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BlackRock Annual Letter to CEOs Calls for Companies to Deliver Financial & Social Value

Chairman and CEO Laurence Fink Calls for 'New Framework' of Engagement to Foster Long-Term Value

On Tuesday, January 16th, BlackRock Chairman and CEO Laurence Fink released his annual letter to CEOs outlining a bold vision linking the prosperity of companies to their ability to deliver both financial performance as well as positive contributions to society. Entitled "A Sense of Purpose," the letter highlights BlackRock's increasingly active approach to shareholder engagement, its view that boards are central in the oversight of companies' long-term strategic direction and what Mr. Fink believes is a connection between companies' management of environmental, social and governance (ESG) risk factors and long-term value creation.

The letter is yet another signal of a fundamental shift in the thinking of mainstream asset managers on matters that some have historically viewed as non-economic. As pressure rises on large asset managers around how they are "overseeing" companies in their portfolios, these social and environmental matters are increasingly being touted as key to value creation and long-term sustainability. The forward-leaning position on corporate responsibility taken in the letter is an indicator of how shifting asset owner expectations are being integrated into asset managers' behavior. For companies this shift has created a new set of expectations, and the potential for greater scrutiny, from investors that may continue to grow for years to come.

Key Themes – ESG, Shareholder Engagement, Directors and Activism

This year's letter reiterated a number of themes from previous years' communications and expanded on ways that BlackRock expects companies to enhance long-term shareholder value:

- **ESG Topics and the Importance of Board Diversity in Creating Long-Term Value:** Mr. Fink's letter highlights BlackRock's belief that management of ESG matters is essential to sustainable growth. In BlackRock's view, exercising oversight of these and other emerging challenges to long-term value creation is the purview of the board, which Mr. Fink emphasizes should include a diversity of gender, ethnicities, experience and ways of thinking. Companies should expect BlackRock (and, with time, other large institutional investors) to invest more time in understanding companies' management of risk related to their broader impact on communities, society and the environment. This likely means growing support for shareholder proposals on these topics and more pressure on boards to demonstrate that they are acting on these issues.

- **Shareholder Engagement:** Citing the need to be "active, engaged agents on behalf of the clients invested with BlackRock," the letter calls for a new model of shareholder engagement which includes year-round conversations about ways to improve long-term value. While Mr. Fink notes that BlackRock has committed significant resources toward enhancing its own investment stewardship efforts over the past few years, he writes that "the growth of indexing demands that we now take this function to a new level." BlackRock intends to double the size of its approximately 30-member investment stewardship team to at least 60 members over the next three years and the team's work will now be overseen by Barbara Novick, Vice-Chairman and a co-founder of BlackRock, who also oversees government relations and public policy. This likely means the stewardship team at BlackRock will have more bandwidth to subject portfolio companies to closer scrutiny and engage more extensively on issues of concern.

- **The Role of the Board in Communicating and Overseeing Corporate Strategy for Long-Term Growth:** Returning to a common theme from previous communications, this year's letter touches on the importance of the board in helping companies articulate a strategic framework for long-term value creation. Although the average number of hours dedicated by board members to their roles has risen in recent years, Mr. Fink continues to raise the bar, pointing out that directors "whose knowledge is derived only from sporadic meetings are not fulfilling their duty to shareholders." This year's letter provides a list of questions BlackRock believes companies (i.e. boards and management) should be asking to ensure that they are in position to sustain long-term performance. These questions explicitly include the societal impact of business as well as ways that broad, structural changes such as economic conditions, automation and climate change affect the potential for growth.

- **Engaging on Activism:** Mr. Fink writes that a "central reason for the rise of activism – and wasteful proxy fights – is that companies have not been explicit enough about their long-term strategies." He points, as an example, to recently-passed tax reform, and its potential for increased after-tax cash flow, as one way that activists may target companies that do not effectively communicate their long-term strategy. Mr. Fink encourages companies to engage with investors and other critical stakeholders early in the process when activists offer "valuable ideas – which is more often than some detractors suggest," an observation consistent with BlackRock's selective support for activists in proxy fights. The letter also notes that Mr. Fink believes companies miss opportunities for meaningful dialogue when their conversations with investors begin after a proxy proposal has been filed rather than in an ongoing and preemptive manner well in advance of an activist challenge.

Takeaways for Issuers

This letter represents a significant evolution of BlackRock's public views on the responsibility of companies and boards to actively manage the societal impacts of their business to the benefit of all stakeholders. Mr. Fink asserts that the goal of asset owners is not only to enhance their investment returns, but also to see the private sector address social challenges that will ensure the "prosperity and security" of their fellow citizens.

BlackRock is not alone in making this philosophical shift. The past several months have provided examples of how this new dynamic is shaping voting and investment decisions. Last summer, climate risk disclosure resolutions passed at major energy companies for the first time. This November, State Street Global Advisors disclosed that it had voted against directors at 400 companies that it believed had not made efforts to increase board diversity. Earlier this month, JANA Partners and CalSTRS teamed up to lead an activism campaign on the question of whether Apple is sufficiently enabling parents to protect their children as they use technology and JANA has also established a fund to target additional companies on similar corporate responsibility topics. Additionally, long-only portfolio managers and sell-side research analysts are increasingly incorporating ESG factors into their investment screening and rating criteria, respectively.

To stay ahead of the issues raised in Mr. Fink's letter, public companies should consider:

- Building a practice of year-round ongoing engagement on governance and sustainability matters with their top investors to stay ahead of activism and be on the front foot with investors when faced with a challenge.
- Explaining the board's process in guiding long-term strategy development and overseeing the role of the company in society and in discussions with investors.
- Introducing investors to a variety of members of the management team and, on occasion, to one or more board members to build relationships and trust over time across the leadership of the business.
- Disclosing how directors are cultivating knowledge of the company outside the scope of the formal board meeting construct in order to fulfill their mandate to protect the long-term interests of investors.

Authors

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