"The Latest: Your Upcoming Proxy Disclosures"

Thursday, January 9, 2020

Audio Archive

Following up where our Fall conference left off, this critical webcast will provide you with all the latest guidance - including the latest SEC positions - about how to use your executive & director pay disclosure to improve voting outcomes and protect your board, as well as how to handle the most difficult ongoing issues that many of us face.

Join these experts:

- **Mark Borges**, Principal, Compensia and Editor of CompensationStandards.com
- **Alan Dye**, Partner, Hogan Lovells LLP and Senior Editor of Section16.net
- **Dave Lynn**, Partner, Morrison & Foerster LLP and Senior Editor of TheCorporateCounsel.net and CompensationStandards.com
- **Ron Mueller**, Partner, Gibson Dunn & Crutcher LLP

Liz Dunshee, *Managing Editor, CompensationStandards.com*: Hi, this is Liz Dunshee, Editor of CompensationStandards.com. Welcome to today's webcast, The Latest: Your Upcoming Proxy Disclosures.

I want to welcome our esteemed panelists and thank them for participating today. We have Mark Borges, a Principal at Compensia and Editor of CompensationStandards.com. Thanks to Mark for putting together the agenda for the program today.

Joining Mark are Alan Dye, a Partner at Hogan Lovells and Senior Editor of Section16.net; Dave Lynn, a Partner at Morrison & Foerster and Senior Editor of TheCorporateCounsel.net and CompensationStandards.com; and Ron Mueller, a Partner at Gibson Dunn.

They're going to pack a lot of information into the next hour. Mark is going to kick things off by covering some of the key lessons from the 2019 proxy season.

2019 Say-on-Pay Results

Mark Borges, *Principal, Compensia, and Editor, CompensationStandards.com*: Thanks Liz and hello everyone, thanks for joining us. As we've traditionally done in past years, we're going to start with the say-on-pay results from the 2019 proxy season and as we generally observed each year, the voting patterns on say-on-pay proposals in 2019 were generally consistent with prior years.

Based on the latest data that I've seen, just over 70% of the companies holding a vote in 2019 received over 90% or more support from shareholders on their named executive officer compensation or their executive compensation program more generally.

If you focus just on companies in the Russell 3000, the percentage was actually even higher at 76% of the companies based on what I saw. And overall a little over 92% of the companies that conducted a say-on-pay vote received more than 70% support on their named executive officer pay, which is entirely consistent with what we've seen over the last nine years.

The number of companies that didn't receive a passing vote on say-on-pay was generally consistent with the results from 2018. I've seen data indicating that overall 60 companies have failed the vote in 2019. I'm not sure if that picks up all of the companies that held meetings near the beginning of December, but at least 56 Russell 3000 companies also failed the vote or are included in that total, which was near the number of failures in 2018.

Last year, you may recall that we were speculating as to whether because of improved efficiencies and the more experience that companies had dealing with say-on-pay, that the number of failed votes was starting to decline. We had seen in 2016 and 2017 that only about 1.5% of the companies that held votes had failed say-on-pay, and then that number went up in 2018. It wasn't clear whether that was an aberration and that the norm was actually somewhat lower, or whether or not we would see a higher rate of failures consistent with what we had seen in previous years.

It appears that more and more 2016 and 2017, when the average number of failed companies was less than 2% of the companies holding votes, were aberrations, and that the norm is somewhere between 2.5% to 3% of companies failing to receive majority support on average. And this is entirely consistent if you look at the 9 years that the say-on-pay vote requirement has been in place. In at least six of those years, the failure rate has been at least 2.5% or higher.

Another statistical note of interest, the average level of support for say-on-pay proposals was approximately 90.5% in 2019, which is consistent with what we saw in 2018, where average support was 90.3%. To me, 90% has become essentially the line of demarcation in terms of what companies are seeking in order to be comfortable that their compensation program is in-step with the expectations and views of their shareholders.

If you look at the data since 2011, the first year of say-on-pay, average support has been consistently at or slightly above the 90% level. The other point about say-on-pay that continues to be of interest to me is the likelihood of a company receiving significant opposition on its proposal in any given year.

While the chances of low support are small, the data seems to suggest that it's inevitable that companies are going to experience what I guess I would characterize as an "off year." The data shows that one-third of the S&P 500 has received vote support below 70% in at least one year since 2011. In fact, 10% of the Russell 3000 and 8% at the S&P 500 have actually failed say-on-pay at least once during that same period.

This to me is clear evidence that we can't take a favorable vote result for granted as well as a reminder that in drafting our disclosure, we need to stay vigilant in being able to frame the discussion effectively as to what our business results were and the correlation between those results and the related executive compensation outcomes.

The ISS approach to say-on-pay proposals continued to be fairly consistent in 2019. ISS recommendations "against" were slightly lower in 2019 than in 2018 - 12.7% compared to 13.9%, but still fairly significant. More notably, ISS continues to wield a great deal of influence on say-on-pay proposals.

From time-to-time, I hear that their influence is waning, but that doesn't appear to be what the data shows. The folks tracking this information note a 30% swing in shareholder support where ISS issues an unfavorable vote recommendation on a say-on-pay proposal. While this continues to be the high-end of the range for what we've seen since 2011, in terms of ISS influence in this area, it seems to be consistent year-over-year in the recent years.

Also, as we know, say-on-pay isn't simply a pass/fail dynamic. Even if you're successful in obtaining a passing score on your say-on-pay proposal, there's a good chance that you may see a decline in support in a given year that represents significant opposition to the proposal in the eyes of one of the major proxy advisors. Specifically, if you'll recall, if you get 30% "against" votes that's considered significant opposition by ISS, while 20% "against" vote is considered significant opposition by Glass Lewis.

Falling below either of these thresholds will trigger an expectation from these proxy advisors that your following year's disclosure is going to address how you responded to the message being sent by shareholders. It's worth pointing out that in its recent policy updates for 2020, Glass Lewis specifically addressed how it expects the company to respond when it has received low shareholder support for its say-on-pay proposal. Like ISS, it not only expects that a company is going to follow-up with its shareholders to understand and address their concerns, but that it's going to provide robust disclosure in its next proxy statement of the company's engagement activities and any specific changes that were made in response to shareholder feedback.

In the absence of such disclosure, Glass Lewis may consider recommending a vote "against" the upcoming say-on-pay proposal. As a practical matter, this new policy simply conforms to what ISS has been doing for a number of years with respect to say-on-pay, albeit at a lower threshold level of opposition.

Consequently, if you're a company that received less than 90% support for your say-on-pay proposal in 2019, it's important to determine whether you've triggered the responsiveness policy for ISS, Glass Lewis or both. In any case if this is your situation, it's now expected that your CD&A is going to describe your shareholder engagement activities and then explain how you responded to the feedback received; either by making changes to your program or policies or explaining why such changes aren't really necessary.

The key point here is that if you've had a significant number of votes cast against your say-on-pay proposal, the major proxy advisors have become laser-focused on what you did in response and the disclosure that you're providing about your subsequent engagement process.

Generally, your disclosures should describe your shareholder outreach efforts, how many shareholders you contacted and what percentage of your shareholder base they represent, who participated in your outreach activities, including whether the independent directors participated and the specific actions that we're taken in response to the feedback that you received. At a minimum, this is what your disclosures should cover.

2019 CEO Pay Ratio Disclosure

Borges: With that, let me switch over to talk for a minute about pay ratio. As for pay ratio, 2019, which was the second year of the disclosure requirement, was much like year one, which for most companies was generally good news. So far through two reporting cycles, there really hasn't been much of a reaction to the ratio.

Certainly, there are exceptions to that, but from either shareholders or employees, we haven't seen the kind of adverse reaction that many others feared in the run-up to the initial disclosures. Now, that may still be coming this year, next year, or years after. But so far, the disclosure has just sort of blended in with the other compensation related information that companies provide in their proxy statements.

With respect to the data generally, based on the statistics that I've seen, the ratios and median employee compensation was slightly higher in 2019 than it was in 2018. For the S&P 500, the median pay ratio was 169 to 1. For the Russell 3000, it was roughly half of that: 77 to 1. And median annual total compensation disclosed for the median employee was around $69,000 for the S&P 500 and $65,000 for the Russell 3000. In any event, these figures didn't seem to trigger much of a reaction this past year, either on an absolute or relative basis.

As for the disclosures that we saw, you may recall that near the end of 2018, a group of institutional investors organized and sent letters to Fortune 500 companies basically asking for more detail in their pay ratio disclosure. In particular, these investors indicated that, because of the disclosure of the median employee pay provided a reference point for understanding the company's workforce, companies should provide more information that would put this pay data into context. In particular, companies should expand their disclosure to provide more information about their overall approach to human capital management.

From what I saw in 2019, this didn't really happen - or it simply hasn't happened yet. There were a few disclosures that were responsive in specific ways. For example, if you want to see one, take a look at the disclosure of CVS Health. Otherwise, companies didn't really touch upon a lot of the items that were identified in these letters.

As we are going to discuss a little bit later in the hour, during 2019, the SEC proposed changes to Form 10-K that would require certain disclosure around human capital management matters. So perhaps the issue's going to get addressed as part of that eventual disclosure. But, bottom line, I didn't see many companies that took up the invitation to provide contextual disclosure about their workforce as part of their pay ratio disclosure.

In addition, from what I've seen, about 10% of the companies that provided pay ratio disclosure included supplemental information including, in some instances, an alternative pay ratio. However, most of these disclosures centered on explaining anomalies in CEO pay that affected the ratio on an absolute basis or relative to the prior year's ratio.

In addition, some companies use supplemental ratios to frame the discussion around the employee groups that they felt best represented their true ratio, such as U.S. employees or full-time employees. Also, with two years of pay ratio in the books, I thought we might see disclosures addressing the year-over-year differences in the ratios. Particularly why there was a significant increase or decrease in the ratio from one year to the next. Such disclosure is not required, but I assumed that companies would be sensitive to these changes and, in anticipating investor questions, be more proactive by saying something about it as part of their disclosure.

While I saw some instances of this disclosure, it wasn't nearly as prevalent as I expected it to be. Obviously the need for such disclosure has to be evaluated on a case-by-case basis. While I'm not expecting a wholesale movement towards analytical comparisons year-over-year, it's probably something that you want to think about and be aware of as some investors will be conducting year-over-year comparisons of their disclosures and will have these types of questions. It's a situation that's probably only going to become more acute as we layer on another year of ratios this year and with each subsequent passing year.

With that, let me stop for a moment and turn things over to Alan, who I think is going to talk a little bit about what we saw in the shareholder proposal arena.

2019 Shareholder Proposal Trends

Alan Dye, *Partner, Hogan Lovells, and Senior Editor, Section16.net*: Yes, thanks Mark. I will start by talking about what we saw in 2019 in the shareholder proposal arena, particularly trends that we saw, and then I'll try to wrap it up by making some observations about late breaking developments at the end of 2019 that may have an impact on this year's proxy season or future proxy seasons for shareholder proposals.

First, just to recap briefly the shareholder proposal results from 2019, the trend in 2019 was consistent with what we've seen in the last few years. The number of shareholder proposals submitted to companies declined as compared to 2018. There were around 700 shareholder proposals submitted to companies in 2019, which is down from 788 in 2018 and down from 836 in 2017.

The largest decline has been in the environmental, social and political proposals, or "ESP proposals," which were down about 12%. Compensation-related proposals were down as well, but not by as much. Governance proposals were down slightly as well. But despite the comparatively larger percentage decline in ESP proposals, ESP proposals outnumbered governance proposals, which in past years have been a more popular area for shareholder proposals. ESP proposals outnumbered governance proposals for the third consecutive year, with 323 ESP proposals in 2019 and 303 governance proposals.

Political contributions and lobbying proposals were the most common of the ESP proposals in 2019. They represented about 29% of the proposals, or a total of 93. The number of proposals that actually made it into proxy statements and went all the way to a vote declined as well. That number was 371 in 2019 as compared to 415 in 2018.

Again, though, ESP proposals got more focus at shareholder meetings, because the percentage of ESP proposals that actually went to a vote rose to 45% of all proposals as compared to 35% of all ESP proposals in 2018. But it seems to be more difficult for companies to negotiate a withdrawal of political proposals than most of the other types of proposals. This is probably because there's not quite as much room for finding a compromise or common ground on a company's disclosure of its political contributions.

While fewer proposals in absolute numbers went to a vote, the number of proposals that passed by getting a majority of votes cast was up. There were approximately 40 proposals in 2018 that passed, but over 50 passed in 2019. None of those proposals were ESP proposals, and something north of 40 were governance proposals: such things as right to call a special meeting or declassification of a board or elimination of super majority voting requirements.

The number of compensation-related proposals was down slightly at around 50. The success rate continued to decline for compensation-related proposals, which tend to get a relatively small number of votes in support. Two compensation-related proposals passed in 2019, however, both of which related to clawbacks.

It is difficult to know the number of proposals that were withdrawn, because there isn't public visibility into withdrawals unless a company submits a no-action letter and then the proponent later withdraws the proposal, or a proponent announces on its website or otherwise that it has withdrawn a proposal. But from what can be determined from public records, about 28% of shareholder proposals were withdrawn last year.

That continues to suggest that negotiating with proponents can be successful in keeping a proposal out of the proxy statement. Often, that requires some form of compromise with the proponent, but in any event, it can help avoid having a shareholder vote on a proposal that the company may not want to put before its shareholders.

I think some proposals that might otherwise have been withdrawn were never submitted, because the company's engagement with the shareholder prior to the beginning of proxy season addressed concerns that might otherwise have led to a shareholder proposal . It's a reminder for companies to continue to pursue, in their annual shareholder engagement efforts, discussion of any issues known to be of concern to shareholders, or that are frequent topics for shareholder proposals, so that those issues can be worked out long before a shareholder might reach a point of frustration that would lead it to submit a shareholder proposal.

Staff Legal Bulletin No. 14K

Dye: A couple of developments occurred late in the year last year. In October of 2019, the Staff issued Staff Legal Bulletin No. 14K. It's the third year in a row that the Staff has issued a Staff Legal Bulletin to address shareholder proposals, particularly the ordinary business exception. The Staff Legal Bulletin was helpful in that it tried to focus companies on what a board analysis should look like when a company submits a no-action letter seeking to exclude a proposal based on the ordinary business exception where the argument is that a social issue raised by the proposal isn't significant to the company.

The Staff said in that Staff Legal Bulletin that a no-action letter should set forth a well-developed a discussion of the board's analysis and should address two elements in particular. The first element is the difference, or "delta," between the specific request in a proposal and the actions that the company has already taken. In other words, the discussion should address the significance of the incremental step that the proposal is asking the company to take is compared to what the company may already have done in addressing the issue.

The second element is to discuss is prior voting results on a particular issue. So if an issue that's being presented in a proposal has already been addressed in a prior shareholder vote, the extent to which the prior vote might suggest that the issue is not significant - particularly if the company has taken action in response to the vote on the issue in the past - might have a bearing on whether the Staff would be willing to agree that the proposal doesn't raise a significant issue for the particular company.

Other issues were addressed in the Staff Legal Bulletin as well, but I don't think they're as pertinent to this year's process as the Staff's clarification of what should be included in a well-developed board discussion. We're already seeing no-action letters submitted under the (i)(7) exception, with arguments that address the factors discussed in Staff Legal Bulletin 14K. While there are only 22 responses to no-action letters posted on the SEC's website for this proxy season, one of those responses allowed exclusion of a proposal under Rule 14a-8(i)(7), and expressly noted the board's analysis of both the delta issue and prior votes on a substantially similar proposal.

Staff Oral No-Action Responses or Decline to State a View

Dye: Separately, the Staff announced in September 2019 some changes to the process for responding to requests for no-action relief on shareholder proposals. There were essentially two elements to the change - one is that the Staff said that it may now respond orally to a no-action letter request instead of responding in writing.

The Staff said that it would respond orally in circumstances where it believes that providing more broadly applicable advice isn't necessary, and would reserve written responses for those circumstances where the rest of the public might gain some benefit from seeing Staff guidance in the written response.

The second element of the Staff announcement was that the Staff might decline to state a view at all in response to a no-action letter request, and leave it to the issuer and shareholder to decide what to do in the absence of staff guidance, including whether or not to litigate the issue.

The announcement initially caused concern for two reasons: one, with respect to oral responses, there was a concern about how the rest of the public would know the Staff's reasoning if it's shared only orally with the proponent and the company.

The second concern was that, if the Staff declines to express a view regarding a proposal, will that mean that if the company decides to stand by its convictions and exclude the proposal, ISS and Glass Lewis will take a negative action regarding the company? Both ISS and Glass Lewis have policies that generally provide that if the company doesn't have a no-action letter as a basis for excluding a proposal, then ISS or Glass Lewis may make a recommendation against re-election of the members of the compensation committee or all of the company's directors.

Ultimately, the Staff clarified its position and I believe has made it clear that when it said it might respond orally, it didn't mean that an oral response would be the sole communication of its disposition of the request. What appears to be playing out in practice is that the Staff will notify the proponent and the company if it doesn't intend to issue a written response, and then will post a brief summary of its disposition of the request on a chart that Corp Fin now has on its website called the "shareholder proposal no-action chart."

That chart lists the name of the company and the name of the proponent in different columns, the basis for the requested exclusion in another column, whether the Staff concurred or did not concur, and then in another column whether a written response was issued. There are 22 letters addressed in that chart through December 20, which is most recent date through which the Staff has updated the chart.

It looks like there have been no requests on which the Staff has declined to take a position, and the Staff has said that it's highly unlikely that it will decide not to take a position on a proposal. But, they're making a lot of use of not issuing any written response at all, particularly on the routine matters, which tend to be the no-action letters based on some procedural problem like the proponent's failure to submit proof of ownership.

The Staff also assuaged the second concern by saying that it didn't mean to suggest that it intends to make more frequent use of its ability to not take a position at all on a proposal. The Staff has always had the ability to decline to take a position on a no-action letter request, and it doesn't expect to do that any more often now than it did in the past. Again, so far, based on the 22 responses that the Staff is posted on its website, there haven't been any refusals to respond. So, there is probably not a reason to be concerned about the Glass Lewis and ISS policies.

Proposed Amendments to Rule 14a-8

Dye: One other development that I will touch on related to shareholder proposals is the proposed amendments to Rule 14a-8. I won't dwell on those because there is likely to be a great deal of change in the give-and-take of the comment process. But, the SEC has proposed to amend Rule 14a-8 to amend the eligibility requirements for shareholders to submit a proposal.

The current rule provides that, to be eligible to submit a proposal, a shareholder must hold at least $2,000 worth of shares or 1% of the company's outstanding equity and must have held that amount for at least one year prior to the date of submission of the proposal. The proposed amendments would make it more difficult for a shareholder to meet the eligibility requirements by implementing a tiered structure for the minimum ownership requirement.

Under the proposed amendments, a shareholder who owns at least $2,000 worth of the registrant's shares for 3 years instead of 1 year would be eligible to submit a proposal. A shareholder who has owned at least $15,000 worth of shares for at least two years also would be eligible to submit a proposal. And a shareholder who owned at least $25,000 of the registrant's securities for at least one year would be eligible to submit a proposal.

The other change to Rule 14a-8 would increase the resubmission thresholds for submitting a shareholder proposal. Under the current rule, if a proposal deals with substantially the same subject matter as another proposal that has been voted on by shareholders in the last three years, it may be excludable, depending on the percentage of the shares that voted in favor of the proposal the last time it was submitted.

The level of support a proposal would have to receive to be eligible for resubmission would depend, as it does now, on how many times the proposal was submitted in the past five years. Currently, if a substantially similar proposal has been voted on only once in the last five years, a proposal may be resubmitted if the prior proposal received 3% of the votes cast. That 3% would go to 5% under the proposed rules.

If the shareholder proposal had been voted on twice in the last 5 years, the current rule allows resubmission if there was a vote in favor of at least 6%. Under the proposed amendments, 6% would go to 15%.

Finally, if the proposal has gone to a vote three or more times in the last 5 years, the current resubmission threshold is 10% of votes in favor, and that number would go to 25%.

I'll stop there on shareholder proposals and I'll move on to one other issue, which is smaller reporting company status, before turning it back over to Mark to give us some predictions for the 2020 proxy season.

Smaller Reporting Company Status

Dye: In 2018, the Commission amended the definition of "smaller reporting company" to expand the number of smaller companies that are eligible to utilize the scaled disclosure requirements in several provisions of Regulation S-K and Regulation S-X.

Before, a company was a smaller reporting company if it had a public float of less than $75 million. Now that $75-million number has been increased to $250 million.

There were other changes to the definition as well that have increased the number of companies that are smaller reporting companies and are eligible to use the scaled disclosure system. The SEC estimated in the adopting release that the expanded definition would add 966 new registrants to the pool of smaller reporting companies, which the SEC said at the time was already 2,400. So, some 3,400 companies should now qualify as smaller reporting companies.

That means that an expanded number of companies are eligible to use scaled reporting. Among the requirements that smaller reporting companies don't have to comply with are various provisions of Item 402, including the requirement to provide a Compensation Discussion & Analysis and a Grants of Plan-Based Awards table.

So, another 966 companies should be eligible to reduce their disclosure in their proxy statements or in any case under Item 402. There is a significant drawback to doing that, though, because the reaction of ISS and Glass Lewis to the expanded definition of smaller reporting company was that companies nevertheless need to continue to make disclosures that are sufficient to allow shareholders to meaningfully assess the company's compensation philosophy and practices.

ISS in particular specifically noted that the CD&A is important to understanding a company's compensation philosophy and practices. So, it remains to be seen whether companies - existing SRCs and newly added ones - will find it advantageous to take advantage of the scaled disclosure in Item 402.

Mark, let me turn it back over to you now to predict the 2020 Proxy Season.

Hedging Disclosure

Borges: Sure. Let me pick up and see if I could move quickly through a couple of items, starting with the new hedging disclosure requirements.

As we all know, there's a new governance disclosure requirement this proxy season - the hedging requirement of Item 407(i) of Regulation S-K. While technically the requirement went into effect 6 months ago, except for smaller reporting companies and EGCs, for whom it goes into effect this July 1st, most companies will be encountering the new rule for the first time during the 2020 proxy season. At a high level, the new rule requires companies to disclose their policies around the hedging activities of their employees, officers, and directors.

As I'm sure you're aware, most companies have been addressing their hedging policies that apply to their executive officers in their CD&As for several years. Perhaps even more importantly, most companies have an affirmative policy that prohibits their executive officers and directors from engaging in hedging transactions.

For most companies, this new requirement is probably only going to involve what I characterize as "incremental disclosure." It's worth noting, however, that the SEC uses a principles-based approach when it drafted Item 407(i). Perhaps more importantly, it didn't define hedging. Instead it says that a company needs to evaluate its policies or practices that apply to the various arrangements that may be conducted by its employees or directors on the basis of whether they may have the same economic effects as a transaction specified in the statute.

Consequently, at the end of the day, companies are going to have to exercise their own judgment about whether transactions or the policies and practices they have around those transactions are subject to disclosure.

As for the disclosure itself, here are a few points to consider. Under the rule, you need to provide either fair and accurate summary of your applicable policies and practices, including who they apply to and the categories of transactions that are specifically permitted or specifically disallowed or disclosed the practices, or provide the policies in full.

If you have a policy that doesn't apply to the entire employee population, all you have to do is focus on the ones that are subject to the policy. You're not required to further disclose that you don't have a policy for your other employees or directors depending upon what category isn't subject to the policy.

In my experience, secondly, many hedging policies are added in insider trading policies. So often you're going to have to parse the language of the broader policy to understand how the hedging policy operates. To date, most companies have provided the summary of their policy in their disclosure, but the real evidence of what the prevailing practice is going to be won't be known until we've gone through this particular proxy season.

Also, the adopting release contemplates that companies will provide their hedging disclosure outside of their CD&A, presumably as part of their corporate governance disclosure, which is where I've been seeing most of the disclosures so far. Then companies are providing a separate disclosure in the CD&A as it pertains to their named executive officers if applicable.

However, you can use your Item 407(i) disclosure to satisfy your CD&A disclosure obligation, if any, as long as the broader disclosure addresses what's required by the CD&A disclosure and it's either located within the CD&A or incorporated by reference into the CD&A.

While disclosing the information in the CD&A may appear to be the most expedient alternative, remember that if you do so, it's covered by the compensation committee report and part of what is subject to your say-on-pay vote.

Nonetheless, I would say at this point, much of the disclosure that I've seen has been included in the CD&A, perhaps because of the relatively straightforward nature of the disclosure that's being provided, since most companies generally has a flat prohibition on any type of hedging transaction.

But if this is a potential issue for you, it's something you need to consider in terms of deciding the appropriate spot for your disclosure.

Year 3 Pay Ratio Disclosure

Borges: Finally, let me just spend a minute talking about pay ratio disclosure for year 3. As you know, the SEC framed the CEO pay ratio rule so that companies were only required to identify their median employee once every 3 years and then calculate compensation for that employee each year.

Specifically, the rule provides that if there's been no change in your employee population or employee compensation arrangements that you reasonably believe will lead to a significant change in your pay ratio disclosure, then it's permissible to use the same employee in year two and again in year three.

I expected that virtually every company would take advantage of this provision so that they could avoid the effort involved in having to identify a new median employee. Much to my surprise however, this didn't happen. While probably more companies use the same median employee than did not, a significant number of companies indicated in their disclosure that they had gone through the process of identifying a new median employee for the 2019 pay ratio.

While I'm not exactly sure why that happened, I can think of two possible reasons. One, having developed a detailed methodology for identifying the median employee for their initial pay ratio disclosure, it simply wasn't that difficult, time-consuming or complex to run the methodology again for purposes of coming up with the median employee for 2019.

Second, as it may have turned out, many companies struggle to determine whether the year-over-year changes in their employee population were sufficiently benign to enable them to use the same median employee again. I ran into a number of instances where it wasn't really clear whether an employee population change was going to change the pay ratio in a way that was significant. As a result, out of an abundance of caution, it was simply easier and more straightforward to re-identify the median employee.

That issue's going to come up again this year, and for many companies it will be more acute, because now you're talking about two years' worth of changes in terms of your employee population or even your employee compensation levels.

So that's something to keep in mind as you head into the third year of disclosure because it's not clear to me that whether companies will continue to be comfortable that they can continue to use their median employee that they identified in year one.

Now the one thing I would note here is that I believe that the SEC really was expecting that you would have to have a truly significant change in your pay ratio in order to be precluded from using the same median employee that you used in the prior year. But that's the factual issue that companies are going to face, and I think that's probably the biggest challenge that they're going to have going into year 3; that is, determining whether there have been changes in their employee population that could potentially be characterized as leading to a significant change in their pay ratio.

Re-Proposal of Clawback Rule

Borges: Finally, the one thing I would note here is we've still got two pending Dodd-Frank rule making projects involving compensation disclosure-related items, the pay-for-performance disclosure requirement and the clawback policy requirement. I want to call to your attention that the SEC recently moved the proposed clawback policy rule to its active list on the Reg Flex Agenda and so we may see a re-proposal of the clawback rule sometime later this year.

Ron, let me now turn it over to you for your discussion.

Ron Mueller, *Partner, Gibson Dunn*: Sure, thanks Mark. Let me just also touch on two things on what Mark was talking about. One, on the hedging policy disclosures, my experience has certainly been the same as Mark's, both about companies providing the "fair and accurate summary" and intending to put it in the CD&A.

TheCorporateCounsel.net website actually has a short survey, that's posted right now that people can go and participate in and that may help us if you want to spend a few minutes looking at that and that may help us all get a better feel about what to expect going forward.

On the pay ratio issues, again of course I agree with Mark. I think the two challenges that we're seeing are when there has been turnover in the CEO during the year.

There's been interpretive questions on that, and I think we talked about that on one of these webcasts earlier. Those issues continue to come up about how companies should apply the rules when they've had several CEOs during the course of the year, and how does that interact with the standard for using the previous determination of who is the median employee.

Then just one other factor that companies are running into when evaluating whether to use the same median employee is whether that particular median employee, or maybe the group of people who were around the median, now two years out are having very divergent compensation trajectories or experiences.

I do think we might see more companies go and just run the calculation again rather than taking the risk that the person - the median compensation that they have picked this year - turns out to be a little off-base and when they run the numbers next year, if they're forced to identify a new median next year, they might have a big change in their median employee compensation and that might generate some stories that really aren't justified, but it's just going to be easier to maybe to say "no, let's do it again this year."

Clawback Policies

Mueller: The other thing I am going to talk about briefly is clawback policies. Here again, as Mark mentioned, rulemaking is pending at the SEC. Again, private ordering, real world practice, is far surpassing what the SEC was focusing on and we do continue to see focus on clawback policies both whenever a company is having some troubles in their business or even when there is some heightened focus on the industry in general.

We're seeing shareholders focusing on clawback policies, and as Alan mentioned, the shareholder proposals in this area appear very popular. I have had a lot of clients revisit their clawback policies over the past year, often kind of doing this in connection with hedging policies.

We're seeing a movement towards detrimental conduct, still no uniform definition of "detrimental conduct" being a triggering event, but I do think this is something that companies should focus on - both the underlying policy and their disclosures on it.

I don't want to spend too much time on the disclosure piece, except I'll touch on one thing. We've seen a little bit on the CompensationStandards.com website lately, and in

The Corporate Executive, about the length of CD&A. Yet you get a webcast with like this when we're all talking about additional disclosure issues.

I think we might start seeing a trend towards kind of a discussion, maybe even a little box somewhere, that sets forth all of your compensation and corporate governance policies and kind of ticks through the hedging policies, clawback policy, and some of these other issues rather than integrating it into a narrative overview of the CD&A or the back part of the CD&A. So that is something you may want to consider as you're focusing on the formatting of your proxy. Alan?

ESG Issues

Dye: Yes, thanks Ron. I'll just touch very briefly on ESG issues as they relate to compensation. Companies are under increasing pressure both from shareholder interest groups and from shareholder proponents to add environmental and social objectives or goals to the metrics included in executive compensation incentive programs.

Liz has another webcast coming up on this topic in a couple of weeks where panelists will address those issues in detail, so I won't touch on those here. I will add only that, in addition to having ESG issues as elements of compensation metrics, it can be helpful to companies to include on their website, as many companies do, as much information as they can about issues that they know are of concern to shareholders.

Whether it's how the company is addressing climate change, how the company is attempting to achieve diversity goals, what the company is doing or what its policies are with respect to pay equity and that sort of thing.

Those voluntary disclosures can be useful for a couple of reasons. First, they can head off shareholder proposals on those subjects. They also can help a company make an argument to the SEC that the company has substantially implemented a proposal if the company receives a proposal requesting action or a report on the same subject.

In addition to keeping stockholders happy, voluntary disclosures can have a bearing on ratings by ISS and Glass Lewis, both of which will look at a company's public disclosures wherever those disclosures are on certain initiatives. ISS and Glass Lewis then include ratings or rankings or other input in the reports that they send to their clients about the company's ESG profile or ESG risk. So, that's another reason to pay attention to ESG issues.

And with that, I will turn it back over to you, Ron.

Proxy Statement Drafting

Mueller: Let me pick up on that theme. This is the discussion in the front half of the proxy as opposed to the back half with the compensation. There is, over recent years, increased focus on the front half of the proxy. As Alan mentioned, one of the increasing focuses - we see it in just so many different areas, whether it's the Business Roundtable statement or other areas - is board oversight of various issues. It's been a hot topic in shareholder proposals, many of them this year are phrased in terms of focus on board oversight of literally every issue under the sun.

Among our clients, we are seeing a lot of attention to those considerations. Both in the proxy statement disclosures and in the underlying governance documents, primarily the committee charters, but sometimes also the corporate governance guidelines, there is express reference to human capital management. There are express references to a committee or the board's oversight of corporate culture and issues like that.

And so this is an area that again, over this year and the next year, I think the statistics will change dramatically as far as the number of companies that we see that expressly address the compensation committee, which seems to be the committee typically having oversight of human capital management issues, and various types of elaboration of detail of what that involves.

Then often times, even if the charter has not been amended, we might see some discussion of that in the proxy statement and viewed as a little bit more of a fluid document where you can adjust your discussions from year-to-year, as Alan was saying, based on what topics your companies are hearing from their shareholders about.

So, the front section of the proxy, which often has a little bit more stasis than the back part, is worth reviewing. To the extent your board and your board committees are spending time with oversight of human capital management issues or more broadly other ESG supply chain type issues, that should be clearly reflected in the proxy statement.

So, let me turn it back to you Alan.

Equity Plan Proposals

Dye: Just a couple of other things to be mindful of in drafting proxy statements, particularly on equity plan proposals. There's still an active and aggressive plaintiffs' bar that is submitting demand letters to companies from time-to-time, alleging deficiencies in the company's proxy disclosure and threatening to seek to enjoin the annual meeting unless the proxy statement is revised and recirculated to shareholders.

Some of those demand letters related to very minor points. There were two cases that actually led to the filing of lawsuits last year where the plaintiffs' lawyers allege that the company hadn't adequately disclosed the impact of broker non-votes on approval of an equity plan.

Their intention, as I understand it, is to try to extract a settlement out of the company right away, mainly in the form of attorney's fees for the benefit that the firm has conferred on the company for pointing out its failures to comply with the disclosure requirements.

Some of those letters have focused primarily on Item 10 of Schedule 14A, and whether the proxy statement has complied with every element of Item 10 of Schedule 14A. Not that people don't already do a rules check on their disclosures, but given the environment it probably makes sense to do a double-check to make sure that all the disclosures in the proxy statement, at least as they relate to the equity plan, have been ticked and tied.

And now I will turn it over to Dave.

Director Compensation

Dave Lynn, *Partner, Morrison & Foerster, and Senior Editor, CompensationStandards.com*: Thanks Alan. I'm going to talk about some of the board of directors-oriented issues that have been coming up and that will continue to influence things in the 2020 proxy season. The first one that's certainly on peoples' minds is director compensation.

This goes back to the *Investors Bancorp* case that came out of Delaware back at the end of 2017, which basically said that the decision to grant compensatory awards to directors is not entitled to the protection of the business judgment rule at the pleading stage if the plaintiff properly alleged that the discretion was inequitably exercised, even if you were within a shareholder-approved limit.

That has focused a lot of people's attention on director compensation in terms of how the director compensation is being approved and considered by the board, and also how it's disclosed to shareholders.

Some of the takeaways that we have seen emerge in the last year and a half or so is that people have been looking to either retain or establish "meaningful limits" on the directors' compensation within their incentive compensation plans, and trying to make sure there's a rigorous process around the establishment of director compensation. That includes having more transparency and proxy statement disclosure about that process.

Things like a "mini CD&A" for director compensation, that's the direction some companies have headed in. As part of that rigorous process, I think looking at peer companies is certainly something that you see more frequently. While it's always been done in some cases, peer company review is more attractive in a post *Investors Bancorp* world, just to ensure the breadth and depth of the process, and that's usually done using the services of compensation consultants.

Then also, moving away from discretionary type of arrangements to more formula-based compensation for directors. That's another outcome of this case and the fear of the flood of lawsuits that could happen as a result. Some companies are just moving to a more formula-based approach for director compensation.

So, we'll see that continue to evolve, I think, particularly for the proxy season. I would say, take a look at your disclosure and think about whether there are things that you could do more generally to describe the process that's undertaken, and try to discourage people from pursuing the company on that point.

Board Gender & Ethnic Diversity

Lynn: The second topic I wanted to mention was gender and ethnic diversity on boards. This topic obviously has been front and center during the last few proxy seasons and it's an important topic for many boards to consider and to address.

This year, ISS's diversity policy goes into effect for Russell 3000 or S&P 1500 index companies. ISS will generally vote "against" or "withhold" from the chair of the nominating committee, or other directors on a case-by-case basis, at companies where there are no women on the board. They will consider a number of mitigating factors that may be employed, like making a firm commitment to put a woman on the board. I think this will evolve over time as ISS implements that policy, but for now that's something that will be new for this proxy season.

Also, at the end of last year, the New York City Comptroller, Scott Stringer, announced the "Board Room Accountability Project 3.0." This was targeting 56 S&P 500 companies to adopt a diversity search policy, where the initial list of candidates from which new directors and CEOs are chosen would include female and racially and ethnically diverse candidates. The idea is that it may cause some companies to look for directors outside of traditional roles, or even consider sources like government, academia, nonprofit organizations, and the like. This is sort of a "Rooney Rule" concept here that the NYC Comptroller is advancing, and some proposals have been filed in this regard and letters have been sent to companies.

Then, against all that backdrop, you have the legal developments, which is the California law that went into effect that requires women on the board of directors of companies that have principal executive offices in the state of California.

Some other states have also adopted disclosure-oriented laws around that; states like Illinois and New York, there's been legislation pending in other jurisdictions including Colorado, Pennsylvania and Massachusetts.

So that's something I think that will continue to develop, and there's no doubt that the board diversity will be an important topic this year during the proxy season.

▲ Overboarding

Lynn: The last thing I was going to mention is overboarding considerations. I think overboarding has obviously been a long-term concern and we're seeing perhaps more clarity around how exactly you measure overboarding.

If I had to pin it down, I'd say that while there's a lot of variability in investor policies and the way that ISS and Glass Lewis look at it, two total boards for the CEO and maybe up to 4 total board seats for other directors, that's sort of the framework through which we're seeing this addressed.

In 2019, you had some of the major asset managers making their policies stricter on overboarding, and that focused a lot of attention on the topic, and also contributed to one of the highest levels of director oppositions since 2011.

So what I'm seeing in this proxy season is a number of situations where people want to have some sort of disclosure in the proxy statement that a director that is up for election is coming off the board of another company, when that's been announced, and adding some sort of disclosure to indicate that this shouldn't be a concern from an overboarding perspective because prospectively the director will be leaving that board.

With that, I'm going to turn it over to Ron to talk about good old Section 162(m).

▲ Section 162(m)

Mueller: Sure, thanks Dave. And for the audience obviously we're as usual running a little bit over, but we'll be wrapping up shortly. It just shows how much is going on in proxy season and proxy statements. So, Section 162(m) is no exception. Here, we continue to deal with the consequences of the changes to Section 162(m) under the Tax Act.

There are two things, particularly, that we're seeing on this. One affects the CD&A, and that's really the discussion about 162(m) in the CD&A. Ideally the CD&A is talking about how different issues and considerations affect the design of executive compensation. Now that the Section 162(m) performance-based exception has been repealed, increasingly that is not a factor that's taken into account, as it may have been at some companies in the past for the determination of executive compensation.

Some companies are looking at their historic disclosure in the CD&A about 162(m), and concluding they really don't have anything to say there anymore because it's not a factor, or they're not designing compensation to be "performance based" under 162(m). Rather, they're designing it in light of all the other considerations they've talked about in the rest of the CD&A.

I do have several bold clients who have actually dropped the 162(m) discussion from their CD&A, and we might see more and more of that in the coming year.

Where 162(m) is relevant still, and I think we're just starting to see the effects of that, is the fact that there's a new approach under the statute that is kind of, "once a Section 162(m) covered employee, always a covered employee."

What that means is there's now also increasing divergence between the standard that makes someone a 162(m) covered employee, versus what results in someone appearing in the Summary Compensation Table.

First of all, that's making it a lot more difficult to track covered employees, and so tax departments are having to make sure that they're following that separately. But it adds a great significance to someone popping into the Summary Compensation Table and including them, even if that person is not an executive officer at the end of the year. Because showing up in the Summary Compensation Table, can result in that person being a "covered employee" for their entire career.

So that has put increased focus on what types of compensation arrangements get counted and make someone show up in the Summary Compensation Table and how do those rules align with the tax rules, because it's not exact alignment.

I'm also starting to see it affect new hire packages, whereas in the past there might not be a concern if someone is going to be an NEO in the first year of their employment because of the new hire package, but then will not be in subsequent years. Now that would mean that person's compensation over $1 million for the rest of their career is not going to be deductible. So, both on the new hire and on the exit packages, it's well worth focusing on the question of, "Is this going to push someone into the Summary Comp Table, and are we comfortable with the tax implications of that?" Dave?

Proxy Advisors

Lynn: Thanks, Ron. Lastly, I'll touch on proxy advisors. ISS and Glass Lewis did their usual updates of their proxy voting guidelines as well as some tweaks to the methodology for evaluating compensation versus performance.

I'm not going to go into the details, rather I was going to focus on a question that comes up this year: "What is the impact of the SEC's attention to proxy advisors in 2019 on how one will interact proxy advisors in 2020?"

Just to review what happened in 2019, you had the SEC Staff first provide interpretive guidance around the applicability of the proxy rules to ISS and Glass Lewis and the other proxy advisors already out there. And then you subsequently had an elevation of that interpretive advice to the Commission level in 2019, and proposals in terms rulemaking to address the proxy advisor concerns.

The one thing I would focus on, just for the purposes of this discussion, is that a lot of attention in the SEC's interpretive release where the Staff guidance was elevated, was fixated on errors and problems from a methodological standpoint in proxy advisor reports.

I think that creates opportunities in 2020 for companies to revisit their strategy around whether they should put forth some additional soliciting material when the proxy voting guidance comes out because of concern about the information that's included in that report, including the conclusions that are reached and the factual matters that are addressed.

When we originally started out with say-on-pay, there was a lot of use of the additional soliciting material in response to the say-on-pay recommendations. Then that died down to some extent, because people got comfortable that they were able to address the proxy advisor recommendations more proactively in the proxy statement as opposed to additional soliciting materials.

But given this renewed focus around the accuracy of voting advice coming from the proxy advisors, it's a good time to revisit whether there's a need to say anything when you don't agree with what ISS or Glass Lewis is saying and their recommendation. And so that'll be something we'll all be having discussions about as proxy season unfolds.

And with that, I think those are all the topics we wanted to cover today.

Dunshee: Thanks Dave, and thank you to all of our panelists, for sharing their insights today. And also, thanks to everyone who joined us.