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# Hot Topics for Boards from the 2016 Proxy Season

In her regular column on corporate governance issues, Holly Gregory considers the major topics for boards and their advisors to consider based on shareholder activity in the 2016 proxy season.

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With the 2016 proxy season winding down, it is time for boards, corporate governance and compensation committees, and their advisors to take stock of voting results and consider their implications for board and committee agendas and shareholder engagement efforts in the year ahead. This article provides an overview of key mid-season voting results on:

- Shareholder proposals.
- Director elections.
- Management say on pay proposals.
- Equity compensation plans.

**SHAREHOLDER PROPOSALS**

While the full data is not yet in, it appears that the overall number of shareholder proposals is approximately 8% higher than last year, according to the Proxy Monitor database which tracks shareholder proposals among Fortune 250 companies. The most common shareholder proposal topics that were voted on, as of June 15, 2016, according to data from Institutional Shareholder Services Inc. (ISS), related to:

## Top Ten Shareholder Proposals for the 2016 Proxy Season

According to the ISS Governance Analytics database, for meetings held between January 1, 2016 and June 15, 2016 (where data was available on June 16, 2016), the ten most prevalent shareholder proposals voted on this proxy season are set out below.

Ten Most Prevalent Shareholder Proposals	Number	Average Voting Support	Passed
1. Provide Shareholders Right of Proxy Access	71	51%	36 (56%)
2. Require Independent Board Chairman	46	29%	0
3. Report on Lobbying Payments and Policy	37	24%	0
4. Report on Political Contributions	22	33%	1 (5%)
5. Report on Climate Change	20	26%	0
6. Vesting of Equity Awards	16	27%	0
7. Reduce Supermajority Vote Requirement	15	59%	9 (60%)
8. Provide Shareholders Right to Act by Written Consent	14	41%	0
9. Report on Sustainability	13	34%	1 (8%)
10. Provide Shareholders Right to Call Special Meeting	11	43%	2 (18%)

**Note:** The percentage of voting support is calculated as the number of votes cast in favor of the proposal divided by the sum of the number of votes cast in favor of, and against, the proposal, and ignoring abstentions.

- Proxy access.
- Independent board chairs.
- Lobbying efforts and political contributions.
- Climate change.

### PROXY ACCESS

In a trend continuing from 2015, proxy access is the predominant shareholder proposal, in terms of the number of proposals submitted, the number of negotiated settlements, and shareholder voting support. As many observers predicted last year, shareholder pressure for proxy access will cause, over a period of several years, widespread adoption of proxy access by-laws, especially by large cap companies. We are now nearing the tipping point where proxy access will be the majority practice in S&P 500 companies. This development underscores that private ordering can accomplish what the SEC has failed to do through regulatory mandate.

Shareholder pressure for proxy access began in earnest in 2011 after the US Court of Appeals for the DC Circuit issued its decision in *Business Roundtable v. SEC*. In this decision, the court struck down an SEC rule that would have required issuers to permit shareholders who owned at least 3% of the company for at least three years to include in the company's proxy materials director nominees for up to 25% of the board. The SEC's rule imposed no limit on the size of the shareholder nominating

group. However, at the time the SEC adopted this rule, it also revised its rule interpretation to allow for shareholder proposals on proxy access.

It took several years for the shareholder proxy access campaign to gain momentum. However, in 2015, 91 proxy access shareholder proposals went to a vote, with an average vote of 55% in support, according to data from the ISS Governance Analytics database and SharkRepellent. Sixty percent of these proposals passed. The 2015 vote results only provide a partial picture. Notably, a number of companies adopted proxy access in response to shareholder proposals and some adopted proxy access on their own initiative. In total in 2015, 118 companies adopted proxy access in some form. The most prevalent formulation was an ownership threshold of 3% for three years, for up to 20% of the board, with a shareholder group size limit of 20.

To date in 2016, 71 shareholder proposals have been voted on, with an average vote in support of 51%, and just over half of these proposals have passed, according to the ISS Governance Analytics database. Proxy access proposals have been somewhat less likely to garner majority shareholder support than in 2015, but the lower pass rate is likely due to lower vote results generally on proposals brought at companies that have already adopted some form of proxy access.

An additional ten shareholder proxy access proposals are scheduled to go to a vote in the coming weeks. According to ISS,

an additional 140 shareholder proxy access proposals have been omitted or withdrawn, and 37 of these were omitted based on SEC no-action relief finding that the proposal was substantially implemented. (ISS Governance Analytics database.)

A total of 123 companies have disclosed that they have adopted a form of proxy access in 2016 (Sidley Alert, Proxy Access Momentum in 2016, June 27, 2016). As of June 15, 2016, proxy access has been adopted by approximately 40% of S&P 500 companies, according to data from SharkRepellent.

Additionally, according to data from SharkRepellent, in terms of management proposals to implement proxy access, 17 proposals have been voted on so far this year, with average support of 86%. Of these, 14 management proxy access proposals passed and three did not pass. At five companies, dueling shareholder and management proxy access proposals were voted on. At three of those five companies, the management proposal passed and the shareholder proposal did not pass. At the other two companies, the management proposal failed, but the shareholder proposal passed.

#### SEC No-Action Relief on Proxy Access

Earlier this year, the SEC staff granted no-action relief to several companies to permit the exclusion of shareholder proposals seeking proxy access where the company had already adopted proxy access. The SEC staff appears to be taking the position that if a shareholder proposal seeks proxy access with an ownership threshold of 3% for three years, the company will be deemed to have “substantially implemented” the proposal if it has adopted a proxy access by-law at 3% for three years (but not at 5% for three years or any other more onerous threshold), even if there are other differences between the proposal’s terms and the company’s proxy access by-law.

Another development relating to shareholder proposals was the issuance of Staff Legal Bulletin No. 14H (CF) (SLB 14H). SLB 14H was issued by the SEC staff in October 2015 and provides new guidance on the excludability of shareholder proposals that

“directly conflict” with management proposals or that relate to a company’s “ordinary business operations.”

For the 2016 proxy season and beyond, the SEC staff will permit a company to exclude a shareholder proposal as directly conflicting with a management proposal only if a reasonable shareholder could not logically vote in favor of both proposals. For example, where a company seeks shareholder approval of a merger, and a shareholder proposal asks shareholders to vote against the merger, the proposals would directly conflict. In the past, companies often attempted to exclude shareholder proposals relating to proxy access, special meeting rights, and shareholder action by written consent by putting forth a management proposal on the same topic but with terms more favorable to the company. Companies are generally no longer able to use this tactic to exclude a proposal.


SLB 14H also provides that the SEC staff will not permit a company to exclude a shareholder proposal on ordinary business operations grounds if the proposal transcends the company’s day-to-day business matters by raising a policy issue so significant that it would be appropriate for a shareholder vote. Further, SLB 14H clarifies that a proposal may transcend a company’s ordinary business operations even if the significant policy issue relates to the “nitty-gritty of its core business.” That clarification resolves some of the uncertainty arising from the *Trinity Wall Street v. Wal-Mart Stores, Inc.* litigation in 2015.



Search [How to Handle Shareholder Proposals](#) for more on shareholder proposals, as well as SLB 14H.

#### INDEPENDENT BOARD CHAIRS

Independent board chair proposals continue to be popular, with 46 proposals going to a vote as of June 15, 2016, according to the ISS Governance Analytics database. Further, no additional proposals are scheduled to be voted on. To date, voting data indicates average support of 29%, but at a number of companies the vote has been greater than 40%, and it appears



In an election year, particularly since the US Supreme Court’s 2010 decision in *Citizens United v. Federal Election Commission*, shareholder attention on the lobbying efforts and political contributions of companies tends to increase. It is not yet clear whether that is the case for 2016.

that shareholder support is rising slightly. In 2015, 62 proposals went to a vote with average support of 29%, and two proposals passed. As of mid-June 2016, no independent board chair proposals have passed.

The prevalence of independent board chairs continues to grow, but at a relatively slow pace. According to Spencer Stuart, 29% of S&P 500 companies had a truly independent board chair in 2015 (up from 28% in 2014 and 9% in 2005), while 48% of S&P 500 boards split the board chair and CEO roles. Of the 92 boards where the board chair is separate but not independent, 87 (95%) have identified a lead or presiding independent director. (2015 Spencer Stuart Board Index.)

In another development, in February 2016, State Street notified directors of companies in which it invests that independent board leadership is a main focus of its 2016 corporate governance engagement program. State Street's February 2016 letter includes a set of guidelines and governance structures that enhance effective board leadership, including, among other factors:

- A robust selection process for the board leader.
- Sufficient tenure for the board leader to develop in the role and build good working relations with management and other stakeholders.
- Performance evaluations of the board leader by the independent board members.
- Succession planning to ensure an orderly succession of the board leader role.

These guidelines may be used by companies to benchmark their own board leadership structures and practices.

## LOBBYING EFFORTS AND POLITICAL CONTRIBUTIONS

In an election year, particularly since the US Supreme Court's 2010 decision in *Citizens United v. Federal Election Commission*, shareholder attention on the lobbying efforts and political contributions of companies tends to increase. It is not yet clear whether that is the case for 2016. By number of shareholder proposals filed, shareholder interest in the disclosure of lobbying efforts and political contributions appears to be significant. However, shareholder interest does not currently appear to be as strong as last year, although the full data set is not yet available.

As of mid-June 2016, shareholders have voted on 37 shareholder proposals seeking corporate reports on lobbying activities with average support of 24%, according to the ISS Governance Analytics database. Another 22 shareholder proposals have gone to a vote seeking reports on political contributions, with average support of 33%. In contrast, shareholders submitted 54 lobbying proposals (of which 30 were voted on) and 48 political contributions proposals (of which 25 were voted on) in 2015, with average rates of support of 26% and 34% respectively.

Since *Citizens United*, the SEC has faced pressure to engage in rulemaking to require issuers to disclose how they use corporate funds to influence politics. The SEC has received more than 1.2 million public comments (the most the SEC has ever received)

on a 2011 rulemaking petition from a group of influential law professors that asked the SEC to develop rules for disclosure of corporate political spending. The professors argued that *Citizens United* sparked the need for formal disclosure rules.

In spring 2015, former SEC Chairs Bill Donaldson and Arthur Levitt sent a letter to SEC Chair Mary Jo White urging the SEC to begin the rulemaking process. Additionally, a lawsuit has been brought against the SEC by the Campaign for Accountability, a nonprofit group, to compel rulemaking in this area.

Despite increased focus on this issue, in December 2015 Congress restricted the SEC's ability to adopt corporate political spending disclosure rules in 2016. The omnibus spending bill adopted by Congress prohibits the SEC from using funds to finalize or implement any rule regarding the disclosure of political contributions in 2016, but does not restrict the SEC from proposing such a rule.

In addition, the confirmation of two new nominees to serve as SEC Commissioners has been delayed this year because of opposition by several Democratic members of the Senate Banking Committee who indicated they would vote against the nominations because the nominees would not commit to supporting rulemaking to require disclosure of political contributions.

## CLIMATE CHANGE

Shareholder proposals regarding environmental issues continue to be brought in significant numbers, with proposals related to climate change being the most widespread. To date in 2016, according to the ISS Governance Analytics database, 20 proposals seeking more detailed reporting on climate change have gone to a vote with average shareholder support of 26%. In addition, 13 proposals seeking greater sustainability reporting have been voted on, with average support of 34%. By contrast, in 2015, a total of 110 environmental proposals were voted on, seeking action on a range of issues in addition to enhanced reporting related to climate change and sustainability.

## DIRECTOR ELECTIONS

According to Semler Brossy, over 80% of directors have received vote support above 95% in uncontested elections to date in 2016. These election results are generally consistent with results over the last three years. On average only 2% of director elections have received support below 75%, and only about 0.3% of directors have failed to receive majority support. (Semler Brossy, 2016 Say on Pay Results, June 1, 2016.)

Further, ISS appears to be recommending in favor of directors at a higher rate than in the past two years. ISS has made a negative vote recommendation for 6% of elections in 2016 (Semler Brossy, 2016 Say on Pay Results, June 1, 2016). When ISS recommends against a director, on average the vote in support of the director is approximately 15% lower.

One factor that could account for at least some of the increase in negative vote recommendations this year is ISS's major

## Say on Pay: Best Practices for Compensation Committees

Understanding the concerns of large institutional shareholders regarding compensation is not a matter that the compensation committee should leave until the proxy statement is being prepared. Although the say on pay vote is advisory, a negative vote generates unfavorable publicity, lowers governance ratings, and, if not addressed, may lead to votes against compensation committee members. Moreover, companies must disclose how they respond to say on pay votes in the following proxy statement.

For these reasons, it is increasingly common not only for companies that fail the say on pay vote but for those that pass with below average support (for example, support in the 90% range) to reach out shortly after the annual meeting to their large institutional shareholders to identify any concerns that may have led to failing or lower than average levels of support. This information is important for the compensation committee to consider as it determines whether, and if so how, to adjust the executive compensation program.

The compensation committee should continue to focus on:

- Adopting and implementing a compensation philosophy that includes:
  - the company's key principles underpinning its executive compensation policies and decisions;
  - the goals of the executive compensation program and the outcomes they are designed to reward;
  - the elements of executive compensation and an explanation of why those elements are included; and
  - a method for determining payout amounts.
- Establishing and providing oversight of the executive compensation program.
- Determining or recommending director compensation in line with corporate strategy and the compensation philosophy.
- Compensating and providing appropriate incentives for the CEO in line with corporate strategy and the compensation philosophy.
- Communicating the compensation philosophy and executive compensation program to shareholders.
- Attending to internal controls and risk oversight in relation to compensation.

Periodically, the compensation committee should step back and assess the extent to which the company's compensation decisions in fact express the compensation philosophy and support the goals of the executive compensation program.

change to its proxy voting policy that took effect in 2016. This change concerned the adoption, in connection with a company's IPO, of provisions adverse to shareholders' rights. A significant percentage of recent IPOs in the US have included provisions that limit board accountability to post-IPO investors and make it difficult for shareholders to amend the company's governing documents. (ISS, ISS Releases 2016 Benchmark Policy Updates.)

Under ISS's revised proxy voting policy, boards that adopt changes to governing documents are now potentially subject to continuing recommendations against reelections until the amendments are reversed or ratified by the shareholders, including boards at recently listed companies that adopt pre-IPO provisions that are particularly detrimental to shareholders. (ISS, ISS Releases 2016 Benchmark Policy Updates.)

### MANAGEMENT SAY ON PAY PROPOSALS

To date in 2016, 25 companies (2%) in the Russell 3000 have failed to achieve majority support for management's say on pay proposal, according to Semler Brossy. This is significantly less than the 34 companies that had failed to pass say on pay at this time last year. The most popular explanation for say on pay

failure is that there is a disconnect between compensation and performance, but this disconnect appears to be less common than in prior years. Semler Brossy states that 1,623 Russell 3000 companies have had their say on pay votes with, on average, 91% shareholder support. Further, 77% of say on pay proposals passed with support of 90% or more, and 93% passed with support of 70% or more. (Semler Brossy, 2016 Say on Pay Results, June 15, 2016.)

If these results hold as expected, the vast majority of companies will pass say on pay in 2016 with substantial shareholder support, as they did in 2015. Over 97% of companies received majority support for their executive pay packages in 2015, with approximately 92% of companies receiving over 70% shareholder approval. In 2015, 61 companies (3%) failed to achieve majority support. Notably, beginning in 2011, 91% of companies have passed say on pay in all six years that it has been mandated. Nine percent have failed say on pay at least once, and 28% have received vote support below 70% at least once. (Semler Brossy, 2016 Say on Pay Results, June 15, 2016.)

Proxy advisory firms continue to influence the outcomes of say on pay votes. ISS has recommended a vote against say on pay proposals at 11% of companies so far in 2016 (Semler



Brossy, 2016 Say on Pay Results, May 4, 2016). According to Semler Brossy, based on data collected over the past six years, shareholder support for say on pay at companies where ISS recommends a negative vote averages 28% lower (Semler Brossy, Behind the Numbers, Feb. 9, 2015).



Even for companies that receive passing grades, the compensation committee cannot become complacent. Unexpected performance problems can quickly expose failures in the pay for performance alignment even where careful attention has been paid.

Not surprisingly, after a failed say on pay vote, compensation committee chairs and members receive lower support than other directors in the following year's election (on average, 12% lower for committee chairs and 9% lower for committee members). Notably, committee chairs and members at S&P 500 companies fare somewhat better in the following election as compared to Russell 3000 companies. Presumably, this is because S&P 500 companies may be better equipped to handle director-related governance issues in the year following a failed say on pay vote. According to Semler Brossy, this is likely associated with larger companies applying greater resources to shareholder engagement and proxy advisor concerns. (Semler Brossy, 2016 Say on Pay Results, June 1, 2016.)

Although the say on pay vote is advisory, a 2015 study by Equilar of corporate disclosures found that 65% of Russell 3000 companies that experienced shareholder rejection of executive compensation responded by changing their compensation policies (Equilar, The Impact of Say on Pay: Analyzing Changes Following a Failed 2013 Vote, Apr. 27, 2015). The percentage is likely higher for S&P 500 companies. Even for companies that receive passing grades, the compensation committee cannot become complacent. Unexpected performance problems can quickly expose failures in the pay for performance alignment even where careful attention has been paid.

## EQUITY COMPENSATION PLANS

Equity compensation plan proposals continue to be well supported by shareholders. Through mid-June 2016, these proposals have received shareholder support of 90% on average although four proposals at Russell 3000 companies did not receive majority support (ISS, Governance Insights, June 17, 2016). Last year, shareholder support was slightly lower at 89% on average, while only one proposal at a Russell 3000 company did not receive majority support (ISS, 2015: Proxy Season Review - Compensation, Sept. 25, 2015).

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