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2014 Proxy Season Preview

In her regular column on corporate governance issues, Holly Gregory identifies potential hot topics for the upcoming proxy season and provides steps companies can take now to prepare.

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Holly specializes in advising companies and boards on corporate governance matters, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, audit and special committee investigations, board audits and self-evaluation processes, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisory firms, compliance with legislative, regulatory and listing rule requirements, and governance best practice.

Notwithstanding the uptick in shareholder activism, the 2013 proxy season was less contentious than expected due in large measure to company efforts to understand shareholder concerns, negotiate with proponents and engage with shareholders generally on key issues. Shareholders supported executive compensation with high votes for say on pay. Even though shareholders filed more proposals, and SEC no-action relief was less likely to be granted, the percentage of proposals that received majority support from shareholders was the lowest in five years.

Company engagement with shareholders is proving successful as a release valve for proxy season tensions. Companies should begin preparing now for the 2014 proxy season to ensure that they are well-positioned to engage with shareholders on executive compensation issues, as well as on issues that may be the subject of shareholder proposals or campaigns targeting directors in re-election efforts.

In particular, companies should consider:

- Shareholder proposals and voting results from the 2013 proxy season.
- The most likely subjects of shareholder proposals for the 2014 proxy season.
- Potential changes in proxy advisor policies and policy implementation.

- Preparatory steps to take now to identify and address vulnerabilities and engage with shareholders.

2013 PROXY SEASON REVIEW

Companies should review shareholder voting results and other key takeaways from the 2013 proxy season.

SHAREHOLDER PROPOSALS AND VOTING RESULTS

According to recently released data from The Conference Board (in collaboration with FactSet), *Proxy Voting Analytics (2009–2013)*, the number of shareholder proposals filed in 2013 increased from 2012. For example:

- At Russell 3000 companies, shareholders submitted 769 proposals, a rise of almost 6% over the same period in 2012.
- At S&P 500 companies, the increase in shareholder proposals was slightly lower, with a 4.6% rise over the same period in 2012.

Although requests for no-action relief also increased in number, the SEC staff was less likely to allow companies to exclude proposals from the proxy statement. This may reflect growing sophistication on the part of shareholders in formulating their proposals. The percentage of proposals omitted based on no-action relief declined from:

- 24.5% to 22.3% for Russell 3000 companies.
- 27.7% to 23.7% for S&P 500 companies.

The percentage of proposals that were withdrawn increased significantly, indicating company success in negotiating with proponents. For example:

- At Russell 3000 companies, 10.1% of proposals were withdrawn, up from 5.9% in the 2012 period.
- At S&P 500 companies, 11.5% of proposals were withdrawn, up from 6.5% in the 2012 period.

In good news for companies, the percentage of proposals that received majority support from shareholders was the lowest in five years and shareholder opposition to director re-election (as indicated by withhold and against votes) declined.

Other trends apparent in the 2013 proxy season include:

- **Changes in shareholder proponents.** The identity of shareholder proponents is changing. The proportion of shareholder proposals from labor unions declined, with activity shifting to shareholder proposals from hedge funds (in the area of shareholder rights and governance) and religious groups (in the area of corporate social responsibility).
- **Prevalence of independent board chair proposals.** Proposals to appoint an independent board chair were among the most common and high-profile shareholder proposals in the 2013 proxy season. However, they received only average levels of support (approximately 31%), possibly indicating that shareholders continue to believe that boards should have discretion regarding the structure of board leadership.
- **Continued focus on board declassification and voting requirements.** Shareholders continued to focus on declassifying boards so that all directors are elected every year, eliminating supermajority voting provisions and majority voting (rather than plurality voting) in the uncontested election of directors, with smaller companies gaining attention on these issues. In particular:
  - proposals seeking to repeal a classified board averaged close to 78% shareholder support (as in past years, Lucian Bebchuk's Harvard Law School Shareholder Rights Project is responsible for most proposals seeking to declassify boards);
  - proposals to reduce supermajority voting provisions averaged more than 70% of votes cast; and
  - proposals seeking majority voting in uncontested director elections averaged more than 57% shareholder support.
- **An increase in board diversity proposals.** Proposals relating to board diversity grew at a relatively fast pace, demonstrating the growing concern of shareholders about slow progress in expanding the number of women and racial minorities on boards.

Social and environmental proposals accounted for an increasing proportion of shareholder proposals. While they continue to achieve relatively low levels of support, issues relating to human rights, sustainability reporting and disclosure of political spending and lobbying activity are slowly gaining interest from shareholders. Political spending and lobbying proposals comprised nearly 40% of social and environmental policy proposals in 2013. Support was generally higher for proposals seeking more disclosure. Proposals asking the board to adopt a policy prohibiting or limiting political spending generally received lower levels of shareholder support.

Search Market Roundup: Political Contributions Policies for a review of publicly available political contributions policies.

SAY ON PAY, EXECUTIVE COMPENSATION PROPOSALS AND RELATED LITIGATION

Shareholders expressed strong support in the 2013 proxy season for executive compensation programs through their say on pay votes. Shareholders approved approximately 98% of management's say on pay proposals. The average level of shareholder support was also high, with over 75% of companies obtaining shareholder support of 90% or more. While a negative Institutional Shareholder Services Inc. (ISS) vote recommendation was associated with on average a 30% lower favorable vote, only approximately 17% of companies that received a negative ISS vote recommendation failed to obtain a majority of votes cast.

Key factors that impacted negative proxy advisor recommendations and low shareholder support for say on pay include:

- **A disconnect between pay and performance.** Most companies that failed to receive a majority of votes cast in favor of say on pay had a disconnect in pay for performance, often in relation to a decline in total shareholder return, that was cited by proxy advisors.
- **The grant of time-based equity awards rather than performance-based awards.** A common factor that

impacted the say on pay vote was a company's reliance on time-based awards of equity rather than performance-based awards of equity.

- **Weak disclosure of performance metrics or performance metrics deemed too easily achieved.** Proxy advisors appear to be scrutinizing disclosed performance metrics more closely.
- **Failure to respond to low votes.** A significant factor in failed say on pay votes appears to be a failure to adequately disclose outreach efforts aimed at addressing a prior low vote of 70% or less. In this respect, proxy advisors and shareholders expect to see compensation committee engagement.

Most companies that failed the 2012 say on pay vote achieved support in 2013, often with votes in favor of 90% or more. Success in reversing the vote outcome was generally associated with a disclosed shareholder outreach effort and changes to the executive compensation program. Shareholder votes were also sensitive to improvements in total shareholder return.

Since the advent of the mandated say on pay vote, shareholders have brought fewer proposals on compensation-related matters and those proposals have received relatively low levels of support. In 2013, compensation-related shareholder proposals focused on:

- Stock retention holding requirements.
- Pro rata vesting of equity awards in change of control situations.
- Compensation clawback provisions.

None of these shareholder proposals received a majority of votes cast.

In the last two proxy seasons, a number of lawsuits were filed alleging breaches of fiduciary duties in relation to certain compensation decisions or inadequate disclosure regarding say on pay and other compensation-related proposals. Plaintiffs often sought to enjoin the company's annual meeting pending supplemental disclosure, which presented significant settlement pressures. More recently, proxy season lawsuits have sought to challenge compensation decisions, for example alleging that the company has failed to meet Internal Revenue Code Section 162(m) requirements, resulting in several companies rescinding certain equity award grants.

PREPARING FOR THE 2014 PROXY SEASON

To get ready for the upcoming proxy season, companies should:

- Review the most likely subjects of shareholder proposals for the 2014 proxy season.
- Monitor potential changes in proxy advisor policies.
- Undertake efforts to engage with shareholders and other key investors.

HOT TOPICS FOR SHAREHOLDER PROPOSALS

Issues relating to shareholders' rights will likely continue to be a focus of 2014 shareholder proposals, including:

- The elimination of supermajority provisions to amend by-laws.
- The annual election of directors (board declassification).
- Majority voting in the election of directors.
- The ability of shareholders to call special meetings.
- The ability of shareholders to act by written consent.
- Proxy access.

In the governance area, companies should expect shareholder proposals on:

- Board diversity.
- Board leadership.
- Director tenure.

In the social and environmental areas, companies should expect shareholder proposals on:

- Political contributions and lobbying.
- Environmental sustainability and risks.
- Human rights policies and impacts.

PROXY ADVISOR POLICIES

The 2014 proxy season will be the first in which ISS applies its policy of recommending against directors where the board did not substantially implement a shareholder proposal that received a majority of votes cast in the prior year. According to ISS, this policy will be applied in a highly nuanced and

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Ten Tips for Proxy Season Preparation

Companies and their governance committees should begin preparing now for the 2014 proxy season, including by:

- **Reviewing 2013 shareholder proposals.** Analyze shareholder proposals submitted to the company for the 2013 proxy season, including the outcome of negotiations, challenges made by the company and voting results. The voting results on management proposals should also be reviewed.
- **Considering areas for action.** Determine whether action is necessary in light of 2013 proxy season voting results and, if so, identify the appropriate action.
- **Monitoring developments and comparing governance practices.** Obtain regular reports on shareholder hot topics, and keep track of and compare governance developments and emerging practices. It is also helpful to maintain relationships with shareholder groups and proxy advisors.
- **Articulating the rationale for governance practices.** Discuss and agree on, and record as appropriate, the rationale behind governance decisions.
- **Identifying key shareholders.** Identify the company's top 15 to 20 shareholders and find out whether those shareholders rely on proxy advisors, have established voting guidelines and are concerned about the company's governance practices.
- **Overseeing shareholder communication and engagement efforts.** Consult with management on shareholder communication and engagement plans and take steps to develop effective shareholder engagement programs and policies.
- **Evaluating board composition and director qualifications.** Assess the board's composition relative to the company's needs and consider whether any experience, skill sets or viewpoints are required. Review individual director qualifications and analyze how the disclosure of the director's attributes is likely to look and whether the director meets the appropriate independence standards.
- **Identifying and assessing director candidates.** Identify which directors will be recommended for re-nomination and reevaluate the director's performance and qualifications. Determine whether the board needs new director candidates and, if so, what attributes should be sought.
- **Reviewing governance documents.** Review company by-laws, shareholder meeting procedures, corporate governance guidelines, committee charters and board policies to ensure that they are up to date and appropriately reflect the company's governance practices.
- **Reserving time for proxy review.** Ensure there is adequate time to review the proxy statement and engage in discussions with management on how to make the proxy statement a more effective communication tool.

company-specific way and ISS is continuing to seek input on this issue through its most recent policy outreach. To date, ISS has disclosed that it will consider, among other things:

- The subject matter of the proposal.
- The level of shareholder support for the proposal at past meetings.
- Disclosure of board outreach to shareholders on the subject matter of the proposal.
- Actions by the board in response to shareholder engagement.
- The continuation of the underlying issue as a voting item on the ballot.

The implementation of this new policy may cause an increase in the number of negative votes in director elections. However, some have suggested that 2014 may be the year in which the proxy advisory firms begin to lose influence, given the trend of certain large institutional investors, such as Blackrock and Vanguard, to invest in capacity to make voting decisions and to engage directly with portfolio companies.

As in prior years, ISS invited input on potential changes to its proxy voting policy guidelines for the 2014 proxy season. ISS received survey responses from 128 institutional investors (66% US-based) and 350 corporate issuers (92% US-based). The topics surveyed included:

- **Board responsiveness to majority-approved shareholder proposals.** Investors had mixed views on whether boards should be expected to always follow shareholder wishes on non-binding shareholder mandates. For example:
  - 40% of investors (versus 92% of issuers) believe the board should be free to exercise its discretion to respond in a manner that it believes is in the best interests of the company and to disclose the rationale for any actions it takes;
  - 36% of investors believe the board should implement a specific action to address the shareholder mandate and that the appropriate timeframe to do so is within 12 to 24 months; and
  - 24% of investors believe it depends on the circumstances.

- **Impact of director tenure on independence.** Investors and issuers expressed opposite views as to whether long director tenure is problematic. For example:
  - 74% of investors said long tenure is problematic (ten years is the most commonly cited length of time that would call into question a director's independence); and
  - 84% of issuers said long tenure is not problematic.
- **Board leadership tenure.** 47% of investors and 10% of issuers indicated that long tenure in board leadership positions (such as chairman, lead director and key committee chair) is cause for concern.
- **Director assessment.** A significant majority of both investors and issuers indicated that positive and negative aspects of a director's current or prior service on other public company boards should be a focal point. For example, 54% of investors (compared to 25% of issuers) indicated that ISS should always consider company performance in director evaluations. Relative total shareholder return (over a three to five year timeframe) was cited most frequently as an appropriate performance metric.

Shareholder engagement usually takes many forms, including in-person meetings and phone calls with one or more significant or influential shareholders and group meetings or conference calls with a like-minded coalition.

- **Evaluating equity-based compensation plans.** Investors indicated that performance conditions on awards (75%), cost of plan (64%) and other plan features (57%) were "very significant" when evaluating equity plans. A majority of issuers indicated that each of these factors (54%, 66% and 61%, respectively) were "somewhat significant."
- **Increases to authorized share capital.** Investors cited the following factors as "very important" in evaluating a new share authorization:
  - the size of the requested increase;
  - the ratio of current shares outstanding to the new authorization; and
  - the company's stated use of shares.

These topics provide insight into policies that ISS may adopt or amend for the 2014 proxy season. For example, ISS may be considering adding years of service to the list of factors it considers in determining whether directors are independent. (ISS already considers tenure when evaluating director independence in several European and Asian markets.) Notably, the Council of Institutional Investors is also considering amending its corporate governance guidelines to include tenure as a factor in evaluating director independence.

ISS has said that it will make every effort to release its policy updates for 2014 in November 2013, one to two weeks earlier than in previous years.

SHAREHOLDER ENGAGEMENT EFFORTS

To promote supportive and peaceful shareholder relations, companies should make early efforts to identify and address vulnerabilities, engage with shareholders and focus on director nominations and proxy disclosures. Management should be encouraged to begin the process early of engaging key investors in discussions about issues that were raised in 2013 and issues that are expected to be of interest to shareholders in 2014.

Shareholder engagement usually takes many forms, including in-person meetings and phone calls with one or more significant or influential shareholders and group meetings or conference calls with a like-minded coalition. An important component of effective engagement is paying attention to the thoughts and interests of the particular shareholder. Topics of concern may vary widely and include:

- Shareholder rights, such as proxy access and majority voting.
- Governance practices, such as the structure of board leadership, board composition and diversity.
- CEO performance, compensation and succession planning.
- Strategic direction and risk mitigation.

Search Shareholder Engagement: Looking Back and Planning Ahead for practical tips on shareholder engagement.

The views stated above are solely attributable to Ms. Gregory and do not reflect the views of Weil, Gotshal & Manges LLP or its clients.