Considerations For The 2018 Proxy Season: Part 1

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Each company faces important decisions in preparing for its 2018 annual meeting and reporting season. This three-part series covers essential items that companies should focus on as they plan for 2018, including corporate governance, executive compensation and disclosure matters. Part 1 of this article focuses on the annual shareholder meeting, including compensation-related matters, guidance from Institutional Shareholder Services and Glass Lewis, and recent developments and trends in proxy access. Part 2 of this article continues to focus on annual shareholder meeting matters with a discussion of trends in shareholder proposals and virtual shareholder meetings, efforts to increase board diversity, updates to director and officer reviews, changes to auditor reports and various proxy statement-related issues, such as, reporting say-on-frequency results and finalizing pay ratio disclosures, in addition to other filing obligations. Part 3 of this article focuses on various disclosure and other considerations, including the impact of U.S. Securities and Exchange Commission staff comments and enforcement trends, efforts to increase environmental, social and governance reporting, SEC guidance and trends in cybersecurity-related matters, finalizing adoption of new revenue recognition standards, monitoring potential changes in pay practices due to the Tax Cuts and Jobs Act, compliance with new IFRS XBRL tagging requirements, and Section 162(m) and recent developments in insider trading laws and policies.

Incorporate Lessons Learned From the 2017 Say-on-Pay Votes and Compensation Disclosures

We recommend that companies consider recent annual say-on-pay votes and disclosure best practices when designing their compensation programs and communicating about their compensation programs to shareholders. We have summarized several key areas below that we believe companies should consider.

Results of 2017 Say-on-Pay Votes

Below is a summary of the results of the 2017 say-on-pay votes and some trends over the last six years since the initial adoption of the say-on-pay rules:

- Average support for the 2017 season was near 92 percent, which is the highest since voting began. The percentage of companies receiving support above 90 percent was also slightly higher than any prior year.

- Approximately 99 percent of companies received at least majority support, with approximately 93 percent receiving above 70 percent.

- The 2017 failure rate of 1.3 percent was the smallest ever, down from 1.5 percent in 2016, and 2.2 percent in 2015.

- While overall support is high, 10 percent of Russell 3000 companies with vote results in each year have failed a say-on-pay vote at least once.

- There was a sharp decrease in failure rates at smaller companies (those in the Russell 3000 that identify as SmallCap 600 companies). In 2016, the failure rate was 32 percent. In 2017, it dramatically improved to 18 percent. The performance of S&P 500 companies was more consistent, reporting a 15 percent failure rate in 2017, down from 17 percent in 2016.

- Almost one-third of companies with annual say-on-pay votes have received less than 70 percent support at least once during the preceding six years.

Say on Golden Parachute

Say-on-golden-parachute votes have historically received lower support than annual say-on-pay votes. The 2017 failure rate of 15 percent was the highest since the advent of the vote and more than double the failure rate of 7 percent in 2016. Average support for golden parachute proposals fell to 79 percent, an all-time low. In fact, ISS issued a negative vote recommendation on 44 percent of the proposals, up from 26 percent in 2016, and the difference in average support between "for" and "against" recommendations from ISS was 37 percent in 2017, the highest on record (up from 28 percent in 2016). Notably, the median CEO golden parachute payment rose close to 75 percent, from $5.2 million in 2016 to $9 million in 2017.

Equity Plan Proposals

Equity plans were approved with an average passing score of 89 percent in 2017, an increase from 88 percent in 2016, and higher than the 2012-2015 range of approximately 86 to 89 percent. ISS supported 70 percent of the equity plan proposals in 2017, an increase from 68 percent in 2016. ISS issued an "against" recommendation at a rate of 9 percent in 2017, down from 13 percent in 2016. Eight equity plan proposals failed in 2017, compared to the five-year high of nine proposals in 2016. Among the factors resulting in a failed proposal, the cost of the plan was cited most frequently.

2017 marked the third year in which ISS applied its Equity Plan Scorecard (EPSC). This year's fewer number of "against" recommendations may be a product of companies incorporating more of the scorecard practices, but the impact of the EPSC on the shareholder approval rating is not entirely clear. In December of each year, ISS publishes frequently asked questions to help stakeholders understand changes to ISS compensation-related methodologies.[1] In November 2017, ISS provided a preliminary set of FAQs highlighting the following updates to EPSC methodology for the 2018 reporting season:

- For companies subject to the S&P 500 scoring model, the passing score for the EPSC will increase to 55 points. For all other EPSC models, the passing score will remain

53 points.

- The change in control vesting factor will be simplified, scoring companies on a basis of full credit or no credit. A company will earn full credit if a company's equity plan contains both of the following provisions:

    - For performance-based awards, acceleration is limited to actual performance achieved, a pro rata of the target based on the performance period, or a combination of both.

    - For time-based awards, acceleration upon a change in control cannot be discretionary or automatic single-trigger.

- The holding requirement factor will be simplified, permitting a company to earn either full credit or no credit. The timeline for receiving full credit on this factor will change from a 36-month holding period to a 12-month holding period. Any holding period of less than 12 months will result in no credit.

- The CEO vesting requirement factors also will be simplified to a vote of full credit or no credit. To receive full credit, the vesting requirement threshold will decrease from greater than four years to at least three years from the date of grant until all shares from the award vest.

Companies should continue to pay careful attention to the EPSC and secure ISS support where the company's equity plan goals are consistent with the EPSC. However, the historically low failure rate arguably makes ISS support less important with respect to equity plan proposals than in the say-on-pay context.

Views of Proxy Advisory Firms and Shareholder Outreach

Below are some of the areas that caused proxy advisory firms to recommend a vote against say-on-pay proposals in 2017. The first two of these areas appear to have been of more significant concern than others:

- A "pay for performance" disconnect (as calculated using the adviser's methodology).

- Problematic pay practices, including, among other examples, renewal of agreements containing excise tax gross-ups, severance payments to an outgoing CEO in the case of a "friendly" termination, and "make-whole" arrangements or off-cycle grants intended to compensate executives for forgone compensation at a prior employer or an unexpected decline in the value of prior grants.

- Performance goals deemed by proxy advisory firms to be insufficiently challenging, particularly where goals are lower than prior years' results.

- Insufficient shareholder outreach and disclosure, including inadequate response to compensation-related concerns raised by shareholders.

- An emphasis on time-based equity grants, rather than performance-based grants.

- Special bonuses and "mega" equity grants.

- Targeting compensation above the 50th percentile of peer compensation groups.

- Bonuses that are not solely determined by a formula based on achievement of prespecified performance criteria.

In addition, ISS recently provided a preliminary set of FAQs highlighting quantitative changes to be included in ISS' 2018 pay-for-performance calculations, including screen thresholds, the calculation of total shareholder return and the inclusion of a financial performance assessment test.[2] On Dec. 14, 2017, ISS published an updated set of FAQs on its U.S. compensation policies.[3]

When companies have not changed their compensation plans or programs in response to major shareholder concerns, a best practice has included providing in the proxy materials a brief description of those concerns, a statement that the concerns were reviewed and considered, and, if appropriate, an explanation why changes were not made. In addition, many companies incorporate useful features into their executive compensation disclosures, including executive summaries, charts, graphs and other reader-friendly tools. These features help to achieve maximum clarity of the company's message. A number of companies also have added a summary section to the proxy statement, generally located at the beginning of the document, that highlights, among other things, business accomplishments and key compensation elements, features and decisions.

The submission period for companies to make updates to the compensation benchmarking peers included in ISS' database closed Dec. 8, 2017. ISS uses these company-selected peers when it determines the peer group it will use for evaluating a company's compensation programs.[4]

Assess Impact of Proxy Advisory Voting Guidelines

Proxy advisory firms ISS[5] and Glass Lewis[6] have updated certain of their voting guidelines for the 2018 proxy season. Companies should assess the potential impact of such updates, summarized below, when considering changes to corporate governance practices and documents, as well as proxy statement disclosures, which could serve as a basis for recommendations by ISS.

Director Compensation

ISS has adopted a new policy providing for adverse voting recommendations for members of the board committee responsible for approving or setting nonemployee director compensation where there is a pattern (over two or more consecutive years) of "excessive" nonemployee director pay without a compelling rationale or other mitigating factors. ISS has not defined "excessive" for this purpose. Because of the two-year pattern requirement, however, this new policy will not impact ISS voting recommendations in 2018. Glass Lewis has not added a similar policy to its guidelines.

Director Attendance

ISS revised its policy regarding director attendance to exempt completely new directors, rather than analyzing their attendance on a case-by-case basis. Glass Lewis has taken a similar approach and typically does not recommend against a director who has served less than a year.

Shareholder Rights Plans (Poison Pills)

ISS has updated its policy to provide adverse voting recommendations for all directors in uncontested elections at companies where the board adopted or renewed a shareholder rights plan that was not approved or ratified by public shareholders. ISS continues to emphasize the plan's term, which is categorized as follows:

- Long-term rights plans (terms of more than one year): All nominees will receive adverse voting recommendations every year that such plan is in place without a shareholder vote, no longer distinguishing between classified and annually elected boards. In addition, a board's commitment to put a long-term rights plan to a shareholder vote will no longer be a mitigating factor.

- Short-term rights plans (terms of one year or less): The adoption of short-term rights plans will be evaluated on a case-by-case basis with emphasis on the board's disclosed rationale for adopting the rights plan without a shareholder vote.

ISS also will apply this updated policy to grandfathered companies that had adopted a rights plan before 2009. Glass Lewis has not updated its policy on rights plans, which are evaluated on a case-by-case basis based on a number of factors.

Board Responsiveness

Glass Lewis updated its guidelines on board responsiveness to company proposals that receive low shareholder support, lowering its threshold from 25 to 20 percent of adverse shareholder votes. This threshold applies to adverse votes on company proposals, such as director elections or management sponsored-proposals, as well as votes in favor of shareholder proposals. Glass Lewis will continue to consider this threshold in determining the board's responsiveness to shareholder concerns when recommending for or against management's recommendations.

Other Updates

As covered in other sections of this checklist, ISS and Glass Lewis also have announced other changes. Both have formalized their positions regarding board diversity and updated their policies regarding shareholder proposals, such as those that concern climate change risk and gender pay gap. ISS also formalized its position on recommending negative votes against committee members who oversee excessive pledging, and Glass Lewis announced its approach on virtual annual shareholder meetings.

Assess Recent Trends in Proxy Access Proposals and Bylaw Provisions

For the third straight year, proxy access topped the list of most common governance-related shareholder proposals submitted to companies. Proposals seeking adoption of a proxy access bylaw almost universally achieve majority support (excluding controlled or quasi-controlled companies and proposals not opposed by the board), receiving approximately two-thirds of votes cast. At the one company where the proposal fell short of majority support, the proposal nevertheless received support at 49.6 percent of votes cast. In contrast, shareholder proposals seeking amendments to proxy access bylaws containing customary provisions have universally failed to achieve majority support.

Response From Shareholders

The voting results above demonstrate a level of investor satisfaction with "middle of the fairway" proxy access bylaws. Such bylaws generally include: an ownership requirement of at least 3 percent of a company's shares for at least three years; an ability to nominate candidates for up to 20 percent of board seats, with a minimum of two nominees; a 20-shareholder limit on the ability of shareholders to aggregate to meet the 3 percent ownership requirement (with related funds counting as one shareholder for aggregation limit purposes); and loaned shares counting toward the ownership requirement so long as the shares are recallable upon reasonable notice.

In addition, although proxy access provisions may vary somewhat with respect to secondary elements of proxy access bylaws, most have similar characteristics. In particular, most require some minimum level of support for a nominee to be eligible to be renominated in subsequent years (typically 10-25 percent); most address "proxy access creep" either by counting recently elected access nominees whom the board renominates toward the maximum number of access nominees allowed in a particular year, placing a "cooling off" period on the nominating shareholders whose access nominee is elected, or both; and most address concerns regarding concurrent proxy contests, either by "cutting off" access in the event of such a contest or by reducing the number of access nominees for that annual meeting by the number of advance notice nominees submitted for the same meeting (sometimes providing for a minimum of one access nominee).

Nearly half of the shareholder proposals to amend existing proxy access bylaws in 2017 sought only a single amendment — to change the aggregation limit from 20 shareholders to 40 or 50 shareholders, or to eliminate the aggregation limit altogether. The other approximately half sought multiple amendments — typically elimination of any aggregation limit, an increase of the number of access nominees from 20 percent of board seats to 25 percent, and removal of any limitations on the renomination of proxy access candidates. For those amendment proposals that made it to the ballot, average voting results were substantially similar for both types of proposals — approximately 28 percent of votes cast.

SEC Staff Response

For companies seeking to exclude proxy access proposals from their proxy statements, the SEC staff's no-action process regarding such proposals may have attained some degree of predictability (with the important caveat that every proposal and response should be analyzed on its own merits). In this respect, companies have continued to be able to exclude as "substantially implemented" proposals to adopt proxy access (typically 3 percent, three years, 25 percent of the board and no aggregation limit) by adopting a proxy access bylaw with 3 percent/three-year ownership requirements, a 20-shareholder aggregation limit and providing access for 20 percent of board seats. Companies also have been able to exclude as "substantially implemented" proposals to amend aggregation limits from 20 shareholders to 40 or 50 shareholders by providing company-specific data to support the view that the company already has provided its shareholders with a meaningful proxy access right. In comparison, companies have been unable to exclude proposals as "substantially implemented" whenever the proposal sought only to eliminate a shareholder aggregation limit or when the company has not shown it adopted at least some of the proposed changes.

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[1] A copy of ISS' preliminary FAQs are available at

https://www.issgovernance.com/file/policy/Preliminary-U.S.-Compensation-FAQ.pdf.

[2] A copy of ISS’ preliminary FAQs are available at https://www.issgovernance.com/file/policy/Preliminary-U.S.-Compensation-FAQ.pdf.

[3] A copy of ISS' updated FAQs are available at https://www.issgovernance.com/file/policy/2018-us-compensation-policies-faq.pdf.

[4] Information about this process is available at https://www.issgovernance.com/company-peer-group-feedback.

[5] A copy of the ISS updates are available at https://www.issgovernance.com/policy-gateway/latest-policies.

[6] A copy of Glass Lewis’ updated guidelines are available at http://www.glasslewis.com/wp-content/uploads/2017/11/ US_Guidelines_2018.pdf.