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Shareholder Activism, Engagement, Proxy Access and Other Governance Challenges in 2015

Public company directors and management are facing increasingly critical scrutiny from institutional investors and other shareholders, activists of every stripe, proxy advisory firms and regulators. To the consternation of many companies, the Chair of the Securities and Exchange Commission ("SEC") recently announced the Staff's temporary and targeted withdrawal from the shareholder proposal arena, declining this proxy season to issue no-action letters resolving disagreements between companies and shareholder proponents regarding "proxy access" proposals (among others). Large institutional investors, proxy advisory firms now formulating voting recommendations, and other interested observers are monitoring how companies respond to this and other looming governance challenges, with the verdict likely to be delivered in the relatively near future via the corporate ballot box.

Several converging trends make it clear that now, more than ever, boards and management must prioritize their focus on corporate governance and effective shareholder communication. A number of issues warrant close board and management attention, including proxy access, continuing shareholder activism borne along by the potent combination of a resurgent M&A market and public dissatisfaction with executive pay levels, and investor demands for enhanced board accountability. Throughout this Alert, we offer practical suggestions on "what to do now" against the background of a still-evolving governance and regulatory environment. Because the issues we address here represent only a part of the broader panoply of challenges corporate boards and management are facing in 2015, we recommend that you also see our January 23, 2015 alert entitled "What's New for 2015: Cybersecurity, Financial Reporting and Disclosure Challenges".[1]

2015 Governance Challenges – Highlights

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Challenge One: New Frontiers in Shareholder Activism

It seems that no company – regardless of its size or industry – is immune from the demands of shareholder activists. The explosive resurgence of the U.S. M&A market in 2014 lent momentum to activist criticisms of corporate performance and management and, in some cases, has led to significant structural and/or governance changes.

But exactly who are these activists, and what do they want? The term ”shareholder activism” is understood to cover a wide spectrum of activities and interests espoused by many different types of shareholders for a variety of reasons, not all of which necessarily go to the heart of corporate control. To illustrate, topics of concern to certain shareholder constituencies may range from such social and environmental issues as disclosure of corporate political contributions and lobbying expenses, human rights and sustainability reporting, on the one hand, to such “traditional” governance matters as separation of the roles of CEO and Board Chair and staggered boards, on the other hand. Concern about one topic – such as climate change – may prompt a public pension fund to advocate shareholder access to a specific company’s proxy statement to nominate director candidates that share this concern. Proponents often use the SEC’s shareholder proposal mechanism provided by Rule 14a-8, which injects the Division of Corporation Finance as arbiter of whether a particular proposals should be included in the company’s proxy statement pursuant to the no-action letter process, in an effort to gain broader shareholder support and attract media attention. (As we discuss below, the SEC’s partial withdrawal from deciding when management and shareholder proposals relating to proxy access “directly conflict” seems already to be having a profound impact on the 2015 proxy season).

Economic Activism

For purposes of this Alert, we will concentrate on the evolving, multi-faceted form of “economic” shareholder activism undertaken by hedge funds that often targets incumbent management’s business strategies and corporate performance and, in at least some instances, promotes and ultimately achieves a change in control. Recently, their goals have encompassed strategic corporate alternatives such as spin-offs, split-offs, or divestitures; returning value to shareholders through special dividends or share buybacks; and operational improvements, changes in management, or company sales.

Among the activities and tactics that characterize such economic activism (some of which also are employed by more conventional, single-issue environmental, social and governance, or “ES&G”, activists) are:

- A full-fledged proxy fight for board representation, which may include collaboration with a hostile bidder (e.g., Allergan vs. Valeant/Pershing Square), and could result in an election contest that replaces an entire board of directors where companies have “de-staggered” their boards (e.g., Darden vs. Starboard Value);
- An attempt to force the restructuring or sale of a company, whether alone (e.g., Starboard’s campaign promoting the recently announced Office Depot and Staples merger) or in conjunction with other fund activists (so-called “wolf packs” [2]); a common tactic is to submit a non-binding shareholder proposal to the company urging the board of directors to form a special committee to consider various value-enhancing strategic alternatives, which may gradually escalate to an election contest;
- An exempt solicitation in the form of a “just vote no” campaign criticizing incumbent management and urging shareholders to express their disapproval by withholding votes from directors standing for election (or voting against nominees where the company has instituted majority voting in uncontested elections), perhaps as the first in a series of planned, gradually escalating attacks, or as part of an arsenal of different tactics simultaneously deployed to pressure incumbent management and directors;
- Running a short-slate contest while criticizing the company’s strategic/operational plans and advancing the activist’s own plan for improving corporate performance (e.g., DuPont/Trian Fund Management)[3]; and/or
- Using sophisticated media campaigns to advance the activists’ agenda (e.g., Carl Icahn’s use of Twitter against Apple in 2014 – a “vote no” campaign).

According to FactSet, activists “scored” a board seat – sometimes through settlement negotiations – in about 73% of all proxy fights in 2014, topping a record 63% set in 2013.[4] Among the well-known companies recently targeted through one or more of the activist tactics listed above are such household names as Dow Chemical, Abercrombie & Fitch, Bank of New York Mellon, Amgen, PepsiCo, Microsoft and eBay.

The Evolving Views of Institutional Investors

Activist hedge funds and their investment advisers also are enlisting the support of institutional investors such as mutual funds and public pension funds, in the form of both investment and votes. And institutions are responding favorably in some cases. For example, BlackRock, Inc. and the Florida State Board of Administration each backed dissidents in ten proxy fights in 2014, while TIAA-CREF supported dissidents in nine contests last year.[5] Mutual fund giant Vanguard sided with Corvex Capital Management and Related Fund Management in a successful campaign to replace the entire board of Commonwealth REIT. California State Teachers’ Retirement System (CalSTRS), the second largest pension fund in the US, is increasingly investing in, or co-investing with, activist funds that in 2014 targeted individual companies such as Pepsico and Perry Ellis International.[6]

Notwithstanding BlackRock’s support of some dissident campaigns last year, CEO Laurence D. Fink recently expressed concern that activists may be going too far in pushing for a heightened corporate focus on short-term shareholder gains at the expense of long-term corporate profitability. In a letter sent on April 14, 2015, to the CEOs of the Fortune 500 companies, Mr. Fink urged senior corporate management to resist Wall Street’s demands for share buybacks and dividends.[7]

Clearly, a significant change has occurred in how activists are viewed by institutional investors and the public at large. In December 2013, SEC Chair White commented that the perception of activists as 1980s-style “corporate raiders” obsessed with short-term profits is evolving and becoming more nuanced, observing that “there is [now] widespread acceptance of many of the policy changes that so-called ‘activists’ are seeking to effect….”[8] Chair White observed more recently that, as the activist landscape continues to evolve in 2015, the SEC will remain neutral in the ongoing debate over the merits of activist campaigns, but will be monitoring the communications of companies and activists alike for regulatory compliance – particularly with the federal proxy rules and beneficial ownership requirements under Sections 13(d) and 16(a) of the Securities Exchange Act of 1934, as amended (“Exchange Act”).[9]

Because economic activist investing has become a viable “asset class” for many institutional investors, management and boards must face a new reality – the need for continuing engagement with major shareholders, preferably long before a crisis erupts, and preparedness for activism even during periods of relative calm and corporate profitability. We offer some suggestions below for anticipating, then coping with, an economic activist challenge, recognizing that each company must formulate its own approach in light of the relevant facts and circumstances.

What To Do Now:

- ***Think Like an Activist and Prepare.*** Management and boards should think like an activist, and assess preemptively where the company’s possible governance, financial and operational weaknesses (as well as its strengths) lie. Management and boards should work with outside advisers to prepare and develop a response plan for activism.
- ***Review Business and Governance Strategies.*** Management and boards should regularly review the company’s business strategy, capital return policy, analyst and investor perspectives, as well as executive compensation and other governance issues in light of the company’s particular needs and circumstances and adjust strategies and defenses to meet changing market conditions. Companies should proactively address reasons for any negative management and/or corporate performance issues, and understand both how an activist might might advocate increasing short-term shareholder value (e.g., through spin-offs and divestitures or financial engineering such as stock buybacks and increased debt) and vulnerabilities in the company’s proposed response to such criticisms.

- ***Know Your Shareholders.*** As discussed in more detail in the next section of this Alert, companies should know who their major shareholders are and cultivate good relationships with them throughout the year, not just during proxy season. Not only should companies listen carefully to their shareholders and other important stakeholders, but they also should communicate a consistent message to the public regarding their business strategies and performance goals . In particular, the best case for voting in favor of the company's board nominees and/or other management-proposed agenda items should be made clearly and concisely in both the proxy statement and other, less formal written or oral communications with shareholders. There is some evidence that this approach has been effective for companies seeking shareholder support for management "say-on-pay" proposals.[10]
- ***Stay Informed.*** Companies should educate themselves on the voting policies and guidelines of their major investors before engaging with them. Boards of directors should be fully and regularly informed of shareholders' views and public perceptions of the company's governance structure and performance, and should not rely unduly on management to provide the requisite information. Directors should ask questions and should not make the mistake of assuming, for example, that large institutional investors vote in lock-step with proxy advisory firm recommendations. Although activists may bring a new perspective that cannot be ignored, boards ultimately have the fiduciary duty to make independent judgments about what is in the best interest of the company and its shareholders.
- ***Monitor Movements in Share Ownership.*** Monitor significant movements in share ownership and public sentiment about the company, including but not limited to those of analysts, proxy advisors, major institutional shareholders and other relevant constituencies. An activist can secretly accumulate more than five percent of a company's voting equity within the infamous "ten-day window" before being required publicly to disclose that position pursuant to Exchange Act Section 13(d) and SEC implementing rules. In addition, most activists are able to gain negotiating leverage with ownership levels far below 5%, particularly where they are backed by large institutions and/or are part of a "wolf-pack" campaign.
- ***Understand the Company's Defense Profile.*** Companies should periodically review their bylaws, including the advance notice provisions, in light of changes in applicable state corporate law and the market environment. As many companies move to de-stagger their boards and otherwise dismantle longstanding takeover defenses in response to investor demands, an effective advance notice bylaw provision has become increasingly important.

Challenge Two: Constructive Engagement with Shareholders – What Does it Mean in 2015?

Pressures growing out of the Dodd-Frank "say-on-pay" regime and the notable successes of activist hedge funds waging proxy fights in recent years – along with the growing momentum of proxy access via private ordering, a more recent development we discuss later in this Alert – have been contributing factors to the increasing interest in dialogue between companies and their shareholders. Many of the larger public companies have recognized that some form of ongoing engagement with shareholders is a necessary element of a viable corporate governance program.[11] A critical component of such engagement, as noted above and discussed further below, is clear, concise and (from the SEC's viewpoint) accurate disclosure in proxy statements, and other investor-oriented communications. Using the proxy statement as a predicate for informal communication with shareholders, company representatives have been able more effectively to make the case for a positive linkage between corporate performance and corporate policies and practices relating to executive compensation, and other matters that shareholders consider important in formulating voting (and, in some instances, investment) decisions.

With respect to which corporate representatives should be engaging with shareholders, the SEC itself has become more vocal on the need for directors to talk with their shareholders. In a wide-ranging speech to the attendees of the Stanford University Directors' College in mid-2014, SEC Chair White urged directors to undertake an "open and constructive dialogue" with institutional and retail shareholders alike, and to pay special attention to shareholder proposals received by their companies. Specifically, she advised directors to "[a]sk your management team about them [shareholder proposals] and about the proposals that other companies are receiving that could be relevant to

your company …. [and] [l]ook at the voting results at shareholder meetings – the percentage of votes for a shareholder-supported resolution or against a management-supported resolution are important, irrespective of whether the resolution is approved, or not.” [12] Again, in March 2015, the Chair noted that “[i]ncreasingly, companies are talking to their shareholders, including the so-called activist[s] …” which, in her view, “is generally a very good thing. Increased engagement is important and a growing necessity for many companies today.”[13]

Where the Dialogue Stands Today

Whether and if so, how, outside directors should communicate with company shareholders is now the subject of lively debate in the global governance arena. Recent reports indicate that some directors and institutional shareholders are interested in exploring the utility of two-way communication.[14] According to a study published by consulting firm Equilar, for example, nearly two-thirds of the S&P 100 (65 major public companies) disclosed some level of board-shareholder engagement regarding executive compensation in their 2014 proxy statements – up from a total of nine companies in 2009.[15] More broadly, the results of a survey of large-cap issuers and institutional investors conducted by ISS for the Investor Responsibility Research Center Institute (IRRCi), published in April 2014, indicate that director participation in corporate-shareholder discussions on a wide variety of corporate governance and performance topics, beyond top management’s pay, had been rising steadily over the past three years (2010-2013), but was still the exception to the rule.[16] By mid-2014, the Shareholder-Director Exchange (“SDX”), a self-described “working group of leading independent directors and representatives from some of the largest and most influential long-term institutional investors” – including directors from JP Morgan Chase and Occidental Petroleum and large investors BlackRock, State Street Global Advisors, CalSTRS and Vanguard Group[17] – sent a letter to the lead directors of companies in the Russell 1000 index urging their consideration and adoption of “a policy for director-shareholder direct engagement” on a variety of topics. [18]

Vanguard followed up in late February 2015 with a letter-writing campaign aimed at the boards of directors of its largest portfolio companies, recommending that they create a channel for communicating with significant shareholders. The author of this letter, Vanguard CEO and Chair F. William McNabb III, suggested one such channel, in the form of a board-level “shareholder liaison” committee.[19] But he acknowledged that any committee of independent directors, or even a single independent lead director, could be assigned this role, stating that, “[u]ltimately[,] it’s more about the behavior than the framework. We’re indifferent as to how a board chooses to engage. What’s important to us is that it engages”.

It remains to be seen whether these developments presage a new era of director-shareholder dialogue that will spread beyond larger companies and their major institutional shareholders, where such dialogue is fast becoming the “new normal.” Whatever the trends, the SEC Staff has made it clear that Regulation FD’s ban on selective disclosure of material, non-public company information alone should not impede constructive engagement between directors and shareholders if desired by all concerned.[20] For those companies that opt to authorize one or more directors to meet with shareholders, the SEC Staff recommends consideration of “implementing policies and procedures intended to help avoid Regulation FD violations, such as pre-clearing discussion topics with the shareholder [or shareholders] or having company counsel attend the meeting”.[21] To give their directors (and/or other representatives) ample FD protection when meeting with shareholders (whether the meeting is held in person or by telephone or videoconference), companies should provide full and fair disclosure of their key governance practices and any pertinent corporate performance metrics in their proxy statements and any supplements thereto – making effective use here of summaries, charts, tables and other “shareholder-friendly” tools in accordance with EDGAR guidance just published by the SEC Staff [22] – as well as in the context of their investor-oriented websites and other forms of electronic communication.

What To Do Now:

- ***Boards Need to Consider How to Obtain Relevant Information.*** Boards should consider – from both a legal and a practical perspective – how best to obtain unfiltered information on shareholder thinking and concerns, including establishing channels for hearing directly from shareholders in appropriate cases.
- ***Consider Which Directors Should be Designated to Communicate with Shareholders.*** Companies should carefully consider which directors should communicate with shareholders, assuming the company determines that such communication is appropriate. Some of the large institutions are selective about whom they will talk with. The director who has the best understanding of the issue shareholders wish to discuss, and the ability to communicate most effectively on behalf of the company, should participate, along with at least one other person, whether that person is inside or outside counsel, someone from investor relations, human resources, or finance.
- ***Consider Regulation FD.*** Be mindful of Regulation FD, but do not use it as a shield or barrier to director-shareholder communication if the company otherwise decides that such communication is in the company's best interests, and key shareholders welcome a dialogue. Equally important, companies should consider the need to file, as proxy materials, any written communications prepared by or on behalf of directors that are provided to shareholders in this context, depending on the timing of these communications and their relationship to any matters to be submitted to a shareholder vote at an annual or other meeting of shareholders.
- ***Continue Outreach and Engagement.*** Develop outreach tactics to engage with key institutional investors and other shareholders on governance-related matters, regardless of whether the company is represented by one or more directors, senior managers or other personnel, especially if the company had a majority-supported shareholder proposal at its last annual meeting that has not been implemented, and/or a poor "say-on-pay" voting result (less than 70-80% of votes cast). Ensure that shareholder engagement efforts continue to focus on what is of most importance to shareholders and accommodates their timetable – it's often better for shareholders to engage outside of proxy season, after the company's annual meeting of shareholders and disclosure of voting results. Where discussions occur before the vote, provide thoughtful, fact-based arguments in urging shareholders generally to vote in accordance with the board's recommendations. Above all, make your best case – both clearly and concisely, in the company's proxy statement and, if necessary, in supplemental proxy materials.

Challenge Three: Keeping Up With Fast-Moving Proxy Access Developments

After the SEC's "proxy access" rule, Exchange Act Rule 14a-11, was vacated by a federal appellate court in 2011,[23] relatively few public companies (e.g., Verizon, Hewlett-Packard, Chesapeake Energy, Nabors Industries) amended their bylaws to adopt a "proxy access" mechanism enabling eligible shareholders to nominate their own board candidates and present these candidates to a vote using the particular company's proxy statement and form of proxy. Some companies did so voluntarily, while others were responding to various forms of shareholder pressure – including the submission of non-binding proposals pursuant to Rule 14a-8 under the Exchange Act that sought a shareholder vote on access bylaw amendments. This use of the shareholder proposal process to secure proxy access through "private ordering" was not affected by the judicial invalidation of Rule 14a-11. Institutional shareholders largely remained on the sidelines, however, until the New York City Comptroller announced last fall that his office and several New York public pension funds had targeted 75 public companies for proxy access proposals calling for bylaw changes modeled on the now-defunct SEC model (i.e., minimum ownership of at least 3% of the company's common stock for at least three years, by an individual shareholder or an unlimited group of eligible shareholders, but only for up to 20% of the board, rather than the 25% limit established by Rule 14a-11). [24]

Until January of 2015, companies were able to seek no-action relief from the SEC's Division of Corporation Finance allowing the exclusion of Rule 14a-8 proxy access proposals on the ground – set forth in Rule 14a-8(i)(9) – that the particular shareholder proposal would "directly conflict" with a management access proposal proxy to be placed on the agenda for the same shareholders' meeting. In December 2014, the Division issued a favorable (i)(9) no-action

letter to Whole Foods Market, Inc.,[25] triggering strong opposition from institutional shareholders. In apparent response, the SEC's Chair directed the Division to review "the proper scope and application" of Rule 14a-8(i)(9), and report to the SEC.[26] Chair White's determination prompted the Division to announce that it would cease expressing its views on the availability of the Rule 14a-8(i)(9) exclusion during the 2015 proxy season, regardless of the subject-matter of the proposal, and to reverse its previous grant of (i)(9) no-action relief to Whole Foods (upon a request for reconsideration by the proponent).[27] Shortly thereafter, the Division's Director Keith F. Higgins delivered a speech explaining the Staff's historical position under Rule 14a-8(i)(9), and offering some insights into the issues under consideration in connection with the mandated review of the scope and application of this exclusion.[28]

Since then, business trade groups have criticized the SEC for imposing the (i)(9) moratorium,[29] while TIAA-CREF, BlackRock, Vanguard and other large institutions have announced their support for proxy access.[30] SEC Chair White re-entered the fray in March, delivering a speech at a large M&A conference explaining her (i)(9) decision and reminding attendees that the Division's "informal" statements of its views in no-action letters were "neither 'precedent' nor binding on the Commission or a court" and, in any case, were subject to reconsideration and/or modification over time as reflected in evolving guidance, interpretation or rule changes where necessary.[31]

In the meantime, it appears that approximately 100 companies will face proxy access proposals in 2015. [32] Companies that have received an access proposal have a number of available alternatives during the SEC's (i)(9) no-action "black-out" period, some of them more desirable than others depending on a company's specific facts and circumstances. Among these alternatives, some of which have already been taken, are the following:

- Seek no-action relief from the Division on alternate grounds under Rule 14a-8. General Electric followed this strategy and was able, in early March 2015, to obtain a favorable Division no-action letter under Rule 14a-8(i)(10), which permits exclusion of a challenged shareholder proposal if the objective of that proposal has been "substantially implemented" by the company.[33] GE's board of directors had acted to adopt a new bylaw, effective February 6, 2015 (as reflected in the company's Form 8-K filed February 11, 2015), allowing one or a group of up to 20 shareholders owning 3% or more of the company's stock for at least 3 years to nominate and include in the company's proxy statement directors constituting a maximum of 20% of the board. The unsuccessful Rule 14a-8 proponent had used the SEC's 3%/3-year formulation, and had limited the number of candidates to 20% of the board, but would not have capped the number of shareholder group members.
- Include the shareholder proposal in the company's proxy statement, with or without the board's support. Citigroup announced in late February 2015, for example, that it would support a non-binding proxy access proposal that mirrored the GE access bylaw discussed above, and has since included this proposal in its proxy statement. By contrast, Monsanto shareholders disregarded the board's stated opposition to a shareholder proxy access proposal to approve (by 53.46% of votes cast, according to the company's Form 8-K filed January 30, 2015) a 3% shareholder (or group thereof, without limitation)/3-year/25% access bylaw amendment. Because the proposal was precatory and therefore nonbinding, the Monsanto board must decide how the company will respond.
- Engage with the proponent and negotiate a modification or withdrawal of the proposal, perhaps by volunteering to adopt a version of proxy access the company's board finds acceptable. Such an approach reportedly was taken by Bank of America, which amended its bylaws in March to permit a single shareholder (or group of up to 20 shareholders), owning more than 3% of the company's common stock for at least three years, to nominate up to 20% of the board's directors. (See Bank of America Corp. Form 8-K filed March 20, 2015).[34] Without prompting from a shareholder proposal, Prudential voluntarily adopted a 3%/3 years/20% access formula via bylaw amendment in early March 2015. (See Prudential Form 8-K filed March 10, 2015).
- Include access proposals from both a shareholder and the company in the company's proxy statement and card, and recommend a vote for the company's proposal.

- Seek a judicial declaratory judgment that the company may exclude a proxy access proposal in reliance upon Rule 14a-8(i)(9), as applied by the SEC Staff prior to the recently imposed moratorium.
- Exclude the proposal on (i)(9) grounds in reliance upon the historical Division position, which may invite litigation against the company.

Proxy Advisors on Proxy Access

Boards of directors weighing the pros and cons of various alternatives should take into account the potential impact of the updated ISS and Glass Lewis voting guidelines published in the wake of the SEC's withdrawal from the Rule 14a-8(i)(9) arena, as well as the viewpoints expressed by major institutional shareholders. In FAQs released on February 19, 2015, ISS stated that it has modified its old "case-by-case" analytical approach and now "will generally recommend in favor of management and shareholder proposals for proxy access" that adhere to the Rule 14a-11 criteria; i.e. ownership threshold of not more than 3% of the voting power for a period of not more than three years, with "minimal or no limits" on the number of shareholders allowed to form a nominating group, and a cap on the total number of shareholder nominees of "generally" 25% of the board. ISS will "[g]enerally recommend a vote against proposals that are more restrictive than these guidelines", whether submitted by management or shareholders. Companies that present both board and shareholder access proposals on a single ballot should expect ISS to analyze each under the modified guidelines. Finally, companies that omit a "properly submitted" shareholder access proposal without obtaining SEC or judicial relief approving such omission, or the proposal's withdrawal by the proponent, are likely to trigger an ISS voting recommendation against one or more directors – possibly even the entire board – regardless of whether a board-sponsored access proposal appears on the ballot.

Glass Lewis re-affirmed, in late January 2015, that it will continue to conduct a case-by-case assessment of access proposals, whether advanced by shareholders or management. But the anchoring principle is Glass Lewis's view that significant, long-term shareholders should have the right to nominate board candidates, subject to "reasonable" restrictions establishing minimum ownership and holding period requirements, and caps on the number of shareholder nominees. No specific thresholds have been identified by the firm as either reasonable or unreasonable per se. If the board sponsors its own proposal, Glass Lewis will evaluate whether that proposal differs materially from any shareholder proposals the company has received, and also will examine the company's overall governance profile (e.g., board independence, quality of board leadership and oversight, responsiveness to shareholder concerns, and alternate avenues for shareholders to effect change, such as their power to call a special meeting) as well as its performance. In circumstances where a company proposal differs materially from a shareholder proposal and there is no persuasive rationale for these differences, Glass Lewis may recommend a vote against individual directors standing for re-election.

What To Do Now:

- ***Consider Alternatives.*** A company that has received a proxy access proposal from one or more of its shareholders should consider its alternatives carefully, at the board level, in light of its own unique facts and circumstances. There are costs and benefits associated with each of the alternatives outlined above that necessarily will vary according to a company's size, shareholder demographics, litigation and reputational risk tolerance, and many other factors.
- ***Be Proactive.*** Work with Proxy Solicitor, Increase Engagement Efforts Early and Enhance Quality of Governance-Related Disclosures. Regardless of whether they have received a shareholder proxy access proposal, companies should be proactive in assessing their vulnerabilities with respect to board composition and other aspects of their governance structure, as well as corporate performance. The prophylactic measures that boards of directors can and should undertake before an activist shareholder challenge emerges, which are discussed in elsewhere in this Alert, may be the most effective safeguard against a shareholder access proposal. Above all, boards should monitor the progress of the SEC Staff's review and developments "on the ground" among companies in their peer group and the broader U.S. market.

Challenge Four: Spotlight on Board Composition Issues, Including Tenure, Skill Sets and Diversity

Shareholders and proxy advisory firms, among others, are increasingly focused on board composition and competence, including director skill sets, tenure and diversity. For example, Vanguard Chair and CEO McNabb observed pointedly in a speech last October that board composition is the "single most important factor in good governance." According to McNabb, the right board composition is critical because the board is the body empowered to oversee the interests of shareholders, hire and fire the CEO, and provide strategic direction and risk oversight for the organization.[35]

Director Tenure

Director tenure is squarely in the spotlight as a result of recent activist campaigns,[36] as well as evolving proxy advisory firm policies and the voting guidelines of institutional investors. The relatively recent U.S. focus on this issue follows a trend originating in Europe, where investors and regulators in the United Kingdom, France and other countries have been questioning for some time whether long-tenured directors can be truly "independent."[37] Last fall, the Council of Institutional Investors (CII) announced a new policy[38] focused on board evaluation of director tenure. CII encourages boards to weigh whether a "seasoned director should no longer be considered independent." While suggesting that long tenure can affect a director's "unbiased judgment," CII did not go so far as to endorse tenure limits or specify the number of years of board service that would make a director "seasoned." Nor has BlackRock, whose 2015 voting guidelines indicate that the fund generally will not vote in favor of shareholder proposals seeking the board's adoption of bright-line term limits, but will not oppose a particular board's decision to impose such limits as a mechanism for board "refreshment." At the same time, BlackRock warns that it may withhold votes from "[t]he independent chair or lead independent director, members of the nominating committee, and/or the longest tenured director(s), where we observe a lack of board responsiveness to shareholders on board composition concerns, evidence of board entrenchment, insufficient attention to board diversity, and/or failure to promote board succession planning over time in line with the company's stated strategic direction."[39]

By contrast, State Street Global Advisors' 2014 revised voting policy on director tenure[40] provides specific guidance relating to the number of years of board service deemed to be excessive, and board succession planning. In general, State Street "takes a skeptical view" of board members whose tenure exceeds nine years,[41] and uses a formula based on a comparison with the market standard, defined as the average director term for a company's peers. Companies with classified or staggered boards will be held to a "higher standard," since the inability of shareholders to vote on the election of all directors on an annual basis may further limit the opportunities for board refreshment.

What do the proxy advisory firms think? ISS has included director tenure in its updated QuickScore governance rating system for public companies, known as Quickscore 3.0. For more information on QuickScore, please see our Alert dated November 12, 2014, which is discussed in the next section of this Alert. QuickScore 3.0 treats board tenure of more than nine years as "lengthy", calling into question a director's independence. Companies with one or more directors having terms that exceed nine years therefore should not be surprised if they receive a "red flag" in this QuickScore category, at least in the absence of a fulsome explanation in the proxy statement of why each such director's continued service is essential to the company. ISS's proxy voting policy applicable to management or shareholder proposals to limit the tenure of outside directors, whether through term limits or the adoption of a mandatory retirement age, provides that ISS will "scrutinize boards where the average tenure of all directors exceeds 15 years for independence from management and for sufficient turnover to ensure that new perspectives are being added to the board."[42] Glass Lewis takes a more flexible position on mandatory age or term limits, stating in its 2015 proxy voting guidelines that "[s]hareholders are better off monitoring the board's approach to corporate governance and the board's stewardship off company performance rather than imposing inflexible rules that don't necessarily correlate with returns or benefits to shareholders." But if a board does adopt such limits, Glass Lewis believes boards should "follow through" and not grant waivers. [43]

Gender Diversity

With respect to gender diversity, for the third consecutive year, the Thirty Percent Coalition, spearheaded by the CalSTRS and Walden Asset Management, is engaging in a letter-writing campaign directed to Russell 1000 companies, encouraging them to improve gender diversity. Walden Asset Management and other proponents are expected to seek progress reports in 2015 from companies with whom they have settled on past diversity proposals. The SEC's Chair also has weighed in on the gender diversity front, stressing in a September 2014 speech the importance of increasing the number of women in the boardroom.[44] In late March 2015, a group of large public pension funds asked the SEC to propose new rules requiring enhanced proxy disclosure regarding diversity, tenure, skills, and other attributes of each director.[45]

ISS's QuickScore 3.0 includes a new weighted factor relating to the number of women directors serving on the board (previously a zero-weighted factor). ISS has not indicated a recommended number of women, nor has it made clear how this factor will be weighted in assigning companies a "good" or "bad" governance score.

What To Do Now:

- ***Be Proactive.*** Boards should take a proactive approach to board succession planning by evaluating the composition, qualifications, attributes and skills of the board of directors on a regular basis. An important, emerging area of expertise that many boards lack, for example, is cybersecurity. As businesses evolve, so must the areas of expertise of their directors.
- ***Enhance Disclosure.*** Directors should expect large institutional investors and activist shareholders to demand more information regarding "board refreshment" than the minimum required under the SEC's current proxy rules, zeroing in on individual directors' tenure and expertise, along with the adequacy of the board's self-evaluation processes.[46] Accordingly, we recommend that companies give careful thought to addressing tenure and other board composition/qualification issues in their proxy statements, which some companies have done, for example, by explaining the benefits to the company from a particular director's long service in terms of his or her particular areas of expertise. Consider including a skills matrix that illustrates the types of expertise or perspectives that the company seeks for its board.
- ***Stay Informed.*** Continue to monitor the evolution of the policies of proxy advisory firms and institutional shareholders on director tenure, gender and other board qualifications, and track trends among companies in your industry and the broader market. In this connection, the National Association of Corporate Directors recently published a helpful report summarizing a series of roundtable discussions in 2014 involving more than 40 directors from a wide spectrum of public companies. [47] Review proxy statements cited for "good" best-practice disclosures in this area by CII and other key shareholders.[48] Understand that director tenure and composition issues are "low-hanging fruit" from an activist's perspective.

Challenge Five: New Proxy Advisory Firm Approaches to Equity Compensation Plans

In late 2014, proxy advisory firms ISS and Glass Lewis updated certain aspects of their proxy voting policies effective for the 2015 proxy season, relating primarily to votes on equity compensation plans and independent board Chair proposals. These changes are discussed briefly below; for more information, please see our alert dated November 12, 2014 available here.[49] Both ISS and Glass Lewis published additional guidance on these updates in December 2014 and early 2015, which are included in the following discussion.

ISS's New Equity Plan Scorecard

Companies that intend to present new or amended equity compensation plans for shareholder approval at their 2015 annual meetings will face the application of ISS's new Equity Plan Scorecard model for evaluating equity compensation plans. Under this model, ISS will formulate voting recommendations based on consideration of a range of positive and negative factors, rather than a series of "pass" or "fail" tests widely regarded as unduly rigid and arbitrary. Understanding ISS' new formulation will be critical in securing a "for" recommendation from ISS.

ISS' new policy reflects a more holistic approach. Scorecard factors fall under the following three "pillars" and will be weighted by reference to company size and status to help ISS determine whether the plan proposal (whether a new plan or amendments to an existing plan) is deemed to be in the shareholders' interests:

- *Plan cost* (45%) – total estimated cost of the company's equity plans relative to industry/market cap peers, measured by the company's estimated shareholder value transfer (SVT) in relation to peers.
- *Plan features* (20%) – including whether the plan provides for automatic single-trigger award vesting upon a change-in-control, discretionary vesting authority, liberal share recycling on various award types and minimum vesting period for grants made under the plan.
- *Grant practices* (35%) – including the company's three-year burn rate relative to its industry/market cap peers, vesting requirements in CEO equity grants over the past three years, estimated plan duration, the proportion of the CEO's most recent equity grants/awards subject to performance conditions, whether the company maintains a clawback policy that covers equity grants (deemed a mitigating factor), and whether the company has established requirements to hold shares after exercise or vesting.

As explained more fully in a set of FAQs ISS issued on December 22, 2014, positive and negative factors can counterbalance one another.[50] (Additional scorecard FAQs were published on March 3, 2015.[51]) It is important to note, however, that ISS will continue to issue negative voting recommendations on plan proposals that feature certain "egregious characteristics," such as authority to re-price options without shareholder approval. ISS sheds further light on its treatment of such "problematic pay practices," as well as its voting policies focused on management "say-on-pay" proposals and other executive compensation issues, in a comprehensive set of FAQs entitled "2015 U.S. Compensation Policies," dated February 9, 2015.[52]

Glass Lewis's Revised Pay-for-Performance and Equity Plan Models

Glass Lewis recently updated the performance metrics used for certain industries in its pay-for-performance and equity plan models applied in formulating voting recommendations.[53] According to Glass Lewis, these changes will better reflect how the operating performance of companies in specified industries is measured and evaluated by management, boards, and industry analysts. Previously, when calculating the performance percentiles against a company's peers, the Glass Lewis model evaluated the following five metrics: Change in Operating Cash Flow, Change in Earnings Per Share, Total Shareholder Return, Return on Equity, and Return on Assets. Under the revised model, Glass Lewis has (i) replace Change in Operating Cash Flow with Tangible Book Value Per Share Growth for companies in the Bank, Diversified Financials, and Insurance sectors and (ii) replace Change in Operating Cash Flow with Growth in Funds From Operations for REITs, with the exception of Mortgage and Specialized REITs.

Glass Lewis has indicated that it expects minimal impact on the grades generated by its application of its pay-for-performance model, as well as minimal impact on the pass/fail assessments generated by the firm's equity plan model.

What To Do Now:

In addition to reviewing the guidance relating to specific proxy voting policy updates provided in our alert of November 12, 2014[54], we recommend that companies take the following steps:

- ***Register with ISS.*** Companies planning to include an equity compensation plan on the ballot for the next annual meeting should register to gain access to the ISS Equity Plan Data Verification Portal and review the data points that ISS will consider as part of its new scorecard approach, each as discussed in our alert dated October 17, 2014.

- ***Understand Proxy Voting Reports.*** Carefully review proxy voting reports relating to the company – with input from outside counsel and compensation consultants, as appropriate – and notify the relevant proxy advisory firm of any errors as soon as possible.
- ***Understand the Vulnerabilities.*** Review the company's corporate governance and compensation practices for vulnerabilities under ISS' policy updates, as amplified by the late December FAQs (for example, in relation to any equity compensation plans that may be up for a vote at the next annual meeting, or an independent chair shareholder proposal) and decide what action, if any, the company should take in light of this assessment and ISS's potential voting recommendation(s).
- ***Enhance Disclosure.*** Review last year's compensation and governance disclosure, and plan to make improvements in this year's proxy statement where appropriate – particularly if the company received comments on this disclosure in 2014 from the SEC Staff. More on this subject under Challenge Seven, below.

Challenge Six: The Current Controversy Surrounding Unilateral Board Adoption of Litigation-Related Bylaws – Exclusive Forum and Fee-Shifting Provisions

Prompted by escalating litigation costs and evolving case law in Delaware and elsewhere, companies have been considering the relative merits of charter and bylaw amendments designed to help reduce these costs. In this connection, an important distinction between corporate articles of incorporation and bylaws comes into play – in many if not most states, including Delaware, a shareholder vote is necessary to amend the charter of a public company, whereas boards of directors generally have the power unilaterally to amend the bylaws to add litigation-related provisions. Critics in the shareholder and proxy advisory firm communities have objected to unilateral bylaw amendments as unduly constraining shareholder rights.

For the many companies that file reports with the SEC, there is another important constituency to consider – the SEC. Chair White warned recently that she is "concerned about any provision in the bylaws of a company that could inappropriately stifle shareholders' ability to seek redress under the federal securities laws."[55] Both the Chair and members of the Division of Corporation Finance staff have indicated during recent conferences that they are monitoring closely the adequacy of a corporate disclosures relating to a fee-shifting bylaw or charter provision that would require a losing shareholder-plaintiff to pay defense costs arising from litigation against the corporation and/or its insiders. The agency's concerns here focus on whether prospective investors in an IPO, or target company shareholders evaluating how to vote on a proposed merger or other business combination – just two situations in which Staff comments may be issued – have sufficient information to understand the potential impact of such a provision on their ability to bring suit under the federal securities laws should they invest or vote in favor of a particular transaction.

How the agency might respond if and when the enforceability of a fee-shifting provision under the federal securities laws becomes a "live" issue remains to be seen. Chair White has offered some insight into what the Commission might do in what it considers to be an egregious situation: "If the Commission comes to believe that these provisions improperly hinder shareholders' exercise of their rights, it may need to weigh in more directly in this discussion as it did with indemnification under the Securities Act." The Commission has taken the position that corporate arrangements that indemnify directors for violations of the federal securities laws are against public policy and unenforceable, and that companies must disclose the Commission's position in Securities Act registration statements. In addition, Chair White pointed out that Commission settlement orders have included bars against seeking indemnification.[56]

Exclusive Forum Provisions

Exclusive forum, or forum selection, provisions generally provide that derivative and other litigation involving a corporation's internal affairs may be brought only in the courts of one state – typically the state of incorporation which, for many large companies, is Delaware. During the last few years, the boards of directors of an increasing number of companies have unilaterally adopted a forum selection bylaw. In addition, some companies undertaking an IPO have included an exclusive forum provision in their organizational documents.

In mid-2013, a former Chancery Court judge who now serves as the Chief Justice of the Delaware Supreme Court rejected a facial validity challenge to the forum selection bylaws of two large public companies that were adopted by their respective boards without a shareholder vote (in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*[57]*)*. Although several courts within and outside Delaware have since upheld the unilateral board adoption of forum selection bylaws, a shareholder litigant may prevail on a claim that an exclusive forum bylaw amendment was effected by the board for an "improper purpose," and therefore invalid as applied in a particular situation. To illustrate, an Oregon state court declined to dismiss a shareholder complaint attacking a proposed merger, having determined that the board had amended the company's bylaws at the same time that it approved the merger in anticipation of seeking dismissal of the plaintiff's case.[58] Shortly thereafter, a Delaware chancery court evaluating a similar set of facts reached the opposite conclusion.[59] Given these conflicting results in an "as applied" context, companies that decide to adopt such provisions are well-advised to do so on the proverbial "clear day" when no specific shareholder litigation is on the horizon.

Companies incorporated in Delaware may soon have the benefit of statutory clarification, at least as to the facial validity of exclusive forum charter and bylaw provisions (along with a resolution of the ongoing debate regarding the validity of fee-shifting charter and bylaw provisions, as explained in the next sub-section). The Delaware General Assembly reportedly will consider a legislative proposal from the Delaware Bar Association's Corporation Law Council ("Delaware Bar Council"), released in early March 2015, that (among other things) would amend relevant sections of the Delaware General Corporation Law ("DGCL") to codify the Boilermaker's ruling without foreclosing "as applied" or "unreasonableness" challenges to such provisions.[60] The draft statutory language, as modified by the Delaware Bar Council after its initial release, makes clear that Delaware corporations would not be able to adopt an exclusive forum provision that forecloses selection of Delaware as the exclusive forum for litigating "internal corporate claims", defined to mean derivative or other claims, including claims "(i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title [Title 8 of the Delaware Code] confers jurisdiction upon the Court of Chancery".[61]

In evaluating the pros and cons of board adoption of an exclusive forum bylaw amendment without a shareholder vote, companies also should be aware of the positions taken by the major proxy advisory firms. ISS published revised voting policies in February 2015, indicating that it will evaluate a board's unilateral amendment of company bylaws to include an exclusive venue/forum provision on a case-by-case basis to determine whether the amendment will be "materially adverse to shareholder rights." If the answer is yes, ISS will recommend a vote against the board.[62] That said, ISS generally will not consider these amendments to be "materially adverse" if they limit litigation to the company's state of incorporation. With respect to bylaw and charter forum selection provisions adopted by pre-IPO companies, where controlling shareholders typically have the power to shape the post-IPO governance structure of such companies through their organizational documents, ISS will consider such factors as the proximity of the planned IPO and the continuity of the board of directors in determining whether the rights of post-IPO shareholders may have been diminished.

Glass Lewis has taken a somewhat less flexible approach. According to its 2015 proxy voting guidelines, the firm "will consider recommending that shareholders vote against … [the director serving as] governance committee chair, when during the past year the board adopted a forum selection clause … without shareholder approval, or, if the board is currently seeking shareholder approval of a forum selection clause pursuant to a bundled bylaw amendment rather than as a separate proposal."[63] While the firm will give newly public companies a one-year grace period on governance matters, its updated policy guidelines explicitly carve out exclusive forum and fee-shifting charter and bylaw provisions. [64]

Fee-Shifting or "Loser Pays" Provisions

Fee shifting bylaws – sometimes called "loser-pays" provisions – have attracted increased attention since the Delaware Supreme Court's May 2013 ruling in *ATP Tour, Inc. v. Deutscher Tennis Bund,*[65] upholding the decision of the board of a Delaware non-stock membership corporation in adopting a bylaw shifting the burden of the defense's legal fees and costs to unsuccessful plaintiffs in intra-corporate litigation. Commentators and practitioners soon

concluded that the Delaware Supreme Court's language was equally applicable to public stock corporations. To date and to the best of our knowledge, no Delaware court has directly addressed this issue, although the Delaware Court of Chancery has ruled that a fee-shifting bylaw did not apply to a former shareholder's challenge to the fairness of a reverse stock split undertaken in connection with a going-private transaction.[66]

In the meantime, draft legislation that would prohibit such fee-shifting provisions entirely with respect to "internal corporate claims" (as defined above) involving Delaware-incorporated stock companies is part of the same legislative package (discussed above) authored by the Delaware Bar Council for consideration by the Delaware General Assembly this year.[67] If enacted substantially as drafted by the Delaware Bar Council, the proposed amendments to the DGCL would uphold the facial validity of fee-shifting bylaw or charter provisions for non-stock corporations in accordance with the *ATP Tour* opinion, but would bar such provisions entirely for Delaware-chartered stock corporations unless expressly agreed to, in writing, by the stockholder against whom such a bylaw or charter provision is to be enforced. According to a recent report, Delaware Chief Justice Leo E. Strine, Jr. expressed support at a March 30, 2015 conference for the Delaware Bar's proposed amendments to the DGCL, and believes that the decision in *ATP Tour* should not be extended to public companies.[68]

Both institutional investors and proxy advisory firms have declared their unqualified opposition to fee-shifting charter and bylaws provisions. In November 2014, the Council of Institutional Investors ("CII") and a coalition of public pension funds launched a letter-writing campaign, aimed at Delaware politicians, in support of efforts by the Delaware Bar in 2014 to restrict the use of fee-shifting bylaws. The CII campaign has continued into 2015.[69] ISS's recently updated voting policy presumes that such provisions, if adopted unilaterally by the board, are "materially adverse" to shareholders and will recommend a vote against the entire board. Even if management seeks a vote on a fee-shifting bylaw, ISS generally will recommend a negative vote if the bylaw mandates that plaintiff pays defense fees and costs unless 100% successful in litigation.[70] Glass Lewis states that it "may" recommend a vote against the chair of the board's governance committee, or the entire committee, if the board acts alone to adopt bylaws that require shareholder-plaintiffs to pay the company's legal expenses in the absence of a court victory, or to arbitrate claims against the company in a non-judicial forum. Should the company submit the proposed adoption of such a fee-shifting bylaw or charter provision to a shareholder vote, Glass Lewis generally will urge shareholders to vote "against" the provision.[71]

Despite the current controversy, approximately 40-50 companies – at least one of which is incorporated outside the United States with a New York Stock Exchange listing – are reported to have adopted fee-shifting bylaw or charter provisions without shareholder approval.[72]

What to Do Now:

- ***Deliberate Carefully Before Unilateral Board Adoption.*** The unilateral board adoption of an exclusive forum provision should follow careful deliberation, as reflected in board minutes, concerning the burdens on the corporation of litigating in multiple jurisdictions in light of its litigation history, and how such a provision will further the best interests of the company and its shareholders. This is particularly important in situations where the provision is adopted in reasonably close temporal proximity to the board's approval of a specific transaction or other corporate action likely to result in litigation. Care also should be taken to provide the board with authority to waive the exclusive forum requirement, in situations where directors conclude that litigation in a different forum (perhaps a federal district court where related federal securities law litigation is pending) would serve the best interests of the corporation and its stockholders. Fee-shifting bylaws remain novel and should be considered and adopted only with great caution and care, given the strong opposition of large institutional investors and the two major proxy advisory firms, and the current uncertainty regarding legislative action in the Delaware General Assembly this year.
- ***Adopters Should Prepare to Engage and to Provide Enhanced Disclosure.*** Companies whose boards have unilaterally adopted exclusive forum bylaws, or any other bylaw that is regarded as materially diminishing

shareholder rights, should be prepared to engage with the proxy advisory firms and investors. We recommend that companies also explain in the company's proxy statement how the adoption of such a provision will benefit the company and its shareholders. For the reasons discussed above, this may be more difficult in the case of fee-shifting provisions because critics regard them as deterring shareholders from pursuing a judicial remedy, rather than determining where shareholders may do so. Companies may also wish to contact their analyst at ISS in anticipation of or shortly after proxy statement filing to talk through this and any other issues that could cause ISS to issue a negative vote recommendation. (Glass Lewis typically will not engage in such discussions with companies).

Challenge Seven: Unfinished Governance Business Under Dodd-Frank

Although the SEC has proposed three of the "Final Four" governance disclosure requirements that remain to be implemented under the Dodd-Frank Act, there are no new SEC rules applicable to 2015 proxy statements. As discussed further below, however, companies are not waiting for SEC rulemaking to disclose voluntarily adopted policies on such matters as hedging of company stock and so-called "clawbacks" of incentive executive compensation.

First, a brief update on the status of the "Final Four" Dodd-Frank rulemaking projects focusing on compensation-related disclosure. The longest pending proposal, which was issued by the SEC more than a year ago under Section 953(b) of the statute,[73] would require disclosure of the ratio of the annual total compensation of the chief executive officer to the median annual total compensation of all employees (except the CEO). The SEC has pushed back the deadline for adoption of a final rule to October 2015, from its original deadline of October 2014.

As described more fully in this alert, the SEC recently proposed new hedging policy disclosure requirements under Section 955 of Dodd-Frank (adding new Section 14(j) to the Exchange Act).[74] The comment period ended April 20, 2015. These requirements, if adopted substantially as proposed, would not prohibit hedging-related activities by directors, officers and/or other company personnel. Instead, disclosure would be required in annual meeting proxy statements of whether the company has a policy allowing directors or employees (including but not limited to officers), or their designees, to purchase financial instruments designed to hedge or offset any decrease in the market value of the company's equity securities (however acquired). If the answer is yes, the company must provide explanatory details regarding the nature and scope of permitted transactions and indicate (among other things) whether such transactions must be pre-approved by the company or are subject to satisfaction of minimum stock ownership guidelines.

By a vote of 3-2, the SEC acted on April 29, 2015, to approve the issuance for public comment of a proposal to implement the Congressional pay-for-performance disclosure mandate set forth in Section 953(a) of the Dodd-Frank Act. According to the SEC's proposing release (available here), the new disclosure would appear in tabular format in proxy or information statements in which executive compensation disclosure otherwise is required (excluding foreign private issuers, which are not subject to the SEC's proxy rules), and would entail a comparison of (a) compensation "actually paid" to the Principal Executive Officer (i.e. the CEO), a defined term which means the total compensation figure disclosed in the present Summary Compensation Table, with certain adjustments to the amounts included for pensions and equity awards, with (b) the company's financial performance, to be measured in terms of cumulative total shareholder return calculated on an annual basis ("TSR") in accordance with the methodology prescribed by Item 201(e) of Regulation S-K (the existing requirement for disclosure of a stock price performance graph). The proposed table would be designed to permit a comparison of the company's TSR with the TSR of companies in a specified peer group over the same period. The company also would have to present, in the proposed new table, the average of the reported amounts "actually paid" in respect of the other named executive officers whose compensation appears in the Summary Compensation Table (to be calculated in the same manner as for the CEO). Based on the information presented in the table, companies would be required to describe, either in a narrative or graphic presentation, or some combination of the two: (a) the relationship between the executive compensation "actually paid" to the CEO and the other named executive officers (again, an average for the latter) and the company's TSR; and (b) a comparison of the company's TSR with that of its selected peer group. With respect to the period of this comparison, larger reporting

companies would have to provide this comparative disclosure for the last five fiscal years (three years for smaller reporting companies), with a transition period. In addition, smaller reporting companies would not be subject to the peer-group TSR comparison, but as noted would have to calculate their own TSR. Last but by no means least, companies would have to tag the disclosure in an interactive data format using eXtensible Business Reporting Language, or XBRL (with phase-in relief for smaller reporting companies). The 60-day comment period does not begin to run until the SEC's proposing release is published in the Federal Register, which should happen soon.

Finally, the SEC has revised its timetable for proposing rules to implement the other open Dodd-Frank compensation-related disclosure provision, addressing clawbacks (Section 954). According to the latest SEC timetable, which is not binding on the agency, this proposal may not be issued for public comment until as late as October 2015.

By and large, some of the largest U.S. companies are not waiting for SEC rulemaking to disclose their own versions of these measures, primarily but not exclusively in the Compensation and Disclosure Analysis (CD&A) section of their proxy statements, as a means of persuading shareholders voting on management-sponsored "say-on-pay" resolutions that executive pay is in fact aligned with corporate performance. As a practical matter, the potent combination of proxy advisory firm voting policies, existing CD&A and other proxy disclosure requirements, and evolving shareholder attitudes, has prompted many larger companies to do one or more of the following: (1) improve the content and clarity of proxy disclosures illustrating the link between executive compensation policies and company performance, using proxy and CD&A summaries, as well as charts, tables and graphics;[75] (2) adopt their own clawback policies that may vary from the Dodd-Frank model set forth in Section 954, and identify them in the proxy statement as risk-mitigation tools; and/or (3) adopt anti-hedging and pledging policies applicable, at a minimum, to all directors and officers.

What to Do Now:

- ***Monitor, and Provide Regular Board Updates on, the Status of the SEC's Remaining Dodd-Frank Governance Rulemaking Projects.*** Companies should keep track of, and update their boards of directors on, the status of the four remaining Dodd-Frank governance disclosure rules affecting the proxy statement, and continue to evaluate the potential impact of these rules while awaiting further SEC action in 2015.
- ***Pay-for-Performance Disclosure.*** As discussed, many larger companies have been sharpening and otherwise improving the quality of their executive pay disclosures through the use of executive summaries, tables, charts and/or graphs designed to illustrate the relationship between corporate performance, however measured by the particular company for purposes of compensation decision making, and the disclosed compensation of the CEO and other named executive officers. Such "additional" disclosures are acceptable to the SEC Staff, so long as they do not obscure or conflict with the mandated tabular and narrative disclosures and otherwise comply with applicable EDGAR requirements that distinguish between mandatory and voluntary disclosures in the proxy statement (discussed above). For more detail on what investors think about the quality of executive compensation disclosure in proxy statements, we suggest that you take a look at the results of a Stanford Graduate School of Business survey of institutional investors entitled *2015 Investor Survey: Deconstructing Proxy Statements – What Matters to Investors.*[76]
- ***Clawback Policies.*** Clawback policies are certain to be a continuing area of shareholder interest this proxy season. Section 304 of Sarbanes-Oxley now enables the SEC alone to seek forfeiture of any incentive-based compensation and profits from either or both the CEO and CFO received in the 12-month period prior to a restatement of the company's financial statements due to material error resulting from misconduct, regardless of any complicity on the part of the CEO or CFO. The new Dodd-Frank clawback provision, which ultimately must be implemented by SEC rule and stock exchange listing standards, will require listed companies to adopt policies enabling them to recover incentive compensation from current or former executive officers who received such compensation based on erroneous financial information during the three-year period prior to restatement. While it remains unclear when the SEC will take action to propose rules relating to the recoupment of incentive

compensation, some shareholders have not been willing to wait for the SEC and stock exchanges to act, submitting shareholder proposals on clawback policies that have proceeded to a vote. In addition, ISS has been promoting the adoption of clawback policies, taking the existence of such policies into account in formulating its voting recommendations with respect to say-on-pay, as well as a part of the QuickScore 3.0 analysis. Companies that have adopted or are considering the adoption of a recoupment policy should be aware that most policies adopted to date include numerous variations from the clawback policy expected to be implemented pursuant to the new rules under Dodd-Frank. For example, companies have adopted policies that apply to different groups of employees, require misconduct, and/or permit board discretion (which can have negative accounting consequences). Each element of a clawback policy will need to be re-evaluated once the Dodd-Frank rules are adopted. Companies will also need to assess any accounting implications resulting from policies that provide for the exercise of board discretion on whether or not to recoup.[77]

- ***Hedging and Pledging.*** The subject of insider hedging and pledging (often undertaken either as part of hedging transactions, or via margin accounts established with broker-dealers) is not new. Companies must disclose, in a footnote to the beneficial ownership reporting table required in proxy statements (and annual reports) the number of shares pledged by any executive officer or director (e.g., as collateral for a margin loan). Officers and directors themselves must report most hedging transactions under Exchange Act Section 16(a), and must be concerned about the short-swing profits recovery provisions of Section 16(b) and the prohibition against short sales codified in Section 16(c). Moreover, pledges generally involve a "sale" for purposes of Exchange Act Section 10(b) and Rule 10b-5. For all these reasons, many companies require pre-clearance of any permissible hedging or pledging transactions by insiders. Some companies have decided to ban such transactions entirely, at least for officers and directors, whether in response to criticism from ISS, QuickScore results, insider trading liability concerns, or otherwise.

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of Weil's Public Company Advisory Group:

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ENDNOTES

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17. *See* The Shareholder-Director Exchange, *Introduction and Protocol* (February 2014), available at http://www.sdxprotocol.com
18. PR Newswire, *"Leading Public Companies and Representatives of Major Institutional Investors – United Under Shareholder-Director Exchange Banner – Announce New Steps Taken to Advance Growing Governance Movement"* (July 22, 2014), available at www.prnewswire.com/news-releases/leading-public-company-directors-and-representatives-of-major-institutional-investors – -united-under-shareholder-director-exchange-banner – -announce-new-steps-taken-to-advance-growing-governance-movement-268085121.html
19. *See* Text of Letter from F. William McNabb III, Vanguard's Chair and CEO, dated February 27, 2015, available at https://about.vanguard.com/vanguard-proxy-voting/CEO_Letter_03_02_ext.pdf. *See also* K. Grind & J. Lublin, "*Vanguard and BlackRock Plan to Get More Assertive With Their Investments*", Wed., Mar. 4, 2015 ("Grind & Lublin"), available at http://www.wsj.com/articles/vanguard-and-blackrock-plan-to-get-more-assertive-with-their-investments-1425445200
20. *See* Division of Corporation Finance Compliance and Disclosure Interpretation, Regulation FD, No. 101.11 (added July 2010), available at https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm
21. Id.

22. *See* Regulation S-T, Compliance & Disclosure Interpretations, Question No. 118.01 (Jan. 23, 2015), available at http://www.sec.gov/divisions/corpfin/guidance/regs-tinterp.htm
23. *See* Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).
24. *See* http://comptroller.nyc.gov/boardroom-accountability/
25. As previously discussed in our alert of December 4, 2014, the issuer community breathed a collective sigh of relief when the Staff granted Whole Foods's no-action request last December, allowing the company to exclude from its proxy statement a shareholder proposal on proxy access in light of management's stated intent to submit to a shareholder vote its own proposal that would "directly conflict" with the shareholder proposal for purposes of Rule 14a-8(i)(9). The shareholder proposal submitted to Whole Foods was derived from the SEC's eligibility formulation in the now-stricken Rule 14a-11: (1) the nominating shareholders must beneficially own 3% or more of outstanding common stock continuously for at least 3 years before submitting a board nomination; (2) the number of shareholder-nominated candidates must not exceed 20% of the directors then serving (the SEC's now-defunct rule had fixed this cap at 25%); and (3) nominations may be submitted by shareholders acting individually or in a group. To the consternation of prominent institutional shareholders, the SEC Staff agreed with the company that this proposal would "directly conflict" with the company's own proposal, which provided for a 9%/5-year formulation (later revised to 5%/5-years voluntarily by the company after receipt of no-action relief), with a cap of 10% of the board, and with nominations to be submitted only by a *single* eligible shareholder (not a group).
26. Statement from Chair White Directing Staff to Review Commission Rule for Excluding Conflicting Proxy Proposals (Jan. 16, 2015), available at http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html#.VLmTFXvQPnP
27. *See* Announcement of the SEC Division of Corporation Finance Related to Exchange Act Rule 14a-8(i)(9) For Current Proxy Season, available at http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2015/jamesmcritchiecheveddenrecon011615-14a8.pdf. Whole Foods disclosed, in a Form 8-K filed February 13,2015, that it is postponing the annual shareholders meeting originally scheduled for March 10 to give it time to consider its options in the wake of the Division's withdrawal of previously granted no-action relief under (i)(9).
28. *See* Remarks of Keith F. Higgins, Director, SEC Division of Corporation Finance, before the Practising Law Institute Program on Corporate Governance, *"Rule 14a-8: Conflicting Proposals, Conflicting Views"* (New York, NY, Feb. 10, 2015), available at http://www.sec.gov/news/speech/rule-14a-8-conflicting-proposals-conflicting-views-.html
29. Letter from Business Roundtable to CEOs of ISS and Glass Lewis, dated January 22, 2015, available at http://businessroundtable.org/resources/brt-letter-response-recent-sec-announcements-conflicting-proposals
30. *See* P. Floyd, *"Heavyweight Investors Back Proxy Access Reform"*, FT Agenda, Mon., Mar. 23, 2015.
31. White, Tulane Remarks, *supra*.
32. *See* http://www.glasslewis.com/blog/glass-lewis-views-proxy-access-developments/
33. GE No-action Letter (Mar. 3, 2015), available at https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2015/kevinmaharrecon030315-14a8.pdf
34. Reuters reported that Bank of America took this action after discussion with the New York City Comptroller, CalPERS and CalSTRS, among other institutional investors, although the proponent was an individual shareholder. *See "BofA joins 'proxy access' trend with new director-nomination rules",* Fri., March 20, 2015, available at http://www.reuters.com/article/2015/03/20/bank-of-america-board-idUSL3N0WM4DM20150320
35. *See* Remarks of F. William McNabb III, Vanguard Chairman and CEO, to the University of Delaware's Weinberg Center for Corporate Governance,*"Getting to know you: Sharing Practical governance viewpoints"* (Wilmington, Del., Oct. 30, 2014), available at http://www.lerner.udel.edu/sites/default/files/WCCG/PDFs/events/Transcript%20_UDel%20Corp%20Governance%2010%2030%202014_%20FINAL%20for%20UD%20website.pdf
36. *See, e.g.,* J. Lublin, *"Boards' Longtimers Face Pressure to Move On,"* Wall St. J., Tues., Dec. 24, 2014, at p. B6 (describing specific situations); *see also* Deloitte LLP and American Society of Corporate Secretaries and Governance Professionals, *2014 Board Practices Report: Perspectives from the boardroom* 4 (9th ed. 2014).
37. A growing number of countries have adopted tenure-related guidelines or restrictions for independent directors. With few exceptions, the "comply or explain" model prevails, and the recommended maximum tenure for a corporate director is between nine and 12 years. For example, the UK Corporate Governance Code applicable to listed companies on a comply-or -explain basis provides that a director will not be considered "independent" if the director has served on the board for more than nine years. In France, directors may not be deemed independent after the end of a term in which they reach 12 years of service on the board. The French rule creates an effective term limit, as longer-serving directors are not eligible for audit committee membership or other board roles left to independent directors.
38. http://www.cii.org/article_content.asp?article=208

39. BlackRock, *Proxy voting guidelines for U.S. securities* (February 2015)("BlackRock Proxy Voting Guidelines"), at 3, available at http://www.blackrock.com/corporate/en-us/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf
40. http://ssga.co.nz/library/povw/733339_Addressing_the_Need_for_Board_Refreshment...in_Investee_Companies_1_CCRI1399281503.pdf
41. Grind & Lublin, *supra*.
42. Institutional Shareholder Services, Inc., *United States Summary Proxy Voting Guidelines: 2015 Benchmark Policy Recommendations* (Dec. 22, 2014)("ISS 2015 Proxy Voting Guidelines"), available at http://www.issgovernance.com/file/policy/2015ussummaryvotingguidelines.pdf
43. Glass Lewis, *Proxy Paper Guidelines 2015 Proxy Season: An Overview of the Glass Lewis Approach to Proxy Advice, United States* (2015) ("Glass Lewis, 2015 Proxy Voting Guidelines"), at 21, available at http://www.glasslewis.com/assets/uploads/2013/12/2015_GUIDELINES_United_States.pdf
44. *See* Remarks of SEC Chair Mary Jo White, *"Completing the Journey: Women as Directors of Public Companies"* (Sept. 16, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370542961053
45. *See* H. Blackford, "*SEC should increase board diversity disclosure – pension funds",* FT Agenda (March 31, 2015).
46. *See* D. DeHaas & M. Bujno, *"Board Refreshment: Addressing Shareholder Concerns",* NACD Directorship (January/February 2015), at 74.
47. NACD, "Director Dialogue Series: Board Composition" (Dec. 2014), available at http://www.nacdonline.org
48. *See, e.g.,* Council of Institutional Investors, "Best Disclosure: Board Evaluation" (Sept. 2014), available at http://www.cii.org/files/publications/governance_basics/08_18_14_Best_Disclosure_Board_Evaluation_FINAL.pdf
49. Weil alert, "Heads Up for 2015 Proxy Season: Two Proxy Advisory Firm Developments" (November 12, 2014)("Weil, Heads Up"), *available* at http://www.weil.com/~/media/files/pdfs/pcag_alert_nov2014.pdf.
50. *See* ISS, 2015 Equity Plan Scorecard, Frequently Asked Questions (Dec. 22, 2014), available at http://www.issgovernance.com
51. ISS, 2015 Equity Plan Scorecard, Frequently Asked Questions (March 3, 2015), available at http://www.issgovernance.com
52. ISS, 2015 U.S. Compensation Policies, Frequently Asked Questions (Feb. 9, 2015), available at http://www.issgovernance.com
53. The 2015 updates, effective on February 2, 2015, are available at http://www.glasslewis.com/blog/enhancements-pay-performance-equity-plan-models
54. Weil, Heads Up, *supra.*
55. White, Tulane Remarks, *supra*.
56. *See id.*
57. 73 A.2d 934 (Del. Ch. 2013).
58. *See* Roberts v. TriQuint Semiconductor, Inc., No. 1402-02441, *slip op.* at 9-10 (Or. Cir. Ct. Aug. 14, 2014)(declining to grant a motion to dismiss a complaint challenging the unilateral board adoption of a forum selection bylaw "in anticipation of this exact lawsuit").
59. *See, e.g.,* City of Providence v. First Citizens Bancshares, Inc., 99 A. 3d 229 (Del. Ch. 2014).
60. A copy of this draft legislation is available via a link appearing in the following article by Michael Greene, *"Proposal Would Nullify Fee-Shifting Bylaws in Delaware Stock Corporation Bylaws, Charters",* published on March 9, 2015, in Bloomberg BNA's Corporate Law & Accountability Report ("Greene").
61. Undated copy of draft legislation attached to Client Memorandum from Richards Layton & Finger, *2015 Amendments to the General Corporation Law of the State of Delaware* (April 13, 2015)("RLF, Delaware Amendments"), available at http://www.rlf.com/Publications/6017. Members of this leading Delaware-based law firm are part of the Delaware Bar Council drafting group.
62. ISS February 2015 FAQs, *supra.*
63. Glass Lewis, 2015 Proxy Season Voting Guidelines, *supra,* at 14.
64. *Id.* at 18-19.
65. 91 A.3d 554 (Del. 2014).
66. *See* Strougo v. Hollander, C.A. No. 9770-CB (Del. Ch. Mar. 16, 2015).

67. *See* Greene, *supra; see also* RLF, Delaware Amendments, *supra.*

68. M. Greene, *Delaware Supreme Court's Chief Justice Voices Support for Fee-Shifting Limitation,* Bloomberg BNA Securities Law Daily (April 2, 2015)(reporting on Chief Justice's Strine's remarks during the Council of Institutional Investors' Spring Meeting).

69. Copies of all CII and institutional investor letters to the Governor of Delaware, state legislators and others are available on CII's website at http://www.cii.org/fee_shifting_bylaws

70. *See* ISS February 2015 FAQs, *supra*.

71. Glass Lewis 2015 Proxy Season Voting Guidelines, *supra,* at 14, 20.

72. *See* ISS February 2015 FAQs, *supra. See also* CII's fee-shifting bylaw informational web page containing a link to a consultant's list of more than 40 companies that have such bylaws as of late January 2015. *See* http://www.cii.org/fee_shifting_bylaws

73. SEC Release No. 33-9452; 34-70443 (Sept. 18, 2013), available at https://www.sec.gov/rules/proposed/2013/33-9452.pdf

74. SEC Release No. 33-9723; 34-74232 (Feb. 9, 2015), available at http://www.sec.gov/rules/proposed/2015/33-9723.pdf

75. *See, e.g.,* Equilar CD&A Analysis Study, *supra.*

76. This study, which was co-authored by Professor David F. Larcker of Stanford and co-authors Brian Tayan (Stanford Business School), Ronald Schneider (RR Donnelley Financial Services) and Aaron Boyd (Equilar), is available at http://www.gsb.stanford.edu/faculty-research/publications/2015-investor-survey-deconstructing-proxy-statements-what-matters

77. For a comprehensive discussion of voluntary clawback disclosures made in 2014 proxy statements, and possible accounting ramifications of provisions permitting the exercise of discretion where a clawback otherwise would be triggered, see PwC, *Executive Compensation: Clawbacks – 2014 Proxy Disclosure Study* (January 2015).

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