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Hot Topics for the 2016 Proxy Season

In her regular column on corporate governance issues, Holly Gregory outlines the issues that are likely to define the 2016 proxy season based on trends from the 2015 proxy season.

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Holly counsels clients on a full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory and listing rule requirements, and governance best practice.

Results from the 2015 proxy season highlight the various ways different types of investors approach their ability to influence the governance of a corporation. Companies seeking to gain support for board and management positions are well-advised to understand these distinctions and differentiate their strategies as they consider how best to engage shareholders.

While large, long-term institutional investors tend to focus on shareholder rights and board composition, as evidenced by their support for shareholder proposals for proxy access and majority voting, individual shareholders show far less support for these reforms (outside of the handful of individual shareholders who account for a significant number of the shareholder proposals brought each year). In contrast, hedge funds appear more focused on achieving actual board composition change to help further their specific near-term financial goals.

The continuing increase in institutional investor influence, evident in the success of the proxy access campaign by New York City Comptroller Scott Stringer, was the defining trend of the 2015 proxy season and is likely to drive how companies respond to other shareholder initiatives in 2016. Institutional investor influence is also likely to impact company efforts to engage with individual shareholders as it becomes clearer that individual shareholders, who are more likely to vote against proxy access proposals and

otherwise support board and management positions when they do vote, are voting at lower rates than ever before.

Companies should begin preparing now for the 2016 proxy season to ensure that they are well-positioned to engage with shareholders on any issue that received significant support in the 2015 proxy season at the company, any executive compensation concerns that became apparent through the say on pay vote and any other issues that could arise in the coming proxy season. Counsel should be ready to advise and update the board on:

- Distinct voting patterns of institutional and retail investors.
- Trends in shareholder activism and engagement.
- The most prevalent shareholder proposals from the 2015 proxy season, including proxy access and other Rule 14a-8 proposals.
- Areas of focus for the 2016 proxy season.
- Steps the board and management should take now to prepare for next year.

DISTINCT VOTING PATTERNS OF INSTITUTIONAL AND RETAIL INVESTORS

The proportion of stock in US public companies held by individuals has fallen precipitously from as high as 92% in 1950 to approximately 33% in 2010, as more individuals have shifted their investments from direct share ownership to intermediary investment vehicles, such as pension funds, mutual funds and exchange traded funds (see *Luis A. Aguilar, SEC Commissioner, Speech at Georgia State University (April 19, 2013)*). This shift, combined with a host of other factors including rule changes that prohibit brokers from voting uninstructed shares on a wide range of matters, has led to a decline in support for board and management positions on matters brought to a shareholder vote.

According to a recent report from Broadridge and PricewaterhouseCoopers, not only the proportion of individual ownership has declined, but individual shareholder participation in proxy voting has also declined (*Proxy Pulse, 2015 Proxy Season Wrap-up, Third Edition 2015 (Proxy Pulse Report)*). In 2015, individual shareholders voted just 28% of their shares, continuing a downward trend in individual shareholder voting. In sharp contrast, institutional investors voted more than 90% of their shares in the 2015 proxy season.

This trend is worth focusing on because institutional investors are less likely than individual shareholders to support the board and management in voting on shareholder proposals. The Proxy Pulse Report observes that among those investors who vote, institutional investors are four times more likely to support proxy access than are individual shareholders (61% of votes cast by institutional investors were in favor of proxy access in 2015, compared with only 15% of votes cast by retail investors). This suggests that companies facing a proxy access vote should consider ways to encourage their retail investors to vote.

However, although individual shareholders tend as a group to support the board and management in their voting patterns, a very small group of individual shareholders continue to account for a disproportionate number of shareholder proposals. According to Proxy Monitor's *2015 Proxy Season Wrap-up*, just

three individuals and their close family members accounted for approximately one-third of all shareholder proposals filed in the 2015 proxy season at Fortune 250 companies.

In 2015, the number of shareholder proposals filed by institutional investors increased due to the 75 proxy access proposals filed by Comptroller Stringer on behalf of various New York City pension funds. Notably, the identity of shareholder proponents continues to gradually shift. While individual shareholders account for the majority of shareholder proposals, followed by public pension funds and labor unions, the number of proposals sponsored by other institutional investors rose.

TRENDS IN SHAREHOLDER ACTIVISM

Shareholder activism aimed at obtaining board representation and influencing particular corporate strategic and financial decisions has been at record highs for several years and shows little sign of abating. This trend is attributed to a number of factors, including the flow of money into activist hedge funds. These funds had less than \$50 billion in assets under management in 2010, compared to more than \$200 billion in 2015.

Companies are negotiating settlements in significant proportion. As a result, the percentage of total proxy contests going to a vote has fallen to approximately 24% of the 91 proxy contests so far in 2015, compared to 35% in 2014. Interestingly, proxy advisor support for the board in contests for board representation has increased. It is estimated that Institutional Shareholder Services Inc. (ISS) has supported the board in approximately 50% of proxy contests in 2015, compared to approximately 33% of proxy contests the previous year. Shareholder activists have succeeded in a significant majority of cases (approximately 65%) if settlements and partial victories are counted.

The DuPont challenge this year shows that even the largest, most respected and successful companies can be targets. In this environment of heightened shareholder activism, corporate preparedness is critical, as well as establishing stable, positive relationships with large, long-term shareholders and a faithful retail investor base.

SHAREHOLDER ENGAGEMENT DEVELOPMENTS

In the 2015 proxy season, the trend of significant engagement between companies and their shareholders continued as companies increased their efforts to understand and respond to shareholder concerns. According to analysis by the EY Center for Board Matters, while only 6% of S&P 500 companies disclosed in their proxy statements information about shareholder engagement in 2010, 56% included this disclosure in 2015 (*EY Center for Board Matters, Four Takeaways from Proxy Season 2015, June 2015 (EY Proxy Season Analysis)*). Clearly, shareholder engagement continues to provide a valve for releasing tensions.

Shareholder engagement efforts are driven by a host of factors, including concerns about shareholder votes on say on pay and other proposals, and concerns about hedge fund activism. This is evident in the topics that companies are discussing with their shareholders, including:

- Executive compensation.
- Shareholder rights, such as proxy access and majority voting.
- Board structure and composition, including independent board leadership, director qualifications, tenure, evaluation and diversity.
- CEO performance, compensation and succession planning.
- Strategic direction and risk oversight.
- Audit committee reporting.
- Sustainability practices and reporting.

Companies should be mindful that large institutional investors have limited resources to devote to engagement efforts relative to the number of companies in their portfolios. Therefore, large institutional investors may prefer to engage only when circumstances necessitate it during the proxy season, reserving more general engagement for the off season. Often companies will organize engagement into two distinct categories:

- An off-season effort to reach out to and hear from investors about the matters that were on the prior ballot and any issues that are likely to come up in the upcoming season. This is aimed largely at learning about shareholder views and perspectives, and establishing relationships. Companies should keep track of these efforts and what is learned since this may provide the basis for helpful disclosure in the next proxy statement.
- Outreach closer to or during the proxy season about specific issues that have arisen.

Shareholder engagement takes various 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.

Depending on the circumstances and the topic, investors may appreciate hearing directly from a director, but this is not necessary in many instances. Where directors do engage directly, they must do so carefully to ensure that the engagement complies with prohibitions on selective disclosure and is consistent with the board's viewpoints. Absent highly unusual circumstances, management should also participate in these sessions. As with management engagement efforts, preparation and careful listening are important to ensure that participants are knowledgeable about the issue.

KEY 2015 SHAREHOLDER PROPOSALS

As in past proxy seasons, S&P 500 companies received the most significant proportion of shareholder proposals on governance and compensation, and environmental, social and political (ESP) issues. These issues also appear to be trickling down to the broader Russell 3000.

Most governance-related proposals sought to increase shareholder rights through:

- Proxy access (approximately 35% of governance proposals).
- The ability to act by written consent (approximately 15% of governance proposals).

- The ability to call special meetings (approximately 9% of governance proposals).
- Majority voting in uncontested elections (approximately 5% of governance proposals).

In addition, the topic of independent board leadership garnered significant attention as the second most common governance proposal after proxy access (approximately 26% of governance proposals).

PROXY ACCESS PROPOSALS

Proxy access was the defining issue of the 2015 proxy season as the campaign by shareholder rights proponents, led by Comptroller Stringer, for the ability of shareholders to nominate director candidates in the company's proxy statement at the company's expense gained momentum. This is evidenced by:

- The number of shareholder proxy access proposals going to a vote (87 proposals, compared to 18 in 2014).
- The average vote in favor of these proposals (54%, compared to 34% in 2014).
- The rate at which these proposals have achieved majority support (59%, compared to 28% in 2014).
- The number of companies that have adopted proxy access in 2015 to date (32 companies, compared to seven in 2014).

A fair degree of consensus about the terms on which proxy access should be available is also developing. All shareholder proposals, including the 75 proposals brought by Comptroller Stringer, sought an ownership threshold of 3% of outstanding shares held for three years as a condition to bringing forward a proxy access candidate. Those companies that have adopted proxy access in 2015 have done so on fairly similar terms with respect to the primary issues (although there continues to be some variation on the details of implementation).

Of the 32 companies that adopted proxy access in 2015:

- All require a nominating shareholder or group to beneficially own either 3% or 5% of the company's outstanding shares for three years, with:
 - 26 companies (81%) requiring 3%; and
 - 6 companies (19%) requiring 5%.
- All limit the maximum percentage of board seats for proxy access candidates to either 20% or 25%, with:
 - 23 companies (72%) limiting to 20%; and
 - 9 companies (28%) limiting to 25%.
- Most limit the number of shareholders that may comprise the nominating group, with a limit of 20 shareholders as the most common limit (23 of the 32 companies, or 72%), but companies have adopted limits of one, five, ten or 15 shareholders, and a small number have adopted no limit.

James McRitchie, a shareholder activist who regularly brings shareholder proposals at a number of companies, has indicated that he will consider submitting shareholder proposals in 2016 to remove limits on the number of shareholders who can join together to satisfy the ownership threshold. Similarly, the Council of Institutional Investors stated that it disfavors any limit

or cap on the number of shareholders in the nominating group (*Council of Institutional Investors, Proxy Access: Best Practices, August 2015*).

Adopting companies also usually specify other procedural and disclosure requirements. Typical provisions include:

- A deadline for nominations.
- A requirement that nominating shareholders commit to continue to hold shares through the meeting (and even beyond).
- A requirement that nominating shareholders possess both full voting and investment rights.
- Disclosure requirements from both the nominating shareholders and proxy access nominees.
- Circumstances in which proxy access nominees may be excluded from the proxy card or disqualified from board service, for example:
 - restrictions on renomination in year two if the candidate did not receive a certain percentage of favorable votes; and
 - disqualification if compensation is received from a third party for serving as a director.

In addition, at some companies the cap on the number of board seats available for proxy access candidates is adjusted depending on whether other director candidates are nominated by shareholders pursuant to the company's advance notice by-law provision. The available proxy access seats in any given year may also be limited by a board decision to renominate a director who originally joined the board as a proxy access candidate. It is also typical to require nominating shareholders to make representations that they have no control intent and are not participating in any solicitation other than related to the proxy access candidate or the board's nominees.

To date, no shareholder has used proxy access to include a director nominee in the proxy materials of a US company.

OTHER RULE 14a-8 PROPOSALS AND VOTING RESULTS

The following results are based on research using the ISS Voting Analytics Database for the number of proposals that went to a vote and the Alliance Advisors 2015 Proxy Season Review for the approximate number of shareholder proposals submitted. While proxy access was the most common shareholder proposal to come to a vote (87 voted on out of approximately 117 submitted), other key shareholder proposals that came to a vote in high numbers related to:

- Sustainability and the environment (84 voted on out of approximately 164 submitted).
- Executive compensation (80 voted on out of approximately 136 submitted).
- Political spending and lobbying activities (65 voted on out of approximately 121 submitted).
- Independent board leadership (63 voted on out of approximately 82 submitted).
- Shareholder action by written consent (36 voted on out of approximately 44 submitted).

The percentage of shareholder proposals withdrawn was down slightly from 2014, and although the number of requests

for no-action relief to the SEC was greater than in 2014, the percentage of successful petitions fell from slightly over 59% in 2014 to just over 44% in 2015.

While proxy access was the big news story, it came in third place in terms of the types of shareholder proposals receiving the highest average votes in support. The shareholder proposals with the highest average support were:

- Board declassification (average support of 71.3%, passed at 14 of 15 companies).
- Majority voting in uncontested director elections (average support of 69.3%, passed at eight of 11 companies).
- Proxy access (average support of 54.3%, passed at 51 of 87 companies).
- Elimination or reduction of supermajority vote requirements (average support of 59.8%, passed at seven of 11 companies).

Other shareholder proposals that showed significant levels of shareholder support were:

- Shareholder ability to call special meetings or to lower the threshold (average support of 42.4%, passed at four of 21 companies).
- Shareholder ability to act by written consent or to lower the threshold (average support of 39.4%, passed at two of 36 companies).

Although there were a significant number of shareholder proposals seeking an independent chair that went to a vote, the proposal passed at only two of 63 companies in 2015, with average support of 29.1% (a five-year low). While the change in ISS vote recommendation policy to a more case-by-case approach rather than a fairly well-defined standard appears to have led to an increase in favorable ISS recommendations for independent chair proposals, the change does not appear to have had any meaningful impact.

Executive compensation shareholder proposals have become a smaller proportion of shareholder proposals in the wake of the mandatory say on pay vote opportunity implemented in 2011. Of the 80 compensation-related shareholder proposals voted on in the 2015 proxy season, most related to accelerated vesting of equity awards (27 proposals).

As in the past few years, ESP topics accounted for a significant proportion of shareholder proposals filed and voted on, but it remains rare for these proposals to achieve majority support. To date in 2015, although one ESP proposal achieved majority support, no ESP proposal has passed.

While ESP proposals overall tended to achieve relatively low levels of support (on average around 22%), depending on the circumstances it was not unusual for shareholder proposals relating to political spending and lobbying activity to achieve votes of more than 35%. Political spending and lobbying proposals comprised almost 32% of ESP proposals voted on in 2015, and achieved average support of 27%. The highest votes received on average for ESP proposals (where the proposal was voted on at more than one or two companies) were on sustainability reporting proposals, which achieved average support of 31%.

DIRECTOR ELECTIONS

In the vast majority of director elections in the 2015 proxy season, shareholders supported the directors nominated by the board, with average levels of support greater than 96%. According to the EY Proxy Season Analysis, opposition to director nominees reached its lowest level in seven years. It concludes that, "For now, it appears that long-term institutional investors' concerns about board composition and accountability are playing out primarily through the support of structural governance changes." However, the EY Proxy Season Analysis notes that this approach is in direct contrast to activist hedge fund investors looking for changes in the board slate to seek greater control.

In the unusual cases where directors have not achieved majority support in an uncontested election, contributing factors include:

- Perceived lack of responsiveness to majority-supported shareholder proposals or to a failed director vote in the prior year.
- Perceived lack of responsiveness to a failed say on pay vote in the prior year or persistent pay for performance concerns.
- Concerns about unilateral board action in adopting a poison pill or by-law amendment involving shareholder rights.
- Overboarded directors.

These are all factors that may contribute to a negative vote recommendation from proxy advisors. The 2015 proxy season was the second in which ISS applied its policy of recommending against directors for the board's failure to substantially implement a non-binding shareholder proposal that received majority support in the prior year. While ISS claimed that this policy would be applied in a nuanced and company-specific way, application of the policy led to a number of negative vote recommendations for directors in both the 2014 and 2015 proxy seasons. As in 2014, it appears that ISS negative vote recommendations based on the perceived lack of board responsiveness to shareholder concerns, as evidenced by a failure to implement a successful shareholder proposal, was the leading factor associated with directors who failed to receive majority support in an uncontested election in 2015.

Proxy advisor policies that seek to discourage re-election of directors who have engaged in conduct they disfavor, when combined with the broad adoption of majority voting as the voting standard in uncontested elections and rules that prohibit brokers from voting uninstructed shares, gives rise to some risk for director re-election should the board act in a manner that does not conform to proxy advisors' views. While directors cannot abdicate their fiduciary judgment, it is not prudent to ignore the concerns of a majority of the voting shareholders. Companies should carefully consider how to respond to any non-binding shareholder proposal that received significant support. Where a shareholder proposal received majority support, special care should be taken to engage with the proponent and other shareholders on the issue and consider whether and how to take responsive action.

AREAS OF FOCUS FOR THE 2016 PROXY SEASON

In addition to reviewing the most prevalent shareholder proposals and voting results from the 2015 proxy season,

counsel should assess and review with the board the most likely subjects of shareholder proposals for the 2016 proxy season. Issues relating to shareholder rights will likely continue to be a focus of 2016 shareholder proposals, including:

- Proxy access.
- Elimination of supermajority provisions to amend by-laws.
- Annual election of directors (board declassification).
- Majority voting in director elections.
- Shareholder ability to call special meetings.
- Shareholder ability to act by written consent.
- Independent board leadership.
- Director tenure.

For ESP topics, companies should expect shareholder proposals on:

- Political spending and lobbying activity.
- Environmental sustainability and risks.
- Human rights policies and impacts.
- Diversity.

On August 4, 2015, ISS released its 2016 Annual Policy Survey designed to elicit input for ISS consideration in determining its voting policies for the 2016 proxy season (available at issgovernance.com). The survey topics provide insight into policies that ISS may adopt or amend for the 2016 proxy season. Counsel should watch for draft policy revisions to be released in October 2015 for comment, and for final release of the policy updates in November 2015.

Additionally, compensation issues are likely to be a subject of much discussion in boardrooms in the coming months as companies prepare for new disclosures given recent SEC action on several mandated Dodd-Frank Act compensation-related provisions. Attending to shareholders' views on say on pay will also continue to be important for those companies that did not achieve shareholder support higher than 80%.



Search [Hot Topics for Compensation Committees for 2016](#) for more on key issues for compensation committees in 2016.

PREPARING FOR THE 2016 PROXY SEASON

The following are actions the board and management can begin taking now to prepare for the next proxy season:

ENGAGE SHAREHOLDERS

- **Identify the company's top 20 to 25 shareholders.** Find out whether those shareholders rely on proxy advisors, have established voting guidelines and have any concerns about the company's governance practices.
- **Review the demographic of the shareholder base.** It is important to understand who owns the company and how they voted, including:
 - the proportion of institutional voters to retail voters;
 - the participation levels for various groups; and
 - any trends regarding distinctions in how the various groups voted.

- **Consider how to encourage retail voters.** Given the higher rates at which individual shareholders will support management and board positions in voting on shareholder proposals, consider whether there are actions that the company can take to encourage greater vote participation by individual shareholders.
- **View the company through an activist hedge fund lens.** It is helpful to periodically consider how an activist hedge fund might propose to unlock value. Should an activist appear, it is critical to keep an open mind and evaluate the proposal on the merits. This review can help illuminate the degree to which the company is vulnerable to activist critiques and whether it would be appropriate to make any modifications to the company's strategy and operations in light of these weaknesses.
- **Preparing in advance for shareholder activism without presuming a negative view.** Advance preparation can be valuable with respect to information flow and communications plans. However, avoid plans that assume that the board will resist an overture.
- **Review, but do not over-rely on, structural takeover defenses.** Although periodic review of structural takeover defenses is important, these provisions do little to protect against an activist who seeks only a minority position on the board.
- **Oversee shareholder communication and engagement efforts.** The board should consult with management on shareholder communication and engagement plans and take steps to develop an effective shareholder engagement program and policies. Consider both the content of communications and an appropriate spokesperson. Communications with shareholders should articulate the rationale for board decisions and, as appropriate, emphasize active board involvement in providing fiduciary oversight, as well as the lack of performance problems and other red flags. While very often one or more members of management will undertake the primary engagement with key shareholders, there are occasions where involvement by a director can be highly effective.

TRACK SHAREHOLDER PROPOSAL DEVELOPMENTS

- **Analyze 2015 shareholder proposals.** Evaluate shareholder proposals submitted to the company for the 2015 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.
- **Determine whether action is necessary given the 2015 proxy season voting results and any other developments.** Carefully consider how to respond to any non-binding shareholder proposal that received significant support. Where a proposal received majority support, carefully engage with the proponent and other shareholders on the issue and consider whether and how to take responsive action (keeping in mind the board's responsibility to apply its own judgment to the matter).
- **Consider proxy access strategies.** Follow proxy access developments closely and discuss with the board the various proxy access terms and the options, including adopting proxy access without receiving a shareholder proposal versus taking a wait and see approach. Under a wait and see approach, the board should also consider the various options if the company receives a shareholder proposal.

- **Monitor hot topics and compare governance practices.** Obtain regular reports on shareholder hot topics, and keep track of and compare governance developments and emerging practices, including changes to proxy advisor voting policies.

CONSIDER COMPENSATION-RELATED MATTERS

- **Continue to apply rigor in the design of compensation programs.** Assure alignment between pay and performance in both good and bad times. Avoid undue complexity and create meaningful metrics to enable straightforward disclosure regarding compensation decisions and rationales.
- **Prepare for new compensation disclosures.** Discuss with the compensation consultant, the compensation committee and human resources the implications of the new SEC compensation-related rules, and the timetables and steps involved in preparing the disclosures.

EVALUATE BOARD COMPOSITION

- **Review board composition and director qualifications.** Assess the board's composition relative to the company's needs and consider whether additional experience, skill sets or viewpoints are required or desired. 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.
- **Identify and assess director candidates.** Identify which directors will be recommended for renomination and reevaluate the director's performance and qualifications. Determine whether the board needs new director candidates and, if so, what attributes should be sought.

REVIEW GENERAL CORPORATE GOVERNANCE PRACTICES

- **Articulate the rationale for governance practices.** Discuss and agree on, and record as appropriate, the rationale behind governance decisions.
- **Review governance documents.** Review the company's charter, 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.
- **Monitor proxy advisor policies and specific reports relating to the company.** Register to take advantage of any opportunity to preview and review proxy advisor reports about the company.
- **Reserve 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.

For a calendar that outlines how a board may wish to organize its activities taking into account applicable SEC rules, listing standards and general governance principles, see *The Sidley Best Practices Calendar for Corporate Boards and Committees*, available at sidley.com.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.