2019 Proxy Season Hot Topics: Part 2 – a deeper dive into 2019 proxy season

PROXY SEASON HOT TOPICS

Corporate Governance Alert

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As we enter the 2019 proxy season, we want to bring your attention to a few topics that are likely to play a prominent role over the next few months. In this alert, we take a deeper dive into issues directly impacting the 2019 proxy season to discuss changes in the voting policies of Glass Lewis, virtual-only shareholder meetings, issues regarding board refreshment, composition and diversity, say-on-pay, CEO pay ratio and director compensation arrangements.

We are excited about our new format for this series and invite you to call the authors of this alert or your DLA Piper contact if you have any questions or would like to discuss any of the issues described in this series in the context of your company.

1. GLASS LEWIS

In late October 2018, Glass Lewis published its updated US policy guidelines and 2019 shareholder initiatives policy guidelines. The following is a summary of the most significant changes to the guidelines that are in effect for annual meetings held after February 1, 2019, except as noted below.

A. Board gender diversity

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For meetings held after January 1, 2019, Glass Lewis will generally recommend voting against the nominating committee chair of a board that has no female members. Glass Lewis may extend this recommendation to vote against other nominating committee members depending upon several factors, including the size of the company, the industry in which the company operates and the governance profile of the company. This policy does not necessarily apply to companies outside the Russell 3000 index or those that have provided a robust explanation for not having any female board members.

B. Conflicting and excluded proposals

Glass Lewis has updated its policy related to "conflicting" management proposals and in those instances where a special meeting shareholder proposal is excluded as a result of "conflicting" management proposals, it will take a case-by-case approach, taking into account the following issues: (a) the threshold proposed by the shareholder resolution; (b) the threshold proposed or established by management and the attendant rationale for the threshold; (c) whether management's proposal is seeking to ratify an existing special meeting right or adopt a bylaw that would establish a special meeting right; and (d) the company's overall governance profile, including its overall responsiveness to and engagement with shareholders. Glass Lewis noted that it generally favors a 10-15 percent special meeting right and will generally recommend voting for management or shareholder proposals that fall within this range.

With respect to conflicting proposals, Glass Lewis will generally recommend in favor of the lower special meeting right and will recommend voting against the proposal with the higher threshold. And, where there are conflicting management and shareholder proposals and a company has not established a special meeting right, Glass Lewis may recommend that shareholders vote in favor of the shareholder proposal and that they abstain from a management-proposed bylaw amendment seeking to establish a special meeting right.

Glass Lewis also noted that, in certain very limited circumstances, where the exclusion of a shareholder proposal is "detrimental to shareholders," it may recommend against members of the governance committee.

C. Environmental and social risk oversight

Glass Lewis states that “an inattention to material environmental and social issues can present direct legal, financial, regulatory and reputational risks that could serve to harm shareholder interests” and that these issues should be carefully monitored and managed by companies, including ensuring that there is an "appropriate oversight structure in place to ensure that they are mitigating attendant risks and capitalizing on related opportunities to the best extent possible." The key is to have appropriate board-level oversight of material risks to a company's operations.

In certain instances where "a company has not properly managed or mitigated environmental or social risks to the detriment of shareholder value, or when such mismanagement has threatened shareholder value, Glass Lewis may consider recommending that shareholders vote against members of the board who are responsible for oversight of environmental and social risks." In instances where there is no explicit board oversight on these issues, Glass Lewis states that it may recommend that shareholders vote against members of the audit committee.

D. Ratification of auditor: additional considerations

Glass Lewis emphasizes the auditor's role as a "gatekeeper" in "ensuring the integrity and transparency of the financial information necessary for protecting shareholder value." The policies list numerous reasons why Glass Lewis may not recommend ratification of the auditor.

E. Virtual-only shareholder meetings

Glass Lewis indicates that virtual-only meetings have the "potential to curb the ability of a company's shareholders to meaningfully communicate with the company's management." If a company wishes to hold a virtual-only meeting, the key is to explain how the shareholders will be afforded the same rights and opportunities to participate as they would at an in-person meeting.

Glass Lewis generally recommends voting against members of the governance committee where the board is planning to hold a virtual-only shareholder meeting and the company does not provide such disclosure. This policy is in effect for annual meetings held after January 1, 2019.

F. Executive compensation

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- ***Tax gross-ups***

In reviewing the performance of a compensation committee, Glass Lewis intends to include the inclusion of new excise tax gross-up provisions as an additional factor that may contribute to a negative voting recommendation against the members of the compensation committee.

- ***Contractual payments and arrangements***

Glass Lewis has provided additional guidance on instances which may contribute to a negative voting recommendation on a say-on-pay proposal. The guidance relates to: (a) sign-on awards; (b) make-whole payments; (c) guaranteed bonuses; (d) severance entitlements; and (e) entitlements.

- ***Smaller reporting company***

In 2018, the Securities and Exchange Commission adopted amendments to raise the thresholds in the definition of "smaller reporting company" (or SRC) which allowed a significant number of eligible companies to comply with reduced disclosure requirements and not provide, among other matters, a compensation discussion and analysis (CD&A) section.

Glass Lewis expects to take into account the impact of materially decreasing CD&A disclosure when formulating its recommendations and may consider recommending against members of the compensation committee where a "reduction in disclosure substantially impacts shareholders' ability to make an informed assessment of the company's executive pay practices."

- ***Grants of front-loaded awards***

In certain instances, a company may choose to provide large grants, usually in the form of equity awards, that are intended to serve as compensation for multiple years. This practice is called front-loading. Glass Lewis believes that there are risks associated with these sort of awards and in evaluating such awards will take into account the quantum of the award, design and the company's rationale for granting awards under this structure into consideration.

- ***Recoupment provisions***

Glass Lewis is paying additional attention to recoupment policies. Specifically, it believes that clawbacks should be triggered, at a minimum, in the event of a restatement of financial results or similar revision of performance indicators upon which bonuses were based.

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- A company that finds itself without any female board members should provide a sufficient rationale for not having any female board members. Issues addressed in explaining the rationale could include a disclosed timetable for addressing the lack of diversity on the board and any notable restrictions in place regarding the board's composition, such as director nomination agreements with significant investors.
- Pay particular attention to the changes related to executive compensation matters adopted by Glass Lewis.
- For an SRC, consider retaining the full CD&A disclosure, rather than taking advantage of the reduced disclosure requirements available to a SRC.

2. VIRTUAL-ONLY SHAREHOLDER MEETINGS

We expect that virtual shareholder meetings will continue growing in popularity during the 2019 proxy season. In recent years, virtual-only shareholder meetings have risen in popularity and increased by approximately 30 percent from the 2017 proxy season to the 2018 proxy season. Despite the rise in popularity of virtual-only meetings, they still represent a small fraction (less than 10 percent) of all annual shareholder meetings and are most common among small cap companies.

Investor opinions on the virtues of virtual meetings are mixed. Some key institutional shareholders, including CalPERS, have stated an opinion that virtual meetings should not replace traditional in person meetings. However, some investors believe that virtual meetings increase shareholder access and are more efficient than traditional, in-person meetings.

Benefits	Objections

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Broader shareholder access. While a shareholder's ability to participate in the meeting may be more limited in a virtual meeting, we would expect that virtual meetings would achieve greater shareholder attendance because shareholders can access the meeting remotely without travel.	***Limited shareholder engagement.*** In a virtual meeting, shareholders do not have face-to-face access to management or the Board and therefore have a limited ability to participate in the meeting or ask questions.
Decreased cost. Virtual meetings generally have less overhead costs than in-person meetings.	***Voting uncertainty.*** Because virtual meetings increase shareholder attendance, the shareholders may be less inclined to submit proxies, which may create uncertainty about voting outcomes.

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A company considering switching to a virtual-only meeting should consider the following factors:

- Whether applicable law, stock exchange rules and the company's corporate documents permit virtual-only meetings and, if so, the rules or guidelines pursuant to which such meetings should be conducted.
- The preferences of its major shareholders and the position of governance advisory firms.
- The company's processes for conducting the virtual-only meeting, considering the Broadridge White Paper "Principles and Best Practices for Virtual Annual Shareowner Meetings."

3. BOARD REFRESHMENT, COMPOSITION AND DIVERSITY – NOMINATING AND CORPORATE GOVERNANCE COMMITTEE TOPICS

We expect that gender and minority board diversity will play a key role in the 2019 proxy season.

The Spencer Stuart Board Index, an annual survey of board composition and governance trends among S&P 500 companies, noted that the 2018 incoming class of S&P 500 directors was historically diverse in terms of gender, race and experience. Women and minorities (defined as directors of African, Hispanic/Latino or Asian descent) composed half of the incoming directors. In addition, nearly two-thirds of the incoming directors had never previously served on a public company board. These "first generation" directors largely have no prior C-Suite experience and instead bring technical, functional or financial expertise to the board.

While women were appointed to boards at record numbers in 2018 – with 40 percent of new board seats going to female directors – increased representation of minority men on boards experienced a slowdown, with minority men representing 10 percent of new board seats in 2018, down from 14 percent in 2017.

Women now represent 24 percent of all S&P 500 directors, up from 16 percent in 2008. Gains for minority directors have been more modest – 17 percent of directors in the top 200 of S&P 500 companies are racial minorities, up slightly from 14 percent in 2008.

As we detailed in an October 2018 publication, "California Mandates Female Board Directors For Publicly Held Companies," factors that have led to increased attention to gender diversity on public company boards include:

- a recent law requiring that publicly held companies based in California have at least one female director by the end of 2019 and, depending on the size of their boards, additional female directors by the end of 2021
- studies that have linked board diversity to better financial performance and
- demands for gender diversity by institutional investors, including State Street, CalPERS and BlackRock.

Another trend that we expect to continue in the 2019 proxy season is increased improvement and institutionalization of the board performance evaluation process. According to the Spencer Stuart Board Index, only nine S&P 500 boards did not conduct an annual board performance evaluation in 2018. In addition, 9 percent of S&P 500 boards engaged an independent third-party governance expert to facilitate the evaluation process in 2018, up from only 2 percent of boards in 2017.

The board evaluation process is an important component to understanding the board's strengths and weaknesses and the results of an annual board performance evaluation will likely guide the near-term goals of the nominating and corporate

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governance committee.

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To prepare for increased attention to board composition, diversity and performance in the 2019 proxy season, we recommend that issuers take the following actions:

- Review with the nominating and corporate governance committee its philosophy and goals related to board diversity and board composition.
- Consider the diversity of the existing board, committees and committee chairs and discuss with the nominating and corporate governance committee its goals for recruiting and retaining directors with diverse backgrounds and perspectives.
- Consider improvements to disclosures concerning the issuer's philosophy and goals related to board diversity and board composition.
- Review and update proxy statement disclosure of director bios and, in particular, disclosures regarding each director's board skills and qualifications.
- Review and evaluate existing board evaluation processes and consider whether to engage an independent third-party governance expert to lead the board evaluation process.

4. SAY-ON-PAY

While the vast majority of publicly-traded companies received broad shareholder support for their compensation programs in 2018, 2018 was also one of the most competitive proxy seasons in recent years for say-on-pay. According to a report by the executive compensation consulting firm Semler Brossy, 57 Russell 3000 companies failed say-on-pay in 2018, the highest number since 2011 and significantly higher than the 35 Russell 3000 companies who failed say-on-pay in 2017. Despite the uptick in failed say-on-pay votes, the Semler Brossy report notes that a significant majority (76 percent) of Russell 3000 companies received over 90 percent of shareholder support for their compensation programs and the overall number of failed votes was small, representing only 2.6 percent of Russell 3000 companies.

Because say-on-pay has become an important driver of the proxy process, more companies have refreshed the presentation of their proxy statement to enhance the presentation of important information and improve readability. Providing reader-friendly features such as graphs and charts helps to transform the proxy statement from a compliance-driven document into a tool for communicating with shareholders.

In addition to improving proxy statement presentation to communicate better with shareholders, ongoing shareholder engagement efforts continue to be a crucial component to ensuring a successful say-on-pay vote.

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- Tailor disclosures in the CD&A and utilize charts and summaries to explain the company's pay-for-performance philosophy, shareholder engagement efforts and the company's response to shareholder feedback.
- Engage with key shareholders and proxy advisory firms to address questions or concerns regarding the company's compensation program.
- Consider refreshing the presentation and design of the proxy statement to improve readability and presentation to transform the proxy statement into a communication tool as opposed to a compliance tool.

5. CEO PAY RATIO

2018 marked the first proxy season for "CEO Pay Ratio" a Dodd-Frank rule requiring public companies to disclose (i) the median annual total compensation of all employees other than its chief executive officer; (ii) the annual total compensation of its chief executive officer; and (iii) the ratio of these amounts.

SEC rules allow issuers some degree of flexibility in adopting a methodology to report this disclosure **–** for example, the SEC rules permit issuers to use statistical sampling as opposed to analyzing the compensation of its entire workforce. However, according to a report by the compensation consultant Pearl Meyer, only 2 percent of issuers used statistical sampling to determine CEO pay ratio. The SEC issued no comment letters related to CEO pay ratio during the 2018 proxy season, and we expect that most issuers will use a similar methodology and presentation in 2019 as in 2018.

According to the Pearl Meyer report, the median CEO pay ratio in 2018 was 69:1 and the average pay ratio was 144:1.

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The Pearl Meyer report noted that the highest average pay ratios occurred in companies with over 10,000 employees (337:1) and companies in the consumer discretionary (384:1) and the consumer staples (295:1) industries. The lowest average pay ratios occurred in companies with under 500 employees (36:1) and in companies in the energy (80:1), financial (67:1) and utilities (59:1) industries. In addition, companies with pay ratios of 150:1 or higher had an average workforce outside of the United States of 35 percent, compared to 10 percent for companies with pay ratios of 35:1 or lower.

While CEO pay ratio disclosures received much attention during the 2018 proxy season, investors generally focused on pay-for-performance when assessing a company's compensation program and gave little attention to pay ratio. The Pearl Meyer report noted that CEO pay ratio, largely, did not correlate with pay-for-performance. High average TSR generally correlated with CEO ratios between 35:1 and 74:1.

Although investors paid little attention to CEO pay ratio in 2018, we expect to see increased attention to CEO pay ratio by investors in the upcoming proxy season. In December 2018, a group of 48 institutional investors and advisors, including representatives from CalPERS, CalSTRS, the AFL-CIO and the Comptroller's Office of New York City and New York State, sent a letter to each public company in the S&P 500 index requesting expanded CEO pay ratio disclosures. The letter stressed the investors' desire to understand the relationship between CEO pay ratio and the company's overall employee compensation philosophy. Supplemental information requested by the investors included, among other information, an explanation of the company's overall employee compensation philosophy, details regarding the company's non-executive employee base (such as its use of seasonal or part-time employees and subcontractors and the skills and education levels of its workforce) and an identification of the median employee's job function. We expect to see additional attention to CEO pay ratio as companies respond to these and other shareholder concerns.

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- Engage with shareholders to determine if revisions to your existing CEO pay ratio disclosure are necessary or desirable.
- Review the methodology used by your peer companies (for example, the use of statistical sampling, or whether to include employees of acquired companies) and consider whether changes to your methodology are necessary. Note that any change in the methodology may confuse investors, so if changes are made, consider soliciting feedback from investors on the proposed change.
- Consider whether to change the location of the CEO pay ratio disclosure. Most companies placed the pay ratio disclosure behind the compensation tables.
- Establish procedures for engaging publications and other third parties, particularly if a particular publication or other third party (such as an industry-wide publication or local news outlet) reported on your 2018 disclosure.

6. DIRECTOR COMPENSATION ARRANGEMENTS

According to the Spencer Stuart Board Index, an annual survey of board composition and governance trends among S&P 500 companies, the average total compensation for S&P 500 directors rose 3.5 percent in 2018 to $298,981. S&P 500 companies have shifted away from paying directors for meeting attendance and towards compensating directors with stock awards (56 percent of total S&P 500 director compensation) and cash (38 percent of total S&P 500 director compensation). Only 4 percent of total S&P 500 director compensation in 2018 consisted of option grants.

The majority of S&P 500 companies (56 percent) pay an annual retainer of $100,000 or more, and the average annual retainer for S&P 500 directors is $124,306. Over half (50.5 percent) of S&P 500 companies permit the director to elect to receive its retainer in cash, stock or stock units, and 77 percent of S&P 500 companies provide directors with stock awards in addition to its retainer.

Most committee chairs (97 percent) and many committee members (44.5 percent) receive retainers. Audit committee chairs and members, on average, receive higher retainers ($25,777 for audit committee chairs and $13,726 for audit committee members, compared to $21,036 for all committee chairs and $12,027 for all committee members).

Recent Delaware challenges to director compensation arrangements have clarified that when shareholders ratify a director compensation plan that permits discretionary awards to directors, the validity of the awards will be judged under the more stringent “entire fairness” standard than the more discretionary “business judgment rule.” We expect that issuers may respond to this litigation in 2019 by reviewing their director compensation programs and perhaps by implementing shareholder-approved annual limits or formulas for calculating awards in existing director compensation plans.

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- Consider adding shareholder-approved annual limits or formulas for calculating awards in existing director compensation plans to avoid shareholder challenges to director awards.
- Consider whether the process of approving director compensation and the compensation arrangement itself (amount and mix of compensation) are fair to the company's stockholders.
- Where the issuer has not adopted shareholder-approved annual limits or formulas for calculating awards, take additional steps to document and ensure fair process- for example, by hiring outside compensation consultants and/or providing additional disclosure regarding the governance and process in the issuer's proxy statement.

Find out more by contacting Sanjay M. Shirodkar, Jason Harmon, Jared Jensen or Brooke Goodlett, and see the entire 2019 Proxy Season Hot Topics Series here.

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