Governance

Say-on-pay has contributed to an environment where shareholder engagement is an increasingly critical component of corporate governance.

In this section, we take a broad look at the corporate governance landscape to review the new dynamics in shareholder engagement and the governance themes likely to impact public companies and their boards of directors over the 2013 proxy season and beyond.

In addition, we examine say-on-pay votes to offer suggestions as to how companies can best position themselves to achieve say-on-pay success in 2013.

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US Corporate Governance: Sense of Déjà Vu Masks New Emphasis on Shareholder Engagement

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Corporate governance issues in 2013: say-on-pay, proxy access, shareholder proposals dismantling corporate defenses, questions concerning the integrity of audits, shareholder engagement. Wait a minute, haven't we seen this list before? Yes, we have. Broadly speaking, public companies and their board members may have a sense of déjà vu in 2013 as they face many of the same corporate governance issues they have considered over the past couple of years.

At the same time, as many public companies head into their third year of mandatory say-on-pay, we must recognize that say-on-pay has fundamentally changed the corporate governance landscape. In the ongoing (and perhaps never-ending) tension between board-centric and shareholder-centric models of corporate governance, say-on-pay — shareholders expressing in annual meeting voting their own view on the board's and compensation committee's executive compensation decision-making — has accelerated a paradigm shift in the relationship between corporations and shareholders, particularly institutional shareholders. This shift has led to a significant increase in the scope and depth of company "engagement" with shareholders. However, this shift is not limited to say-on-pay, nor is it limited to the few months of the year that comprise the traditional proxy season. Rather, company "engagement" with shareholders is becoming a year-round exercise that can cover the full range of the corporate governance spectrum.

2012 in Review

Once again, for many companies 2012 was an uneventful proxy season. Most public company directors continued to be re-elected with shareholder support in excess of 90 percent of votes cast. The number of directors failing to achieve majority support in 2012 was comparable to 2011 and down from 2009 and 2010 levels. The decrease remains attributable, at least in part, to shareholders being able to voice disagreement over executive compensation matters through say-on-pay votes rather than by voting against directors, particularly members of compensation committees.

Say-on-pay votes continued to go well for most companies, although not without significant efforts by some. Approximately three-fourths of companies received 90 percent or higher support for their executive compensation. The number of companies failing to achieve majority support in their say-on-pay votes remained low at approximately 60, although this represents a 50 percent increase from 2011. More noteworthy than the number of companies failing say-on-pay (or passing with low levels of support) is the fact that many receiving low levels of support in 2012 had received strong support in 2011. Companies need to remain vigilant regarding how year-to-year changes in the operation of compensation programs and changes in company performance impact investors' perceptions of a company's pay-for-performance (see "Say-on-Pay: Keys to a Successful 2013 Proxy Season").

In addition, certain corporate governance shareholder proposals remained popular in 2012. A board declassification campaign spearheaded by Harvard Law School's Shareholder Rights Project (SRP) submitted approximately 90 proposals. Roughly half of the recipients agreed to put management declassification proposals to a vote. The other

half allowed the shareholder proposals to be voted on, with the proposals averaging 81 percent of votes cast in favor. Also, shareholder proposals on majority voting in director elections passed at many companies, with proposals relating to shareholder ability to call special meetings or act by written consent having mixed results.

Perhaps the corporate governance shareholder proposal topic attracting the most attention in 2012 was proxy access, as this was the first year that proxy access shareholder proposals were submitted following the D.C. Circuit Court of Appeals' determination to vacate the mandatory proxy access rule adopted by the SEC. Although some investors view the concept of proxy access favorably, the voting results showed that shareholder support of proxy access has boundaries. A number of proxy access proposals that were fashioned to give proxy access rights to retail investors owning as little as $100,000 worth of company stock failed to gain traction and garnered support only in the single digits or low teens, as a percentage of votes cast. Binding bylaw amendments that would give proxy access rights to holders of 1 percent of company stock for one year, proposed by Norges Bank at a number of very large companies, did better, with support averaging approximately 35 percent of votes cast. Proxy access proposals modeled on the vacated SEC rule, submitted to companies perceived as having repeated and long-standing corporate governance issues, received majority support at Nabors Industries and Chesapeake Energy. Also noteworthy was that Hewlett-Packard was able to negotiate the withdrawal of a proxy access proposal by agreeing to submit its own three-year, 3 percent proxy access proposal in 2013. Based on public information to date, it is possible that there will be fewer proxy access proposals in 2013. Nevertheless, an HP proxy access proposal and any proxy access proposals put forth by Nabors or Chesapeake in response to the 2012 votes could represent bellwethers.

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Shareholder Engagement

While the corporate governance agenda in 2013 looks very similar to the agenda of the past few years, the landscape has shifted. This shift can catch the unwary off guard and may require companies to recalibrate their approaches to dealing with their shareholders. Historically, companies viewed shareholder "engagement" as their investor relations departments dealing with portfolio managers to explain the merits of an investment in the company. However, at most institutions, the proxy voting is handled by a specialized corporate governance group with little or no input from the portfolio managers making investment decisions. Also, not long ago, the cycle of shareholder engagement on corporate governance matters may have started when companies received a shareholder proposal in the late fall or early winter, involved attempting to negotiate with the proponent to have the proposal withdrawn and, if unsuccessful, extended to soliciting proxies for the annual meeting in favor of the company's position. When the annual meeting was concluded, the shareholder engagement cycle on corporate governance matters was done until the following season. Say-on-pay has changed all of that.

In the say-on-pay era, proxy statements (at least those for many larger companies) have transformed from black-and-white compliance documents to colorful, graphic and chart-filled materials that attempt to clearly communicate the company's performance, demonstrate why compensation decisions make sense in light of that performance, and highlight other corporate governance and executive compensation changes adopted by the company that show it in a positive light (often in response to direct or indirect shareholder feedback).

Consistent with the views expressed by Institutional Shareholder Services (ISS) and institutional investors, the substance of proxy statements in the say-on-pay era often contains a new narrative, and one that may have seemed highly unusual just a few years ago — a discussion of shareholder engagement efforts and how those interactions were considered by the board or relevant board committee and resulted in changed policies or programs. Specifically, ISS policy for 2012 indicated that recommendations would be made on a case-by-case basis for compensation committee members (and, in exceptional cases, the full board) if the company's previous say-on-pay proposal received the support of less than 70 percent of votes cast, taking into account the company's response to that vote, including "dislosure of engagement efforts with major institutional investors regarding the issues that contributed to the low level of support."

As a result, many companies that did not fare well in their 2011 say-on-pay votes engaged in a process in the second half of 2011 and into 2012 to meet or speak with larger investors to identify investor concerns and consider changes in response to those concerns. Proxy statements then summarized those efforts and explained how companies had been responsive to those interactions. Similarly, many companies that failed their 2012 say-on-pay votes have been going through a similar process in the second half of 2012, and we can expect to see disclosure of those engagement efforts in 2013 proxy statements.

Although we knew, anecdotally, that this shareholder engagement was not limited to executive compensation matters, recent updates by ISS and Glass Lewis — the two most influential proxy advisory firms — make explicit that this enhanced level of shareholder engagement applies across the board to all matters of corporate governance and beyond.

Specifically, ISS has updated its voting policy concerning majority-supported shareholder proposals. In past years and in 2013, ISS recommended/will recommend against directors who fail to act on a shareholder proposal receiving support of (1) a majority of the shares outstanding the previous year or (2) a majority of the votes cast in the last year and one of the two previous years. Beginning with shareholder proposals voted on in 2013 meetings (affecting 2014 voting recommendations for directors), ISS will recommend against directors who fail to act on a shareholder proposal receiving support of a majority of votes cast in the previous year.

In response to calls from the corporate community to more clearly describe how ISS views the sufficiency of a company's response to majority-supported shareholder proposals, ISS indicated that it generally expects full implementation of a proposal or, if a shareholder vote is required to implement the proposal, submission of a management proposal to shareholders at the next annual meeting. ISS then explained that responses involving less than full implementation are reviewed on a case-by-case basis, taking into account (among other things) "disclosed outreach efforts by the board to shareholders in the wake of the vote" and "actions taken by the board in response to its engagement with shareholders." This engagement process may very well support company-proposed action that does not go as far as the majority-supported shareholder proposal. Importantly, however, engagement is a two-way street. This is not simply a meet-and-greet with the corporate governance team. The investors with whom a company engages expect a serious discussion, reasonable consideration of their views and company follow-through. That engagement may indicate that less than full implementation will not be viewed favorably by investors.

Glass Lewis, the other leading proxy advisory firm, has a more expansive view of board responsiveness and the need for shareholder engagement. In its description of its 2013 voting policies, Glass Lewis states its view that "any time 25% or more of shareholders vote against the recommendation of management, the board should demonstrate some level of engagement and responsiveness to address the shareholder concerns." These policies, and the overall push for engagement — particularly institutional investor requests to include one or more company directors (typically the board chair or lead independent director, chair of the compensation committee and/or chair of the nominating and governance committee) as part of any meeting — require companies to devote more time, attention and strategic thinking to their overall corporate governance interactions with investors.

Corporate Governance: 2013 and Beyond

Say-on-Pay. Say-on-pay, and executive compensation more generally, will continue to be a significant topic for boards of directors and board committees in 2013 and beyond. Although directors must make executive compensation decisions that they believe are in the best interests of the corporation and most effectively attract, retain and incentivize management regardless of ISS or investors' policies, they need to: understand how those decisions will be viewed externally; make sure the rationale for those decisions is effectively communicated to investors in the proxy statement; and, where investors manifest disagreement through their votes, engage with investors in a meaningful way to show that the board is thoughtfully undertaking its oversight responsibilities, including with respect to executive compensation matters.

Shareholder Proposals. Companies also can expect to see many of the same shareholder proposal topics in 2013 that were popular in 2011 and 2012. With many S&P 500 companies already having declassified boards of directors or adopted majority voting in director elections, the recipients of proposals on those topics likely will include many companies outside of the S&P 500. Other common shareholder proposal topics will address shareholder ability to call special meetings or act by written consent, separation of the CEO and chairman roles, proxy access, elimination of supermajority voting requirements, and expanded disclosure and oversight concerning corporate political contributions and lobbying activity.

Dodd-Frank Act. Dodd-Frank will remain a significant part of the 2013 corporate governance discourse. The stock exchanges will finalize rules concerning enhanced compensation committee independence and committee consideration of compensation adviser conflicts of interests. On another front, unless and until the rules are vacated in pending litigation, many companies will have to continue to plan to comply with the conflict mineral rules and rules requiring disclosure of certain payments by resource extraction issuers. Finally, the SEC has yet to propose rules to implement the Dodd-Frank provisions on pay ratio disclosure, pay-for-performance disclosure, compensation clawbacks and disclosure on hedging policies.

Board Composition. The focus on board composition — particularly with respect to the skill sets and experiences of directors — has increased over the past few years. As the average age of directors of S&P 500 companies continues to increase and the number of new independent directors joining boards continues to decline (Spencer Stuart Board Index 2012), we anticipate that boards of directors will spend an increasing

amount of time considering director succession planning — *e.g.*, when should the company add new directors and what skills/experiences should they possess in light of when other directors may come off of the board due to reaching mandatory retirement age or otherwise. A related item is that some institutional investors remain concerned about the increasing tenure of directors and the need for new faces in board rooms. For some, the need for new faces raises particular questions about gender and race. The European Union has proposed legislation that listed companies in the EU target increasing women board members to comprise 40 percent of the board. Although such a bright-line numerical target seems unlikely to gain traction in the U.S., boards of U.S. companies are likely to face continued questions on the diversity of directors, in terms of both gender and race, as well as diversity of backgrounds and experiences.

Regulation of Auditors. In another case of déjà vu, auditors appear to be facing increased scrutiny. Over the past year or two, there has been increased discussion by the PCAOB and some institutional investors regarding audit firm rotation. Although recent public comments suggest that PCAOB action is not likely, the EU continues to consider legislation that would mandate audit firm rotation. Separately, the PCAOB issued a recent report critical of the eight largest audit firms' audits relating to internal control over financial reporting. Perhaps the greatest feeling of déjà vu, coming in part not long after the HP write-down of its Autonomy acquisition, stems from various public statements by regulators and others criticizing the levels of consulting work done by audit firms — an issue that was squarely addressed in the Sarbanes-Oxley Act.

Conclusions

Public companies and their board members may very well conclude that there is nothing new on the corporate governance front in 2013. In a sense, they may be correct. Yet, that sameness should not lull the corporate community into a sense of security. A lesson learned in 2012 is that prior say-on-pay success does not guarantee future performance. More importantly, across the corporate governance spectrum, there is a continued push to take shareholders' views — especially those of institutional investors — into account and, where those shareholders voice their disagreement with the board, to engage with them at levels beyond what many companies are accustomed to. As a result, public companies and their directors must remain vigilant — as always, their decision-making must be based on their views as to what is in the best interests of the corporation. What is new is that board members may find themselves, under the banner of "engagement," sitting across the table from their investors and being asked to justify their decision-making.

Say-on-Pay: Keys to a Successful 2013 Proxy Season

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Companies are preparing for the third proxy season under the "say-on-pay" rules established by the Dodd-Frank Act, which provide shareholders with the opportunity to vote on a company's executive compensation program on an advisory basis. Based on our experiences in 2012, we have the following suggestions for the 2013 proxy season:

Begin the proxy-drafting process now. Companies should begin the proxy-drafting process as soon as possible by identifying those individuals who will need to provide input for the proxy. Each piece of the puzzle should be integrated into a reader-friendly document that "tells the story" of the company's executive compensation programs in a compelling manner. This is a complex and nuanced area with a tremendous amount of media scrutiny, and we urge companies to consult with internal and external advisers as early in the process as possible to make the most appropriate strategic decisions with respect to their executive compensation programs.

Conduct shareholder outreach efforts. ISS made clear in its 2012 reports that it expects any company whose say-on-pay proposal failed (or passed without strong support) to conduct shareholder outreach efforts and to describe these efforts thoroughly in the next proxy. Companies in this situation should reach out to their largest shareholders to solicit reactions to the company's existing executive compensation program, as well as views regarding any concerns raised by ISS and others. Such outreach could include making presentations via teleconference, providing written materials regarding the company's current program and proposed changes, and holding in-person meetings.

Analyze last year's advisory reports. Companies should analyze the reports issued by ISS, Glass Lewis and other advisory firms in 2012 with respect to their 2011 executive compensation to better understand the concerns of those firms. Even if the company decides not to make changes, it should note in its next proxy that those concerns were reviewed and considered. If they do make changes, it may be viewed favorably by ISS and other services if the changes are described in some detail and explicitly linked to the concerns that were raised.

Focus on the lessons learned in 2012 by other companies. In the face of ISS "against" recommendations during this past proxy season, many companies issued supplemental filings as a rebuttal. This year, companies will be able to take advantage of the knowledge gleaned from the past season to both address known ISS concerns in 2012 proxy statements and make informed decisions regarding 2013 compensation:

- **Peer Groups.** One of the most controversial issues during the 2012 proxy season was the degree to which the peer groups chosen by ISS were different from the peer groups chosen by companies. Glass Lewis has indicated that it will employ a new model in 2013 that uses the company's peers — and the peers of those peers — to construct its peer group, and ISS similarly has indicated that it will use a more targeted industry classification analysis and will focus more closely on aligning its peer groups with those chosen by companies. As a general matter, companies should consider including additional information regarding the company's peer selection process to provide more context for shareholders to make decisions regarding the company's say-on-pay proposal.

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- **Realizable Pay.** Many supplementary filings in 2012 focused on the perception by companies that ISS had materially overstated CEO pay by focusing on the theoretical full value of awards, without regard to the likelihood of whether any actual value would ever be received by the CEO. ISS has indicated in its 2013 policies that, for "large cap" companies, it will add a consideration of realizable pay to its research reports. It also has indicated that, for ongoing awards, it will focus on the target value, calculated using the stock price at the end of the performance measurement period. Companies may want to consider adding a realizable pay chart to the Compensation Discussion & Analysis (CD&A) in their next proxy to provide additional context to shareholders.
- **Equity Awards.** Despite many complaints by companies in their supplemental filings, ISS does not consider stock options to be performance-based pay, and a large grant of stock options can skew the ISS determination of CEO pay in the year of grant dramatically. Equity-based awards with time-based (rather than performance-based) vesting schedules are viewed extremely negatively by ISS, particularly when they comprise all or substantially all of the awards made under a company's equity award program. This should be kept in mind (among other relevant factors) in considering the terms of future grants.
- **Bonus Disclosure.** A number of negative ISS comments in 2012 addressed disclosure of incentive compensation. ISS indicated that it views vague descriptions of the manner in which annual and long-term bonuses are calculated as problematic, and we recommend that companies take a fresh look at whether the narrative description of such plans is detailed sufficiently. Further, ISS has not hesitated to analyze the actual payment thresholds and measurements in plans and to deem them insufficiently challenging. Companies should take care to use analytical rigor in setting goals and provide a description of the process through which any payment thresholds were set.
- **Total Shareholder Return.** ISS considers total shareholder return to be the most important measure of a company's performance in determining whether there is a "pay-for-performance disconnect." If a company believes that measures other than total shareholder return are more relevant to its stockholders — such as quality of assets held (in the case of financial institutions), safety (in the case of industrial companies), or low volatility and consistent dividends (in the case of utilities) — it should discuss this point in the CD&A to provide stockholders with that context.
- **Pay Disparity.** ISS indicated to a number of companies that it views a significant disparity between CEO pay and that of other executive officers to be problematic because it suggests inadequate succession planning and may impact executive morale. We recommend that a company with significant pay disparity provide disclosure regarding its reasons and a general description of any succession planning processes to show that the company has considered the issue.
- **Retention Bonuses.** Based on ISS reactions during the 2012 proxy season, we recommend that companies giving retention bonuses, stay bonuses or similar awards provide a detailed explanation of how the appropriateness of such an award was determined, the conditions under which it was to be paid and any other relevant information.

- **CEO Transitions and Tenure.** For companies that have gone through a CEO transition, we recommend that detailed disclosure be provided as to the rationale for any payments made to the departing CEO and any special payments or grants made to the new CEO in connection with the transition, together with any relevant factors considered in making any payments and grants. Conversely, companies with a long-tenured CEO who is highly compensated should consider highlighting the CEO's years of experience.
- **Excise Tax Gross-Ups.** ISS reserves its most negative comments for "golden parachute" excise tax gross-ups in new or renewed agreements and arrangements. The inclusion of such a provision can be sufficient on its own to draw a negative vote recommendation. In at least one case, the rescinding of the provision following a negative ISS reaction was sufficient to trigger a positive change in the recommendation. While most companies are aware of the issue in the context of new arrangements, they should be careful to monitor the renewal or extension of existing arrangements without the elimination of any existing provision for an excise tax gross-up. It also should be noted that ISS has changed its policies for purposes of its "say-on-golden-parachute" vote recommendation process and no longer will consider any existing provisions (such as existing gross-ups) to be grandfathered in that regard.