require a supermajority.

Each year between 10% and 12% of Russell 3000 companies' ballots also contain one or more shareholder resolutions. Most are filed at larger companies: 42% of S&P 500 companies' ballots contained a shareholder resolution in 2018, down from a five-year high of 48% in 2016. Altogether, 500-600 shareholder resolutions appear on 310 to 360 proxy ballots each proxy season.

Management Resolutions, Shareholder Governance

The proxy process is the primary way that shareholders participate in the governance of public companies in equities markets around the world. In the U.S., where shareholders are the most powerful corporate stakeholders, the proxy process is a central feature of corporate governance.

Board members are shareholders' representatives inside the company. They are charged with creating and overseeing internal checks and balances, and ensuring that compensation practices encourage management to pursue long-term value-creation strategies. Shareholders therefore have an interest in who represents them on the board and how senior management compensation is structured. Board elections and say-on-pay votes are therefore followed closely by companies and investors alike.

Governance failures at large banks were significantly implicated in the global financial crisis of 2008. However, weaknesses in board practices, executive compensation, and the exercise of shareholder rights went well beyond the financial sector. Therefore, the financial reform legislation that followed in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act, or "Dodd-Frank," contains governance reform provisions that apply to all U.S. public companies.

Key Dodd-Frank governance provisions were intended to a) strengthen shareholders' power to elect board members through proxy access and b) strengthen shareholders' voice in pay-setting through say-on-pay votes and CEO pay ratio disclosures.

Shareholder Power to Elect Corporate Boards

Shareholders elect the board of directors to act in the best interests of the corporation and its shareholders. Directors act as agents of shareholders, overseeing officers and setting the company's strategic course.

Company directors are elected by one of two voting methods: majority vote or plurality vote.

Under majority voting shareholders can vote for or against a nominee. Directors earning more than 50% of votes are elected. Under plurality voting, instead of voting against a director nominee, shareholders can only withhold their support. Directors are elected to the board in the order of the number of votes received until all board seats are filled.

In practice, regardless of the electoral system, the number of nominees put forward by an incumbent board usually matches the number of available board seats. In uncontested elections, when a director fails to win 50% support under majority voting, a company typically appoints an alternate director pending shareholder approval at the next annual meeting. In uncontested elections with plurality voting, a nominee who fails to win more than 50% would nevertheless earn a seat on the board.

Majority voting as applied to director elections clearly gives shareholders greater influence over who represents them on the board. However, incumbent boards typically control who gets nominated. If shareholders want to offer their own candidates, they must issue a separate proxy ballot. These proxy fights can cost proponents millions of dollars and are therefore only undertaken by so-called activist investors, such as Pershing Square and Trian Partners.⁸

Proxy access, as originally ruled on by the SEC in 2010, following Dodd-Frank, would have allowed shareholders holding at least 3% of a company's shares continuously for three years to have their own board nominees included in the company's proxy materials. Without proxy access, shareholders who nominate their own board candidates must provide and pay for their own proxy materials informing other shareholders about their alternative candidates. Notwithstanding the SEC's subsequent abandonment of the proxy access rule,⁹ arrangements giving shareholders the power to nominate board candidates have been widely adopted by large U.S. public companies under concerted pressure from shareholders through resolution-filing activity. Where adopted, the proportion of eligible seats is usually limited to between 10% and 25% of the size of the board, and shareholding thresholds vary, but often exceed the 3% originally stipulated by the SEC. Shareholders therefore continue to use the proxy process to advance proxy access and to align access thresholds with the original Dodd-Frank requirements.

Say-on-Pay

Since 2011 the SEC has required companies to offer shareholders an advisory vote on compensation paid to named executive officers in the preceding fiscal year. The vote outcome is nonbinding, but closely watched as a metric of shareholder confidence in board oversight.

The say-on-pay vote takes place at intervals of one, two or three years, depending on the outcome of a shareholder preference poll, called "say-on-pay frequency." The poll is to be taken at least once every six years. This means that most companies held these polls in 2011 and again in 2017.

In 2015 the SEC implemented the Dodd-Frank CEO pay ratio disclosure requirement. Starting in 2018 (for the 2017 fiscal year), proxy materials reveal how the total pay of the company's CEO stacks up against the total amount paid to the company's median employee, as determined by a total pay ranking of all non-CEO employees. This is considered a key input for shareholders as they cast say-on-pay votes. CEO pay ratio disclosures have been watched closely by corporate and civil society stakeholders concerned

⁸ In December 2017 Trian Partners succeeded in getting Nelson Peltz appointed to Procter & Gamble's board after a proxy fight estimated to have cost both sides a combined \$100 million in solicitations.

⁹ Shortly after its inception, the US Chamber of Commerce and Business Roundtable sued the SEC over Rule 14a-11, the 'proxy access' rule, (Business Roundtable v. SEC) claiming that it had not conducted an adequate economic impact analysis. Following a judicial review and controversial opinion against the new rule by the U.S. Court of Appeals for the D.C. Circuit, it was ultimately abandoned by the SEC in 2011.

with containing large CEO pay packages, and with the economic, social, and political impacts of deepening income inequality in the U.S.

In addition to the regular say-on-pay vote, SEC rules implemented under Dodd-Frank requirements also afford shareholders the opportunity to cast advisory votes on golden parachutes, which are payouts made to senior management in the event of termination as a result of a merger or acquisition of the company. Corporate insiders exercise considerable control over these transactions, yet their financial interests in the outcome may not be aligned with those of minority shareholders. Resolutions providing say on golden parachutes are therefore presented on ballots for special meetings alongside resolutions requesting shareholder approval of the merger or acquisition.

How Do Shareholders Vote on Directors and Executive Pay?

Companies publish the results of voting on all ballot items via an 8-K disclosure form, which must be filed with the SEC within four business days of the annual meeting.

When shareholders have no widely held concerns about how a company is governed, support for resolutions that management places on the ballot is typically high. Usually around 99% of votes are cast in support of the auditor ratification proposal. Each year, support for board nominees averages around 97% for S&P 500 companies and around 95% across all annual meetings. Out of 24,230 votes on director nominees in the 2018 proxy season, only 72 failed to achieve majority support from shareholders. Support for say-on-pay items averages around 91%. In 2018 only 67 of 2,900 say-on-pay resolutions failed.

How bad must things be for shareholders to revolt against management's standard ballot items?

In 2018 only 13 out of 4,200 auditor ratification items across the whole 2018 proxy season failed to win at least 75% support. One of these was at General Electric GE, where shareholders pressured the board to fire KPMG, its auditor of 109 years, following announcements late in 2017 of an SEC investigation into "revenue recognition practices and internal controls over financial reporting related to long-term service agreements," and in early 2018 of massive write-downs affecting 2016 and 2017 financial statements.¹⁰

After the Wells Fargo WFC phony account scandal broke in 2016, average support for the bank's board nominees dropped to 72% in 2017 from an historical average of 97.5%. Shareholders clearly blamed the board for compensation practices and oversight failures that encouraged and enabled business practices that defrauded clients. Only 3% of boards failed to average at least 72% since the beginning of 2017. Revolts against large company boards are rare but carry reputational consequences for the directors involved.

At Bed Bath & Beyond BBBY, where the CEO pay ratio is 961 times that of the median employee, shareholders voted against the say-on-pay resolution and voted down the re-election to the board of one

¹⁰ See GE's report for first-quarter 2018: <https://www.sec.gov/Archives/edgar/data/40545/000004054518000032/ge1q201810-q.htm>

of the longer-standing compensation committee members at the 2018 AGM. The two other compensation committee members received less than 75% support. Investor advocacy group As You Sow has consistently listed Bed Bath and Beyond's CEO, Steven Temares, amongst the 100 most overpaid executives in its annual roundup of the worst pay packages. Shareholder frustration with longstanding pay problems was directed at the board members with oversight of executive compensation.

These examples illustrate the disciplinary role, as well as the informational significance, of shareholder proxy voting on management-sponsored ballot items in addressing governance failures.

Shareholder Resolutions

Apart from voting on management resolutions, shareholders have certain rights to propose resolutions to be included on corporate ballots.

Shareholder resolution filing has been an integral part of how shareholder democracy works in the US since 1943. The SEC first ruled that management must admit shareholder resolutions to the corporate ballot in 1942. Early proposals filed by shareholders addressed governance and corporate performance. Shareholder proposals addressing social and environmental issues started appearing on ballots in the early 1970s.

In 1969 a shareholder resolution requesting that Dow Chemical halt sales of napalm to the U.S. government was filed. While the SEC supported the company in keeping the resolution off the proxy ballot, in 1970 the Court of Appeals for the District of Columbia upheld the right of the Medical Committee on Human Rights to have its resolution voted on by shareholders. This opened the gates for subsequent proposals on social and environmental issues.¹¹

The filing of a shareholder proposal can function as the opening of an engagement, or a dialogue, between the company and the proposing shareholder. Such engagements are often successful and may result in the proponent withdrawing the resolution.

Failing this amicable outcome, management generally recommends voting against shareholder resolutions that appear on the proxy ballot. This was the case in all but 12 of 488 shareholder resolutions published in proxy materials in the 2018 proxy season. In 10 cases management made no recommendation on the proposal, and in two cases management recommended a vote in favor. Over the past 15 years, only 2% of the nearly 9,000 shareholder resolutions published in U.S. company proxy materials have not received an against vote recommendation from management.

¹¹ See: A Judicial Challenge to The SEC's Shareholder Proposal Rule, 28 Wash. & Lee L. Rev. 147 (1971), <https://scholarlycommons.law.wlu.edu/wlulr/vol28/iss1/7>

A shareholder proposal must satisfy conditions set out in SEC Rule 14a-8 in order to qualify for inclusion in proxy materials.¹²

The first condition is that the filer hold company stock worth at least \$2,000, or representing 1% of shares outstanding, whichever is less, for at least one year before the proxy materials are filed and right up to the shareholder meeting date. Effectively, this means that only longer-term investors are eligible to propose a resolution.

Further, if a resolution has previously been filed at the same company, it must have achieved a minimum level of support to qualify for resubmission: a minimum of 3% support if filed once previously, 6% if filed twice previously, and 10% if filed three times previously within in the last five calendar years.¹³

Industry groups have lobbied for raising the shareholding and resubmission thresholds as a strategy for limiting shareholder resolution-filing activity. Raising thresholds even by a small amount could significantly affect how the proxy process functions. Morningstar has strongly opposed such rule changes, recently discussed in an SEC-hosted roundtable review of the proxy process. Drawing on historical proxy voting data, Morningstar's submission makes the case that shareholder resolution-filing activity supports shareholder democracy and makes a valuable contribution to the functioning of the U.S. equities market.¹⁴

Filed resolutions must reach the company's principal executive office approximately 120 days before publication of the proxy materials. This date is indicated in the previous year's proxy materials and is projected based on the previous year's filing and meeting dates.

Shareholder resolutions that satisfy conditions of the filing procedure do not automatically progress to the proxy ballot. Companies may petition the SEC under Rule 14a-8 for permission to leave a shareholder resolution off the proxy ballot. If granted by the SEC, this permission is called "no-action relief" and takes the form of a no-action letter explaining the reasons. Effectively this amounts to a guarantee from the SEC that it will not recommend enforcement action against the petitioning company for omitting a proposal from the proxy materials.

Grounds for no-action relief are usually that the resolution deals with the ordinary business operations of the company, is of marginal economic relevance, is in direct conflict with one of management's own proposals, has already been substantially implemented, or does not meet prior support thresholds.

The SEC's no-action decision is only an opinion, not a legal ruling. Shareholders can legally challenge companies that omit their resolution from the ballot, even following an SEC-issued no-action letter. Shareholder advocates, with limited resources for a legal contest, usually accept the SEC's decision.

¹² See SEC Staff Legal Bulletin 14D providing supplementary information on shareholder resolution filing and rule 14a-8: <https://www.sec.gov/interps/legal/cfslb14.htm>

¹³ For the purpose of comparing vote outcomes to resubmission thresholds, the SEC counts only votes cast 'for' and 'against', ignoring abstentions. This methodology is applied throughout this paper in reporting proxy voting results.

¹⁴ Morningstar's submission to the SEC proxy process review (File No. 4-725). <https://www.sec.gov/comments/4-725/4725-4793622-176946.pdf>

Likewise, companies that fail to secure a no-action letter, or who do not request one, usually place the resolution on their proxy ballot.

A notable exception is the case of *Trinity Wall Street versus Walmart Stores*, in which the Federal Court for the District of Delaware, based on a reading of the SEC's own 14a-8 rules, overturned an SEC no-action letter allowing Walmart to omit from its 2014 proxy materials a resolution filed by the plaintiff. The plaintiff, an Episcopal church, had called for board oversight of products that endanger public safety and well-being, risk the company's reputation, and/or violate the family and community values fundamental to the company's brand, referring to products such as high-capacity assault rifles used in mass shootings.¹⁵

This ruling was overturned in April 2015 on an appeal by the company to keep the resolution off the 2015 ballot. Nevertheless, in August 2015, following continuing investor pressure after the Emanuel African Methodist Episcopal Church shooting massacre in Charleston, SC (June 2015), the company agreed to stop selling this type of weapon along with its munitions.

With 14a-8 conditions having been met, shareholder resolutions that do make it to the ballot flag potentially material risks at both the company and financial market level. Shareholders have been able to shape the governance landscape through multiyear filing campaigns and raise market awareness of material environmental, social, and governance (or ESG) risks.

Once a resolution is on the ballot, shareholder proponents get 500 words to make their case in the company's proxy materials. The specific action being requested is contained in a subsection of the resolution text called the resolved clause. This clause is essentially what shareholders are voting on. Appendix A contains some examples of resolved clauses. Most shareholder resolutions that address E&S issues ask for disclosures around specific types of risks or for sustainability reports. Resolutions that address governance issues often request bylaw changes to shareholder voting rights, shareholder rights to call meetings, or to governance structures.

The final task of a shareholder proponent in bringing a proposal to vote is to present the resolution to the annual meeting of the company's shareholders, either in person or via a proxy. While this is a requirement of the proxy process and failure to present can, and does, result in the resolution being omitted from the final vote count, it also affords the opportunity to directly address arguments raised in the supporting statement of the resolution to others in attendance at the meeting. Besides shareholders, corporate board members and senior management, the meeting audience may also include analysts and members of the media, if permitted to attend. The proponent is usually given two to five minutes to make their case. Shareholder proponents consider this to be an important opportunity to raise the general level of awareness of the issue being addressed by their resolution.

Shareholder Resolutions and Board Oversight

¹⁵ <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2014/trinitychurch032014-14a8.pdf>

Governance is primarily about how accountable boards are to shareholders. Shareholder rights advocates argue that boards become insulated and, by extension, less accountable, through staggered, or classified, board structures. Classified boards are typically arranged into three classes, with only one third (or one class) of board members eligible for re-election annually. Shareholder proposals for board declassification would require all board members to be re-elected annually. Recent board data shows that declassified boards are more diverse¹⁶ and evidence is mounting that diversity is a valuable board attribute.¹⁷

An example of a staggered board is that of Vista Outdoor VSTO. Exhibit 3 below lists the items that came to vote at the company's 2017 AGM. Only two of seven directors were up for re-election.

Exhibit 3 Proxy Ballot for Vista Outdoor's 2017 Annual Meeting of Shareholders

Ballot Item	Resolution	Management's Recommended Vote
1.1	Gary McArthur	For
1.2	Mark Gottfredson	For
2	Advisory vote on 2017 named executive officer compensation	For
3	Ratification of the appointment of Deloitte & Touche LLP	For
4	Stockholder proposal to declassify the board of directors	Against

Source: Vista Outdoor's DEF 14a Filing, June 17, 2017.

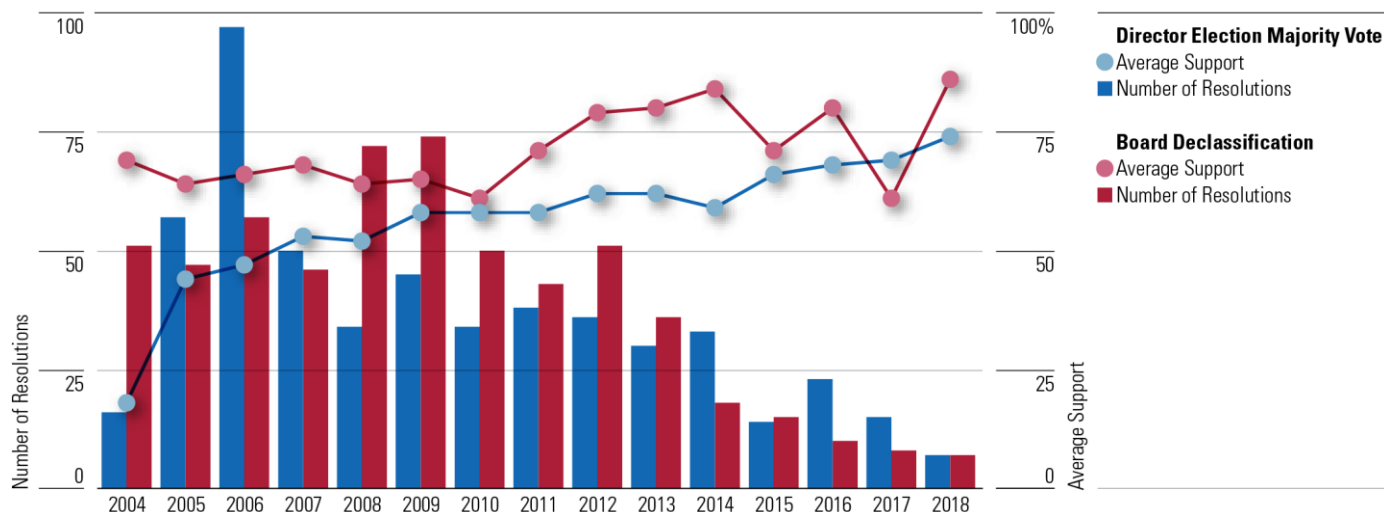
In the case of classified boards, shareholder activists with a competing vision for how to run the company find it impossible to replace enough incumbent directors in a single annual meeting in order to effect significant changes. Board declassification and majority voting in director elections have been priority issues for shareholders since the accounting scandals of the early 2000s.

Exhibit 4 traces 15 years of voting on shareholder resolutions proposing director elections by majority vote and proposing board declassification. With average support remaining well over 50%, and strengthening over time, boards have been pressured into adopting these measures. As both standards have become general practice among large companies, the number of resolutions filed in recent years has declined.

¹⁶ Equilar Inc., Declassified Boards Are More Diverse, June 24, 2017. <https://www.equilar.com/blogs/286-declassified-boards-are-more-diverse.html>

¹⁷ Larson, E., New Research: Diversity + Inclusion = Better Decision Making at Work, *Forbes*, Sept. 21, 2017

<https://www.forbes.com/sites/eriklarson/2017/09/21/new-research-diversity-inclusion-better-decision-making-at-work/#5554a57d4cbf>

Exhibit 4 Shareholder Resolutions Requesting Director Elections by Majority Vote and Board Declassification

Source: Morningstar Proxy Data as of Dec. 31, 2018. Shareholder support for a resolution is calculated as votes cast for as a percentage of all votes cast for and against.

More than 90% of S&P 500 companies have adopted majority voting in director elections, either as a direct response to shareholder resolutions or under pressure to avoid attracting the attention that comes with a shareholder proposal. Plurality voting remains more prevalent among medium-size and smaller companies¹⁸ and some resolutions are now targeted at companies outside the S&P 500.

Item 4 on Vista Outdoor's 2017 proxy ballot was filed by the Connecticut State Retirement Fund, a public pension fund, asking the board to reconstitute itself into a single class with annual elections held for all board members. The resolved clause reads as follows:

*RESOLVED: That shareholders of Vista Outdoor Inc. ('Vista') urge the board of directors to take the necessary steps (excluding those steps that must be taken by shareholders) to eliminate the classification of Vista's board and to require that all directors stand for election annually. The declassification should be completed in a manner that does not affect the unexpired terms of directors.*¹⁹

This case is particularly illustrative. Although management recommended a vote against the proposal, 94% of shareholders sided with Connecticut State Retirement Fund in support of board declassification. In 2018 Vista Outdoor's management sponsored a proposal requesting shareholders to ratify a bylaw change that would declassify the board. Ninety-nine percent of shareholders supported this measure.

Interpreting Vote Outcomes on Shareholder Resolutions

¹⁸ Council of Institutional Directors, FAQ: Majority Voting for Directors

https://www.cii.org/files/issues_and_advocacy/board_accountability/majority_voting_directors/CII%20Majority%20Voting%20FAQ%201-4-17.pdf

¹⁹ Vista Outdoor's 2017 Proxy Statement: <https://www.sec.gov/Archives/edgar/data/1616318/000161631817000110/0001616318-17-000110-index.htm>

Shareholder resolutions are almost always nonbinding, even where a majority of shareholders vote in support of an item. To be binding, a shareholder resolution would direct specific bylaw changes and be supported by at least a majority of shareholders.

In 2018, 149 of the 488 shareholder resolutions included in proxy materials proposed making bylaw changes. Only two of the 149 proposed specific changes to the wording of named sections of corporate bylaws, and only one of these received majority shareholder support. A resolution filed by the Service Employees International Union at Netflix NFLX that proposed specific bylaw changes that would effect election of directors by majority shareholder support received 72% support from shareholders (counting votes cast for and against). Since Netflix's bylaws stipulate that a supermajority of 66.7% of all votes outstanding would be required to effect this change and only 70% of eligible votes were cast, the result is not binding.²⁰

In the vast majority of cases, therefore, the board can choose to ignore a shareholder request even where it earns majority support.

In practice many shareholders, including large institutional shareholders, reflexively follow management's recommended vote, particularly on new types of resolutions, and on resolutions addressing E&S issues.

Environmental and social shareholder resolutions are often more industry- or company-specific and require shareholders to grapple with new information and risk considerations. It may take a season or two, and possibly an accumulation of evidence that the issue is material, before a significant portion of shareholder votes are cast in support of an issue.

The progressively stringent resubmission thresholds required by the SEC allow shareholders to file the same resolution at the same company over subsequent filing years, provided it gains traction. For instance, resolutions addressing prescription drug affordability and gun safety have received much stronger support in recent years, following weaker support early in their filing history.

It therefore doesn't take a very large amount of support for a new resolution to catch management's attention.

A resolution receiving 20% or more of votes in support is seen as a strong signal to management that the issue deserves attention. This is particularly so for resolutions that reference E&S issues. Following the signing of the Paris Climate Agreement by almost all the states of the world at COP 21, a resolution on ExxonMobil's XOM 2016 ballot, calling for regular disclosure of the risks to, and resilience of, Exxon's

²⁰ The resolved clause reads: "RESOLVED, that the stockholders of Netflix, Inc. ("Netflix") hereby amend the bylaws by (a) replacing the first sentence of the third paragraph of Article III, Section 3.3, which provides for directors to be elected by a plurality of shares voted, with the following: "Elections of directors at all meetings of the stockholders at which directors are to be elected shall be by ballot. Subject to the rights of the holders of any Preferred Stock of the corporation...". (Netflix, Inc.'s proxy filing for annual shareholders' meeting held on June 6, 2018 <https://www.sec.gov/Archives/edgar/data/1065280/000119312518125771/d522527ddef14a.htm>).

portfolio of reserves and resources under a scenario in which global warming was limited to 2 degrees above 1990 levels, earned 38% support from shareholders. In 2017, 62% of shareholders supported this call. Shareholder proponents withdrew the same resolution in 2018 after Exxon agreed to produce the report.

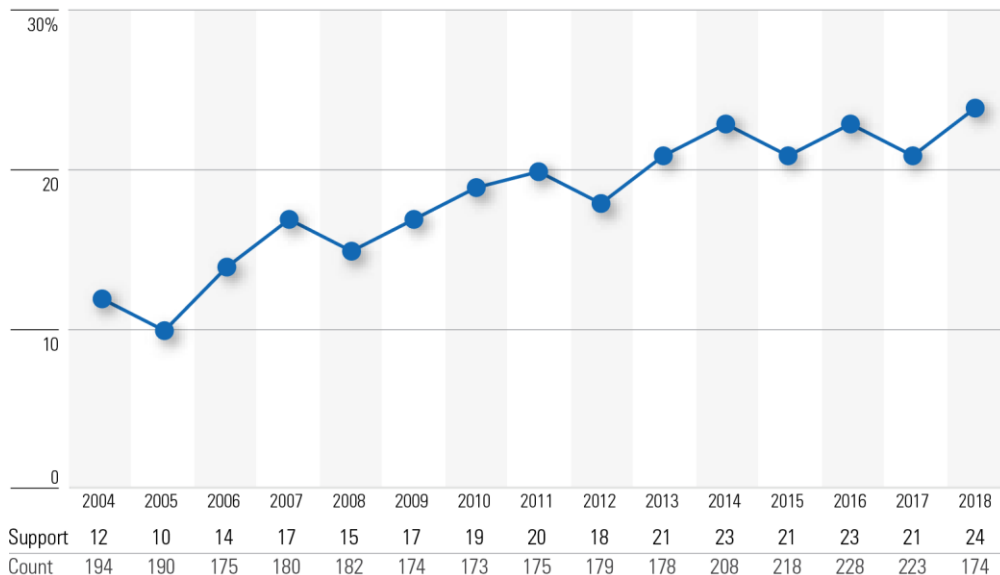
RESOLVED: Shareholders request that, beginning in 2018, ExxonMobil publish an annual assessment of the long-term portfolio impacts of technological advances and global climate change policies, at reasonable cost and omitting proprietary information. The assessment can be incorporated into existing reporting and should analyze the impacts on ExxonMobil's oil and gas reserves and resources under a scenario in which reduction in demand results from carbon restrictions and related rules or commitments adopted by governments consistent with the globally agreed upon 2-degree target. This reporting should assess the resilience of the company's full portfolio of reserves and resources through 2040 and beyond, and address the financial risks associated with such a scenario.²¹

In summary, resolutions that fail to pass with majority support are not necessarily considered to have failed. Those that do pass aren't automatically acted on. Shareholder resolution filing is a way of exercising shareholder voice rather than forcing management to act on specific requests.

Environmental and Social Shareholder Resolutions

Shareholders are increasingly concerned about how E&S risks affect firm performance. This concern is reflected in long-term proxy voting trends, where average support for E&S shareholder resolutions has increased from 12% to 24% over the past 15 years.

²¹ Exxon Mobil Corp's proxy filing for annual shareholders meeting held on May 31, 2017:
<https://www.sec.gov/Archives/edgar/data/34088/000119312517122538/0001193125-17-122538-index.htm>

Exhibit 5 15-Year Trend in Average Support for Resolutions Addressing Environmental and Social Issues

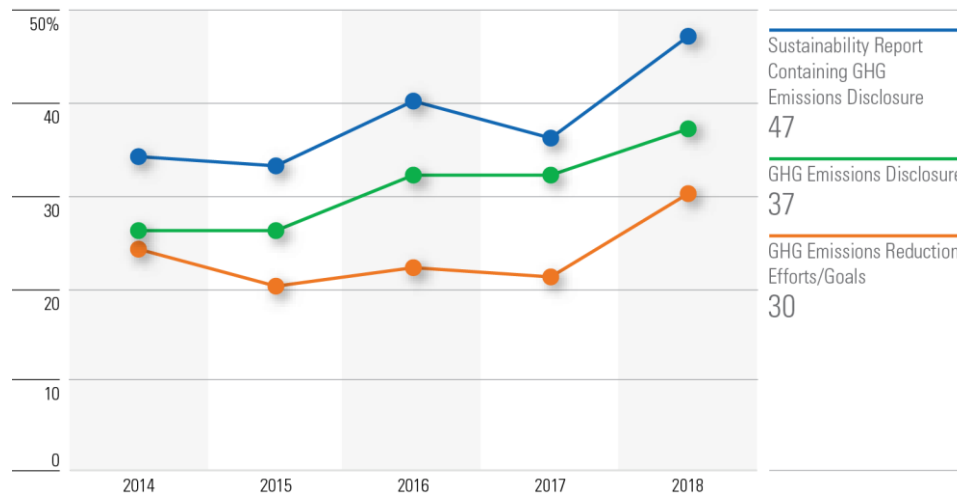
Source: Morningstar Proxy Data as of Dec. 31, 2018. Shareholder support for a resolution is calculated as votes cast for as a percentage of all votes cast for and against.

Ten E&S resolutions opposed by management passed with majority support in 2018 (See Appendix A for a list of these resolutions with additional information about each). The four highest-supported resolutions addressed climate change and reputational risk. Two resolutions at Kinder Morgan KMI earned 60% support; one requested an assessment of how a 2-degree global warming limit would affect the company's business, and the other requested a sustainability report. At Depomed ASRT, 63% of shareholders voted for a resolution requesting management report on the reputational and financial risks of the opioid crisis. At Sturm, Ruger RGR, 69% of shareholders supported a resolution calling for gun safety disclosure.

The increasing urgency of responding to climate change risk and the central role that investors can play in moving economies away from fossil fuel dependence and adapting to some of the inevitable impacts of climate change, has found expression in the proxy process. The 2017 recommendations of the Task Force on Climate-Related Financial Disclosures, organized into four pillars, provide companies with standards for the disclosures that investors need to steward capital away from climate risk and toward sustainable investment opportunities.²²

One of the TCFD pillars is "metrics and targets," containing guidelines for disclosing quantitative greenhouse gas emissions data and emission reduction targets. This is decision-useful information that helps investors forecast companies' exposure to carbon constraints. Aggregated across portfolios, this risk exposure is called Carbon Asset Risk. Exhibit 6 shows that resolutions requesting GHG emissions disclosures from companies were particularly well supported by shareholders in 2018.

²² "Implementing the Recommendation of the Task Force on Climate-Related Financial Disclosures," June 2017 <https://www.fsb-tcfd.org/wp-content/uploads/2017/12/FINAL-TCFD-Annex-Amended-121517.pdf>.

Exhibit 6 Average Support for Resolutions Requesting Greenhouse Gas Emissions Metrics and Targets

Source: Morningstar Proxy Data as of Dec. 31, 2018. Shareholder support for a resolution is calculated as votes cast for as a percentage of all votes cast for and against.

While the proposals that appear on proxy ballots are publicly debated and raise general shareholder awareness, there is a significant amount of productive engagement that takes place between corporate management and shareholders in the shadow of shareholder resolution-filing activity. This very often leads to resolutions being taken off the ballot. In many cases, the filing of a shareholder resolution opens the door to meaningful engagement over ESG risks.

In 2018 more E&S resolutions were withdrawn through engagement than appeared on corporate ballots.²³ Most withdrawn resolutions addressed gender pay equity, board diversity, carbon asset risk, equal employment opportunity reporting, and money in politics. Those that remained on ballots received record levels of support from shareholders.

The fact that a clear process exists for shareholders to propose resolutions helps management be more attentive to shareholder concerns. Indeed, very often management will meet and engage with shareholders well before an issue is even proposed for inclusion on the ballot. Some of the largest financial institutions use direct engagement with corporate boards as a means of proactively addressing sustainability and governance concerns.

²³ Welsh, H. (2018). Proxy Season Review: Social, Environmental & Sustainable Governance Shareholder Proposals in 2018. Sustainable Investments Institute.

Asset Manager Proxy Voting

Investor stewardship refers to the active involvement of institutional investors in the governance of the companies in their portfolios. Resolution filing, proxy voting, and engagement with corporate management and boards are all stewardship strategies that fiduciaries can leverage in protecting long-term portfolio value.

The six UN Principles for Responsible Investment contain a number of possible actions that signatories can take which, together, compose the best-known reference point for what investor stewardship entails.²⁴ These cover engagement, policy advocacy, shareholder resolution filing, requesting ESG disclosures, transparency about stewardship activities, and collaboration on stewardship initiatives. The most visible and possibly the most powerful stewardship strategy is proxy voting.

Large asset managers control a sizable portion of the U.S. equities market through their mutual funds and exchange-traded funds. The years since the financial crisis have seen massive flows into passively managed index funds and the portion of U.S. equities held in index funds has grown considerably.²⁵

Invested as they are across the length and breadth of the market, large asset managers, especially those with large amounts of passive assets, occupy a central role in the financial system as stewards of equity capital. As fiduciaries, managing assets on behalf of fund beneficiaries, asset managers have a responsibility to promote long-term value, not only company by company, but also through marketwide governance practices that build resilience and avoid systemic risk.

With sustainability recognized as a driver of long-term value, there is therefore considerable interest in how funds offered by the largest asset managers vote their proxies.

Since 2004, U.S. mutual funds have been required to publicly disclose their proxy voting policies and procedures as well as their annual proxy voting records via SEC filings. At the end of August each year, asset managers must disclose — fund by fund, item by item — how they voted on portfolio company ballots for meetings held in the preceding proxy calendar.

Recently, Morningstar acquired Fund Votes Research Ltd, which has tracked mutual fund and ETF proxy voting data on company resolutions and shareholder proposals across the 15 years of SEC fund proxy voting disclosure. This dataset complements a growing suite of Morningstar ratings and metrics that give investors insight into funds' and managers' approach to sustainability.

Voting data shows clearly that, while there are considerable differences in asset managers' voting patterns, the largest global asset managers recently shifted their voting styles and are increasingly voting in support of E&S issues.

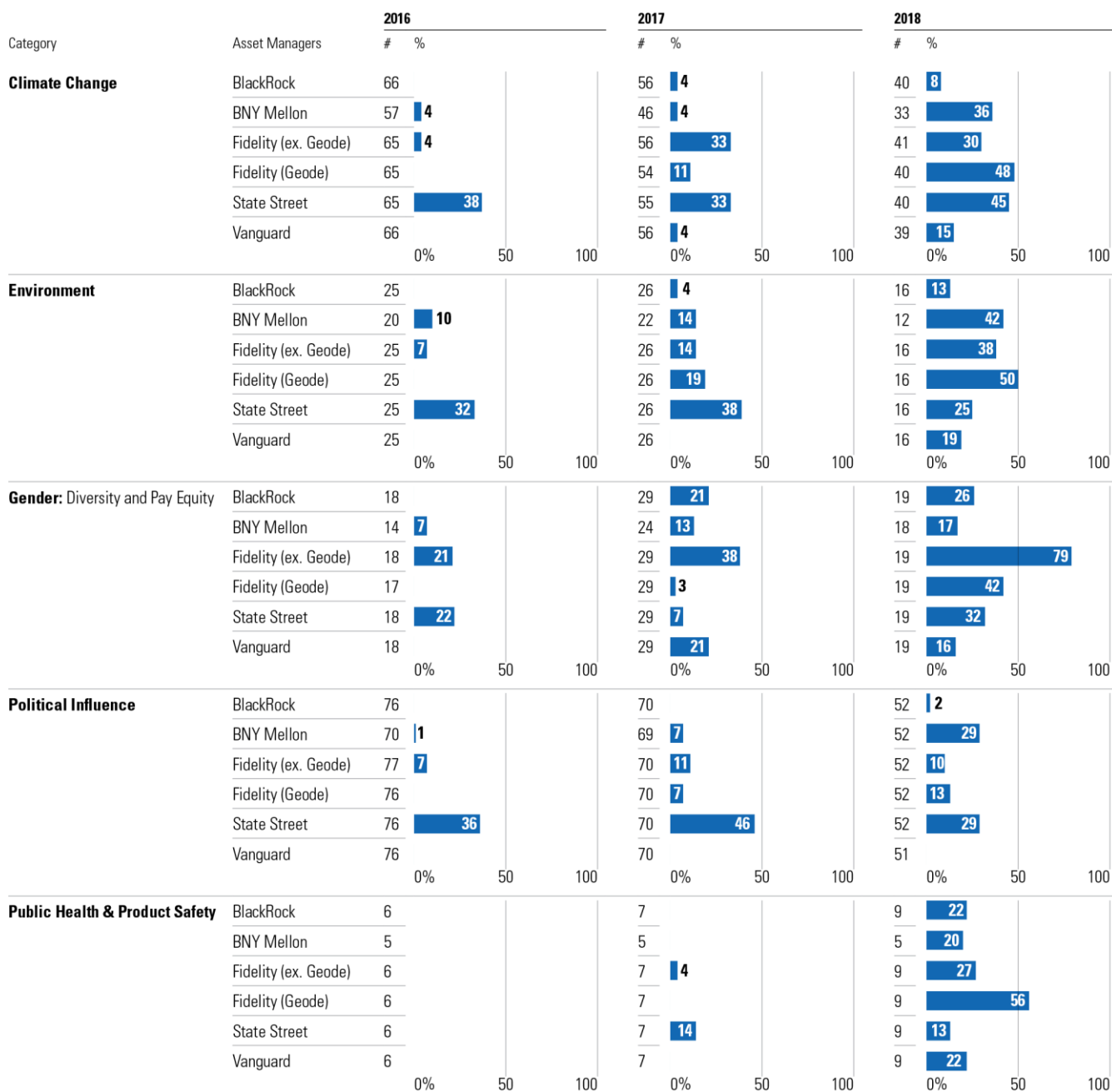
²⁴ UN PRI, "What are the Principles for Responsible Investment?" <https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment>

²⁵ Stein, C., Shift From Active to Passive Approaches Tipping Point in 2019, Bloomberg, Dec. 31, 2018.

<https://www.bloomberg.com/news/articles/2018-12-31/shift-from-active-to-passive-approaches-tipping-point-in-2019>

Exhibit 7 tracks three years of votes by the largest five asset managers (BlackRock, Vanguard, State Street, Fidelity,²⁶ and BNY Mellon) across broad groupings of E&S resolution categories.

Exhibit 7 Large Asset Manager Support for Shareholder Resolutions in Broad E&S Category Groupings



Source: Morningstar Proxy Voting Data as of Dec. 31, 2018. Support is calculated as the percentage of the resolutions supported by funds within fund groups offered by each of the asset managers.

²⁶ Geode Capital Management, LLC. manages Fidelity Investments' equity index funds. Votes cast by Geode are therefore summarized separately. BlackRock's vote summary does not reflect votes by iShares Sustainable ETFs as these funds are voted separately to all other BlackRock and iShares funds.

Underscoring voting trends on E&S shareholder resolutions, asset managers may increasingly bring to bear sustainability considerations on other parts of the ballot. State Street has publicly stated that it will vote against boards that fail to diversify their gender composition. BlackRock has indicated that it expects demonstrable climate competency from boards in sectors exposed to climate risk. Recognizing E&S issues as material to investment performance challenges investors to consider their votes across the entire ballot through a sustainability lens. This could increasingly affect votes on board nominees and say-on-pay, where oversight of ESG risk is lacking and incentive structures fail to incorporate sustainability metrics.

Conclusions

- ▶ Shareholders have used the proxy process to shape governance practices for almost 80 years.

Shareholder resolution filing and the dialogue between management and shareholders that this activity often leads to is a distinctive feature of the ecosystem of checks and balances that characterize the U.S. equities market. A look back at resolution filing prior to the financial crisis shows that shareholders were working through the proxy process to strengthen corporate governance against short-termist business practices well before 2008.

- ▶ The proxy process raises awareness of issues that pose material investment risks to portfolios and the equities market.

While asset managers are responding to retail investor demand for products that are screened or themed against E&S issues, they are also being challenged to consider how their proxy votes protect their portfolios from material ESG risks. Investment fiduciaries have an obligation to take an active approach to proxy voting. Increasingly, retail investors want to know how funds vote their proxies and whether a fund's vision for long-term portfolio health incorporates E&S considerations. The active involvement of the largest financial institutions, heavily invested as permanent owners across capital markets, enhances the effectiveness of the proxy process in avoiding and addressing systemic financial risks.

Multiyear comparisons of voting records show that the largest asset managers are increasingly supporting shareholder resolutions that address E&S concerns. Their votes are driving record levels of support and the resolutions they support are raising investor awareness of how issues like cyber security, gun safety, the opioid crisis, human trafficking, ocean plastics, indigenous peoples' rights, and the role of money in politics have a material bearing on investment risk and opportunity.

- ▶ The proxy process ignites and amplifies investors' engagement efforts.

Climate change is the biggest sustainability challenge facing financial markets and the world. The Paris Climate Agreement carved out a special role for the financial sector in making the global energy transition needed to avoid catastrophic climate change. As the world barrels past the 400ppm carbon level in the atmosphere, shareholders' calls for 2-degree reporting and disclosure of GHG emission

reduction targets are as much about the resilience of individual business models as they are about avoiding a carbon-induced global financial crisis.

In the absence of stronger climate policy, shareholders are pressing high-impact and carbon-exposed companies to provide the information that they need to navigate a carbon-constrained future. Majority support for resolutions requesting disclosure of business risks associated with carbon constraints at ExxonMobil, Occidental Petroleum, and PPL in the 2017 proxy season turned the tide on climate change engagement. In 2018, only six of the 22 resolutions that asked for carbon asset risk disclosure went to vote, according to the Sustainable Investments Institute's report. Withdrawn resolutions signal successful engagements between investors and companies. In December 2017 the Climate Action 100+ was formed as a global alliance of investors committed to engaging the most egregious emitters of GHGs on climate disclosure, climate governance competence and emissions reduction.

Proxy voting and investment stewardship are therefore key to protecting long-term portfolio value. More broadly, the degree to which the proxy process gives voice to investors' concerns about material E&S risk will shape the resilience of the equities market. It is therefore essential for investors to remain vigilant in protecting their right to submit shareholder resolutions and to use the proxy ballot to enhance governance of natural and social capital.

Appendix

Exhibit 8 Environmental and Social Shareholders Resolutions Supported by a Majority of Shareholders in 2018

Company	Resolved Clause	Filer	Management's Recommended Vote	Main Issue	Support	Proposal Title
Sturm, Ruger & Co Inc	Shareholders request the Board of Directors issue a report by February 8, 2019, at reasonable expense and excluding proprietary information, on the company's activities related to gun safety measures and the mitigation of harm associated with gun products, including the following: * Evidence of monitoring of violent events associated with products produced by the company. * Efforts underway to research and produce safer guns and gun products. * Assessment of the corporate reputational and financial risks related to gun violence in the U.S.	Sisters of the Holy Names of Jesus and Mary of Marylhurst, Oregon	Against	Gun Safety and Reputational Risk	69%	Safety Measures And Mitigation of Harm Associated With Company Products
Depomed Inc	That shareholders of Depomed, Inc. ("Depomed") urge the Board of Directors (the "Board") to report to shareholders by September 30, 2018 on the governance measures Depomed has implemented since 2013 to more effectively monitor and manage financial and reputational risks related to the opioid crisis in the United States (U.S.), given Depomed's manufacturing and past sale of opioid medications, including whether Depomed has assigned responsibility for such monitoring to the Board or Board committee, revised senior executive compensation metrics or policies, adopted or changed mechanisms for obtaining input from stakeholders, or altered policies or processes regarding company political activities.	Calvert Research and Management	Against	Opioid Crisis and Reputational Risk	62%	Report on Financial And Reputational Risks of Opioid Crisis
Kinder Morgan, Inc.	Shareholders request that Kinder Morgan issue an annual sustainability report describing the company's analysis of, and short- and long-term responses to the ESG-related issues that are most important to the company. The report should be prepared at a reasonable cost, omit proprietary information, and be made available to shareholders by December 2018.	New York State Common Retirement Fund	Against	Sustainability Report	60%	Annual Sustainability Report
Kinder Morgan, Inc.	Shareholders request that by 2019, KMI publish, with board oversight, an assessment of the long-term portfolio impacts of scenarios consistent with the internationally recognized goal of limiting the global increase in temperature to 2 degrees Celsius. The assessment should analyze the impacts on KMI's portfolio of assets and explain how capital planning and business strategies incorporate analyses of the financial risks of a low-carbon transition. The report should be done at reasonable cost and omit proprietary information.	Zevin Asset Management	Against	2-Degree Climate Scenario Impact	60%	Assessment of the Long-Term Portfolio Impacts of Global Climate Change Policy Scenarios
Genesee & Wyoming Inc	Shareholders request that Genesee & Wyoming adopt time-bound, quantitative, company-wide goals for reducing greenhouse gas (GHG) emissions, taking into account the goals of the Paris Climate Agreement, and report at reasonable cost and omitting proprietary information, on its plans to achieve these goals.	Calvert Research and Management	Against	GHG emissions goals	57%	Greenhouse Gas Emission Goals

Source: Morningstar Proxy Data as of Dec. 31, 2018. Support is calculated as the percentage of the resolutions supported by funds within fund groups offered by each of the asset managers.

Exhibit 8 Environmental and Social Shareholders Resolutions Supported by a Majority of Shareholders in 2018 (Continued)

Company	Resolved Clause	Filer	Management's Recommended Vote	Main Issue	Support	Proposal Title
Middleby Corp	Shareholders request The Middleby Corporation (Middleby) issue a report describing the company's environmental, social, and governance (ESG) policies, quantitative performance metrics, and improvement targets, including a discussion of greenhouse gas (GHG) emissions management strategies and metrics. This report should be updated annually, be prepared at reasonable cost, and omit proprietary information.	Trillium Asset Management	Against	Sustainability Report	57%	ESG Reporting
Ameren Corp	Shareholders request that the Board prepare a complete report on the company's efforts, above and beyond current compliance, to identify and reduce environmental and health hazards associated with past, present and future handling of coal combustion residuals, and how those efforts may reduce legal, reputational and financial risks to the company. This report should be available to shareholders within 6 months of the 2018 annual meeting, be prepared at reasonable cost, and omit confidential information such as proprietary data or legal strategy.	School Sisters of Notre Dame; As You Sow; Kalpana Raina and Robert M. Hogg; Sisters of Charity of the Blessed Virgin Mary; Sisters of St. Joseph of Carondelet	Against	Coal Combustion Waste	53%	Report on Coal Combustion Residual and Water Impacts
Anadarko Petroleum Corp	Shareholders request that Anadarko publish with Board oversight, at reasonable cost and omitting proprietary information, an assessment of the impacts to the Company's portfolio of scenarios consistent with limiting global warming to 2 degrees Celsius or below. The assessment should outline the resilience of the company's reserves and resource portfolio in response to multiple demand and price scenarios and explain how capital planning and business strategies incorporate the financial risks posed by such scenarios.	Park Foundation Inc.	Against	2-Degree Climate Scenario Impact	53%	Climate Change Risk Analysis
Palo Alto Networks Inc	Shareholders request that Palo Alto Networks prepare a diversity report, at reasonable cost and omitting confidential information, available to investors including: 1. A chart identifying employees according to gender and race in major EEOC-defined job categories, listing numbers or percentages in each category; 2. A description of policies/programs focused on increasing diversity in the workplace.	Trillium Asset Management obo William A. Gee IV	Against	Workplace Gender Diversity	51%	Diversity Report
Range Resources Corp	Shareholders request Range Resources issue a report (by September 2018, at reasonable cost, omitting proprietary information) that reviews the Company's policies, actions and plans related to methane emissions management, including efforts to: measure, monitor, mitigate, disclose, utilize leak detection and repair (LDAR) technologies (including frequency, scope, and methodology).	Unitarian Universalist Association	Against	Methane Emissions	50%	Report Regarding Methane Emissions

Source: Morningstar Proxy Data as of Dec. 31, 2018. Support is calculated as the percentage of the resolutions supported by funds within fund groups offered by each of the asset managers.

For More Information

Jackie Cook
Director, Sustainable Stewardship Research
+1 416-489-7074
jackie.cook@morningstar.com

Jon Hale, Ph.D., CFA
Director, Sustainability Investing Research
+1 312-696-6093
jon.hale@morningstar.com



22 West Washington Street
Chicago, IL 60602 USA

©2019 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. The information, data, analyses, and opinions presented herein do not constitute investment advice; are provided solely for informational purposes and therefore are not an offer to buy or sell a security; and are not warranted to be correct, complete, or accurate. The opinions expressed are as of the date written and are subject to change without notice. Except as otherwise required by law, Morningstar shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses, or opinions or their use. The information contained herein is the proprietary property of Morningstar and may not be reproduced, in whole or in part, or used in any manner, without the prior written consent of Morningstar. To license the research, call +1 312 696-6869.