



Lessons for the 2015 Proxy Season

In her regular column on corporate governance issues, Holly Gregory examines trends emerging from the 2014 proxy season and related developments, and suggests steps companies can take now to prepare for the 2015 season.



HOLLY J. GREGORY

PARTNER
SIDLEY AUSTIN LLP

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.

While concerns about shareholder activism and the influence of proxy advisor vote recommendations remained high, the 2014 proxy season continued the modest trend toward calmer, less contentious annual meetings. This is due in part to significant efforts by companies to actively engage with their shareholders and understand and respond to shareholder concerns. It may also reflect a modest waning of proxy advisor influence, as certain large institutional investors increase their capacity to make voting decisions and to engage directly with portfolio companies.

Company engagement with shareholders continues to provide a valve for releasing potential annual meeting tensions. Engagement efforts are driven by a host of factors, including concerns about shareholder votes on say on pay and other proposals, and activist efforts. A recent study from the Investor Responsibility Research Center Institute and Institutional Shareholder Services Inc. (ISS) determined that since say on pay was instituted, shareholder engagement efforts have increased by more than 50%. Further, more than two-thirds of Russell 3000 companies disclosed some form of engagement with their investors.

Companies should begin preparing now for the 2015 proxy season to ensure that they are well-positioned to engage with

shareholders on executive compensation issues, as well as on issues that may be the subject of shareholder proposals or campaigns targeting directors in re-election efforts.

In particular, companies should consider:

- Shareholder proposals and voting results from the 2014 proxy season.
- Recent SEC guidance relating to proxy advisory firms and their investment adviser clients.
- Potential changes in proxy advisor policies and policy implementation.
- Steps to take now to identify and address vulnerabilities and engage with shareholders.

2014 PROXY SEASON REVIEW

Companies should begin reviewing shareholder voting results and other key takeaways from the 2014 proxy season in order to take any necessary action well before the time they start drafting their proxy statement for 2015.

SHAREHOLDER PROPOSALS AND VOTING RESULTS

According to recently released data from The Conference Board (in collaboration with FactSet), the number of shareholder proposals filed in 2014 at Russell 3000 companies (752) was relatively flat from 2013 (763) (*Proxy Voting Fact Sheet (July 2014)*). However, in 2014 a higher proportion of proposals went to a vote (67.2% versus 64.5%) reflecting a continuing trend of fewer proposals being omitted under the SEC no-action process. The percentage of omitted proposals has declined from 24.5% in 2012, to 22.3% in 2013 and 19.8% in 2014. At the same time, the percentage of voluntarily withdrawn proposals increased, indicating company success in negotiating with proponents. In 2014, 11.6% of submitted proposals were voluntarily withdrawn, up from 10.1% in 2013 and 5.9% in 2012.

The identity of shareholder proponents continues to gradually shift. While individuals account for the majority of shareholder proposals, followed by public pension funds and labor unions, the number of proposals sponsored by hedge funds and other institutional investors rose.

Corporate Governance Shareholder Proposals

Corporate governance topics comprised the largest set of shareholder proposals at Russell 3000 companies (291 proposals brought, 206 voted on), closely followed by proposals related to social and environmental issues (288 proposals brought, 194 voted on).

The governance-related topics of shareholder proposals in the 2014 proxy season are familiar from past seasons. These trends include:

- **The prevalence of independent board chair proposals.** By far, the most common governance proposal that went to a vote related to policies and practices for implementing an independent board chair structure (62 voted on). This proposal on average received 31% of votes cast, although it did pass at five companies. This may indicate that most

shareholders believe that boards should have discretion regarding the structure of board leadership. Shareholders may also view the lead independent director as adequate to ensure objective leadership of the non-management and independent directors when needed.

- **The pressure to expand shareholder rights.** The next most common governance-related shareholder proposals to go to a vote sought:
 - majority voting in the uncontested election of directors in place of plurality voting (27 voted on), which averaged 56.5% of votes cast, with 15 passed;
 - the ability of shareholders to act by written consent or the easing of related requirements (27 voted on), which averaged 38.1% of votes cast, with none passed;
 - to allow shareholders to call a special meeting or to ease related requirements (14 voted on), which averaged 45% of votes cast, with five passed; and
 - to reduce supermajority voting provisions (12 voted on), which averaged 66.2% of votes cast.



While individuals account for the majority of shareholder proposals, followed by public pension funds and labor unions, the number of proposals sponsored by hedge funds and other institutional investors rose.

- **The continued focus on board declassification.** Shareholders also continued to focus on declassification of boards so that all directors are elected every year, with proposals seeking to repeal a classified board (15 voted on), which averaged a record 80.6% of votes cast.
- **The adoption of proxy access.** Proposals to include shareholder nominees in the company's proxy materials were voted on at 13 companies, which averaged 39.1% of votes cast. Five of these proposals passed.

Social and Environmental Shareholder Proposals

Social and environmental policy proposals accounted for an increasing proportion of shareholder proposals filed and voted

on at Russell 3000 companies, but it remains rare for these proposals to achieve a majority of votes cast. 2014 saw the following trends:

- Social and environmental policy proposals overall tended to achieve relatively low levels of support, which averaged around 20% of votes cast.
- Depending on the circumstances, it was not unusual for proposals relating to the prohibition of discrimination, and the disclosure of political spending and lobbying activity, to achieve votes of more than 40%.
- Political spending and lobbying proposals comprised almost 45% (86 proposals) of all social and environmental policy proposals voted on, but averaged only 21% of votes cast.
- Among social issue proposals, board diversity proposals achieved the highest votes, which averaged 29.1% of votes cast.

Executive Compensation Shareholder Proposals

Executive compensation shareholder proposals have become a smaller proportion of shareholder proposals in the wake of the say on pay vote opportunity implemented in 2011. According to The Conference Board, of the 70 executive compensation shareholder proposals voted on at Russell 3000 companies in the 2014 proxy season, most related to requiring equity retention periods (26 voted on, averaged 26.1% of votes cast, one passed) and limiting severance agreements (22 voted on, averaged 37.3% of votes cast, five passed, all relating to prevention of acceleration of vesting of equity awards upon a change in control).

NEGATIVE SHAREHOLDER VOTE RECOMMENDATIONS

The 2014 proxy season was the first 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 a majority of votes cast in the prior year. While ISS claimed that this policy would be applied in a nuanced and company-specific way, application of the new policy led to a number of negative votes in director elections.

It appears that ISS negative vote recommendations based on the perceived lack of board responsiveness to shareholder concerns (as evidenced by the failure to implement a successful shareholder proposal) was the leading factor associated with directors who failed to receive a majority of votes cast in an uncontested election in 2014. Clearly, shareholder votes in director elections are no longer mere protest votes. Negative shareholder vote campaigns can have an impact on board composition, given:

- The replacement of plurality voting with majority voting in director elections.
- The effect of the prohibitions on broker voting of uninstructed shares.

Companies should carefully consider how to respond to any non-binding shareholder proposal that received a significant vote. However, where a proposal received a majority of votes cast, special care should be taken to engage with the proponent

and other shareholders on the issue and consider whether, and if so how, to take responsive action. The board cannot abdicate its judgment to the will of shareholders on matters that fall within its responsibility. However, it is also not prudent to ignore the concerns of a majority of the voting shareholders.

MANAGEMENT SAY ON PAY PROPOSALS

In the fourth year of say on pay, shareholders continued to support the vast majority of management say on pay proposals with relatively high affirmative votes. Of the 2,207 Russell 3000 companies that held a say on pay vote as of July 11, 2014, only 2.4% failed to receive majority shareholder support (*Semler Brossy, Report update: five additional companies with support below 50% (Jul. 16, 2014)*). In 2013, the figure for failed votes was 2.5%.

According to Semler Brossy, since say on pay was instituted in 2011, of the Russell 3000 companies that have held a vote in all four years:

- 92% of companies have passed every year.
- Only 6.6% of companies have failed to receive majority support once in the four years.
- Only 1% of companies have failed to receive majority support two out of the four years.
- Three companies have failed to receive majority support three out of the four years.
- Two companies have failed to receive majority support every year.

For those companies that elected in 2011 to hold their say on pay vote every three years (a triennial vote), 2014 presented the second opportunity for shareholders to vote on executive compensation. Only 1.8% of companies in this group failed to receive majority shareholder support, a lower fail rate than the fail rate for all companies (2.5%), even though a negative ISS recommendation was more likely. ISS recommended against say on pay proposals at 19% of companies with a triennial vote, but only at 12% of all other companies. (*Semler Brossy, 2014 Say on Pay Results, Russell 3000, Jul. 16, 2014*.)

Shareholder support tended on average to be 29% lower at companies that received a negative ISS vote recommendation, although this influence appears less robust at those companies that hold a vote every three years (rather than every year).

As in past years, not only was the failure rate low, but the level of shareholder support for say on pay proposals was significant at most companies:

- 75% of Russell 3000 companies received greater than 90% shareholder support.
- 92% of Russell 3000 companies achieved shareholder support of more than 70%.

(*Semler Brossy, 2014 Say on Pay Results, Russell 3000, Jul. 16, 2014*.)

Companies should not be lulled into complacency by a passing vote. Unless the vote is in the 80% or above range, efforts should be undertaken to understand the drivers of minority dissatisfaction.

PROXY ADVISOR DEVELOPMENTS

As companies prepare for the 2015 proxy season, they should consider:

- Staff Legal Bulletin No. 20 (SLB 20), which was jointly published on June 30, 2014 by the SEC's Division of Corporation Finance and Division of Investment Management, relating to both proxy advisory firms and their investment adviser clients (available at sec.gov).
- The ISS 2015 Policy Survey released on July 17, 2014, designed to elicit input for ISS consideration in determining its voting policies for the 2015 proxy season (available at issgovernance.com).

SLB 20

SLB 20, in the form of 13 questions and answers, addresses:

- Investment adviser responsibilities related to the voting of proxies.
- Investment adviser considerations regarding retention and oversight of proxy advisory firms.
- The availability and requirements of two exemptions to the proxy solicitation rules on which proxy advisory firms may rely.

While this guidance does not directly address many of the concerns and criticisms raised to date about proxy advisors, it may cause investment advisers that engage proxy advisory firms to act as better watchdogs regarding the quality of the services the proxy advisory firms provide and it may even prompt some to reduce their reliance on these services. The guidance could also raise the costs for proxy advisors to provide quality services.

ISS 2015 POLICY SURVEY AND POLICY UPDATES

The ISS Policy Survey questions serve as a good indicator of areas in which ISS voting policy may change. This year, the survey topics focus on:

- **Executive compensation.** In this area, issues include:
 - the relationship between incentive compensation targets and award values;
 - the magnitude of CEO pay regardless of company performance;
 - the extent to which disclosures regarding positive amendments to a compensation program should mitigate compensation problems apparent in the past year; and

- the weight to be given in the evaluation of equity plans to plan cost (such as dilution), plan features (such as share recycling and vesting acceleration) and company practices (such as historic burn rate and use of performance-based grants).
- **Defensive by-law adoption.** The circumstances and factors to consider in assessing director accountability for unilateral adoption of by-law and charter provisions (including pre-IPO that "diminish" shareholder rights).
- **Boardroom diversity.** Whether and how gender diversity should factor into assessing the board.
- **Risk oversight.** The circumstances and factors to consider in assessing director accountability for material failures of risk oversight.
- **Audit oversight.** The circumstances and factors to consider relating to re-electing audit committee members and ratifying the selection of the independent audit firm, such as tenure of the audit firm.
- **Cross-market companies.** Whether to continue to apply non-US standards to companies that are incorporated outside of the US, but are US registrants listed only on a US exchange ("cross-market companies").
- **Environmental and social goals.** This area relates to quantitative environmental and social performance goals and alternatives.

These topics provide insight into policies that ISS may adopt or amend for the 2015 proxy season. Companies should watch for draft policy revisions to be released in October 2014 for comment, and for final release of the ISS 2015 policy updates in November 2014.



Search [How to Handle Shareholder Proposals](#) for more on the steps a company should take after it receives a proposal.

PREPARING FOR THE 2015 PROXY SEASON

Companies and their governance committees should begin preparing now for the 2015 proxy season by:

- **Reviewing 2014 shareholder proposals.** Analyze shareholder proposals submitted to the company for the 2014 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.

In the fourth year of say on pay, shareholders continued to support the vast majority of management say on pay proposals with relatively high affirmative votes.

- **Monitoring developments and comparing 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. It is also helpful to maintain relationships with shareholder groups and proxy advisors.
- **Considering areas requiring action.** Determine whether action is necessary in light of 2014 proxy season voting results or other developments and, if so, identify the appropriate action. Think carefully about how to respond to any non-binding shareholder proposal that received a significant vote. Where a proposal received a majority of votes cast, special care should be taken to engage with the proponent and other shareholders on the issue. Consider whether, and if necessary how, to take responsive action in line with the board's responsibility to apply its own judgment to the matter.
- **Continuing to apply rigor in the design of compensation programs.** Compensation programs should be designed to ensure alignment between pay and performance in both good and bad (or challenging) times.
- **Articulating the rationale for governance practices.** Discuss, agree on and record, as appropriate, the rationale behind governance decisions.
- **Identifying key shareholders.** Identify the company's top 20 to 25 shareholders and find out whether those shareholders:
 - rely on proxy advisors;
 - have established voting guidelines; and
 - are concerned about the company's governance practices.
- **Overseeing shareholder communication and engagement efforts.** Consult with management on shareholder communication and engagement plans and take steps to develop effective shareholder engagement programs and policies. Consider both the content of communications and the appropriate spokesperson. Regardless of the 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 flag concerns. Although one or more members of management will often undertake the primary engagement with key shareholders, there are occasions where involvement by a director can be highly effective.
- **Evaluating board composition and director qualifications.** Assess the board's composition relative to the company's needs and consider whether any experience, skill sets or viewpoints are required. Review individual director qualifications and analyze how the disclosure of the director's attributes is likely to look and whether the director meets the appropriate independence standards.
- **Identifying and assessing director candidates.** Identify which directors will be recommended for re-nomination and reevaluate the director's performance and qualifications. Determine whether the board needs new director candidates and, if so, what attributes should be sought.

- **Reviewing governance documents.** Review company by-laws, shareholder meeting procedures, corporate governance guidelines, committee charters and board policies to ensure that they are up to date and appropriately reflect the company's governance practices.
- **Reserving time for proxy review.** Ensure there is adequate time to review the proxy statement and engage in discussions with management on how to make the proxy statement a more effective communication tool.
- **Monitoring and providing comments to proxy advisor reports.** Take advantage of any opportunity to preview and review proxy advisor reports about the company. ISS provides S&P 500 companies with the opportunity to review the facts in proxy voting reports, if they register with ISS (available at issgovernance.com). Companies can also provide comments about errors or omissions in their Glass Lewis reports (available at glasslewis.com).

Peaceful and supportive shareholder relations require attention to identify and address vulnerabilities, understand shareholder concerns and apply that understanding to communications with shareholders, including in engagement efforts and proxy disclosures.



Search [Corporate Governance Practices: Commentary](#) for more on issues companies should consider in evaluating corporate governance practices.

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