

From the Public Company Advisory Group of Weil, Gotshal & Manges LLP

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BlackRock Announces Engagement Priorities and Key Performance Indicators for 2020:

Will Hold Directors Accountable for Failure to Make Progress on Sustainability

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Against the backdrop of social and economic uncertainty arising from the COVID-19 pandemic, BlackRock has released its engagement priorities for the 2020 proxy season available [here](#). The priorities center on environmental, social and governance (ESG) issues, with an emphasis on sustainability issues and disclosure. On the heels of BlackRock CEO Larry Fink’s annual letter to CEOs, available [here](#), BlackRock has made clear its intention to hold boards, board committees or senior-most non-executive directors (depending on the circumstance) accountable for demonstrating “material progress” on ESG-related disclosures and practices. State Street and other major institutional investors and pension funds are sending similar signals.

Each of BlackRock’s five key areas of engagement has an associated key performance indicator (KPI) against which BlackRock will track a company’s progress. BlackRock has also begun to more frequently post company-specific voting bulletins explaining its voting decisions. In this Alert, we discuss some of the key takeaways for public companies and their boards about engagement with BlackRock, which have applicability to engagement with other major institutional investors as well. We note that while BlackRock’s priorities do not expressly address COVID-19, there would seem no better indication this season of a board’s quality and effectiveness than how it is working with management to blunt the impact of COVID-19 on the company, its employees and its other important constituencies.

Key Engagement Priorities at a Glance

1. ***Board Quality:*** Board composition, effectiveness, diversity and accountability remain a top priority.
2. ***Environmental Risks and Opportunities:*** Disclosure provides enhanced understanding of board and management oversight of policies, risk factors and opportunities that drive long-term sustainable financial performance.
3. ***Corporate Strategy and Capital Allocation:*** A clear articulation of corporate strategy and capital allocation provides a clear sense of the direction a company intends to take.
4. ***Compensation That Promotes Long-Termism:*** Executive pay policies and outcomes should link closely to long-term strategy, goals and performance.
5. ***Human Capital Management:*** In a talent constrained environment, companies should focus on sound business practices that create an engaged and stable workforce.

BlackRock's Key Engagement Priorities, KPIs and Board Accountability

1. **Board Quality.** Board composition, effectiveness and accountability remain a top priority for BlackRock, which encourages engagement that includes conversations with independent directors who can speak to the board's strategic risk oversight.
 - **Disclosure.** BlackRock expects to see disclosure of the board's position on director responsibilities and commitments, turnover, succession planning, and diversity. With regard to responsibilities and commitments, BlackRock states that it is seeking to understand the board's role in crisis management. The examples of crises it cites include cyber events, sudden departures of senior executives, negative media coverage or proxy contests. The board's role in helping the company weather the COVID-19 pandemic will likely emerge as another highly pertinent board oversight issue to address in an engagement. With regard to diversity, BlackRock states that it recognizes that diversity encompasses both personal factors (gender, ethnicity, age) as well as professional characteristics (industry, area of expertise, geographic location).
 - **KPIs.** BlackRock expects access to least one non-executive, and preferably independent, director, who has been identified as being accessible to shareholders where appropriate.
 - **Board Accountability.** BlackRock states that it will hold the most senior non-executive director – the chairman or lead independent director – accountable for ensuring that a director with whom BlackRock can engage is identified. In addition, BlackRock may vote against directors on the nominating and/or governance committee where it considers the board to be insufficiently diverse.
2. **Environmental Risks and Opportunities.** BlackRock continues to view the management of climate and environment-related factors as “an increasingly defining factor in companies' long-term prospects.” BlackRock says it sees three outcomes from its engagements on climate risks: better company disclosure that will contribute to improved market-level data, substantive company action, and more informed voting decisions aligned with long-term value-creation.
 - **Disclosure.** As announced in the 2020 annual letter to CEOs, BlackRock is asking companies to issue, by the end of 2020, reports aligned with applicable recommendations of the Sustainability Accounting Standards Board (SASB) and Task Force on Climate-Related Financial Disclosures (TCFD). BlackRock believes that robust disclosure is essential for investors to effectively gauge companies' preparedness for environmental risks and opportunities, and that in the absence of robust disclosures, investors will conclude that companies are not adequately managing risk.
 - **KPIs.** Companies with which BlackRock has already engaged on TCFD-aligned reporting should disclose sufficient detail across the four pillars of the TCFD framework and provide a timeframe within which the company will report fully in line with the eleven more granular recommendations of the TCFD framework.
 - **Board Accountability.** BlackRock will hold directors accountable if a company does not make adequate progress on disclosure under the SASB and TCFD rubrics and, where BlackRock has already engaged on TCFD, BlackRock will hold members of the relevant committee, or the most senior non-executive director, accountable for inadequate disclosures and the business practices underlying them. For example, in connection with the March 2020 annual meeting of National Fuel Gas Company, BlackRock explained in its voting bulletin that it voted against the election of the chair of the audit committee, as the longest tenured director up for re-election on the company's classified board, because it “would have expected the company to be farther along in its reporting” on material company risks associated with climate change given prior engagement between the company and BlackRock on the issue.
 - **Management Accountability.** Citing the groundwork that BlackRock's investment stewardship team has laid in engaging on climate risk disclosure, including BlackRock's participation in Climate Action 100+, an investor-led

corporate engagement initiative, BlackRock states that it will be “increasingly disposed to vote against management when companies have not made sufficient progress” on climate risk disclosure.

3. **Corporate Strategy and Capital Allocation.** BlackRock expects boards to be fully engaged with management on the development and implementation of the company’s strategy for long-standing value creation, particularly when the company needs to enhance its competitiveness or pivot in light of unanticipated developments.
 - **Disclosure.** BlackRock believes that companies should “succinctly explain” the long-term goals that the board and management are working toward, the applicable measures and milestones, and steps taken in response to challenges. The explanation should include how the company prioritizes its capital allocation among demands such as investment, R&D, technological adaptation, employee development, and returns to shareholders via dividends and buybacks. BlackRock expects that this explanation will be refreshed periodically as the business environment changes. BlackRock also reiterated the message in Mr. Fink’s 2019 letter to CEOs, available [here](#) that “profits and purpose are inextricably linked”, citing that corporate strategy disclosures should clearly explain a company’s purpose – what it does every day to create value for its stakeholders.
 - **KPI.** As part of long-term strategy and capital allocation, companies should articulate publicly how sector-relevant sustainability risks and opportunities are integrated into business strategy. BlackRock will engage with companies to review its reporting expectations and encourage them to make the connection between long-term planning and business-relevant sustainability risks and opportunities. The engagement priorities mention SASB’s disclosure framework as a reference for sector-specific standards.
 - **Board Accountability.** BlackRock will hold the most senior non-executive director accountable if, within an agreed timeframe, the company has not provided adequate disclosures and made progress on the business practices underlying them.
4. **Compensation That Promotes Long-Termism.** BlackRock continues to keep a watchful eye on how boards establish and explain executive compensation programs in the context of the company’s long-term strategy. BlackRock states that it expects a meaningful portion of executive pay to be tied to the long-term returns of the company, as opposed to short-term increases in the stock price.
 - **Disclosure.** Companies should disclose the metrics used to trigger payments under incentive plans and should justify those metrics and payments in the context of a company’s business model and sector. The disclosure should articulate the company’s balance and prioritization between “input” metrics that are within management’s control relative to “output” metrics such as earnings per share or total shareholder return. Where pay seems misaligned with performance, BlackRock expects the company to provide detailed justification in its public disclosures, and may seek to engage with independent directors if its concerns are not addressed. BlackRock may also ask the board to explain the extent to which it considers factors such as internal pay equity.
 - **KPIs.** Executive pay should be adequately aligned with performance and shareholder investment return. BlackRock expects pay outcomes to be correlated with a business-relevant long-term performance metric, such as 3-5 year total shareholder return or return on invested capital. BlackRock will also evaluate company-wide structures, as it believes compensation, including base, bonus, and pension contributions, is an important element of a company’s ability to retain and attract talent at all levels and provides insight into a company’s human capital management in practice.
 - **Board Accountability.** BlackRock will hold compensation committee members accountable for pay outcomes, or failing to demonstrate the connection between strategy, long-term shareholder value creation, and executive incentive plan design.
5. **Human Capital Management.** BlackRock expects boards of directors to oversee human capital management and that companies disclose the board’s role, including an explanation of the type of information reviewed and how frequently such review takes place. BlackRock views factors such as employee development, corporate

culture, compensation, inclusion and diversity, as well as a commitment to sound practices in relation to equal employment opportunity, health and safety, labor relations, and supply chain labor standards as critical components of a robust HCM strategy, especially in light of market trends such as shortages of skilled labor, uneven wage growth and shifts in technology.

- **Disclosure.** BlackRock expects disclosure to provide investors with an understanding of how the board oversees and works with management to improve performance around business practices likely to create an engaged and stable work force. BlackRock indicates that qualitative and quantitative disclosures will help investors understand how companies are considering HCM as a business risk and valuing their employees as a long-term asset to the company. BlackRock suggests the use of industry-specific metrics, such as those provided by SASB.

In August 2019, the SEC proposed rules available [here](#) to modernize the description of business, legal proceedings and risk factor disclosures. Specifically, one possible new topic would be human capital resources, including any material human capital measures or objectives that management focuses on in managing the business.

- **KPIs.** Given most companies identify their employees as their greatest asset, BlackRock expects boards to oversee human capital management strategies.
- **Board Accountability.** Absent disclosure about the board's role in overseeing the company's human capital practices, including an explanation of the type of information reviewed and how frequently, BlackRock will hold members of the relevant committee, or the most senior non-executive director, accountable.

Sustainability as BlackRock's New Standard for Investing

Simultaneously with the release of the 2020 annual letter to CEOs, BlackRock published a letter to its clients available [here](#), "*Sustainability as BlackRock's New Standard for Investing*." In the letter to its clients, BlackRock announced a number of initiatives to place sustainability at the center of BlackRock's own investment approach, engagement priorities and voting decisions. BlackRock committed that, as part of satisfying its fiduciary responsibility to help clients navigate this transition, BlackRock will make sustainability integral to the way that it manages risk, constructs portfolios, designs products and engages with companies. BlackRock indicated that it will focus on reducing ESG risk exposure, bolstering its proprietary analytics tools, enhancing transparency of its products, as well as increasing access to sustainable investment options by increasing the number of funds and indexes. For example, BlackRock has committed to move away from high-risk sectors such as the thermal coal industry and has promised to provide transparent, publicly available data on sustainability characteristics – including data on controversial holdings and carbon footprint – for BlackRock mutual funds. According to BlackRock, these efforts will result in more resilient portfolios that achieve better risk-adjusted returns. After an annual meeting, BlackRock makes available company-specific voting reports that explain in detail its voting decisions around high-profile votes. BlackRock also promised to include greater disclosure of engagement topics it discusses with companies in its annual report on investment stewardship (see, e.g., 2019 report available [here](#)).

What to do Now?

- **Continue to Engage on ESG.** Companies and their boards should recognize that investor focus on ESG issues is unlikely to diminish as a result of COVID-19. As the 2020 proxy season unfolds, public companies should continue to engage with their various constituencies on ESG issues and understand the priorities of their most significant investors, keeping in mind the constraints of Regulation FD and the antifraud provisions of the federal securities laws.
- **Plan for implementing the SASB and TCFD frameworks, which have been harmonized.** Given the endorsement of the SASB and TCFD frameworks by BlackRock and State Street, companies that have not done so already should begin to plan how they can put these into practice – and demonstrate progress by the end of the year. It is worth noting in this regard that more than 100 companies, a list of which is available on the SASB website [here](#), have adopted the SASB disclosure framework.

State Street recently launched the R-Factor scoring system (the ‘R’ stands for Responsibility), which measures the performance of a company’s business operations and governance as it relates to financially material and sector-specific ESG topics. Leveraging the SASB materiality-focused disclosure framework, R-Factor generates ESG scores for over 6,000 listed companies globally, evaluating a company’s performance against both regional and global industry peers. State Street’s annual letter warns that beginning this proxy season, it will “take appropriate voting action against board members at companies in the S&P 500 . . . that are laggards based on their R-Factor scores and that cannot articulate how they plan to improve their score.” State Street has also provided an [ESG Oversight Framework](#) for boards to incorporate sustainability into the company’s strategy.

- ***Tell Your ESG (and COVID-19) Story.*** Public disclosure, including the annual proxy statement and other SEC filings, the corporate website and stand-alone sustainability reports, should be approached as an opportunity to tell the company’s story about how both management and the board are addressing the opportunities and risks of climate-change and other ESG risk and opportunities the company is or will be facing. While likely to be a more in-depth discussion in the 2021 proxy statement, companies that are putting the final touches on this year’s proxy statement should also consider a discussion of how management, under the oversight of the board, is addressing the myriad challenges of COVID-19, such as disaster preparedness, continuity planning and protecting the health and well-being of employees. As we discussed in our alert available [here](#), the SEC staff continues to monitor and provide guidance with respect to corporate filings and disclosures (e.g., changes in trends and outlook, risk factors, and discussion of supply chain and distribution matters), and provide updates to its key initiatives available on the Division of Corporation Finance website available [here](#). Companies should also consider the SEC’s guidance available [here](#) on disclosure of key financial and non-financial performance indicators and metrics in MD&A, which is useful in assessing the accuracy and completeness of disclosures made elsewhere.

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