"Proxy Season Post-Mortem: The Latest Compensation Disclosures"

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Audio Archive

With a much-anticipated season of new executive compensation disclosures now in, investors, journalists - and yes, the SEC Staff - will be taking a look at what was disclosed this proxy season. Join these experts as they analyze what was disclosed (and what was not):

- **Mark Borges**, Principal, Compensia
- **Dave Lynn**, Editor, CompensationStandards.com and Partner, Morrison & Foerster
- **Ron Mueller**, Partner, Gibson Dunn & Crutcher LLP

Dave Lynn, *Editor, CompensationStandards.com and Partner, Morrison & Foerster*: Hello, everyone. Welcome to today's webcast, "Proxy Season Postmortem - The Latest Compensation Disclosures."

For our program today, as many of you have probably listened before, we like to cover the latest issues and considerations from this past proxy season. For that purpose, I want to introduce myself and my esteemed colleagues who are joining me on the webcast today.

I'm Dave Lynn, Editor of CompensationStandards.com and Partner at Morrison & Foerster. I'm joined by Mark Borges, a Principal at Compensia, co-author of *The Executive Compensation Disclosure Treatise and Reporting Guides*, and author of Borges' Proxy Disclosure Blog on CompensationStandards.com; and Ron Mueller, Partner at Gibson Dunn, who is also a veteran of many of these programs, as well. Thank you both for joining me today.

First, I'm going to kick it over to Mark to get us started talking a little about what we saw this proxy season on the Say-on-Pay front.

Say-on-Pay Results

Mark Borges, *Principal, Compensia*: Thanks Dave, and good afternoon everyone. It's good to be with you once again.

It's hard to believe that we're coming up upon the 10-year anniversary of Say-on-Pay next year. It's certainly been one of the overarching highlights of every proxy season.

I'm happy to report that consistent with prior years, the results to date have pretty much followed in line with what we've seen in prior years. With approximately two-thirds of the companies that are scheduled to hold a Say-on-Pay vote having conducted their annual meeting and published the voting results of the meeting, about 70% have gotten more than 90% support from their shareholders on their executive compensation program. And about 90% of the companies have gotten more than 70% support. Those results are consistent with what we've seen in 2018 and in prior years.

The one thing I note this year, if you look at the trend from year one of Say-on-Pay through the most recent year, the number of companies getting more than 90% support has been slowly inching up over time. In 2011, the first year of Say-on-Pay, the percentage of companies getting 90% support was in the low 70s. It's now in the high 70s. I think it's approximately 78% to date and continuing to increase year over year. It wouldn't surprise me if in the next year or so we get to 80% of the companies holding the vote getting more than 90% support.

It wouldn't surprise me if in the next year or so we get to 80% of the companies holding the votes getting more than 90% support. So far this year, the average support for Say-on-Pay is approximately 91%, which is slightly higher than what it's been at this point in time last year.

What we're eventually going to see, and it's certainly been taking shape for the past few years, is that a vast majority of companies don't seem to have any trouble in getting significant support for their named executive officer compensation.

Then you have another group of companies for which the results are more problematic. This is generally less than 10% of the companies with 5, 6 or maybe 7% of those companies getting between 50% to 70% support. The remaining companies are failing the vote outright.

There's a very small number of companies in the middle of those two extremes. It's an indication that companies have gotten savvy in understanding not only the proxy advisor policies, which shape the analysis of Say-on-Pay proposal, but also the expectations of their shareholders, particularly the largest or most influential shareholders.

Companies, either through their own efforts or through dialogue with their key shareholders, have a firm understanding of what investors are looking for in the executive compensation program and have designed the programs in that direction - so that shareholders are generally comfortable with the program design. There's very little in between in terms of shareholders which may have a more uncertain opinion about the compensation program.

I believe that, over time, we are going to continue to see this trend take shape, with most companies either at the very high end of support or, for one or more reasons, at the low end of support because shareholders are unhappy with some aspect of their compensation program - or more likely, with their performance. These latter shareholders are using the vote as a means of expressing their displeasure and signaling to the company that they need to be more responsive to the concerns of their shareholders.

At this point in time, we have 33 companies that failed the Say-on-Pay vote, which is slightly higher than where we were in the middle of June last year. We also are on track for about 2 or 2.5% of the companies by the end of the year failing the vote.

With the exception of 2016 and 2017, when we had only half that many companies ultimately failing over the course of the year, we are on track for somewhere between 55 and 60 failures. That is consistent with virtually every other year that the Say-on-Pay vote has been in effect.

Generally, the reasons for failures are consistent with past practice. Typically, for most companies there's a disconnect between pay and performance that brings the company under the greater scrutiny of the proxy advisors.

Then there's typically some other aspect of their compensation program, a problematic pay practice, or perhaps something related to their shareholder outreach efforts, or the use of nonperformance-based equity awards, that runs afoul of the qualitative review of their compensation program. This review results in an "against" recommendation from one or more of the proxy advisors that ultimately leads to the failed Say-on-Pay vote.

It is almost consistent with what we've seen over the last eight years. If a company doesn't have a strong correlation between its financial performance and its CEO pay, that's typically an indication it's going to be down at the bottom of the list when it comes to shareholder support.

In terms of the ISS recommendations, the "against" recommendations so far this year are at about 12.5%, which is slightly lower than what we saw last year. Ultimately, by the end of the year, we are probably going to be somewhere close to 13% against recommendations, which is consistent with past historical practice.

The thing that I like to remind my clients is that just because you got an "against" recommendation, it's not a guarantee that you're going to fail the Say-on-Pay vote. Certainly, the statistics back that up. It means, however, that you're going to have to engage in a concerted outreach effort to your key shareholders in order to obtain their support.

Once again, based on recent practice, companies seem to be savvy about what they need to do. If the early indicators are that you are either not going to get a favorable recommendation from the proxy advisors or the results of their analysis are somewhat uncertain, it's probably a good bet that you will need to engage in outreach efforts to your key shareholders in order to make sure you understand where they sit relative to your executive compensation program. That way, you know what efforts you may have to undertake in advance of your annual meeting in order to ensure you don't wind up on the wrong side of the equation when it comes to a vote.

That's where we sit with Say-on-Pay. Next year will be the tenth anniversary of Say-on-Pay and we'll see a lot of analyses summing up where we are after 10 years. We will be looking more at the retrospective in terms of whether Say-on-Pay has led to better pay practices and facilitated a strong dialogue between shareholders and companies on their executive compensation philosophy program. Ron, over to you.

Performance-Based Compensation Disclosure

Ron Mueller, *Partner, Gibson Dunn*: Thanks, Mark. Let me introduce four topics that we are going to talk about regarding some of the main things we saw in proxies this year. Mark and Dave will add their comments as we go through these topics.

The first one is what was the big focus of disclosure on the compensation side. Really, no surprise there. It's performance-based compensation. It's still not a requirement, but companies continue to appropriately spend a good amount of time describing why their compensation programs are designed to tie pay to performance.

On the annual incentive side, I've seen a slight trend over time that has continued this year with companies moving away from the old traditional bonus pool arrangement. That pool was still based on performance expectations and evaluations going on of executives and a target bonus amount, but there wasn't a rigorous formulaic process there.

Perhaps it's because of the nine years we have had so far of Say-on-Pay votes. That is one thing that shareholders and others criticize when companies have a down year. "Hey, here's some compensation and it's not clear what it's based on."

Even when companies don't have a down year, it's one of the things that the proxy advisors and some shareholders have been skeptical of - they want greater transparency of the basis upon which these bonuses are being paid.

It did seem this past year continued a trend of companies moving more towards formulaic annual incentive plans and having components there based on individual performance that was more subjective. That might be anywhere from 10% to 20% of the total target amount.

Even that, of course, gets closely scrutinized. Is that being paid out when companies had challenging years? That's one of the areas for companies that do have non-formulaic plans continues to be one of the major challenges.

Mark and Dave, any thoughts on what you've seen with annual incentives?

Borges: Well, I have certainly seen a pronounced shift towards providing the rationale behind the key decision or design points in the program. This is in direct response to the proxy advisors extending their analysis to go beyond just whether a program has a sound formula to questioning the rigor of the performance goals and determining whether you're setting your performance levels higher than you were in prior years.

Enough companies have fallen victim to being second-guessed on these points so that now there certainly are more and better disclosures and analyses about how the plan was designed, compared to prior years. That's become somewhat commonplace throughout the disclosures that we are now seeing.

Mueller: Right. How the targets line up to the company's budgeting process or guidance process.

Borges: Yes. People are anticipating that and responding to it in their initial draft.

Mueller: The long-term comp is where I'm starting to see the early signs of some reevaluation of long-term compensation arrangements, both by companies and institutional investors.

You often hear concern expressed by companies about the difficulty of setting long-term performance goals. I'm hearing feedback from some investors, and it was interesting that at the Council of Institutional Investors annual spring meeting they had here in D.C., there were two panels discussing nontraditional compensation arrangements.

By that, they meant compensation arrangements that were moving away from some rigorous three-year performance goals, or something like that. I don't know that we can call it a trend yet, but I think there is some discussion and debate going on even among the institutional investor community to consider whether there's a better way to align pay and performance over the long term.

For the time being, three-year performance goals for equity-based compensation, and increasingly the weighting of the percentage of equity-based comp that is granted in the form of performance shares, PSUs, continues to grow.

Again, at the same time, some people are questioning the ability to establish goals like that. There has also been increased scrutiny on how those goals are getting established. We are seeing it both in the press and spilling over in a few voting recommendations. This year in some annual meetings, there's some concern about whether companies are basing performance on non-GAAP measures that have inappropriate adjustments in them.

Certainly, some of the pharmaceutical companies are under scrutiny by some investors that are concerned about the opioid epidemic and consequences of that like legal fees and other things to be considered in determining performance under some of these long-term measures. That type of scrutiny is spreading into other areas.

The other thing I saw this year that I thought was interesting is a little divergence on views of what qualifies as "performance-based compensation." Particularly, there were some of these evident in a range of industries, with a lot in tech, where some of these equity awards being done either as new hire awards or as mega-grants, and where they were based on stock price performance over time.

Some of these arrangements would vest when the stock price achieved a certain appreciation over a 30 or 60-day period at any time over the next three or five years. What was interesting on those arrangements is that many of the active portfolio managers thought those were great incentive compensation arrangements. They align with the bottom line for the shareholders of how the stock is performing - "If the portfolio I hold goes up to this value, then that's fine to pay the executive X dollar amount."

Whereas, some of the index funds and ISS had some skepticism with those arrangements and said, "Are they really long term because they can be earned within a year if the stock price hits that, and how are the stock price triggers being set against historical perspectives?"

It's interesting, again, as another area where there's some divergence on what qualifies as performance-based compensation. Companies that are drafting proxy statements will need to be focusing on some of these nuances.

The fact that you have some objective goal that ties to vesting isn't going to get you off the hook of having to explain why this goal was appropriate, how it was being set, and how it's being calculated. We may start seeing more focus on the payout amounts, and how was financial performance measured on those.

Borges: A lot of attention is starting to be focused, as you said, on the amounts, particularly where the amounts are more than what would otherwise be considered an annual grant size.

There's a lot of sensitivity around being able to analyze and explain why the size of the award is appropriate. We started to see this type of disclosure this year and that's only going to increase going forward, as the proxy advisors begin to focus more on these so-called "mega grants" - which are outsized awards that are not consistent with past practices.

Mueller: The other area where I've seen a new area of focus, or an area of increased focus, is on new-hire and severance packages. I don't think it's just because of the #MeToo movement, the economy or whatever, but in the past three year in my practice I've seen a very high level of executive turnover compared to historic rates, and a full range of situations.

On both the exit and new hire packages there has been a lot of focus on the performance-based elements of it. When these people leave, are you paying even if there was bad performance? Many companies are getting caught on that, because many don't provide for pro rata vesting in some of these equity awards, even time-based equity awards, and yet want to provide something if someone is leaving on not bad terms or not under a cloud.

In that situation, you have equity compensation reported because of a modification of an equity award, if it's not built into your award. And that's being viewed as not performance-based comp.

We are seeing many more times where companies are disclosing the new hire package, and there is a piece of it that was not performance-based which was designed to replace equity, pensions or something else that the person forfeited when they left their other job. It is necessary to attract them. There are some discussions about the difficulty of this job market, even though, at the same time I'm saying there's a lot of turnover. You also see many times where people say we're having a difficult time finding qualified executives, particularly CFOs or CEOs.

I saw that in the newspaper yesterday on one prominent company. It's not just that company, it's a broad experience and some of these comp packages are having to be rich to get people. That was a challenge this year and a transition for the proxy advisors and institutions getting used to seeing some of the numbers they are seeing.

Shareholder Responsiveness Disclosure

To follow up on what Mark said regarding voting results, if you have a vote of less than 70% or 80% on your Say-on-Pay, the proxy advisors and institutional investors expect to see some further engagement and discussion. That's a fairly common reaction we see.

You can always see how some companies' Say-on-Pay vote went the previous year based on some of their discussions about what we heard and did. You're also seeing that much more broadly because there is so much more engagement going on. That's the biggest takeaway from Say-on-Pay is it has supercharged the engagement process.

Perquisites Disclosure

So, we've seen a lot of focus this year on disclosures about performance-based comp and shareholder responsiveness. Another area that people have been paying attention to is perquisites. This is partly due to several things going on with the perquisites topic. There was the *Dow Chemical* case - and one of the takeaways from that case was the documentation of processes and procedures.

A lot of companies this past year spent some time going through their perquisite programs making sure that they had good controls and reporting systems around those. That didn't necessarily hit the proxy statement a whole lot. It was a very good practice we saw by companies and something many other companies will do when they get a breather this summer, in offseason, those types of internal reviews, documentations, quality checks around their perquisite reporting processes.

Then the other factor that's drawing attention to perquisites is again based on the strong economy. We are seeing more and more disclosure of perquisites. Certainly, executive security has been high on many companies' minds. The amounts that are being reported as perquisites where the company is saying, "We are concerned and think this is a good investment of our money." We certainly see those amounts going up.

That's one area where I see more pushback from the proxy advisors than I do from actual shareholders. A lot of institutional shareholders think it's worth the money.

Dave or Mark, any perquisite stories to tell from the past year?

Lynn: I agree it's been a focus. It's always been a focus, but for a variety of reasons that you mentioned, people have been looking at it even more. It always strikes me that the perquisites often are positively correlated with the economy. When times are good, the number of perquisites that are available increase and, therefore, more disclosure and controls must be put in place to address that.

Certainly, one area in particular is the use of corporate aircraft. In that area we've seen a lot of disclosure around the extent to which incremental costs are incurred for the use of corporate aircraft, as well as when timesharing arrangements are used that allow for reimbursement by the executives for either fractional interests or company owned aircraft.

Borges: I certainly got more questions this year. It's clear that the heightened sensitivity that the SEC may have been looking for when it issued those enforcement proceedings last year had an effect on proxy disclosures this year.

Director Compensation Disclosure

Mueller: The final area I'll talk about is director compensation. Again, there have been lawsuits that are taking advantage of the status of Delaware law where directors setting their own compensation is considered an interested party transaction and, therefore, does not have business judgment rule deference around it.

Plaintiffs' lawyers are bringing these challenges and that has resulted in some litigation and focus on the amount of directors' compensation. We had another court decision right before our proxy season last year. We had the *Investors Bancorp* decision last year, and this year we have the *Goldman Sachs* decision, which was a week or two ago.

Both, I would say are not necessarily the best facts to come up in front of the court. In both, the Delaware courts pushed people to say if you want to shift the burden onto who must defend the appropriateness of directors' compensation, you need to have these specific arrangements approved by shareholders.

They seem to suggest that you cannot even have a very well-tailored limit approved specifically for directors and pay less than that, which is counterintuitive. The courts don't want to get into the area of line drawing of saying, well, was this disclosure good enough given the amount that they ended up paying if they paid something different.

We have seen, over the past two years, a couple of companies going out seeking shareholder approval for specific amounts of directors' compensation. That still seems to be the exception.

Most companies instead are doing a more thorough job of explaining the elements and amounts of their directors' compensation, how they have determined those amounts, and why they believe they are appropriate. They are invoking part of the Delaware law about utilization of experts, with compensation consultants helping support those determinations.

That's another area we will see some developments, probably depending on how much this litigation continues to surface. Other than that, this was the second year of the CEO pay ratio disclosures. Dave, why don't you talk about those?

CEO Pay Ratio Trends

Lynn: Thanks, Ron. Obviously, the 2018 proxy season was really the year of CEO pay ratio because we had to take our first stab at preparing the disclosure and wait around for the backlash, which didn't really come. For some, there was more attention paid to it than one would have liked. All in all, it turned out to be a non-event in the grand scheme of things.

With that backdrop, we came into 2019 focused on replicating our process so that we could calculate the pay ratio disclosures and reassess exactly how we did it now in light of what everyone else ended up doing in terms of the level of detail and analysis, and the approaches that people took in preparing the disclosures.

When we talked about this before the proxy season got off to a start, we basically advocated for staying the course. There's no need, based on what we saw from 2018, to upend the apple cart in terms of how you put the number together and the types of disclosures you provide. Doing any of that stuff would draw more attention to it than you would need to and wouldn't serve much purpose given the overall reaction to the disclosure.

Now, unfortunately, we can't always anticipate all the external forces at play and the one interesting thing that everyone acknowledged which came out of the first year CEO pay ratio disclosures was that there was a lot of focus on the median employee number. The median employee pay, as opposed to the relationship between the median employee pay and the CEO pay, proved to be the interesting number there.

That certainly drove some interest from a variety of areas, including the media and investor community, as to what really drives that median employee number and how do you look at it compared to others in the same industry or sector pay, and what other disclosures might be useful along those lines?

At the end of 2018 we saw a trend where compensation committees of companies in the Fortune 500 started receiving a letter from a group of 48 institutional investors that basically requested more information on workforce compensation practices generally. The principle underlying the letter was that the disclosure of the median employee's pay provides a reference point for understanding the company's workforce and, therefore, companies should help investors put that information into context by describing more of the company's overall approach to human capital management.

This request for more disclosure came at a time when, for a variety of reasons, including increased focus on issues like sexual harassment, employment diversity, and pay disparities, the notion of more information about human capital management became a topic that many people started discussing. It was opportune timing, from this group's perspective, that the CEO pay ratio focused attention in that area.

The letter outlined a number of specific things that the group was looking for - and that included things like identifying the median employee's job function, breaking the workforce down by job function or business unit, the geographic location of the median employee, country-level breakdown of the global employee headcount, a breakdown of full-time versus part-time employment status, use of temporary or seasonal workers, use or nonuse of subcontracted workers, tenure and experience of the workforce, education levels, overall compensation philosophy, and the mix of benefits and incentives for the workforce.

Also around the same time, the New York State Comptroller's Office, which also was a signatory to this 48 institutional investor letter, announced that the state's Common Retirement Fund had reached agreements with five companies to pull back a shareholder proposal that it had submitted which urged companies to adopt policies that take into account compensation of the workforce when setting CEO pay.

This is a trend that we've been seeing where these types of issues are more and more being looked at in the context of how they affect executive compensation pay. The things that the companies agreed to do range from things like adding more human capital disclosure, enhancing workforce benefits, and considering CEO pay ratio when determining pay. The companies that were subject to that settlement were CVS Health Corp, Macy's, Microsoft, Salesforce, and the TJX companies.

These developments were the tip of the iceberg in terms of this broader topic of human capital management. Just this year we saw BlackRock designating human capital management as one of its 2019 engagement priorities.

State Street created a framework that basically was designed to assist boards and management in aligning their cultures with long-term strategies. Then you saw a coalition of California pension funds essentially coming up with a set of principles about managing human capital management risks. Obviously, this concept goes well beyond issues of pay inequity, including issues such as sexual harassment, labor practices, diversity and workers' rights.

Another topic that the CEO pay ratio tended to also bolster or surface in a way, was an ongoing debate about gender pay equity. Rightfully so, many people have focused attention on this issue, and you've seen shareholder proposals in this regard.

Going back to 2016 or so, Arjuna Capital had success getting companies in technology, consumer and financial services to provide more information about internal pay equity data by gender. This year, that campaign shifted to request basically global median gender pay gap disclosures and the focus was on financial and technology firms. That looked at, basically, the median pay of all men versus the median pay of all women in the companies' workforce regardless of what their position is.

Basically, they were focused on this notion of a leadership gap, to the extent that it existed. The proposals were also made against the backdrop of the new U.K. requirement where companies with over 250 employees must report mean and median gender pay gap disclosures.

What we saw coming out of this campaign is that one of the targeted firms, Citigroup, became the first U.S. company to report median pay gap data for women and minorities. Ultimately, that resulted in the withdrawal of the shareholder proposal.

While the CEO pay ratio itself continues to exist as a disclosure item, all these other issues have continued to gather steam in a way that is related to the CEO pay ratio disclosure.

In terms of what we saw people disclosing in 2019 for CEO pay ratio, basically everyone continued the minimalist approach of complying with the disclosure item. The disclosure isn't taking up a lot of real estate in proxy statements. It's basically one or two paragraphs providing the data and the explanatory information about how the data is captured.

The most popular place continued to be nestled at the end of the executive compensation tables. We didn't really see companies in 2019 taking the opportunity to make the disclosure more prominent.

I saw some data that Pearl Meyer recently put together at the end of last month and they found that only 4% of the companies that had been looked at had changed their "consistently applied compensation measure" in 2019 from what they used in 2018. That tends to indicate people were very much staying the course of the CACM determination.

They also said 15% of the companies included some comparison of this year's pay ratio to the pay ratio that was disclosed last year. A minority practice but, nonetheless, people felt compelled to make some explanation.

We didn't see a rush to provide disclosure comparing the CEO's pay ratio to the pay ratio of other companies, peers or the like. Nor did we see a lot of that incremental disclosure this year that the 48 institutional investors had been looking for.

Supplemental pay ratios didn't really become an issue in 2019. We saw them in 2018 perhaps with more frequency, although on that one I'm speaking more anecdotally. If you had a situation where a supplemental pay ratio made sense, there was some openness to including it. But the reaction to supplemental pay ratio had been mixed-to-negative from the investor community. So, it wasn't something people felt compelled to do.

One of the continuing issues from 2018 to 2019 was the question of whether you could use the same median employee. The rules say you could use your same median employee for up to three years. If the employees or the company's circumstances change, then the company may have to identify a new median employee, and they can look to those employees who have compensation similar to last year's median employee.

Once companies have the framework in place, there were situations where I think the benefit of using the same median employee from year to year wasn't that high, because they could easily identify a median employee each year. There weren't a lot of savings achieved by keeping the same median employee.

That said, when people have fixed a median employee for the three-year period, the one issue that continues to come up is, "How much of a change is significant for this purpose where we can no longer use this median employee?" That's an issue that's very facts and circumstances driven.

I don't know that there's any real bright lines there, but it is something increasingly we'll have to debate as we move through time with this rule. That's everything I had on CEO pay ratio.

Hedging Disclosure Rule

Mueller: Thanks, Dave. This webcast wouldn't be complete if we didn't touch on Dodd-Frank rulemaking. The surprise this year was in December the SEC did adopt the rules on hedging disclosure.

What caught some people off guard about those is that the effectiveness of those rules is phrased a bit differently than often how these things are set up. Instead of being based on the proxy that is filed for the year in which the rule goes into effect, it's basically the proxy filing that's made during the year in which they go into effect.

Basically, the rules go into effect the end of this month, June 30th, so they will be applicable to any company with a fiscal year beginning after that period that files a proxy statement. If you're filing a proxy statement for your June 30 fiscal year, it needs to have the hedging disclosure in that.

The rules will be interesting in that hedging is not strictly an executive compensation issue. Again, it will be interesting to watch where companies put this disclosure. I expect a number of them will put that disclosure in the CD&A, but that will be something that we'll have to watch.

There are certainly other places it can go, depending on what topics you already have on some of these governance provisions elsewhere in your proxy statement. It might end up being in the beneficial ownership table or in the governance section generally.

The rule requires companies to disclose any type of hedging that is specifically allowed or prohibited. There's an alternative of being able to set forth the text of your policy in total if you want to. As companies focus on that decision, we'll see whether they're going to try to summarize the policy - knowing that the SEC rules say that even if your policy is not written down you have to summarize it. If you have some informal practices on how you interpret situations, that may need to be disclosed, versus just setting forth the full text of the policy.

Status of Other Dodd-Frank Rulemaking

The other two Dodd-Frank compensation-related rulemakings are still outstanding. There is no sign of action on those.

One is clawback disclosures and the other one is pay-for-performance disclosure. These are two areas where, in my view, the market has surpassed anything the SEC would have done to begin with.

You wonder whether it still makes sense, but for the Dodd-Frank mandate, for the SEC to move forward with those projects, because as we've been discussing, Say-on-Pay has led to pay-for-performance disclosure being what the CD&A is all about these days. It's not clear that a mandated format for that would achieve any greater enhanced disclosure.

On clawbacks, most companies these days do have some forms of clawback and good disclosures in their proxy statement around those. Dave, do you want to talk about shareholder proposals?

Shareholder Proposals

Lynn: Yes, definitely. In terms of the shareholder proposal season this year, I would say there were a few key takeaways that are worth considering, particularly as they are related to some of the compensation proposals.

Where all the action was, by and large, in terms of the bases for exclusion this year was in 14a-8(i)(7), the "ordinary business" exclusion - and related to that, 14a-8(i)(5) "relevance," as well as 14a-8(i)(10), the "substantially implemented" basis for exclusion.

The reason there was action in these areas is that the Corp Fin Staff took a different look and approach in both those areas, particularly as was discussed in the most recent Staff Legal Bulletin that I'll talk about in a little more detail. The SLB resulted in a revisiting of the approach that the Staff was taking, and some would say a reversal of position on some matters. As a result, companies were able to make new arguments based on a new understanding of how the Staff was going to look at those rules.

For 14a-8(i)(7), the Staff Legal Bulletin announced the resurgence of "micromanagement" as a basis for excluding a shareholder proposal as ordinary business. Basically, the way the Staff interpreted and clarified that it would be viewing that basis for exclusion is that you can rely on that as a basis for exclusion where a proposal involves intricate detail or seeks to impose specific timeframes or methods for implementing complex policies, regardless of whatever the subject matter of the proposal is.

Specifically, with regard to the compensation area, we saw the Staff applying its guidance from the SLB 14J, which said that in applying the ordinary business portion of 14a-8(i)(7) to proposals about executive & director compensation arrangements that are also available or applicable to the general workforce, you must essentially demonstrate both that the aspect of the compensation that was addressed by the proposal is broadly available to the general workforce, and the senior executives' eligibility to receive that aspect of the compensation doesn't implicate significant compensation matters.

The Staff gave us more guidance around the reliance on the ordinary business portion of 14a-8(i)(7) when a board analysis is needed, which was building upon the guidance in Staff Legal Bulletin 14I. What we saw was that it's going to depend on the specific types of situations in terms of the evaluation of the level of significance, particularly where the level of significance is not self-evident, the board may be well positioned to consider, evaluate and provide guidance that the Staff could then look at. That analysis basically must go to the significance of the proposal to the company in a lot of detail.

Then, on the substantially implemented prong of 14a-8(i)(10), when the Staff was looking at things like proposals related to governance changes, the exclusion could be permitted if the company's policies, practices and procedures compare favorably to the actions sought by the proposal.

Where it related to public disclosures that the company had been making, the Staff was able to concur when the company's public disclosures compare favorably to the disclosures that the proposal had sought. Also, in terms of governance changes, it may have made sense in some cases to make the changes and have shareholders approve them in the proxy statement as a basis to ask for the Staff concur that the proposal could be excluded.

In those two areas, we saw a different approach from the Staff, and that led to some different outcomes. One of the things, focusing on executive compensation issues, is we saw a lot of interest in proposals that drilled down on the metrics the companies use to evaluate performance of executives for compensation purposes. That has been a trend we've seen in the last few years.

It was a wide range this season, in terms of the type of proposals. A couple of examples are, first, the proposal from Dale Wannen who is from Sustainvest Asset Management. There was a proposal seeking a report assessing the feasibility of integrating sustainability metrics into the performance quotas for senior executive compensation plans.

That proposal was able to be excluded at Dunkin' Brands. There, the staff concurred that the proposal had been substantially implemented, looking at the policies, practices and procedures that the company had in place and determining they compared favorably to what was being requested in the proposal. The same proposal went to Anthem, Inc., and they were able to exclude it on a proof of ownership issue.

We also saw some other proposals that were looking at compensation targets. AT&T had a proposal that asked the board to amend the compensation of the CEO and COO to include the long-term issuer's debt rating, in an advisory manner, as an incentive metric weighting.

The company basically argued that when you looked at the proposal in coordination with the supporting statement, the proposal was all about the company's debt levels and ratings, as opposed to focusing on senior executive compensation, that would have transcended ordinary business, and basically that the compensation element was "window dressing." The Staff concurred that the proposal could be excluded.

We also saw situations like at Verizon, where they got a proposal requesting that the compensation committee publish a report looking at the feasibility of integrating cyber security and data privacy performance measures in the executive compensation programs. The company argued that was not a senior executive officer issue, it was more of a general company issue. The Staff did not concur with that argument and didn't allow the proposal to be excluded.

Then AbbVie and Johnson & Johnson were two companies that got proposals that asked the board to adopt a policy that no financial performance metric could be adjusted to exclude legal or compliance costs when evaluating performance. The Staff, in a reversal of prior approaches, looked at that as micromanagement and allowed those to be excluded.

Those are just a flavor of some of the things that happened and where the main issues played out in the shareholder proposal season.

Proxy Advisors

Borges: Let me finish up by talking for a minute about the proxy advisors and how they updated their policies for the 2019 proxy season.

Rarely a year goes by where ISS and Glass Lewis don't have some impact on how things play out during the proxy season. This was probably one of the years where they had less of an immediate impact.

Although, certainly there are things that changed in their policies or are about to change which will have an impact going forward. On the ISS front, their board gender diversity policy goes into effect next year. Under this policy, they will recommend an "against" vote for the chair of the nominating and governance committee if there's no gender diversity on the board of directors.

This is a policy that went into effect this year for Glass Lewis, but we are in the grace period for ISS and that will be something that will be on their agendas for next year. There are still approximately 100 boards of directors in the Russell 3000 that were determined not to have any female members. I'm sure they're all working to make sure that they get that addressed if they haven't so far, so they don't end up with an unfavorable vote recommendation next year.

Something else that ISS looked at this year and then ultimately backed off on was the financial performance assessment test in their quantitative review of the executive compensation programs.

If you remember, this is a test that was introduced a couple of years ago which is a secondary screening modifier to their pay-for-performance methodology. For this year, they had proposed, or at least indicated they were considering, changing from using GAAP-based measures to evaluate a company's financial performance against the ISS-constructed peer group to using "Economic Value Added" factors.

Economic Value Added is a way of determining the economic profit of the company based on the net operating profit after taxes, reduced by the cost of capital. ISS has been indicating that they believe there may be additional value to using that as a substitute for GAAP-based measures in order to evaluate how a company's financial performance compares against the competitive market.

For this year, they are simply providing their EVA analysis on an informational basis in the performance reports that they provided on the companies that they analyzed. It was something the companies could look at and get a sense of where they stood relative to their ISS peers using this particular methodology.

It may mean that ISS is going to undertake a more deliberative process in the future in order to standardize the way it evaluates pay-for-performance for purposes of the financial performance assessment test. It is something to keep an eye on. We had some questions this year about what this was all about and what the implications are likely to be for companies going forward. We're still probably not at a point yet where we know how that's going to work out.

The other thing that ISS had indicated it was going to implement this year, but ended up postponing, was their new policy on excessive director compensation. They essentially reset the methodology for how they were going to identify when director compensation was considered excessive relative to market norms. A company that is found to have excessive compensation for two years will receive an unfavorable vote recommendation for the non-employee directors who were responsible for setting director pay. That particular policy will not go into effect until 2020.

So, we know that next year there will be two new policies from ISS that companies need to focus on. They are board gender diversity as well as excessive director compensation.

ISS implemented a couple of other policies this year that didn't have much of an effect on companies, because they were intended to address outliers. One was excessive share capital dilution, which was added under its Equity Plan Scorecard and could result in an automatic negative recommendation for an equity compensation plan if the outstanding share capital dilution was more than 20% in the case of an S&P 500 company, or 25% in the case of a Russell 3000 company.

I'm not aware of any companies that got caught by that this year, but as ISS continues to refine its policies in terms of what it views as good corporate governance and executive compensation practice, it makes it more difficult for companies to navigate these policies and make sure that their plans are designed and operated in a manner that is consistent with the policy guidelines that ISS has in place.

The other notable policy that ISS updated this year related to the change in smaller reporting company status and the fact that more companies are now eligible to file reports as smaller reporting companies and provide reduced disclosure about their executive compensation program. ISS indicated that they were not going to be okay with that, if it meant that it was going to result in reduced clarity or disclosure for shareholders on a company's executive compensation program, even though as a smaller reporting company the company would be technically eligible to use the scaled disclosure system - and, perhaps, not even include a CD&A as part of its executive compensation disclosure.

I'm not sure there were situations where companies who had provided that type of information in the past changed over to the scaled disclosure system, where they essentially weren't providing that kind of information. It's something that companies that are eligible for the new standard must remain aware of, because the proxy advisors are looking at it from the standpoint of whether investors are receiving the same overall level of information that they were eligible to receive previously.

The other thing I would note here is that, in case of the employee stock plans that were put up for shareholder approval through the first portion of the proxy season, there were only two plans that did not receive majority support from their shareholders.

Last year under the ISS standard, there were only two plans all year that didn't receive shareholder approval. We are already at that level this year, and we still have a few more months to go.

The number of plans that were put up for a shareholder vote was lower than in prior years. Last year, the number was down compared to what we saw in 2017. That was certainly true again this year and was probably attributable to the change to Section 162(m) to eliminate the provision for "qualified performance-based compensation."

The last thing I would note here is something we may be talking about in the near future, which is that there appears to be an ongoing rumor that the SEC is going to propose rules that would provide for some level of regulation of the proxy advisors.

I keep reading and hearing that proposed rules are in the works. So far, nothing has been forthcoming, although on the Regulatory Flexibility Agenda that was published a few weeks ago, it was an item that was listed as a near term project. Perhaps we will see something coming up before the end of the year.

Dave or Ron, do either of you have any market intelligence as to whether there's a realistic possibility of a rule proposal in the near future?

Lynn: I think that's still in the rumor phase, but coming from you, it must be a good rumor!

Mueller: Certainly, Chairman Clayton appointed Commissioner Roisman to study and make recommendations on that area, and that's going on.

Part of the focus will be the Congressional Review Act. If there's a change in the administration in 2020, then the new administration can look back and veto rules adopted within a certain amount of time prior to the election.

To avoid being subject to that, any rules must be finalized by this time next year, next April or May. I think agencies in Washington generally are going to be racing to get the rules out before that deadline. I don't know if this one can move that fast, but we'll see.

Proxy Strike Suits

Borges: Should we spend a minute and talk about the strike suits that have popped up during the proxy season?

Mueller: I think the important thing is to realize that these are still going on. These are largely in the area of shareholder approval of stock plans. Some different plaintiffs' lawyers that all seem to use the same plaintiffs have been making demands to companies when there are what might be viewed as either a foot fault or disclosure requirements of debatable applicability under Item 10 of Schedule 14A relating to shareholder approval stock plans.

The plaintiffs' lawyers threaten they might seek an injunction to enjoin the annual meeting unless additional disclosure is provided. Then they might seek attorneys' fees for helping all the shareholders by prompting the companies to provide some additional disclosure.

What's interesting, as Mark mentioned, there was a lower number of plans that went up for a vote this year, probably because of the changes to 162(m), but if you are putting a plan out for vote, it's important to do a fly speck compliance check to be mindful of those lawsuits.

Lynn: That's everything we wanted to cover today. I appreciate you both taking time to walk us through all that. I hope everyone has a great afternoon.