Harvard Roundtable on Executive Compensation and Corporate Governance

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Background Materials

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The Harvard Law School Forum on Corporate Governance and Financial Regulation
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A Say on "Say-on-Pay": Assessing Impact After Four Years

Posted by Joseph E. Bachelder III, McCarter & English, LLP, on Friday April 3, 2015

Editor's Note: Joseph Bachelder is special counsel in the Tax, Employee Benefits & Private Clients practice group at McCarter & English, LLP. The following post is based on an article by Mr. Bachelder, with assistance from Andy Tsang, which first appeared in the *New York Law Journal*.

The 2015 proxy season is the fifth one in which shareholders of thousands of publicly traded corporations have cast non-binding votes on the executive pay programs of the companies in which they are invested. The holding of such a vote, commonly known as Say-on-Pay, is required under Section 951 of the Dodd-Frank law.[1] That requirement applies to most publicly traded companies. Following are some observations on Say-on-Pay.

Results of Votes

In each of the four years of Say-on-Pay—2011-2014 proxy seasons—at the Russell 3000 companies holding Say-on-Pay votes (i) the executive pay program received favorable votes from over 90 percent of the shareholders voting at 75 percent of those companies and (ii) 60 or fewer companies had a majority of votes cast disapproving the executive pay program.[2]

Evaluating the Impact

Following are two propositions on how well Say-on-Pay is working.

***Proposition #1*:** Say-on-Pay causes shareholders to become better informed and more involved in the executive pay process.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, §951, 124 Stat. 1376, 1899 (2010). Dodd-Frank Section 951 amended the Securities Exchange Act of 1934 by adding Section 14A (codified as amended at 15 U.S.C. §78n-1). For prior discussions on Say-on-Pay, see NYLJ columns Aug. 25, 2011, Dec. 1, 2011, March 23, 2012 and July 3, 2012.

[2] In each of the years 2011-2014 the Russell 3000 companies receiving negative Say-on-Pay votes numbered 37, 57, 57 and 60, respectively. This represented, for each year, 1.4 percent, 2.6 percent, 2.5 percent and 2.4 percent, respectively, of the total number of Russell 3000 companies holding votes. (The largest proxy adviser, Institutional Shareholder Services (ISS), recommended a negative vote as to the executive pay programs at approximately 300 of these companies (representing between 12 percent and 14 percent of the total number of Russell 3000 companies holding votes each year).) See, for example, the report entitled, "2014 Say On Pay Results—Russell 3000," published by Semler Brossy Consulting Group, LLC (January 2015).

Viewpoint Supporting Proposition #1:

Say-on-Pay encourages shareholders to cast votes (non-binding) on the executive pay programs at the companies in which they are invested. Giving the owner of a business enterprise a voice (even a non-binding one) on executive pay is good corporate governance.[3]

Institutional shareholders, encouraged by the U.S. Securities and Exchange Commission (SEC), are retaining proxy advisers to better inform themselves on how they should vote.[4] In that same process, issuers themselves are becoming better informed and consultants, legal counsel and others advising institutional shareholders on executive pay are likewise becoming better informed. Finally, the Say-on-Pay process encourages issuers to reach out directly to shareholders and explain the strategies and business needs underlying their executive pay decisions.

Viewpoint Opposing Proposition #1:

Many institutional shareholders, as noted, "outsource" their Say-on-Pay vote to proxy advisers. These advisers, for a fee, recommend to the shareholders retaining them how the shareholders should vote and provide the shareholders a report explaining the basis for the recommendation. A vote based on the proxy adviser's recommendation does not mean the shareholder understands the reasons underlying the executive pay decisions at the particular issuer.

Most shareholders of most public companies have limited interest in the design or content of executive pay at the company in question provided it is generally in line with pay at comparable companies. They are much more interested in the current price of the stock. A Say-on-Pay vote at a particular issuer will be favorable unless the stock price is falling or there is clear misalignment of top management's pay (i) with pay at other companies and/or with (ii) the company's performance (including its stock price). Say-on-Pay is as much a referendum on stock price as it is on pay practices.

A recent paper published by MFS Investment Management (May 2014), "Lengthening the Investment Time Horizon," estimates that the average period that a share of stock is held by investment managers of certain large equity mutual funds is approximately 17 months. This

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[3] The regulations under Dodd-Frank Section 951 suggest an example of a Say-on-Pay resolution as follows:

> RESOLVED, that the compensation paid to the company's named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis, compensation tables and narrative discussion is hereby APPROVED. (17 CFR 240.14a-21(a))

[4] See Proxy Voting by Investment Advisers, SEC Release No. IA-2106 (Jan. 31, 2003). See also Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, Staff Legal Bulletin No. 20 (June 30, 2014).

means that many of the shares being voted in a Say-on-Pay vote will not be owned by the same shareholders at the next Say-on-Pay vote. To the extent a Say-on-Pay vote involves transient voters it can hardly be described as a vote by investors with a long-term interest in the enterprise who have informed themselves regarding the alignment of executive pay with the long-term value of the enterprise.

Comment on the Two Viewpoints on Proposition #1:

There is little evidence that most shareholders in major public companies have a robust understanding of executive compensation at the companies of which they are shareholders. This includes the policies and decisions underlying executive pay and the relationship of those policies and decisions to corporate performance (not just stock price). In fact, a recent survey indicates that many institutional investors find that proxy statement discussions of executive compensation are confusing and difficult to understand.[5]

If there is an egregious disconnect in executive pay, whether relative to stock price or otherwise, there will be votes of disapproval. In those cases, expressions of shareholder concern can contribute to a solution. But a vote that simply represents a "for" or "against" based on a proxy adviser's recommendation is not itself a reflection of shareholder understanding of the underlying pay issues.

Proposition #2: Say-on-Pay results in better decision-making by boards of directors in determining the design of executive pay.

Viewpoint Supporting Proposition #2:

Proxy statements, proxy adviser reports and other information exchanged in connection with the Say-on-Pay vote brings better information to the boards of directors (and, in particular, the compensation committees that are making the decisions on executive pay). In this process, as noted in connection with Proposition #1, shareholders, especially institutional shareholders, are becoming better informed and they, in turn, encourage directors to make better executive pay decisions.

Viewpoint Opposing Proposition #2:

- 1. The quantity of information being processed by compensation committees is overwhelming. Compensation committees have a fiduciary duty to understand the data

[5] RR Donnelly Financial Services, Equilar, Inc. and The Rock Center for Corporate Governance at Stanford University, "2015 Investor Survey: Deconstructing Proxy Statements—What Matters to Investors" (2015).

and, based on that data, to make appropriate decisions in light of the specific circumstances at the issuer. (Their decisions are often in conflict with the thinking of proxy advisers). The schedule faced in connection with Say-on-Pay is daunting.

  - a) Most proxy statements are distributed approximately 30 days before the shareholders' annual meeting.
  - b) Within that 30-day period, proxy advisers prepare their reports and recommendations to shareholders retaining them.
  - c) In those cases where directors are able to see a copy of the proxy advisers' reports and recommendations, directors have even less than 30 days before the annual shareholders' meeting to respond (or to decide not to respond). Even when proxy adviser evaluations lead to affirmative vote recommendations (the vast majority of cases), there may be elements of the evaluations—quantitative and/or qualitative—with which directors disagree, including factual errors (not surprising if there are some, given the limited amount of time and the large quantity of data involved in preparation of proxy advisers' reports).
  - d) Within this same 30-day period, shareholders cast their vote. It is doubtful how much time shareholders have to really reflect on the proxy advisers' reports and recommendations regarding the many companies in which these shareholders are invested.

- 2. The schedule noted in paragraph 1 above forces proxy advisers into a "one-size-fits-all" methodology in preparing their reports and recommendations in connection with Say-on-Pay votes. One example of this "one-size-fits-all" model is the treatment by Institution Shareholder Services (ISS), the largest proxy adviser, of total shareholder return (TSR) as a dominant factor in its quantitative analysis of whether CEO pay is "aligned" at an issuer. TSR compares the stock price on two different dates (and takes into account dividends in between). One of the three basic quantitative tests used by ISS is to measure the alignment of the company's TSR relative to TSR of a comparator group of companies between two dates, 36 months apart under the current ISS model, and compare this with the three-year average of the CEO's pay relative to the three-year average of the pay of CEOs at the same group of companies during the same period. TSR is not a proper measure of corporate performance producing sustained value in a business enterprise. It is a measure of stock price changes, which is a reflection of many factors including factors outside the control of the management of a business. Furthermore, this "one-size-fits-all" approach ignores the fact that executive pay decisions overseen by directors involve circumstances that are often very complicated and frequently of a confidential nature.

- 3.The “elephant in the living room” for directors is the potential inhibiting effect of this Say-on-Pay process on directors’ own decision-making. Obviously, a key intention of Say-on-Pay is to encourage directors to think carefully about the pay policies and decisions that they make. On the other hand, unfortunately, many directors may feel they have to look over their shoulders at proxy advisers, because of concerns such as: (i) their decisions may be criticized in the reports to shareholders by the proxy advisers; (ii) a proxy adviser may recommend and, as a result, a majority of shareholders may cast a negative Say-on-Pay vote (even a favorable-vote majority may not be satisfactory if it is not a substantial majority); and (iii) a proxy adviser may recommend a negative vote (or withholding a vote) with regard to re-election of directors (a special concern to compensation committee members) if the proxy adviser does not like the pay decisions made by the compensation committee. This is not encouraging or assisting directors in following a rational thought process on executive pay.

Comment on the Two Viewpoints on Proposition #2:

Directors, especially compensation committee members, are being swamped by information and analytics relating to executive pay. None of the parties to the Say-on-Pay process—directors, shareholders and their advisers (including proxy advisers)—have enough time to truly absorb and understand all the data and analytics. The “one-size-fits-all” models may seem to be a solution, but they are not. Perhaps a solution would be to give more time to all the parties in this process. This point is discussed in the following section.

Recommendation

Say-on-Pay votes should not be held every year. Every two or three years is frequent enough for shareholders to review and express their views on executive pay at an issuer. In order to change from an every-year frequency to one that is once every two (or three) years, an issuer should seek a favorable shareholder vote on the frequency of Say-on-Pay. An exception to the recommended frequency should be made if the executive pay at an issuer receives a favorable vote below a certain level—such as 70 percent of votes cast. In that event, a Say-on-Pay vote would be required every year until a majority vote of more than 70 percent, or other minimum that might be set, is obtained.[6]

[6] Approximately 85 percent of the Russell 3000 companies hold Say-on-Pay votes every year. There are several ways this practice might be changed.

(i) Congress could amend Dodd-Frank Section 951 (more specifically, Section 14A(a)(2) of the Securities Exchange Act of 1934) to provide that Say-on-Pay be held no more frequently than once every two or three years, except in cases of favorable votes falling below a prescribed level, such as noted in the text.

The reasons for this recommendation include the following:

- Given the current schedule for Say-on-Pay there is not enough time each year for the parties involved to collect and understand the information needed for a meaningful Say-on-Pay vote. All parties are forced to scramble, and the consequences are very problematic.
- In many cases (especially the cases in which proxy advisers are recommending an "against" vote) issuers need to sit down with institutional shareholders and, if necessary, with the proxy advisers and explain why the issuer's particular situation warrants the pay practices involved. A Say-on-Pay vote every two or three years would permit this. A Say-on-Pay vote every year does not.[7]
- Say-on-Pay is contributing to "shaking the bad apples from the trees." But it is not contributing to the development of sound executive pay standards. Instead, it is creating a "one-size-fits-all" mentality. The establishment of meaningful incentive pay standards must take into account financial performance criteria such as economic profit and return on capital versus cost of capital.[8] Other criteria include human resource issues, research and development, government regulation, meeting challenges of competitors and many others. Identifying the appropriate criteria, understanding how they should be applied and making the correct decisions based on those criteria would lead to more rational executive pay practices and standards.

(ii) An issuer currently holding a Say-on-Pay vote every year could hold a vote to change the frequency to once every two (or three) years (with exceptions as noted in clause (i)).

(iii) An issuer currently holding a Say-on-Pay vote every year might simply change the frequency of such vote to once every two (or three) years (with exceptions as noted in clause (i)). The problem with this last approach is that ISS has stated in its guidelines that in such event it might recommend a negative vote on some or all current directors of the issuer. See "United States—Summary Proxy Voting Guidelines—2015 Benchmarking Policy Recommendations," published by ISS (Dec. 22, 2014), at p. 14.

[7] A concern might be raised that even if Say-on-Pay were held only once every two or three years, the 30-day schedule between proxy statement distribution and the Say-on-Pay vote would remain. The answer is that it is not those 30 days that are of most concern. It is the time between votes that is the problem. This is a period when proxy advisers' reports and the results of the Say-on-Pay vote need to be studied by issuers. Issuers then need to discuss with major shareholders and, if necessary, with proxy advisers any questions that have been raised. These discussions then must be considered by the issuers and incorporated into the pay decision process. (Issuers are considering many matters, not just Say-on-Pay issues, in reaching their pay decisions.) Approximately 10 months after the last Say-on-Pay vote, issuers are preparing the proxy statement for the next annual meeting (and Say-on-Pay vote). This is insufficient time for a meaningful Say-on-Pay process to take place.

[8] A recent research report on this subject was published by the Investor Responsibility Research Center Institute (Nov. 17, 2014) entitled, "The Alignment Gap Between Creating Value, Performance Measurement and Long-Term Incentive Design."

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Compensation Season 2015

Posted by Kobi Kastiel, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Friday January 9, 2015

Editor's Note: The following post comes to us from Michael J. Segal, partner in the Executive Compensation and Benefits Department of Wachtell, Lipton, Rosen & Katz, and is based on a Wachtell Lipton memorandum by Mr. Segal, Jeannemarie O'Brien, Andrea K. Wahlquist, Adam J. Shapiro, and David E. Kahan.

Boards of directors will soon shift attention to the 2015 compensation season. Key considerations in the year ahead include the following:

1. **Be Prepared for Shareholder Activists**. Companies today are more vulnerable to activist attacks than ever before. Companies should therefore ensure that they understand how their change in control protections function if an activist obtains a significant stake in the company or control of the board. A change in board composition can trigger the application of the golden parachute excise tax under Section 280G of the Internal Revenue Code and can result in negative tax consequences for executives and the company. In addition, in the age of performance awards and double-trigger vesting, clarity about the impact of a change in control on performance goals matters more than ever. Appropriate protections ensure that management will remain focused on shareholder interests during a period of significant disruption; inadequate protections can result in management departures at a time when stability is crucial.

2. **Manage Say-on-Pay Proactively**. Companies should evaluate in advance of proxy season whether or not they expect to be vulnerable in the upcoming say-on-pay vote. The single biggest reason for a negative ISS recommendation is a perceived pay for performance disconnect. If a company anticipates a challenging say-on-pay vote, it should proactively reach out to large investors throughout the year (not just during proxy season), communicate the rationale for the company compensation programs and give investors an opportunity to voice any concerns. Fulsome disclosure in the annual meeting proxy statement of proactive shareholder communications may improve a company's say-on-pay results.

3. **Avoid Litigation Pitfalls**. The plaintiffs' bar continues to target executive compensation matters. Set forth below are the principal categories of compensation-related litigation in recent years and some suggestions that may mitigate the likelihood of such actions.

- ***Disclosure Regarding New or Amended Equity Plans***. Additional disclosure regarding dilution analysis, the methodology for determining the requested number of shares and related matters may reduce the likelihood of this type of suit.
- ***Compliance with Plan Terms and/or Section 162(m)***. Companies should take care to administer plans in accordance with their terms, including applicable limits on share grants and cash incentive payments. In addition, companies should draft plans that provide flexibility to grant non-deductible awards and should include proxy statement disclosure that highlights that flexibility. Compensation committee materials should clearly identify the performance goals that are intended to satisfy the Section 162(m) performance-based exception and any separate business goals that are not intended to be threshold goals for purposes of Section 162(m).
- ***Director Equity Grant Limitations***. Consider including in new or amended omnibus equity plans reasonable annual limits on the levels of individual grants to directors. These limits may help to avoid claims challenging the level of director compensation.

4. **Be Mindful of ISS, but Don't Lose Sight of the Big Picture**. Management and compensation committees should understand the potential consequences of their decisions under applicable ISS policies, but should not waver in their commitment to create a culture that attracts and retains talented personnel who will contribute to the long-term success of the company. The ISS position on a particular issue does not always serve the best interests of stockholders.

5. **Keep an Eye Out for Dodd-Frank Regulations**. We continue to await final regulations regarding pay ratio disclosure and proposed regulations on clawbacks, disclosure of pay for performance and disclosure of hedging by employees and directors. Based on SEC pronouncements to date, it would be surprising if any of the disclosure rules take effect prior to the 2016 proxy season. If the final rules regarding pay ratio disclosure are consistent with the proposed regulations, companies will need significant lead time to prepare compliant disclosure, especially those companies with large employee populations located in multiple countries.

* * *

Plaintiffs' lawyers, shareholder activists and the proxy advisory firms present a significant challenge to designing and implementing effective executive compensation programs. These groups invent new issues with each new proxy season, distracting directors from core principles

and objectives. The most effective companies navigate this obstacle course of activism, strike suits and short-termism by resolutely returning to core principles that promote the long-term interests of stockholders.

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Shareholder Activism and Executive Compensation

Posted by Jeremy L. Goldstein, Jeremy L. Goldstein & Associates, LLC, on Thursday, June 18, 2015

Editor's note: Jeremy L. Goldstein is founder of Jeremy L. Goldstein & Associates, LLC. This post is based on a publication by Mr. Goldstein. Related research from the Program on Corporate Governance about CEO pay includes Paying for Long-Term Performance (discussed on the Forum here) and the book Pay without Performance: The Unfulfilled Promise of Executive Compensation, both by Lucian Bebchuk and Jesse Fried.

In today's environment in which all public companies—no matter their size, industry, or performance—are potential targets of shareholder activists, companies should review their compensation programs with an eye toward making sure that the programs take into account the potential effects of the current wave of shareholder activism. In this regard, we have provided below some considerations for public company directors and management teams.

"Say on Pay": Early Warning Sign

Low levels of support for a company's "say on pay" vote can serve as an early warning sign for both companies and activists that shareholders may have mixed feelings about management's performance or a board's oversight. An activist attack following a failed vote may be particularly inopportune for target companies because a failed vote can result in tension between managements and boards. Moreover, activists will not hesitate to use pay as a wedge issue, even if there is nothing wrong with a company's pay program. Companies should get ahead of potential activists by (1) understanding how their pay programs diverge from standards of shareholders and proxy advisors, (2) developing a robust, year-round program of shareholder engagement by management and independent directors, and (3) considering appropriate changes to pay and governance structures if advisable. Companies that are the most aggressive at shareholder outreach and develop the best relationships with both the investment and the governance representatives of their major holders will be best able to address an activist attack if it occurs.

What Pay Programs Do Activists Like to See?

While we have seen several recent situations in which certain prominent activist firms have expressed a preference for programs that emphasize return on invested capital, economic profit and/or return on equity rather than earnings per share or revenue-related targets, there is not a general type of pay program favored by most activists. In fact, few activist "white papers" even address executive pay and those that do usually only cite negative reports by proxy advisory firms and make vague reference to pay for performance disconnects in an effort to use pay as a wedge issue. The best way for a company to withstand these criticisms is to make sure that its

pay programs reward executives for achievement of stated strategic and operational goals and that such goals are consistent with the company's attempt to achieve sustainable, long-term growth.

Are Your Employees Protected if an Activist Attacks?

All too often change of control protections in compensation plans do not trigger under circumstances in which an activist is most likely to take control of a company in the current environment. Amending compensation programs—particularly change of control and severance protections—in the midst of an activist situation can often be difficult if not, from time-to-time as a practical matter, nearly impossible. Companies should therefore review the change of control provisions of their compensation programs on a clear day to ensure that they fulfill their intended purpose. In this regard, we note that many change of control programs do not trigger if an activist takes control of the majority of a board by reason of the *settlement* of an actual or threatened proxy contest. This can be a critical problem, given the number of activists that have recently attempted to gain control of at least a majority of board seats and given that ISS is increasingly showing support for "control" slates.

Do Your Pay Programs Work if an Activist Agenda is Implemented?

Activists pushing for changes at public companies most frequently advocate in favor of returns of capital through extraordinary dividends and share buybacks; divestitures through sales, spin-offs or otherwise; and sales of the entire company. Companies should review their pay programs to ensure that they work properly if any of these events occur, regardless of whether the activist actually obtains seats on the board or control of the company. Specifically, companies should take measures to ensure that (1) adjustment provisions of stock plans permit adjustments to awards in the event of both extraordinary dividends and divestitures, (2) all plans are clear as to whether an employee ceasing to be part of the affiliated group of companies in a divestiture will be treated as a terminated employee for purposes of the relevant plans, (3) performance goals still work after extraordinary dividends, the divestiture of a major business and, particularly if there are per share performance metrics, a share buyback, and (4) performance plans are designed in a manner to minimize the effect of such events and related adjustments on the deductibility of compensation under Section 162(m) of the Internal Revenue Code. Finally, while it has become less fashionable in recent years to focus on change in control protections, companies should, in light of the robust activist and M&A environment, have their change of control programs reviewed on a clear day by advisors who are experienced with how these programs should work when an actual change of control is threatened or occurs.

* * *

In today's environment, all public companies are susceptible to attack from activist investors. As part of their advanced preparation efforts for activist attacks, companies should review their executive compensation programs to ensure that they understand any features of their programs that can be exploited by activists in winning the hearts and minds of shareholders or are likely to function improperly if and when an activist strikes. After careful review, companies should consider whether they wish to make any appropriate changes.

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Incentive Alignment through Performance-Focused Shareholder Proposals on Management Compensation

Posted by R. Christopher Small, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Thursday March 12, 2015

Editor's Note: The following post comes to us from Steve Fortin of the Accounting Area at McGill University; Chandra Subramaniam of the Department of Accounting at the University of Texas at Arlington; Xu (Frank) Wang of the Department of Accounting at Saint Louis University; and Sanjian Bill Zhang of the Department of Accountancy at California State University, Long Beach. Work from the Program on Corporate Governance about CEO pay includes: The CEO Pay Slice by Lucian Bebchuk, Martijn Cremers, and Urs Peyer (discussed on the Forum here); Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here); and Lucky CEOs and Lucky Directors by Lucian Bebchuk, Yaniv Grinstein and Urs Peyer (discussed on the Forum here).

Corporate boards are conscious of the role that executive pay practices play in improving corporate governance and increasing shareholder wealth (Gammeltoft, 2010). Economic theory suggests that the key to aligning managerial compensation with shareholder interest is to increase the sensitivity of executive compensation to firm performance (Core et al., 2005; Jensen and Meckling, 1976). Firms finance their operations, however, with funds from both shareholders and creditors, e.g., bondholders. Thus, agency theory also concerns shareholder-bondholder agency conflict and the difficulty of concurrently aligning the interests of shareholders, bondholders, and managers (Ahmed et al., 2002; Jensen and Meckling, 1976; Ortiz-Molina, 2007). In the past decade, the business press has focused on excessive CEO pay, observed during the 2001 Enron/Worldcom scandals as well as the recent 2007–2008 credit crisis, e.g., AIG. Critics contend that contracting between CEOs and boards has been shadowed by pervasive managerial influence (Bebchuk and Fried, 2005; Crystal, 1992). Consistent with these concerns, shareholders have begun to use the "shareholder proposal rule" (Rule 14a-8) established by the Securities and Exchange Commission (SEC) to defend their interest and have submitted hundreds of proposals to many of the largest U.S. corporations.

In our paper, Incentive Alignment through Performance-Focused Shareholder Proposals on Management Compensation, forthcoming in the *Journal of Contemporary Accounting and*

Economics, we document a related concept, emerging pay-performance activism sponsored by shareholders, and examine how bondholders perceive such activism. We identify pay-performance activism as those shareholder proposals with a sharp focus on executive compensation issues tied to financial performance. Such performance-focused shareholder proposals (PSPs) are theoretically and practically different than those proposals that call only for CEO pay constraints or that tie CEO pay to certain social and environmental actions (non-performance-focused shareholder proposals [NPSPs]). The appendix provides two examples of both types. Our study centers on PSPs that demand that directors tie executive compensation more closely to firm performance, thereby realigning manager interests with those of their shareholders.

Our first research question, a building block for our next and primary question, rests on the uniqueness of the increasing number of PSPs filed by investors. There has been some research into the effects of shareholder concerns or threats on stock price, financial performance, or executive compensation (Johnson and Shackell, 1997; Johnson et al., 1997; Karpoff et al., 1996). From a rational shareholder's perspective, performance-focused proposals should be most beneficial to shareholder interests. Given that Section 953a of the Dodd-Frank Act of 2010 requires firms to disclose more details of their pay-for-performance practices, an examination of PSPs has the potential to provide timely insights to the SEC, the designated market regulator. Little is known, however, about the determinants and market impact of performance-focused shareholder proposals. Thus, we extend prior research by providing new evidence on the differences between PSPs and NPSPs in terms of their economic determinants and consequences.

Our primary research question is related to the probable negative side effects of PSPs on bondholders and their regulatory implications. Equity-linked compensation (especially CEO executive compensation, heavy with stock options) can increase risk-taking incentives for managers (Jensen and Meckling, 1976; Jensen and Murphy, 1990). Bebchuk and Spamann (2009), in reflecting on the crisis between 2007 and 2009, attribute bankers' excessive risk-taking behavior to the high equity component in executive compensation. They noted that, with the increase in executive pay sensitivity to stock price as well as to stock price volatility, management may serve the interests of shareholders through further risk-taking and at the expense of all other stakeholders, including bondholders.

By constructing a sample of 136 S&P 500 companies that received at least one PSP between 1996 and 2006, we first test whether targeted firms that receive PSPs have, ex ante, pay practices that are suboptimal from an alignment perspective, as compared with control firms. The first of our two control groups consists of 262 S&P 500 companies that were not targeted by

either PSPs or NPSPs between 1996 and 2006. Our second control group is comprised of 51 firms that received NPSPs during the same period. We start by studying the determinants of a firm that received a PSP relative to no proposals and/or received an NPSP. Next, we test for improvement in management incentive alignment following the proposal year by studying changes in pay-performance sensitivity for PSP firms, compared with control firms. Third, we examine stock returns as related to the proposal day to determine the effect of proposals on shareholders and the bond market reaction around the proposal day. We test our bond results at both the firm and bond levels and find that our results are robust under both settings.

Our results show that firms with higher excess CEO compensation are more likely to receive PSPs, compared to firms that receive NPSPs or firms that receive no proposals. Second, firms that receive PSPs see their equity-based pay-for-performance sensitivity increase significantly following the proposal year, compared with control firms that received NPSPs or did not receive proposals. Third, as a result of PSPs, shareholders enjoy significantly positive abnormal stock returns, while bondholders suffer significant negative abnormal bond returns. Further exploratory analyses suggest that high-leverage firms experience more negative abnormal bond returns than do low-leverage firms and that the volatility change after PSP proxy filing dates explains the negative bond reaction. This is consistent with the notion that pay design changes lead to more risk-taking behavior by target firms.

We contribute to the literature as well as to the ongoing regulatory debate in several ways. First, to the best of our knowledge, we present the first evidence of bondholder reaction to shareholder proposals. Specifically, the realignment of manager and shareholder interests due to the PSP is associated with a decrease in bond returns. Because there is a trade-off between shareholder-manager interest alignment and shareholder-bondholder conflict (DeFusco et al., 1990; Klein and Zur, 2011; Ortiz-Molina, 2007), our results suggest that boards of directors and regulators should adopt a balanced approach in dealing with activist shareholder campaigns, particularly those concerning top management incentive compensation. The SEC was established in the 1930s with a mandate to protect investors in securities (both stocks and bonds). To fulfill its duty toward public bondholders, the second SEC chairman William Douglas lobbied Congress to pass the Trust Indenture Act of 1939 and established the bond trustee system in the United States. In response to the Dodd-Frank Act of 2010, the SEC released the new “Say-on-Pay” regulation in January 2011. From a bondholder’s perspective, the new SEC regulation might result in unintended consequences that have the potential to compromise its duty toward bondholders.

Second, we provide the initial evidence that PSPs are very different from NPSPs through our investigation of the determinants and consequences of the emerging pay-performance activism through PSPs. Recent studies focus on the effect of overall shareholder votes and related

regulations on compensation issues (e.g., Carter and Zamora, 2009; Ferri and Maber, 2012). Prior research does not, however, differentiate PSPs from NPSPs. We extend the findings of such research by isolating PSPs from NPSPs based on incentive alignment and agency theory (Jensen and Meckling, 1976), on increased investor demand (Rappaport and Nodine, 1999), and on emerging trends in institutional practices (CalPERS, 2010). We find that PSPs and NPSPs are different with respect to the rationale for targeting a specific firm and their impact on firm pay-performance sensitivity.

Shareholder proposals are often perceived by the business community and some popular business newspapers to be submitted by less-sophisticated investors and to have little effect on important governance matters, as compared with activist campaigns by large investors, such as hedge funds. Our results, however, suggest that PSP (but not NPSP) sponsors are more sophisticated investors, who understand the proper use of management compensation contracts in maximizing their own utility. For instance, our results show that PSP sponsors target firm CEOs with excess compensation, while NPSP target CEOs without excess compensation. Firms targeted by PSP (but not NPSP) sponsors increase their CEO pay-for-performance sensitivity. Our evidence suggests that treating shareholder proposals based on whether they are performance-focused can provide additional insight into how different types of shareholders interact with their target firms.

Third, our research also informs the ongoing debate about executive compensation regulation. The business press cites poor incentives as “one of the most fundamental causes” of the recent economic crisis (Blinder, 2009). According to Solomon and Paletta (2009), the Obama administration clearly believes that “more closely align[ing] pay with long term performance” is the lesson from the recent recession. Nevertheless, lack of pay-performance sensitivity does not seem to be the actual cause for the excessive risk taking between 2002 and 2007 (DeYoung et al., 2009). Further, the collapse of any high-leverage business, such as banking, e.g., Lehman Brothers, implies larger losses in absolute dollars for bondholders and average depositors than for shareholders. Interestingly, these anecdotal results are consistent with our untabulated test results that show that the bonds of high-leverage firms suffer more negative returns than do those of low-leverage firms. In summary, we are concerned that more shareholder activism, as further encouraged by the Dodd-Frank Act of 2010, could generate unintended negative effects for bondholders.

The full paper is available for download here.

Tab 2: Executive Compensation Disclosure

Compensation Disclosure Practices

David Chun
Founder and Chief Executive Officer, Equilar

Why Alternative Pay Calculations Matter

P4P

Provides a better measurement than the SEC tables

Proxy Advisors

Use them in company evaluations

Institutional Investors

Included as part of voting decisions

SEC

New rules on pay for performance

Alternative Pay Comparison

ISS Realizable

- Includes payouts and intrinsic value of equity at end of period
- Revalues options using Black-Scholes

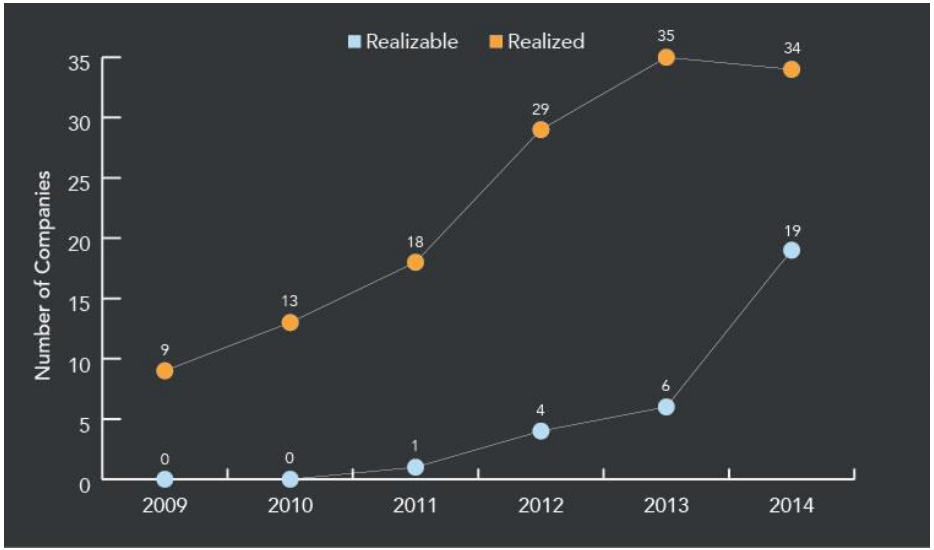
Glass Lewis Realizable

- Includes payouts and intrinsic value of equity at end of period
- Does not revalue options

Realized

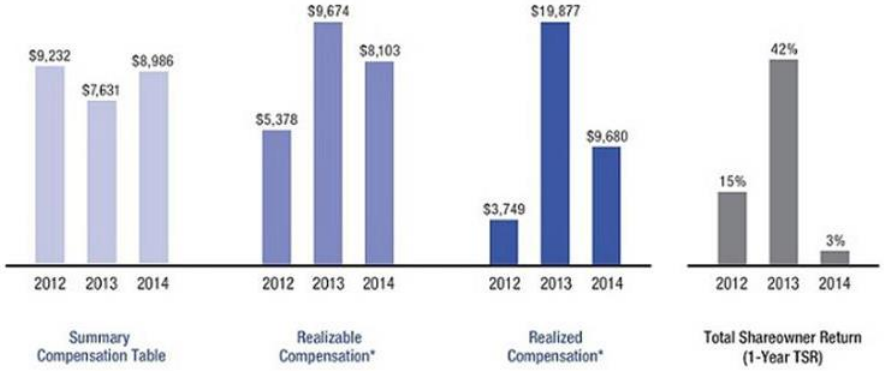
- Includes value of options exercised and stock awards vested during period
- Focus on payouts not grant timing

Alternative Pay Calculations



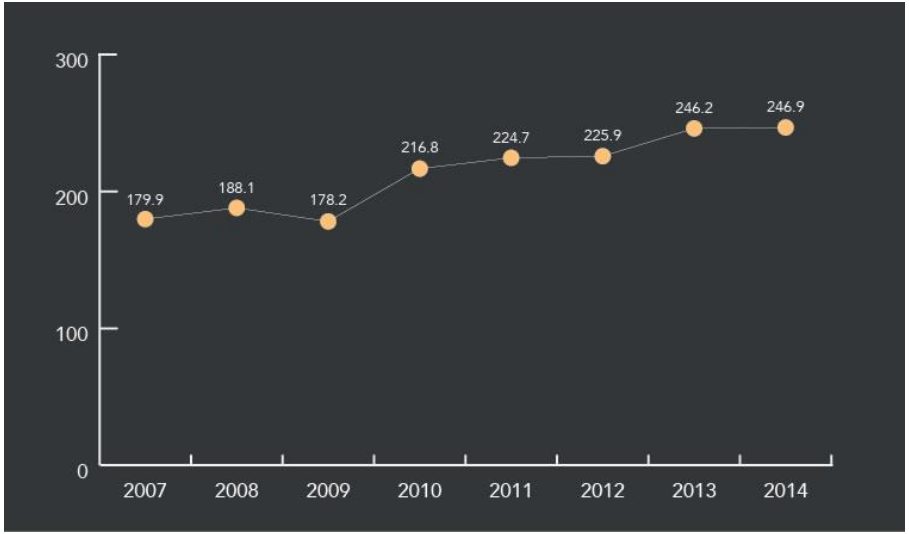
Company Highlight

- **United Technologies (UTX)**
  DEF 14A filed on March 13, 2015



CEO Pay Ratio

S&P 500 CEO Pay vs. Median Income



Company Highlight

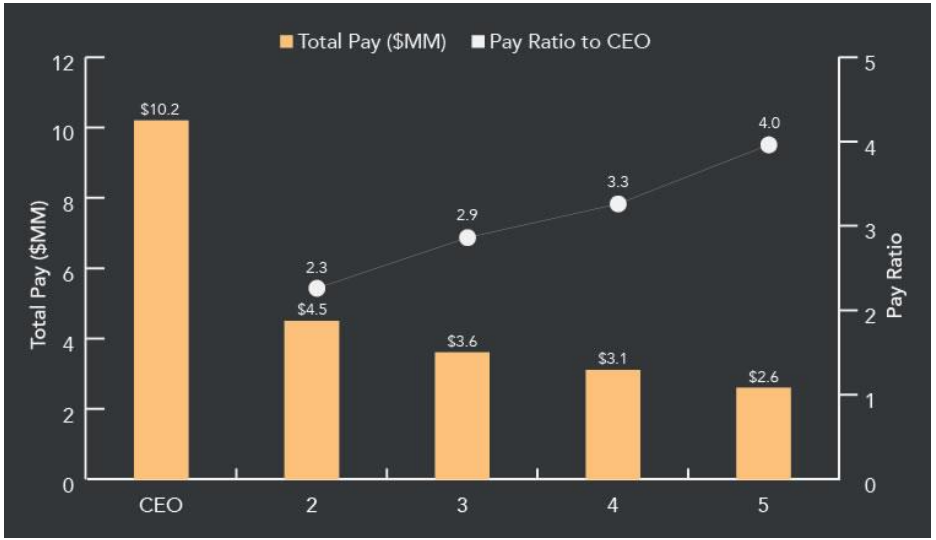
- **Noble Energy (NBL)**
  DEF 14A filed on March 27, 2015

"Mr. Davidson, who was both Chairman and CEO until Mr. Stover was appointed CEO on October 21, 2014, had 2014 annual total direct compensation of **$8,479,814**, while Mr. Stover's was **$4,901,031**, as reflected in the Summary Compensation Table included in this Proxy Statement. We estimate that the median of the annual total direct compensation for all of our employees, excluding our CEO, was **$103,500** for 2014. As a result, we estimate that Mr. Davidson's 2014 annual total direct compensation was approximately **82** times that of the median annual total direct compensation for all of our other employees and Mr. Stover's 2014 annual total direct compensation was approximately **47** times that of the median annual total direct compensation for all of our other employees."

	Total Annual Direct Pay	CEO Pay Ratio
Former CEO	$8,479,814	82
New CEO	$4,901,031	47
Median Employee	$103,500	

Internal Pay Equity

Median S&P 500 NEO Pay Levels



Company Highlights

- **E. I. du Pont de Nemours and Company (DD)**
  DEFC14A filed on March 23, 2015

Element (Pay Equity Multiple Range)	2014
TCC (2–3 times NEO)	2.6
TDC (3–4 times NEO)	3.5

- **SpartanNash Co (SPTN)**
  DEF 14A filed on April 20, 2015

"The ratio between Chief Executive Officer and other named executive officer target compensation is used by some as an indicator of reasonableness of Chief Executive Officer compensation based on internal pay equity. For SpartanNash as of fiscal 2014, this ratio was 3.5 to 1. The Compensation Committee believes that this ratio is generally in line with the normal market range between 3.0 and 3.5 to 1."

What Matters to Investors

2015 Investor Survey: What Matters to Investors

- Surveyed 64 asset managers with over $17 trillion under management
  - How do you use information in proxies to make voting/investment decisions
- Proxies Are Too Long, Difficult to Read
  - 55% percent of investors believe that a typical proxy statement is too long
  - Only 38% of institutional investors believe that corporate disclosure about executive compensation is clear and easy to understand
- Investors Rely on Only a Small Fraction of the Information
  - They report that the ideal length of a proxy is 25 pages, compared to the actual average of 80 pages among companies in the Russell 3000

Equilar & RR Donnelley 2015 Disclosure Analysis

- Alternative methods of calculating compensation (realizable & realized pay) have been growing more common since 2012
- “Pay for performance” references increased in the wake of Say on Pay
  - 84 companies in the S&P 100 now include the phrase
- Companies are starting to highlight changes made based on shareholder feedback
- Only handful of companies proactively disclosed internal pay equity. SEC has approved pay ratio disclosure beginning with fiscal year January 1, 2017
- Disclosure of shareholder engagement has increased
  - 65 companies in the S&P 100 included disclosure of outreaches vs. 7 in 2009
- Board skills matrices are being introduced to more clearly demonstrate qualifications

COMPENSATION DISCUSSION AND ANALYSIS TEMPLATE

Second Edition

CFA Institute

Contents

Introduction

Since the first edition of this template was published in 2011, many best practices in compensation discussion and analysis (CD&A) have emerged. We wish to highlight these best practices to aid companies currently struggling with the CD&A process or with limited resources and to clarify the elements of disclosure that are most useful to investors. All companies can find something in this report to improve their communications documents.

The CD&A is a company's primary engagement tool with investors and, therefore, needs to tell a company's compensation story in a concise manner that investors will understand. The CD&A is also used to comply with US SEC requirements,[1] but thinking of it first and foremost as a compliance document misses the opportunity to communicate effectively with investors.

As many shareowners and markets around the world continue to scrutinize executive pay practices, we hope that this template will improve understanding, serve as a global model for improved investor communications about this important issue, and elevate compensation disclosure beyond an exercise in legal compliance.

The sections of the model CD&A are arranged in order of importance from an investor's perspective, starting with an overview of the company's corporate performance for the previous year and an explanation of the link between that performance and executive pay. The remaining sections delve into detail about compensation elements and decisions, compensation-setting process and policies, and other areas of interest.

CFA Institute, in partnership with the CD&A working group, offers this CD&A template as a step toward making compensation communications clear and relevant to investors. To achieve these goals, the working group members agreed that the template should help issuers produce a CD&A that, like any good communications document, tells a clear and easily understood story.

[1]See Appendix D.

CD&A Working Group

For the working group, CFA Institute assembled a distinguished group of experts, including issuers, investors, proxy advisers, lawyers, and other parties who play a role in the CD&A process.

The Template

This CD&A template offers companies a guide to help ensure that the CD&A is a clear, concise, and understandable tool for communicating to investors the company's approach to its executive compensation program. Essentially, it gives insight into the analytical underpinnings of the numbers reflected in the tabular and other disclosures that follow the CD&A.

A good CD&A needs to answer the questions **"How?"** and **"Why?"** concerning compensation decision making at a company.

Companies and compensation committees should view this CD&A template as a flexible template, particularly because the CD&A should be a properly customized story and should not devolve into "boilerplate" language. The goal is to use the template approach to include the basic elements of the compensation narrative in a manner that best tells a company's compensation story. This template is designed as a best practice source for creating a CD&A that is a clear, concise, and legally compliant representation of a company's unique, and often complex, compensation scheme.

I. Executive Summary

Companies should provide the essential data shareowners are looking for in a short summary. Essential information includes the following:

- What has changed (strategy, leadership, pay philosophy, pay practices) in the past year
- Most recent say-on-pay vote results and engagement activities
- Pay governance practices
- Elements of compensation
- Annual and long-term metrics and performance
- Link between pay and strategy

We encourage the use of user-friendly charts and graphics for such information. For an example that contains this list, see **Figure 1**.

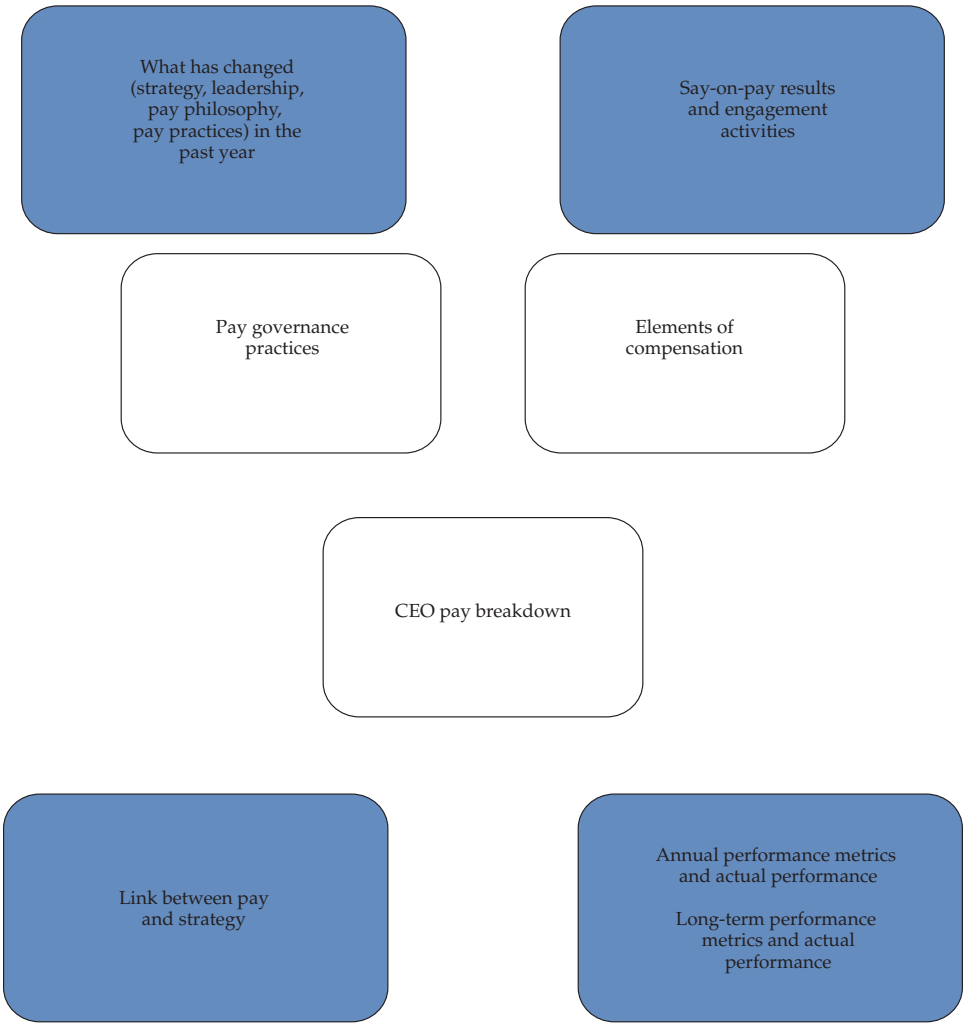
The information in the graphic summary in Figure 1 can easily be contained on one or two pages of the proxy statement to provide a summary of the most meaningful information. This graphic summary is, of course, only one suggestion of what a summary should contain. The CD&A working group believes, however, that such a summary goes a long way toward giving investors most of the information they are looking for at the very beginning of the CD&A. More detail on each of these items can then be provided in the remainder of the CD&A.

Other items companies place in their executive summaries include the following:

- A summary of the company's performance over the past year
- Key compensation decisions made in the past year (a more detailed review comes later)
- What (by amount and type) was paid or awarded (including awards payable in future periods) to named executive officers (NEOs) and how each element of pay is linked to performance
- Peer group information—especially if there were any material changes

Companies organize this information in the order or format that they prefer that will communicate to investors the story of their executive compensation over the past year. We wish to emphasize the power of using concise and direct language to convey this story. CD&A working group members agreed that such a succinct overview can be conveyed in one to two pages. For more ideas on what to include in this section, please look at the best practices provided in Appendix B.

Figure 1. Compensation Discussion and Analysis Graphic Summary



II. Elements of Compensation for the Past Fiscal Year

Section Points of Emphasis

- *The main compensation tools the company uses to motivate and retain executives*
- *The approach the company uses in valuing equity incentives*

The various elements of executive compensation should be defined in this section. A statement disclosing the elements of compensation for the CEO and other NEOs should be provided. The discussion should give a typical investor a clear understanding of what each specific element is and what each element is designed to reward. This section aims simply to define the various components of the compensation plan. Discussions of such issues as "realized" versus "realizable" pay[2] may be best introduced here.

Realized vs. Realizable Pay

- Realized pay—pay that an executive is actually awarded in a given year
- Realizable pay—potential value of pay awarded over a specific period of time and valued at a specific point in time

For examples of realized vs. realizable pay, see Appendix B.

Preparers should present this information in an easy-to-read format, such as a table or bulleted list, with the elements of compensation identified. The compensation committee should explain why each element was chosen, how those elements work, and how each element links to the company's business strategy.

A company should take the opportunity here to very deliberately address the rationale for unique and potentially controversial pay practices and decisions.

[2]The following resources provide discussions of realized versus realizable pay: *Trends in Realized/Realizable Pay Disclosure: Top 250 Companies*, Frederic W. Cook & Co. Inc. (2014); *Executive Pay Disclosure: Realized and Realizable Pay*, Compensation Advisory Partners (2014); *Supplemental Pay Disclosure: Overview of Issues, Proposed Definitions, and Conceptual Framework*, The Conference Board (2013):5.

III. Performance Targets for Past Fiscal Year/Performance Period

Many companies combine Sections III and IV in their CD&A disclosures. We separated them here for clarity, but companies should do whatever best tells their story.

Section Points of Emphasis

- *The company's short-term and long-term performance targets and how they relate to the company's strategy and operating plan*
- *Total CEO/management compensation versus stock performance*

Many companies explain their short-term and long-term plans separately to clarify the nuances of each plan.

The CD&A should comment on the individual and corporate performance goals selected, why these performance goals were selected, the rigor of the performance goals, how incentives are tied to these performance goals, and how compensation reflects actual corporate and individual executive performance. Companies should describe how the incentives align with strategic objectives and enhance the company's performance. This discussion should disclose the following:

a. In straightforward terms, annual and longer-term performance targets (including specific numeric targets), nonfinancial or environmental, social and governance targets, and the extent to which such targets were achieved

b. Remarks on the company's ongoing business direction and expectations and how they may influence future targets

Some of this information can be effectively presented in a different context in other places.

It is a good idea to emphasize the cohesive discussion of the design and outcome of each plan that includes performance conditions (short term and long term). The following elements should be tied together:

- Design of plan
- Basis for target awards
- Performance metrics—reason for choice(s)
- Goals set for each metric—how they relate to the business climate or other considerations and also to prior goals
- Basis for payouts—goal attainment versus payout amount

IV. Compensation Decisions Made in Past Fiscal Year/Performance Period

Section Points of Emphasis

- *Company performance relative to targets*
- *Effects of individual and company performance on compensation*

A company should discuss the actual compensation decisions made during the previous year to the extent these decisions relate to salary, annual or long-term incentives, or other material elements of compensation, including the following:

a. Salary or bonus and, to the extent a bonus or salary increase is guaranteed, the reason for the guarantee

b. Specific performance targets on which each compensation element is based and whether the targets were achieved

c. Material increases or decreases in any elements of compensation, with an explanation of the changes

d. In summary form, any other material types of compensation, such as executive perquisites, consulting agreements, severance payments, or tax-related payments that may result or have resulted in payouts to the executive or the executive's family

e. The use of tax gross-ups (if any) and why they are provided

f. Discretionary compensation linked to individual executive performance rather than specific quantitative goals and how/why this compensation supports the company's long-term strategic goals

Many companies now disclose this information in a table or bulleted list that succinctly reviews the information. Best practice includes a discussion of *why* each decision was made. Discussions of equity-based and other long-term incentive compensation should also provide a summary of one-off awards and other compensation that may be nonrecurring in nature and an explanation of why such awards occurred. The company may also discuss here the realization of gains by key executives from long-term performance targets (such as long-term performance awards that have been earned or vested over a period greater than a year).

V. Compensation Framework: Policies, Process

Section Points of Emphasis

- *The principles underlying the company's compensation policies*
- *The company's compensation policies*
- *The board's compensation-setting process*
- *The role risk plays in compensation decisions*

Compensation Policies

This section of the CD&A can address investor questions about what the company does in regard to compensation and why. A company should briefly discuss the principles of its executive compensation framework, including the key considerations it makes when setting pay. The working group emphasizes that this discussion should be brief, should clearly communicate a company's compensation philosophy, and should avoid boilerplate language. Some of the considerations a company may address are the emphasis on performance in the compensation structure, the emphasis on future pay opportunity versus current pay, the discretionary nature of compensation programs, whether executives have employment contracts, and the portion of variable ("at risk") compensation. Many companies have begun to disclose this information in a user-friendly tabular format.

A best practice emerging for a CD&A is called "pay governance."

Based on a review of many of the proxies highlighted in Appendix B, we consider that pay governance generally boils down to a discussion of "what we do and what we don't do." You can review the proxies for yourself to see examples, but here is a summary of what you'll see:

What we do:

- Clawbacks
- Share ownership requirements
- Tally sheets
- Engaging with shareowners
- Risk assessment of pay
- Annual say on pay
- Double-trigger severance agreements
- An independent compensation consultant for the board
- A cap on long-term and incentive awards
- Limits on perquisites

What we don't do:

- Tax gross-ups
- Employment agreements
- Payment of dividend equivalents on unearned shares
- Stock-option repricing
- Hedging or pledging
- Single-trigger equity acceleration
- Supplemental retirement plans

Some companies have used this section of the CD&A to highlight best practices in compensation and compensation disclosure and to discuss why the company has or has not adopted such practices. Some have even taken the step to highlight poor compensation practices and discuss why the company does not engage in such practices.

In this section, a company should discuss its compensation policies to help investors understand ways the compensation committee and the board have aligned management and shareowner interests. The company also should discuss the frequency and results of the company's advisory (or binding) vote on executive pay packages.

Descriptions of policies concerning equity-based and other long-term incentive compensation should summarize the following:

a. Vesting periods and retention requirements

b. The timing and pricing of stock-option grants and other stock-related awards

c. The policies related to repricing or exchange of stock options or other stock-related awards if the action occurred during the last fiscal year, has been approved, or is pending

d. Stock ownership guidelines for NEOs and board members

e. Performance targets

f. Material tax or accounting treatments

g. Policy on the hedging of company stock by executives and board members

h. Clawback provisions

i. Policy on the modification of performance targets

Compensation Process

The CD&A should clearly illustrate the process undertaken to link compensation, corporate strategy, and performance and should answer the question, How does this compensation framework drive results at this company? A company should discuss the process the compensation committee undertook with management, the board, and compensation consultants in setting and implementing executive compensation. This

section should allow the investor to obtain a clear sense of how and why compensation targets are determined and awards made. A company also should discuss the level of discretion exercised by the compensation committee, on the upside and downside, in setting executive compensation. This is a section of the CD&A in which the compensation committee can speak to its process for engaging with investors. Items covered in the narrative should include the following:

a. The role of compensation consultants and management in the determination of compensation. This discussion should focus on how advice from the compensation consultants is reflected in the compensation committee's decisions in setting executive compensation.[3]

b. A statement addressing the independence of the compensation consultants from company management and a discussion of (or a reference to) the information concerning how consultants are compensated for this work and other consulting work for the company unrelated to the specific executive compensation engagement.

c. The use of benchmarks for compensation targets.

d. Whether and how a peer group is used in the determination of compensation for the CEO and other NEOs. If a peer group is used, the selection criteria for that peer group should be discussed. If different peer groups are used for different officers, an explanation should be provided.

e. Changes to the list of peer group companies. If a change has occurred in the peer group in the past fiscal year, an explanation should be provided.

f. The company's process for engaging with shareowners on compensation issues and the results of engagement efforts over the past year—or longer, if appropriate.

The compensation committee is not required to address in the CD&A risks arising from a company's compensation plan, although some companies have done so to assure shareowners that a company's executive compensation is aligned with prudent risk taking and risk management.

[3]In June 2012, the SEC approved new rules to implement Section 952 of the Dodd–Frank Act, which mandates disclosure of whether the work of the compensation consultant has raised any conflict of interest with the issuer and, if so, the nature of the conflict and how the conflict is being addressed.

VI. Employment and Termination Agreements

Employment and separation or termination agreements can be depicted in a brief chart. A succinct disclosure could be a chart that summarizes the details of the plan, including potential termination amounts, and shows what triggers a payout. The chart would include a link to the original document in which it was disclosed.

Section Points of Emphasis

- *The guaranteed compensation to executives during employment and in the event of termination/severance*

The CD&A should disclose whether executive employment and termination agreements are used and the rationale for their use (why they benefit shareowners). This section should also summarize the material terms of executive employment and termination agreements. It should note stipulated salary or bonus guarantees and total payouts resulting from potential termination scenarios and instances of accelerated vesting or retention requirements postemployment. This section can also address connections between these agreements and the other elements of the compensation plan. Specific items to be addressed, if applicable, include the following:

a. Guaranteed salaries or bonuses or other benefits per the employment agreement

b. Duration of employment and associated termination issues as stipulated by the employment agreement

c. Potential termination circumstances and the resulting outcomes

d. Payment from postemployment agreements resulting from the triggering of a single event (e.g., change in control) rather than a double trigger (e.g., change in control and subsequent termination)

e. Rationale for termination payments totaling multiples of annual salary and bonuses

f. Accelerated compensation or immediate vesting of otherwise unvested equity incentives and associated retention requirements

[Appendices Omitted]

The Harvard Law School Forum on Corporate Governance and Financial Regulation
SUPPORTED BY: CSC CORPORATION SERVICE COMPANY

2015 US Compensation Policies FAQ

Posted by Carol Bowie, Institutional Shareholder Services Inc., on Monday March 2, 2015

Editor's Note: Carol Bowie is Head of Americas Research at Institutional Shareholder Services Inc. (ISS). This post relates to ISS compensation policy guidelines for 2015. The complete publication is available here.

US Executive Pay Overview

1. Which named executive officers' total compensation data are shown in the Executive Pay Overview section?

The executive compensation section will generally reflect the same number of named executive officer's total compensation as disclosed in a company's proxy statement. However, if more than five named executive officers' total compensation has been disclosed, only five will be represented in the section. The order will be CEO, then the second, third, fourth and fifth highest paid executive by total compensation. Current executives will be selected first, followed by terminated executives (except that a terminated CEO whose total pay is within the top five will be included, since he/she was an within the past complete fiscal year).

2. A company's CEO has resigned and there is a new CEO in place. Which CEO is shown in the report?

Our report generally displays the CEO in office on the last day of the fiscal year; however, the longer tenured CEO may be displayed in some cases where the transition occurs very late in the year.

3. How is Total Compensation calculated?

Total Compensation = Base Salary + Bonus + Non-equity Incentive Plan Compensation + Stock Awards*+ Option Awards** (based on full grant date values, as calculated by ISS) + Change in Pension Value and Nonqualified Deferred Compensation Earnings + All Other Compensation. The calculation will generally match the Summary Compensation Table with the exception of the stock option value and/or stock awards, described further below.

*Stock Awards – Grant date value, generally as reported in the Grants of Plan-Based Awards Table for stock awards, but ISS may calculate values as deemed appropriate based on assessment of the grant. Note that performance shares (equity incentive plan awards) may be calculated at target value (# of shares X stock price on grant date) if it differs from the value disclosed in the GPBAT. If the stock awards disclosed in the Grants of Plan-Based Awards table reflect grants made in the current rather than past fiscal year, ISS will not include the value in our current report; pursuant to SEC disclosure requirements, the Grants of Plan-Based Award values should reflect equity awards made in the past fiscal year. The disclosed stock awards value should generally be the same in both the Summary Compensation Table and Grants of Plan-Based Awards Table.

**Option Awards – Grant date present value of options using Black-Scholes Option Pricing Model, as calculated by ISS.

4. What inputs are used in ISS' Black-Scholes methodology?

Variable	**Item**	**Source**	**Comments**
C	Option Value	Calculated	
S	Stock Price	Proxy	
E	Exercise Price	Proxy	
σ	Volatility	XpressFeed	Historical three-year stock price volatility measured on a daily basis from the date of grant. If a company has not been publicly traded for at least three years, ISS measures volatility from the IPO date through grant date.
Q	Dividend Yield	XpressFeed	Average dividend yield over five years. If a company has not been publicly traded for at least five years, ISS averages dividend yield from the IPO date and the grant date of option. Dividend yield is based on each dividend divided by the closing stock price on the last business day before the dividend date. The calculation excludes the payouts of special dividend

R	Risk Free Rate	Dept of Treasury website	U.S. Government Bond Yield on the date of grant corresponding to the term of the option. For example, if the option has a 10-year term, the risk free rate is the 10- year U.S. Government Bond Yield on the date of grant.
T	Term/Expected Life	Proxy	Full term of the option.
E	Base of Natural Logarithm	N/A	N/A
Ln	Natural Logarithm	N/A	N/A
N(x)	Cumulative Normal Distribution Function	N/A	N/A

5. How is the present value of all accumulated pensions calculated in the CEO Tally Sheet table?

This figure represents the amounts disclosed as the present value of the benefits for all pension plans (including qualified and non-qualified), as disclosed in the Pension Benefit table of the proxy statement.

6. How is the value of Non-Qualified Deferred Compensation calculated in the CEO Tally Sheet table?

This figure represents the summation of all deferred compensation values, from both qualified and non-qualified plans, as disclosed in the Non-Qualified Deferred Compensation table.

7. How are Potential Termination Payments calculated in the CEO Tally Sheet table?

The values for an involuntary termination without cause and a change in control related termination are provided as disclosed under the relevant termination scenario in the Change in Control Table and/or narrative of the proxy statement.

Financial Data: Total Shareholder Return and Revenue

8. Where does ISS obtain a company's 1-year fiscal total shareholder return, 3- year fiscal total shareholder return, and revenue?

ISS obtains all financial data in the Compensation Profile from Standard & Poor's Research Insight. Here is a link to their data dictionary.

9. How does Research Insight calculate 1-Year fiscal Total Shareholder Return (TSR)?

The one-year total shareholder return is the annualized rate of return reflecting price appreciation plus dividends (based on reinvestment as of the end of the month of the dividend payment) and the compounding effect of dividends paid on reinvested dividends over a one-year period.

10. How does Research Insight calculate 3-Year fiscal Total Shareholder Return (TSR)?

The three-year total shareholder return is the annualized rate of return reflecting price appreciation plus reinvestment of dividends (as described above) and the compounding effect of dividends paid on reinvested dividends over a three-year period.

11. How does Research Insight calculate company revenue?

Revenue is the gross sales (the amount of actual billings to customers for regular sales completed during the period) reduced by cash discounts, trade discounts, and returned sales and allowances for which credit is given to customers.

12. How does Research Insight calculate company net income (loss)?

Net income or loss is reported by a company after expenses and losses have been subtracted from all revenues and gains for the fiscal period including extraordinary items and discontinued operations.

13. Why is the CEO pay as percent of a company's revenue showing NA (not applicable)?

If a company's revenue is zero, the CEO pay as percent of a company's revenue will be NA.

14. Why is the CEO pay as percent of company's net income showing NA?

If a company's net income is zero or negative, the CEO pay as percent of a company's net income will be NA.

The Harvard Law School Forum on Corporate Governance and Financial Regulation
SUPPORTED BY: CSC CORPORATION SERVICE COMPANY

ISS 2015 Equity Plan Scorecard FAQs

Posted by Carol Bowie, Institutional Shareholder Services Inc., on Monday February 2, 2015

Editor's Note: Carol Bowie is Head of Americas Research at Institutional Shareholder Services Inc. (ISS). This post relates to ISS' Equity Plan Scorecard for 2015.

General Questions

1. What is the basis for ISS' new scorecard approach for evaluating equity compensation proposals?

The new policy will allow more nuanced consideration of equity incentive programs, which are critical for motivating and aligning the interests of key employees with shareholders, but which also fuel the lion's share of executive pay and may be costly without providing superior benefits to shareholders. While most plan proposals pass, they tend to get broader and deeper opposition than, for example, say-on-pay proposals (e.g., only 60% of Russell 3000 equity plan proposals garnered support of 90% or more of votes cast in 2014 proxy season, versus almost 80% of say-on-pay proposals that received that support level). The voting patterns indicate that most investors aren't fully satisfied with many plans.

ISS' new policy is rooted in several years of feedback from clients as well as issuers indicating that, while a proposal's estimated cost to shareholders is important, other factors warrant some consideration in voting decisions on equity proposals. A majority of investor participants in ISS' 2011-2012 policy survey, for example, indicated that factors such as low average burn rates, double triggered change-in-control vesting, reasonable plan duration, and robust vesting requirements should be either somewhat or very much considered in equity proposal evaluations, and a majority of issuer participants also favored consideration of reasonable plan duration and low relative burn rates, as well as long-term TSR performance. In the 2013-2014 ISS policy survey, 75 percent of investor respondents indicated that performance conditions on awards should be "very significant" when weighing factors in a holistic approach to equity plan evaluation. More than 50 percent mentioned other features, such as minimum vesting requirements and repricing authority as "very significant," while a majority also cited plan cost and burn rates as important. Both issuers and investors who submitted comments during ISS' 2014 Policy

Consultation period also expressed support for a proposed “scorecard” approach to the evaluation. And participants in ISS’ 2014 Compensation Roundtable voiced similar support, citing estimated plan duration as an important factor and also agreeing that separate scoring models for different size companies would be appropriate.

In the course of developing the new model, ISS conducted regression analysis to identify factors with measurable correlation to superior or lagging long-term shareholder return performance; certain factors, including burn rate and repricing authority, showed significant association with performance over time. Finally, ISS conducted extensive back-testing of prototype scorecards for various index groups, which guided development of four models that reflect a combination of all of the above input, feedback, and testing. These models are not designed or intended to change the general mix of ISS recommendations, although the vote recommendation for a particular plan may differ from those under prior policy in some cases.

2. How does the new ISS’ Equity Plan Scorecard (ESPC) work?

The EPSC considers a range of positive and negative factors, rather than a series of “pass/fail” tests, to evaluate equity incentive plan proposals. The new policy (in effect for shareholder meetings as of Feb. 1, 2015) also will continue to result in negative recommendations for plan proposals that feature certain egregious characteristics (such as authority to reprice stock options without shareholder approval). In general, however, a company’s total EPSC score—considering the proposed plan and certain grant practices relative to applicable factors—will determine whether a “For” or “Against” recommendation is warranted.

3. How do the EPSC models differ?

The chart below summarizes the pillar (and applicable scores) for each model:

Maximum Scores by EPSC Model and Pillars

Pillar	Model	Maximum Pillar Score	Comments
Plan Cost	S&P 500, Russell 3000, Non-Russell 3000	45	All models include the same Plan Cost factors
	IPO/Bankruptcy	60	
Plan Features	S&P 500, Russell 3000	20	All models include the same Plan Features factors
	Non-Russell 3000	30	
	IPO/Bankruptcy	40	
Grant Practices	S&P 500, Russell 3000	35	The Non-Russell 3000 model includes only Burn Rate and Duration factors. The IPO/Bankruptcy model does not include any Grant Practices factors.
	Non-Russell 3000	25	
	IPO/Bankruptcy	0	

4. How many EPSC points are required to receive a positive recommendation?

A score of 53 or higher (out of a total 100 possible points) generally results in a positive recommendation for the proposal (absent any overriding factors).

5. Which types of equity compensation proposals will be evaluated under the EPSC policy?

Proposals related to the following types of equity-based incentive program proposals will be evaluated under the EPSC policy:

- Approve Stock Option Plan
- Amend Stock Option Plan
- Approve Restricted Stock Plan
- Amend Restricted Stock Plan
- Approve Omnibus Stock Plan
- Amend Omnibus Stock Plan
- Approve Stock Appreciation Rights Plan (Stock-settled)
- Amend Stock Appreciation Rights Plan (Stock-settled)

Other types of equity-based compensation proposals will continue to be evaluated as provided under ISS' policy for Equity-Based and Other Incentive Plans.

6. How are non-employee director plans treated when another equity plan is on ballot?

The EPSC model will not be used for stand-alone non-employee director plans that are on the ballot (although they will receive a standard cost (Shareholder Value Transfer (SVT)) evaluation)—i.e., features of a stand-alone non-employee director plan will only impact that plan, the same as under our current case-by-case evaluation of those plans.

When a proposal enumerated in FAQ #5 is on the ballot, the shares available for grant under a non- employee director plan will be incorporated into the Plan Cost evaluation of the EPSC policy.

7. How will equity plan proposals at recent IPO companies be evaluated?

Companies that have IPO'd or emerged from bankruptcy within the prior three fiscal years may be evaluated under an EPSC model that includes fewer factors. As under our prior policy, neither the burn rate nor duration factors apply for companies that have less than three years of disclosed grant data.

Factor-Related Questions

8. What factors are considered in the EPSC, and why?

EPSC factors fall under three categories ("pillars") in each EPSC model:

Plan Cost: This pillar considers the potential cost of the transfer of equity from shareholders to employees, which is a key consideration for investors who want equity to be used as efficiently as possible to motivate and reward employees. The EPSC considers the total *potential* cost of the company's equity plans relative to industry/market cap peers, measured by Shareholder Value Transfer (SVT).

SVT represents the estimated cost of shares issued under a company's equity incentive plans, differentiating between full value shares and stock options where applicable. ISS' proprietary SVT model determines SVT benchmarks (expressed as a percentage of the company's market capitalization) based on regression equations that take into account a company's market cap, industry, and performance indicators with the strongest correlation to industry TSR performance. The EPSC measures a company's SVT relative to two benchmark calculations that consider:

(1) new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised grants, and
(2) only new shares requested plus shares remaining for future grants.

The second measure reduces the impact of grant overhang on the overall cost evaluation, recognizing that high grant overhang is a sunk, expensed cost and also may reflect long-term positive stock performance, long vesting periods for grants, and/or employee confidence in future stock performance.

Plan Features: Based on investor and broader market feedback, the following factors that are newly examined for 2015 may have a negative impact on EPSC results:

- *Automatic single-triggered award vesting upon a change in control,* which may provide windfall compensation even when other options (e.g., conversion or assumption of existing grants) may be available;
- *Broad discretionary vesting authority* that may result in "pay for failure" or other scenarios contrary to a pay-for-performance philosophy;
- *Liberal share recycling* on various award types, which obscures transparency about share usage and total plan cost; and
- *Absence of a minimum required vesting period (at least one year)* for grants made under the plan, which may result in awards with no retention or performance incentives.

Grant Practices: Based on market feedback and analysis of long-standing (and some emerging) techniques, the following factors may have a positive impact on EPSC results, depending on the company's size and circumstances:

- *The company's 3-year average* burn rate *relative to its industry and index peers*—this measure of average grant "flow" provides an additional check on plan cost per SVT (which measures cost at one point in time). The EPSC compares a company's burn rate relative to its index and industry (GICS groupings for S&P 500, Russell 3000 (ex-S&P 500), and non-Russell 3000 companies).
- *Vesting schedule(s) under the CEO's most recent equity grants* during the prior three years—vesting periods that incentivize long-term retention are beneficial.
- *The plan's estimated duration*, based on the sum of shares remaining available and the new shares requested, divided by the 3-year annual average of burn rate shares—given that a company's circumstances may change over time, shareholders may prefer that companies limit share requests to an amount estimated to be needed over no more than five to six years.
- *The proportion of the CEO's most recent equity grants/awards subject to performance conditions*—given that stock prices may be significantly influenced by market trends, making a substantial proportion of top executives' equity awards subject to specific

performance conditions is an emerging best practice, particularly for large cap, mature companies.

- *A clawback policy that includes equity grants*—clawback policies are seen as potentially mitigating excessive risk-taking that certain compensation may incentivize, including large equity grants.
- *Post-exercise/post-vesting shareholding requirements*—equity-based incentives are intended to help align the interests of management and shareholders and enhance long-term value, which may be undermined if executives may immediately dispose of all or most of the shares received.

9. Are the factors binary? Are they weighted equally?

EPSC factors are not equally weighted. Each factor is assigned a maximum number of potential points, which may vary by model. Some are binary, but others may generate partial points. For all models, the total maximum points that may be accrued is 100. The passing score is 53 in all cases, i.e., slightly more than half of the potential maximum factor scores. The chart below summarizes the scoring basis for each factor.

EPSC Factors & Point Allocation System

Factor	Definition	Scoring Basis
SVT – A+B+C Shares	Company's Shareholder Value Transfer (SVT) relative to peers – based on new shares requested + shares remaining available + outstanding grants and awards	Scaled depending on company SVT versus ISS' SVT benchmarks
SVT – A+B Shares	Company's Shareholder Value Transfer (SVT) relative to peers – based on new shares requested + shares remaining available	Scaled as above
CIC Single Trigger	Automatic vesting of outstanding awards upon a change in control	Yes – no points No – full points
Liberal Share Recycling – FV	Certain shares not issued (or tendered to the company) related to full value share vesting may be re-granted	Yes – no points No – full points
Liberal Share Recycling – Options	Certain shares not issued (or tendered to the company) related to option or SAR exercises or tax withholding obligations may be re-granted; or, only shares ultimately issued pursuant to grants of SARs count against the plan's share reserve, rather than the SARs originally granted	Yes – no points No – full points
Minimum Vesting Requirement	Does the plan stipulate a minimum vesting period of at least one year for any award	No or vesting period < 1 year – no points

		Vesting period =/> 1 year – full points
Full Discretion to Accelerate (non-CIC)	May the plan administrator accelerate vesting of an award (unrelated to a CIC, death, or disability)	Yes – no points No – full points
3-Year Average Burn-Rate	Company's 3-year average burn rate (as a percentage of common shares outstanding) relative to industry and index peers	Scaled depending on company's burn rate versus ISS benchmarks
Estimated Plan Duration	Estimated time that the proposed share reserve (new shares plus existing reserve) will last, based on company's 3-year average burn rate activity	Duration =/< 5 years – full points Duration >5 </= 6 years – ½ of full points; Duration > 6 years – no points
CEO's Grant Vesting Period	Period required for full vesting of the most recent equity awards (stock options, restricted shares, performance shares) received by the CEO within the prior 3 years	Vesting Period > 4 years – full points; Vesting Period =/> 3 years </= 4 (or no award in prior 3 years) – ½ of full points; Vesting Period < 3 years – no points
CEO's Proportion of Performance-Conditioned Awards	Proportion of the CEO's most recent fiscal year equity awards (with a 3-year look-back) that is conditioned on achievement of a disclosed goal	50% or more – full points; 33% < 50% — ½ of full points; < 33% — no points
Clawback Policy	Does the company have a policy that would authorize recovery of gains from all or most equity awards in the event of certain financial restatements?	Yes – full points No – no points
Holding Period	Does the company require shares received from grants under the plan to be held for a specified period following their vesting/exercise?	At least 12 months or to end of employment – full points; < 12 months (or until ownership guidelines met) – ½ of full points; No holding period/silent – no points

10. Which factors, on a stand-alone basis, will continue to result in a negative recommendation on an equity plan proposal, regardless of the score from all other EPSC factors?

The following egregious features will continue to result in an "Against" recommendation, regardless of other EPSC factors ("Overriding Factors"):

- A liberal change-of-control definition (including, for example, shareholder approval of a merger or other transaction rather than its consummation) that could result in vesting of awards by any trigger other than a full double trigger;
- If the plan would permit repricing or cash buyout of underwater options or SARs without shareholder approval (either by expressly permitting it—for NYSE and Nasdaq listed companies—or by not prohibiting it when the company has a history of repricing—for non-listed companies);
- If the plan is a vehicle for problematic pay practices or a pay-for-performance disconnect; or
- If any other plan features or company practices are deemed detrimental to shareholder interests; such features may include, on a case-by-case basis, tax gross-ups related to plan awards or provision for reload options.

11. Are all covered plans subject to the same EPSC factors and weightings?

No, EPSC factors and weightings are keyed to four models related to company size or status: S&P 500; Russell 3000 index (excluding S&P 500 companies); Non-Russell 3000; and Recent IPOs or Bankruptcy Emergent companies (or any company that does not disclose at least three years of grant data).

The S&P 500 and Russell 3000 EPSC models utilize all of the factors enumerated. The EPSC model for Non-Russell 3000 companies utilizes all of the factors in the Plan Cost and Plan Features pillars but only the Burn Rate and Duration factors in the Grant Practices pillar. The IPO/Bankruptcy model utilizes all of the factors in the Plan Cost and Plan Features pillars but none of the factors in the Grant Practices pillar.

12. How do the SVT factors work in the EPSC model?

SVT is calculated the same as under prior ISS policies (see Plan cost for additional information), except that there are now two SVT measures:

(1) One includes the new share request ("A shares" in ISS' internal parlance) plus all shares that remain available for issuance ("B shares") plus unexercised/unvested outstanding awards ("C shares").
(2) The second includes only A shares and B shares, excluding C shares.

EPSC points allocated for each SVT factor are based on the relationship of the company's SVT measures (ABC and AB) to their respective ISS benchmarks. The ISS benchmark SVT is based on regression analysis for the company's GICS industry group, market cap size, and operational and financial metrics identified as correlated with total shareholder return performance in the industry. Maximum potential EPSC points are accrued for proposals with total costs at or less than approximately 65% of the ISS benchmark SVT (which is equivalent to the SVT "Allowable Cap" under prior policy).

13. How does the burn rate factor work in the EPSC?

ISS calculates burn rate benchmarks for specific industry groupings in three index categories: S&P500; Russell 3000 (excluding S&P 500); and Non-Russell 3000. For each index, these benchmarks reflect each 4-digit GICS industry group's 3-year mean burn rate plus one standard deviation (with a floor for the benchmark of 2.00 percent). Scoring for the Burn Rate factor is scaled according to the company's 3- year average annual burn rate relative to its applicable index/industry benchmark; maximum EPSC points for this factor are accrued when the company's 3-year average burn-rate is at or below 50% of the benchmark.

Methodology-Related Questions

14. Will ISS continue to potentially "carve out" a company's option overhang in certain circumstances?

No. The dual SVT measurement approach in the EPSC (which considers SVT that excludes the impact of grant overhang) eliminates the need for a carve-out of long-term outstanding option overhang.

15. Will there still be a 2% de minimis burn rate?

The minimum burn rate benchmark for each industry group will be 2 percent.

16. Will ISS continue to accept burn rate commitments under the new policy?

No. The new policy considers the company's 3-year average burn rate as a factor in the EPSC evaluation, where it is scored based on a range relative to industry benchmarks (as discussed in previous questions). This eliminates the potential for companies to commit to specific future burn rate levels.

17. Is the CEO equity award proportion that is considered "performance based" explicit (i.e., as disclosed in proxy by the company) or calculated based on the Grants of Plan-Based Awards table?

The proportion of the CEO's equity grants deemed to be "performance conditioned" is based on the ISS valuation of awards reported in the Grants of Plan-Based Awards table. Time-vesting stock options and SARs are not considered performance conditioned unless the vesting or value received depends on attainment of specified performance goals, or if ISS determines that the exercise price is at a substantial and meaningful premium to the grant date fair market value.

18. How is plan duration calculated under the EPSC?

Duration is calculated as the sum of all new shares requested plus shares remaining available for issuance, divided by the average annual burn rate shares over the prior three years. This calculation yields an estimate of how long the company's requested total reserve is expected to last. If a company's proposed plan has a fungible share design (where full value awards count against the share reserve at a higher rate than appreciation awards), the proportion of the burn rate shares that are full-value awards will be multiplied by that fungible ratio in order to estimate the plan's duration. Under the EPSC, maximum points are accrued for plan duration of 5 years or less.

19. How will the EPSC operate if multiple equity plans are on the ballot?

When approval is sought for multiple equity plans, the Scorecard will evaluate the plans as follows:

- The Plan Cost pillar will consider the cost of all plans on the ballot in aggregate. The Plan Features and Grant Practices pillars will evaluate the factors based on the "worst" scenarios among the plans. If an acceptable score is generated on the aggregate basis, all plans will be considered passed (absent overriding factors).
- If the score on an aggregate basis is lower than the passing threshold, then the following logic will apply, subject to the overriding factors:

- If each plan's individual EPSC score is below the EPSC threshold, then each plan fails.
- If only one plan's individual EPSC score is equal to or exceeds the threshold, then that plan will pass and the other plan(s) fail.
- If all plans' individual EPSC scores are equal to or exceed the threshold, then the plan with the highest SVT cost (on an A/B/C basis) will pass and the other plan(s) fail.

20. How will plan proposals that are only seeking approval in order to qualify grants as "performance-based" for purposes of IRC Section 162(m) be treated?

Proposals that only seek approval to ensure tax deductibility of awards pursuant to Section 162(m), and that do not seek additional shares for grants, will generally receive a favorable recommendation regardless of EPSC factors, provided the Board's Compensation Committee (or other administrating committee) is 100 percent independent according to ISS standards. In the case of proposals that include additional plan amendments, such amendments will be analyzed to determine whether they are, on balance, positive or negative with respect to shareholders' interests, and ISS will determine the appropriate evaluative framework and recommendation accordingly.

Proposals for Section 162(m) approval that represent the first time public shareholders have an opportunity to weigh in on a plan following a company's IPO or emergence from bankruptcy will be subject to ISS' full equity plan evaluation.

Harvard Law School Forum on
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SEC Proposes "Pay Versus Performance" Rule

Posted by Edmond T. FitzGerald, Davis Polk & Wardwell LLP, on Friday, May 8, 2015

Editor's note: Edmond T. FitzGerald is partner and head of the Executive Compensation Group at Davis Polk & Wardwell LLP. This post is based on a Davis Polk client memorandum; the complete publication, including Appendix, is available here. Related research from the Program on Corporate Governance about CEO pay includes Paying for Long-Term Performance (discussed on the Forum here) and the book Pay without Performance: The Unfulfilled Promise of Executive Compensation, both by Lucian Bebchuk and Jesse Fried.

On April 29, 2015, a divided Securities and Exchange Commission proposed requiring U.S. public companies to disclose the relationship between executive compensation and the company's financial performance.[1] The proposed "pay versus performance" rule, one of the last Dodd-Frank Act rulemaking responsibilities for the SEC, mandates that a company provide, in any proxy or information statement:

- A new table, covering up to five years, that shows:
    - compensation "actually paid" to the CEO, and total compensation paid to the CEO as reported in the Summary Compensation Table;
    - average compensation "actually paid" to other named executive officers, and average compensation paid to such officers as reported in the Summary Compensation Table; and
    - cumulative total shareholder return (TSR) of the company and its peer group; and
- Disclosure of the relationship between:
    - executive compensation "actually paid" and company TSR; and
    - company TSR and peer group TSR.

The proposed rule (attached to the complete publication as Appendix A) would provide flexibility in some areas, such as permitting companies to select their peer groups. In other respects, however, the proposed rule would be highly prescriptive in ways not mandated by the Dodd-Frank Act—for example, in creating a new measure of compensation "actually paid," as well as requiring the use of cumulative TSR as the metric by which to compare the company's performance to its executives' pay and to the performance of its peers.

The Q&A below addresses some of the issues raised by the proposed rule.

[1] The full text of the release is available here; the SEC's factsheet is available here; and the Commissioners' statements are available here: Chair White, Commissioner Aguilar (discussed on the Forum here), Commissioner Gallagher, Commissioner Piwowar, Commissioner Stein (discussed on the Forum here).

Background

Section 953(a) of the Dodd-Frank Act amended Section 14 of the Securities Exchange Act of 1934 to direct the SEC to implement rules requiring each registrant to disclose, in proxy or information statements in which Item 402 executive compensation disclosure is required, a clear description of the relationship between compensation actually paid to the registrant's "named executive officers" and the financial performance of the registrant, taking into account any change in the value of the registrant's shares and any dividends and distributions.

The proposed pay versus performance rule implements Section 953(a) by adding a new Item 402(v) to Regulation S-K.

Timing

Q: When will pay-versus-performance disclosure first be required?

A: In the first proxy or information statement filed after the final rule becomes effective.

Pay-versus-performance disclosure must be provided in the first proxy or information statement filed after the final rule becomes effective. Because it is possible that the rule will be finalized in 2015, calendar year companies may be required to provide this disclosure in the 2016 proxy season.

Q: Which filings must include pay-versus-performance disclosure?

A: Any proxy or information statement in which Item 402 compensation disclosure is required.

Pay-versus-performance disclosure would be required in proxy statements for annual and special shareholder meetings filed on Schedule 14A and information statements filed on Schedule 14C. The disclosure is not required in Form S-1 registration statements or Form 10-K annual reports, regardless of whether such forms include Item 402 compensation disclosure.

Because the disclosure will be provided pursuant to Item 402, it will be covered by the advisory (non-binding) say-on-pay vote.

The disclosure will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the company specifically incorporates it by reference.

Q: Which companies are subject to pay-versus-performance disclosure?

A: Most companies that file proxy and information statements.

The following types of companies are *exempted* from compliance with the proposed rule:

- emerging growth companies, or EGCs;[2]
- foreign private issuers (even those filing on U.S. periodic disclosure forms); and
- registered investment companies.

Smaller reporting companies are subject to the proposed rule, but with more limited disclosure requirements that are phased in over time, as discussed below.

Q: Do any transition rules apply to new companies?

A: Yes. Pay-versus-performance disclosure is not required in an IPO. In addition, a newly public company that does not otherwise qualify for EGC relief need not provide disclosure for fiscal years prior to the most recently completed fiscal year if the company was not an Exchange Act filer during those years.

> *Example:* A non-EGC closes its IPO in 2016 and files its first annual proxy statement in 2017. The company was not an Exchange Act filer prior to 2016. The company is not required to provide pay-versus-performance disclosure in its IPO registration statement. In its 2017 proxy statement, the company is required to provide disclosure only for 2016. In its 2018 proxy statement, the company is required to provide disclosure only for 2016 and 2017.

Details

Q: Whose compensation is covered?

A: The CEO, individually, and the other named executive officers as a group.

If more than one person served as CEO in any fiscal year, the aggregate compensation actually paid to those persons is required to be disclosed for that year as the compensation actually paid to the CEO.

Compensation for the other named executive officers is required to be disclosed as an average, which the SEC indicates is because the numbers and identities of these officers can vary over the requisite five-year period. Absent clarification to the contrary by the SEC, this would include all CFOs for each year in which a registrant has more than one CFO. This would also include the up to two additional individuals for each year who would have been one of the three named executive officers (other than the CEO and CFO) based on their total compensation, if they were serving as executive officers at the end of such year (including any separation payments made to such additional individuals that were required to be disclosed under Item 402).

[2] EGCs include issuers that completed their IPOs after December 8, 2011, and that have less than $1 billion in total annual gross revenues during their most recently completed fiscal year. An issuer remains an emerging growth company until the earliest of (i) the last day of the fiscal year in which it has total annual gross revenues in excess of $1 billion, (ii) the last day of the fiscal year following the fifth anniversary of its IPO, (iii) the date on which it has issued more than $1 billion in non-convertible debt in the last three-year period and (iv) the date on which it becomes a “large accelerated filer.”

Q: For what period is pay-versus-performance disclosure required to be provided?

A: After a transition period, companies other than smaller reporting companies must provide the information for five years, and smaller reporting companies must provide the information for three years.

Registrants are required to provide pay-versus-performance disclosure for the following number of years prior to the year in which the proxy or information statement is filed:

Year of Filing	Companies Generally	Smaller Reporting Companies
First year	3 years	2 years
Second year	4 years	3 years
Third year and thereafter	5 years	3 years

This differs from the Summary Compensation Table, which requires reporting compensation for only three years (or two years, for smaller reporting companies).

Q: How is the amount of executive compensation "actually paid" determined?

A: By starting with the total amount of compensation disclosed in the Summary Compensation Table and then adjusting that amount by including equity awards that vested (rather than awards that were granted) and the service cost relating to pension benefits (rather than the change in pension value).

The amount of compensation "actually paid" for a fiscal year equals the amount reported in the "Total" column of the Summary Compensation Table for such fiscal year, as decreased and increased as follows:

- Equity awards:
  - *Subtract* the *grant* date fair values of the equity awards reported in the "Stock Awards" and "Option Awards" columns of the Summary Compensation Table for such fiscal year; and
  - *Add* the *vesting* date fair values of the equity awards that vested during such fiscal year.

- Pensions:
  - *Subtract* the aggregate change in the actuarial present value of the accumulated benefit under all defined benefit and actuarial pension plans reported in the "Change in Pension Value and Nonqualified Deferred Compensation Earnings" column of the Summary Compensation Table for such fiscal year; and
  - *Add* the actuarially determined service cost for services rendered by the executive during the applicable year under all such defined benefit and actuarial pension plans (consistent with "service cost" as defined in FASB ASC Topic 715).

The vesting date fair values of the equity awards are required to be computed in a manner consistent with FASB ASC Topic 718. Footnote disclosure is required if any assumption used for

the vesting date valuation differs materially from the grant date assumptions used for the grant date valuations, as disclosed in the footnotes to the Summary Compensation Table.

Requiring the vesting date value of a stock option to be reported at fair value, rather than intrinsic value (i.e., the excess, if any, of the aggregate value of the shares underlying the option minus the aggregate exercise price of the option), typically results in more compensation actually paid, because an option's fair value almost always exceeds its intrinsic value and an "out-of-the-money" option has some fair value (but no intrinsic value).

The vesting date fair value of an option is required to be included in the amount of compensation actually paid, even if the option is not exercised (or even exercisable) on the vesting date. The vesting date fair value of restricted stock units is also required to be included, even if the underlying shares are not delivered until a later date (so, for example, if the executive is retirement-eligible on the grant date, the units presumably are deemed to be vested at grant for purposes of the proposed rule).

The SEC explains that it believes that pension service cost is a better measure of pension benefits actually paid because pension value is subject to significant volatility (e.g., due to changes in interest rates). Smaller reporting companies are not required to include the service cost under pension plans (as they are not required to report changes in pension value in the Summary Compensation Table).

Computing the compensation "actually paid" will require calculating historical values for equity and pension benefits that were not previously required to be calculated for purposes of Item 402 disclosure.

> *Example:* For 2015, the co mpensation reported for a company's CEO in the Summary Compensation Table totals $4,000,000, consisting of $700,000 in salary, $1,000,000 in annual cash bonus, $2,000,000 in stock awards granted in 2015, $200,000 in change in pension value and $100,000 in all other compensation. In 2015, the fair value of the CEO's equity awards that vested is $3,000,000 and the pension service cost is $100,000. The compensation actually paid to the CEO for 2015 is $4,900,000 ($4,000,000 –$2,000,000 + $3,000,000 – $200,000 + $100,000).

Q: How is the company's peer group determined?

A: By using the same index or peers that the company uses either for purposes of the stock performance graph required under Item 201(e)(1)(ii) of Regulation S-K or in the CD&A for purposes of disclosing compensation benchmarking practices.

Item 201(e)(1)(ii) requires companies to provide a line graph comparing the yearly percentage change in their cumulative TSR with that of any of the following:

- A published industry or line-of-business index;
- Peer companies selected in good faith by the company; or

- Companies with similar market capitalizations (but only if the company does not use a published industry or line-of-business index and does not believe it can reasonably identify a peer group).

Alternatively, if the company uses a different peer group in the CD&A for purposes of describing compensation benchmarking practices, it may use that peer group for purposes of the proposed rule.

If the peer group is not a published industry or line-of-business index, the company must identify the companies comprising the group. If the company disclosed the companies in its peer group in prior filings, it may incorporate those filings by reference.

The proposed rule does not prohibit a company from changing its peer group from year to year or require disclosing the reason for any changes (unlike Item 201(e), which requires disclosing changes to the peer group for the stock performance graph).

Regardless of which peer group a company selects, proxy advisory firms may select different peer groups for their analyses of the link between executive pay and the company's performance.

Smaller reporting companies are not required to disclose peer group TSR, as they are not otherwise required to present the TSR of a peer group or to disclose peers used for compensation benchmarking.

Q: How is cumulative TSR calculated?

A: In the same manner, and over the same measurement period, as under Item 201(e).

Consistent with Item 201(e), the proposed pay-versus-performance rule requires cumulative TSR for each year to be calculated as follows:

- the sum of (1) the cumulative amount of dividends for such year, assuming dividend reinvestment, *plus* (2) the difference between the company's share price at the end and the beginning of such year; *divided by*
- the share price at the beginning of such year.

The share price at the beginning of each year is the market closing price on the last trading day of the year preceding such year, and the share price at the end of such year is the market closing price on the last trading day of such year.

The returns of each company in the peer group must be weighted according to their respective stock market capitalizations at the beginning of each period for which a return is indicated. The same methodology must be used in calculating both the company's TSR and that of the peer group.

Note that TSR, as calculated for purposes of the proposed rule, may differ from TSR as calculated by a company for other compensation purposes. For example, a company may grant restricted stock units that vest based on attainment of a TSR goal, with TSR measured using the average closing price over a 30-day trailing period (rather than the spot closing price), and with

the returns of each company in the peer group not weighted according to their respective stock market capitalizations.

There is some ambiguity as to whether cumulative TSR is required to be disclosed for each year on an annual basis (i.e., only for such year), rather than on a multi-year basis (i.e., for such year and all years prior to such year that are required to be disclosed). Given that the proposed rule requires compensation to be reported on an annual basis, it would seem inconsistent with one of the SEC's stated goals that the rule promote comparability if cumulative TSR were reported on a multi-year basis. We also note that Commissioner Piwowar described TSR as a single-year metric.

> *Example:* In its 2016 annual proxy statement, a company that does not pay dividends is required to disclose its TSR for 2013 through 2015. At the market close on December 31 of 2012, 2013, 2014 and 2015, the company's share price is $20, $30, $24 and $27, respectively. The company's cumulative TSR for 2013 is 50% (($30-$20) / $20), for 2014 is -20% (($24-$30) / $30) and for 2015 is 12.5% (($27-$24) / $24).

Q: How and where is the disclosure required?

*A: The **amount** of compensation actually paid and the cumulative TSR of the company and its peers must be presented in tabular format. The **relationship** between pay and performance may be presented graphically and/or narratively*.

The proposed rule mandates use of the following table:

Year (a)	Summary Compensation Table Total for PEO (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for non-PEO named executive officers (d)	Average Compensation Actually Paid to non-PEO named executive officers (e)	Total Shareholder Return (f)	Peer Group Total Shareholder Return (g)

A company must describe the relationship between pay and performance following the table. The company must clearly describe (1) the relationship between executive compensation actually paid and company TSR and (2) the relationship between company TSR and peer group TSR. The description may be presented graphically and/or narratively. The SEC provides the following as examples of ways to present the description:

- a graph providing executive compensation actually paid and change in TSR on parallel axes and plotting compensation and TSR over the requisite period; or
- showing the percentage change over each year of the requisite period in both executive compensation actually paid and TSR, along with a brief description of that relationship.

The proposed rule does not mandate a specific location within the proxy or information statement for the new disclosure, although the SEC indicates that it expects companies to provide the disclosure with the Item 402 executive compensation disclosure.

The disclosure must be electronically formatted using XBRL, in order to increase the comparability and usefulness of the information. The interactive data for the table is also required to be provided as an exhibit to the proxy or information statement. Smaller reporting companies are not required to present the disclosure in XBRL until the third filing in which they provide such disclosure. This is the first time that the SEC plans to require proxy statement disclosure to be formatted using XBRL.

Q: May companies provide supplemental pay-versus-performance disclosure?

A: Yes.

A company may provide pay-versus-performance disclosure based on a measure of compensation other than compensation "actually paid" (e.g., realized pay or realizable pay) if the company believes that the alternative measure provides useful information about the relationship between compensation and company performance. However, perhaps borrowing from the SEC's rules on non-GAAP disclosure and on alternative tables in the CD&A, the supplemental disclosure may not be misleading and may not be presented more prominently than the required disclosure.

Q: How does the proposed rule apply to smaller reporting companies?

A: As noted above, the proposed rule applies on a scaled basis to smaller reporting companies.

Specifically, the proposed rule exempts smaller reporting companies from, or phases in, the requirements, as follows:

- Only three years of pay-versus-performance disclosure are required (two years, for the first filing). Other companies are required to provide five years of disclosure (three years for the first filing, and four years for the second filing).
- No requirement to include the service cost under pension plans in calculating compensation actually paid.
- No requirement to disclose peer group TSR.
- The requirement to present the disclosure in XBRL does not apply until the third filing.

Request for Comments

Q: On what aspects of the proposed rule does the SEC request comments?

A: The SEC specifically requests comments on 64 questions relating to all aspects of the proposed rule.

A number of these questions ask whether the final rule should provide companies with more flexibility or reduce the burden of complying with the rule's requirements. Here are a few of such questions:

- Should disclosure be required only for the CEO?
- Should companies be permitted to determine which elements of compensation to include in calculating compensation actually paid, so long as they clearly disclose how the amount is calculated?
- Should companies be allowed flexibility in choosing the relevant measure of performance to disclose?
- Should the five-year disclosure period (for companies other than smaller reporting companies) be shorter (e.g., three years)?

That the SEC has posed such questions might signal that it is open to adopting a more principles-based approach in the final rule, at least as to certain of the rule's requirements. The two Commissioners (Gallagher and Piwowar) who voted against adopting the proposed rule noted that they did so largely because they view it as overly prescriptive.

Action Items

Q: What should companies be doing now?

A: Companies may want to prepare.

Companies should consider taking the following actions now, as developing the new disclosure will require work:

- Model how your company's cumulative TSR may compare to the compensation actually paid to your CEO and to the cumulative TSR of your peers. Consider whether supplemental disclosure and/or alternative performance measures may be useful to address any perceived disconnect between pay and performance that might result from the mandated disclosure.
- Inform your company's board of directors or the relevant committee(s) of the proposed rule and the story that it may tell regarding the relationship between executive pay and company performance.
- Consider commenting on the proposed rule—the SEC pays particular attention to the comments it receives from those directly affected by its rules. Once the proposed rule is filed in the Federal Register (likely within the next week), comments are expected to be due in 60 days.

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Improving Transparency for Executive Pay Practices

Posted by Luis A. Aguilar, on Thursday, April 30, 2015

Editor's Note: Luis A. Aguilar is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on Commissioner Aguilar's remarks at a recent open meeting of the SEC; the full text, including footnotes, is available here. The views expressed in the post are those of Commissioner Aguilar and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff. Related research from the Program on Corporate Governance about CEO pay includes: Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here); Golden Parachutes and the Wealth of Shareholders by Lucian Bebchuk, Alma Cohen, and Charles C.Y. Wang (discussed on the Forum here); and The Growth of Executive Pay by Lucian Bebchuk and Yaniv Grinstein.

Today, as part of a series of Congressionally-mandated rules to promote corporate accountability, we consider proposed rules to put a spotlight on the relationship between executive compensation and a company's financial performance. It is well known that the compensation of corporate executives has grown exponentially over the last several decades, and continues to do so today. It is also commonly accepted that much of that growth reflects the trend towards equity-based and other incentive compensation, which is thought to align the interests of corporate management with the company's shareholders. Specifically, the idea is that stock options, restricted stock, and other incentive-based compensation encourages management to work hard to improve their company's performance, because managers will share in the wealth along with shareholders when stock prices rise.

Nonetheless, we've now seen too many instances where managers have received outsized compensation even when companies experience large losses and shareholders suffered. Indeed, one 2013 study found that of the 25 highest-paid CEOs for each year in a twenty-year period ending in 2012, 38% were held by CEOs who led firms that were bailed out or crashed during the 2008 financial crisis, were fired by their firms, or had to pay settlements or fines related to fraud charges. Other studies have found a significant disconnect between the financial performance of companies in the S&P 1500 and the incentive compensation of their executives. In fact, a recent study found that in a three-year period after the 2008 financial crisis, while overall stock-based performance declined for companies in the S&P 1500, total CEO compensation during this same period increased.

Today's proposed rules, as required by Section 953(a) of the Dodd-Frank Act, are designed to shed light on the relationship between executive pay and company performance by providing shareholders with additional information to enable them to better determine whether their companies are appropriately and responsibly setting executive pay. These rules attempt to fulfill this goal by requiring companies to provide shareholders with a clear description of the

relationship between compensation actually paid to the companies' senior officers—the so-called "named executive officers"—and the financial performance of the issuers.

Although the Commission's current disclosure rules already require certain summary executive compensation information to be disclosed to shareholders, today's proposal will supplement this disclosure by providing for executive compensation information to be calculated and presented in different ways—so as to highlight the relationship between a company's executive compensation practices and its financial performance. More specifically, the proposed rules will require that registrants present in a proxy or information statement a table that includes, for each of the company's last five years, the following:

- First, the executive compensation actually paid to the company's principal executive officer and separately, as an average, the compensation paid to the other named executive officers;
- Second, the financial performance of the company and, in addition, either a recognizable industry or line-of-business index and/or an identified peer group, calculated by using cumulative total shareholder return; and
- Third, for comparison purposes, the summary compensation data that is already disclosed under current rules for the principal executive officer and the other named executive officers.

In addition, the proposed rules require registrants to provide a clear description of the relationship between the executive compensation actually paid and the financial performance of the company. However, registrants are provided flexibility to choose how best to present this relationship, such as in a narrative form, a graphic form, or both.

Today's rules also take an important step forward in furthering the usability and comparability of executive compensation disclosures by requiring that "pay versus performance" information be provided in an interactive data format using XBRL. This is a new development in the corporate governance context that has long been discussed. Indeed, in its 2010 Concept Release on the U.S. Proxy System, the Commission stated that if issuers provided reportable items in interactive data format, "shareholders may be able to more easily obtain specific information about issuers, compare information across different issuers, and observe how issuer-specific information changes over time as the same issuer continues to file in an interactive data format." More recently, in 2013, the Commission's Investor Advisory Committee recommended that the Commission prioritize tagging of data that would provide increased transparency with respect to corporate governance issues, including portions of the proxy statement that relate to executive compensation. Although data tagging is already required in other contexts, today's proposed rules would, for the first time, implement an interactive data format into a Commission rulemaking involving the proxy process and corporate governance.

It is important to note what today's proposed rules do not do: they do not attempt to direct or otherwise define what an executive should earn. That is left to a company's board of directors and senior management. Instead, today's proposed rules focus on providing increased transparency on the linkage between executive compensation and the company's performance.

Today's pay versus performance proposed rules go to the heart of good corporate governance. Indeed, one of the principal elements of effective corporate governance is accountability.

Accountability means that actions have consequences, and good corporate governance demands that boards and company management be held accountable for the decisions they make. A company's executive compensation practices can demonstrate whether senior management will be held accountable for their performance. When it comes to executive pay, shareholders benefit when good performance is rewarded, and when poor performance is not.

Good corporate governance also reminds a company's directors that they do not answer to management, but rather work for the true owners of the public corporation—the company's shareholders. To that end, the disclosure proposed today can better inform shareholders and give them information needed to hold directors accountable for the executive compensation decisions that they make. In this context, company boards must be vigilant in ensuring that corporate pay practices adequately reflect the performance of their executives.

Many boards have already adopted strong corporate governance measures and do a good job in representing the interests of shareholders. Others can do better—much better. For those boards in particular, the public disclosure of "pay versus performance" information should serve to dissuade them from being complacent and simply rubberstamping the salaries of their executives. This concept of motivating boards to action is critical to good corporate governance, because when boards allow themselves to be dictated to by management, the harm to shareholders can be devastating.

Ultimately, this proposing release is a positive step in the direction of better corporate governance—through increased transparency and greater accountability—and is a step forward in ensuring that a company's management and directors are acting in the best interests of shareholders.

Conclusion

In conclusion, I will support today's rules as proposed. As with all proposing releases, this proposing release includes many requests for comment regarding the approach that the Commission has decided to take to implement the statutory mandate. Public comments are an important part of the rulemaking process, and I especially encourage investors to review and submit their thoughts on the proposed release.

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Does the SEC's New "Compensation Actually Paid" Help Shareholders?

Posted by Ira Kay and Blaine Martin, Pay Governance LLC, on Thursday, July 2, 2015

Editor's Note: Ira Kay is a Managing Partner and Blaine Martin is a Consultant at Pay Governance LLC. This post is based on a Pay Governance memorandum.

On April 29, 2015, the SEC released proposed rules on public company pay-for-performance disclosure mandated under the Dodd-Frank Act. Pay Governance has analyzed the proposed rules and the implications for our clients' proxy disclosures and pay-for-performance explanations to investors. We are concerned about the validity of describing a company's pay-for-performance alignment using the disclosure mandated under the SEC's proposed rules, and its implications for Say on Pay votes.

The disclosure of "compensation actually paid" (CAP) as defined by the SEC may prove helpful for investors and other outside parties to estimate the amount of compensation *earned* by executives, in contrast to the compensation *opportunity* as disclosed in the Summary Compensation Table (SCT). However, the SEC's proposed rules are explicitly intended to compare executive compensation earned with company stock performance (TSR), per the relevant section of the Dodd-Frank legislation.[1] If the rules are intended to help shareholders understand the linkage between executive compensation programs and stock performance, then the technical nuance of the proposed methodology may be problematic.

Key Takeaways

- The SEC's proposed CAP disclosure was intended to facilitate a pay-for-performance comparison by investors. Its definition does not chronologically align executive stock grants to the performance period for the calculation of total shareholder returns. As a result, the SEC's methodology does not facilitate an accurate assessment of pay-for-performance.
- CAP for 3 years as of 2014, for example, includes pro-rata vesting tranches of equity awards that could have been granted in 2009, 2010, 2011, 2012, and 2013. In comparison, TSR is measured over the 2012-2014 period.
- We illustrate the problems inherent in the SEC's methodology using a real-world anonymous example.
- Such misalignment is inherent in the CAP methodology. Thus the SEC's suggestion that a time-series comparison of CAP and TSR can help investors to understand the alignment of pay and performance is not valid.

[1] ISS uses a modified version of SCT pay for their relative degree of alignment pay-for-performance model.

- Instead, realizable pay, which provides an updated value of equity awards granted in the preceding three years, provides a better view of pay-for-performance alignment for inve*stors.*

The most apparent problem with comparing CAP and company TSR is that the CAP figure, which includes the value of equity awards *vesting* in each year, includes multiple equity grants that may have been granted one, two, three, four, or more years before the TSR measurement period. This depends heavily on the vesting schedule or performance period of equity awards. This mismatch in the timing of the stock grants and TSR significantly limits the utility of CAP in pay-for-performance analysis.

This post explores this concern by modeling a real-world CEO CAP disclosure table for the 3-year period allowed under the SEC's disclosure transition relief. While this example is based on a real public company and CEO, identifying data have been withheld to protect confidentiality.

Pro-Forma SEC Mandated Table

The table below is a pro-forma version of the SEC mandated CAP table representing a 3-year period. Our pro-forma table focuses only on the CEO to simplify discussion and analysis, but results would be similar for all other named executive officers.[2]

	CEO Compensation ($000's)		Total Shareholder Return (Cumulative)		
Year	Compensation Actually Paid	Summary Compensation Table Pay	Company TSR	Peer Group TSR	TSR Period
2014	$5,010	$9,144	**20%**	**97%**	**3-year**
2013	$3,145	$8,326	-7%	61%	2-year
2012	$20,163	$20,828	0%	19%	1-year
Total	**$28,318**	**$38,298**			

Potential Narrative Disclosure

The proposed rules require a narrative discussion of the *relationship* 1) between CAP and company TSR, and 2) between company TSR and peer TSR. In the case of our example, the narrative below attempts to describe these relationships:

In the three year history of CEO compensation in the SEC-mandated table above, CAP was significantly below Summary Compensation Table pay in 2013 and 2014. CAP in 2012 approximates SCT pay, but 2012 was an unusual year for the Company due to a CEO transition, and the CAP value in 2012 includes severance and vested equity awards for our departing CEO, in addition to annual compensation for our new CEO. The disclosed level of CAP was delivered commensurate with 3-year cumulative TSR of 20%, which was below the 3-year TSR for the peer

[2] The pro-forma disclosure provided, including the TSR period, is based on our good-faith interpretation of the proposed SEC regulations. The disclosure format may change pursuant to the SEC's final rules, and subsequent Q&A provided by the SEC.

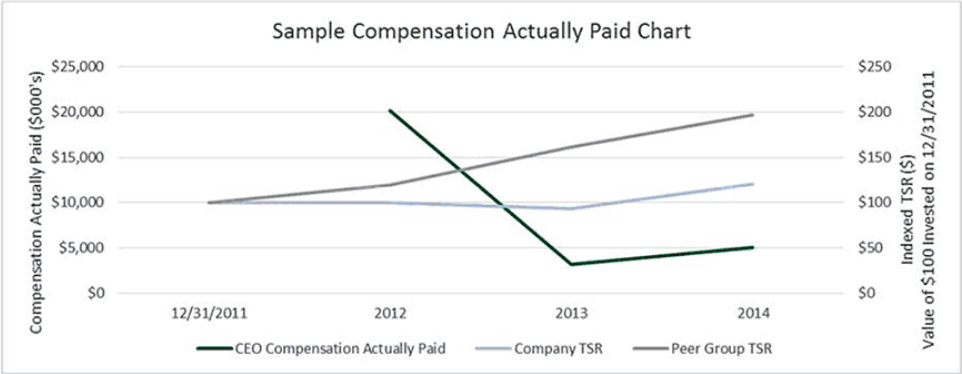
group of 97%. Additional information on company pay-for-performance alignment is provided in the Compensation Discussion and Analysis.

The SEC's proposed disclosure rules suggest that the SEC believes that a comparison of the year-over-year change in CAP, company TSR, and peer group TSR would help investors to understand pay-for-performance alignment. This expectation is potentially problematic because CAP is composed mostly of the equity awards that vest in a particular year, *many of which were not granted during the TSR performance period (e.g., a 3-year award granted in 2009, which vests in 2012)*. Vested equity awards are valued using the stock price on the date of vesting, and not the year-end stock price (as used for TSR calculation purposes), further contributing to the CAP/TSR timing disconnect. The methodology is further complicated by the SEC's requirement that companies disclose the aggregate CEO CAP for years in which a CEO transition occurred mid-year. Thus, it is *unlikely* that CAP would track company stock performance based on these nuances in the SEC-mandated methodology.

As a result, our pro-forma narrative focuses not on the year-to-year change in CAP, but on the relationship between CAP and summary compensation table pay (pay opportunity) and the relationship between 3-year company TSR and 3-year peer group TSR. While the comparison of 3-year CAP and summary compensation table pay is not perfect because the two values do not represent the same equity awards, it is nearly meaningless to compare CAP to TSR without reference to either pay opportunity or peer company compensation. Companies may also wish to consider disclosing a peer group comparison of CAP levels, although such an analysis would have to lag one year behind the disclosure year based on availability of peer group CAP disclosure.

Graphical Comparison Alternative

The SEC proposed rules suggest that companies may wish to provide a time series line chart which would plot CAP, Company TSR, and Peer Group TSR. We provide an example of such disclosure below:



As described above, the SEC may believe a time-series comparison will tell the story of CEO pay relative to company TSR, and Company TSR to peer group TSR. However, in this test scenario, an investor may conclude that CAP has decreased since 2012 while company stock performance

remained relatively flat versus peer company returns. While those facts are true, the 2012 CAP values are inflated due to a CEO transition in 2012, and the chart does not demonstrate the reality that the value of the new CEO's equity awards have tracked company stock price performance. Additionally, the chart does not illustrate that CAP was significantly lower than pay opportunity in 2013 and 2014, or have a reference for CAP relative to peer companies. Without some context for pay, comparing CAP to company and peer group TSR performance is not particularly helpful to investors.

Realizable Pay as a Supplemental Disclosure

Fortunately, the SEC proposed rules allow for supplemental analyses of pay-for-performance alignment in the proxy statement, as long as that analysis is not disclosed more prominently than the required CAP disclosure.

Our research demonstrates that realizable pay is the best methodology for companies to assess and communicate the pay-for-performance alignment of their executive compensation programs. Unlike CAP, realizable pay tracks the change in value of equity awards over the same three-year period for TSR. Thus, 2012, 2013, and 2014 equity grants are valued on 12/31/2014 in our example below. Further, realizable pay is directly comparable to Summary Compensation Table pay since it generally represents an updated valuation of the equity awards provided in 2012, 2013, and 2014. In contrast, CAP measures the value of stock vested in each year, so the equity value for the pro-forma 3-year CAP disclosure includes the portion of awards vesting ratably from grants in 2009, 2010, 2011, 2012, and 2013. Realizable pay compares both pay and performance to competitive peer group levels, because comparing company TSR to peer TSR without the same comparison for pay tells an incomplete story at best. As a result, any peer competitive analysis of realizable pay would lag one year behind the most recent fiscal year since competitive peer data would not be available until the follow year.

	CEO Compensation			Total Shareholder Return (Cumulative)			
Year	Company Realizable Pay	Median Peer Realizable Pay	Company Realizable Pay Percentile Rank	Company TSR	Peer Group TSR	TSR Percentile Rank	TSR Period
2014	$11,147	$8,190	71st	**20%**	**97%**	**2%**	**3-year**
2013	$8,492	$11,602	23rd	-7%	61%	Lowest	2-year
2012	$7,217	$16,920	9th	0%	19%	2%	1-year
Total	**$26,856**	**$36,712**	**19th**				

The table above presents an analysis of realizable pay for our pro-forma example. We ranked the company realizable pay and TSR relative to the peer group and found that the company's 3-year CEO compensation is currently valued at the 19th percentile of the peer group, aligned with performing at the 2nd percentile of the peer group for TSR.

This approach shows how the CEO's equity award values track company stock price. In well-aligned pay programs, CEO realizable pay is typically ranked low relative to peers when TSR is underperforming peers, and is typically ranked high when TSR is outperforming peers. The example above, and research on hundreds of companies over the years, show alignment

between CEO pay and company performance more clearly, consistently, and reliably than can be expected using the SEC's CAP disclosure.[3]

Conclusion

Our pro-forma analysis of the SEC's proposed mandated CAP disclosure reveals major technical and practical problems with the SEC's proposed approach to mandatory pay-for-performance disclosure. If the intention is to help investors understand the pay-for-performance linkage of company executive compensation programs with company stock returns, disclosures complying with the proposed regulations may provide a hazy or even coincidental understanding of pay-for-performance linkage at best. Based on these findings, we believe that supplemental disclosure, and the use of realizable pay in particular, will be critical in communicating the alignment of executive pay programs with the financial interests of shareholders.

[3] While the example above shows that both CAP and realizable pay are aligned with TSR, this outcome may be coincidental. There are numerous possible scenarios where CAP shows misaligned pay while realizable pay is closely aligned.

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SEC Adopts CEO Pay Ratio Disclosure Rule

Posted by Holly J. Gregory, Sidley Austin LLP, on Friday, August 14, 2015

Editor's Note: Holly J. Gregory is a partner and co-global coordinator of the Corporate Governance and Executive Compensation group at Sidley Austin LLP. The following post is based on a Sidley update by Ms. Gregory, John P. Kelsh, Thomas J. Kim, Corey Perry, and Rebecca Grapsas. Related research from the Program on Corporate Governance includes The Growth of Executive Pay by Lucian Bebchuk and Yaniv Grinstein.

On August 5, 2015, the Securities and Exchange Commission (SEC), by a 3-2 vote, adopted rule amendments[1] to implement Section 953(b) of the Dodd-Frank Act, which requires public companies to disclose the "pay ratio" between its CEO's annual total compensation and the median annual total compensation of all other employees of the company.[2]

The pay ratio disclosures that will result from this much-anticipated new rule will further heighten scrutiny on corporate executive compensation practices—with specific focus on how CEO compensation compares to the "median" employee. Companies should be aware that, depending on the magnitude of pay ratios, these new disclosures may exacerbate existing concerns among investors, labor groups and others around executive compensation.

[1] SEC Release No. 33-9877, Pay Ratio Disclosure (Aug. 5, 2015), available here.

[2] Chair Mary Jo White and Commissioners Luis A. Aguilar and Kara M. Stein voted to approve the final rule, and Commissioners Daniel M. Gallagher and Michael S. Piwowar dissented. In his dissenting statement, Commissioner Gallagher described his concerns around the definition of "employee" encompassing a broader group than U.S. full-time employees and that the rule "improperly compels corporate speech." In his dissenting statement, Commissioner Piwowar described his concerns around the lack of specific or convincing justification for the rulemaking. Moreover, in an unusual development, two days after the SEC's open meeting, Commissioner Piwowar issued *additional* dissenting comments setting forth the following "defects" in the pay ratio disclosure rulemaking: (a) the proposing release did not provide sufficient notice under the Administrative Procedure Act, in particular, in relation to what objective, goal or benefit the SEC believed the rulemaking was intended to accomplish; (b) once the SEC decided what objectives Section 953(b) of the Dodd-Frank Act was intended to accomplish, it failed to publicly disclose such understanding prior to adopting the final rule; (c) the SEC failed to consider what the quantitative effects of providing flexibility would be on the accuracy of the pay ratio and thereby acted in an "arbitrary and capricious" manner when it limited the *de minimis* exclusion of non-U.S. employees to 5%; (d) the SEC acted "arbitrarily and capriciously" when it defined "employee" to exclude contract workers only if they are employed by an unaffiliated third party; (e) the SEC's economic analysis failed to consider academic studies as to whether the pay ratio might create pressure to increase CEO compensation; and (f) use of the pay ratio for comparative purposes among companies may violate an investment advisor's fiduciary duty under the Investment Advisers Act of 1940, given the significant limitations to using pay ratio information for such purposes. See Commissioner Piwowar, Additional Dissenting Comments on Pay Ratio Disclosure (Aug. 7, 2015),available here (and discussed on the Forum here). Statements made at the open meeting on August 5, 2015 are available on the SEC website here.

Highlights of the Final Rule—New Item 402(u) of Regulation S-K	
Applicability	Applies to all companies required to provide summary compensation table disclosure pursuant to Item 402(c) of Regulation S-K. Smaller reporting companies, emerging growth companies, foreign private issuers, MJDS filers and registered investment companies are exempt.
Required Disclosures	Must disclose (a) the median of the annual total compensation of all employees of the company (except the CEO), (b) the annual total compensation of the CEO and (c) the ratio of (a) to (b) (the "pay ratio").Must disclose the methodology and material assumptions, estimates, adjustments and exclusions (including relating to cost-of-living, non-U.S. employees, business combinations and acquisitions) used in the identification of the median employee and the calculation of that employee's annual total compensation.
Filings Where Disclosures are Required	Must include disclosure in any annual report on Form 10-K, proxy or information statement or registration statement that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K.
Identifying the Median Employee	May identify the "median" employee: • using the company's entire employee population or by means of statistical sampling and/or other reasonable methods • once every three years, assuming no significant changes in either (a) the median employee's circumstances or (b) the company's compensation levels or employee composition • using any date within the last three months of the last completed fiscal year • using annual total compensation or any consistently applied compensation measure • by making cost-of-living adjustments for employees in jurisdictions other than the jurisdiction in which the CEO resides Once identified, the median employee's annual total compensation must be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K.

Employees Included in the Identification of the Median	Must include all full-time, part-time, seasonal, temporary and non-U.S. employees of the company and its consolidated subsidiaries. Independent contractors and "leased" workers providing services to the company are excluded from the definition as long as they are employed by an unaffiliated third party and their compensation is determined by such party. May exclude: • employees employed in a foreign jurisdiction in which the laws or regulations governing data privacy are such that, despite reasonable efforts to obtain or process the necessary information, the company is unable to do so without violating such data privacy laws or regulations • a *de minimis* number of non-U.S. employees (up to five percent of the company's global workforce, including any employees excluded under the foreign data privacy law exemption)
Compliance Dates	First reporting period is the first full fiscal year commencing on or after January 1, 2017. For calendar-year companies, first disclosure will typically be in the proxy statement for the 2018 annual meeting of shareholders.

Background

Section 953(b) of the Dodd-Frank Act directed the SEC to amend Item 402 of Regulation S-K to require companies to disclose:

- the median of the annual total compensation of all employees of the company (except the CEO);
- the annual total compensation of the CEO; and
- the ratio of the median annual total compensation of all employees of the company (except the CEO) to the annual total compensation of the CEO (this measure is commonly referred to as the "pay ratio").

In response to Congress' mandate, the SEC proposed a pay ratio disclosure rule in September 2013[3] and received approximately 287,000 comment letters, including over 1,500 unique letters, in response to that proposal. (The proposed rules were discussed in our Sidley Update dated September 19, 2013, available here.) The primary concern raised in those letters was the potential cost of compliance, particularly for large and multi-national corporations. The SEC noted

[3] SEC Release No. 33-9452, Pay Ratio Disclosure (Sept. 18, 2013), available here.

that the significant cost estimates submitted by some commenters supported its view that certain accommodations were appropriate. Accordingly, the final rule maintains the flexibility and accommodations of the proposed rule (such as permitting the use of statistical sampling) and provides additional flexibility as follows:

- the ability to exclude non-U.S. employees under certain circumstances;
- the ability to use cost-of-living adjustments;
- the ability to identify the median employee once every three years; and
- the ability to choose as an identification date any date within the last three months of the last completed fiscal year.

The Final Rule

Applicability

New Item 402(u) of Regulation S-K applies only to companies required to prepare a summary compensation table pursuant to Item 402(c) of Regulation S-K. Smaller reporting companies, emerging growth companies, foreign private issuers, MJDS filers and registered investment companies are exempt from having to comply with Item 402(u).

Filings Where Disclosures are Required

A company must include the pay ratio and related disclosures in any filing, including an annual report on Form 10-K, proxy or information statement or registration statement, that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K.

Identifying the Median Employee

The rule requires a company to identify its median employee (that is, the individual employee whose annual total compensation is in the middle of all of the company's employees except the CEO) once every three years and calculate the total compensation for that employee once each year, provided that there have been no significant changes in any of the following that the company reasonably believes would result in a significant change to its pay ratio disclosure:

- the circumstances of the median employee;
- the company's employee population; or
- the company's compensation arrangements.

A company must re-identify its median employee for any year in which it believes a significant change has occurred. If a company concludes that there was no significant change, then the company must disclose that it is using the same median employee and briefly describe the basis for its belief that there was no significant change.

Under the new rule, a company may select any date within the last three months of its last completed fiscal year to identify its median employee. "Employees" are defined to include full-time, part-time, seasonal, temporary and non-U.S. employees of a company and its consolidated subsidiaries, but do not include independent contractors or "leased" workers providing services to

the company if such individuals are employed by an unaffiliated third party and their compensation is determined by such party. A company may annualize compensation for its permanent (part-time and full-time) employees who were not employed during the entire fiscal year, but may not annualize the compensation of its seasonal or temporary employees or make any full-time equivalent adjustments. In addition, any employees that became employed by a company as the result of a business combination or acquisition may be omitted from that company's median employee identification for the fiscal year in which the transaction became effective.

A company may exclude employees employed in a foreign jurisdiction in which the laws or regulations governing data privacy are such that, despite reasonable efforts to obtain or process the necessary information (including at a minimum, using or seeking an exemption or other relief under governing data privacy laws or regulations), the company is unable to do so without violating such data privacy laws or regulations. If the company excludes such employees, it must obtain a legal opinion from counsel in that jurisdiction that opines on the inability of the company to obtain or process the information necessary for compliance with the new rule, including the company's inability to obtain an exemption or other relief.

In addition, the rule contains a *de minimis* exemption that allows a company to exclude from its median employee identification:

- if non-U.S. employees account for five percent or less of the company's total employees—all non-U.S. employees; or
- if the company's non-U.S. employees exceed five percent of total employees—up to five percent of total employees who are non-U.S. employees, provided that if non-U.S. employees in a particular jurisdiction are excluded, all U.S. employees in that jurisdiction must be excluded.

This *de minimis* exemption is limited by the fact that any employees excluded using the data privacy exemption count toward the number of non-U.S. employees that may be excluded.

The rule allows a company, based on its own facts and circumstances, to select an appropriate methodology for identifying its median employee and use reasonable estimates. Rather than analyzing its entire employee population, a company may make its median employee identification based on statistical sampling and/or by using other reasonable methods.

In response to concerns that the rule may effectively require a company to conduct the complicated Item 402(c)(2)(x) calculations for all of its employees, as is required for named executive officers, the final rule does not require a company to use a specific compensation measure in identifying its median employee. Instead, a company may identify its median employee based on any compensation measure that is consistently applied to all employees (e.g., compensation amounts reported in payroll or tax records). In making its median employee identification, a company may make cost-of-living adjustments to the compensation of employees in jurisdictions (i.e., countries) other than the jurisdiction in which the CEO resides so that the compensation in those jurisdictions is adjusted to the cost of living in the jurisdiction in which the CEO resides. The SEC notes in the adopting release that cost-of-living adjustments could be based on, for example, purchasing power parity.

Calculating Annual Total Compensation of the Median Employee and CEO

Once a company identifies its median employee, the company will be required to calculate that employee's annual total compensation. "Annual total compensation" is defined to mean total compensation for the company's last completed fiscal year and must be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K; note that companies can, at their discretion, include personal benefits that aggregate less than $10,000 and compensation under non-discriminatory benefit plans in calculating the annual total compensation of the median employee as long as these items are also included in the CEO's calculation (these items are typically excluded from the CEO's total compensation in the summary compensation table). The company will then use this amount to calculate the required pay ratio.

A company may use reasonable estimates when valuing the elements of its median employee's total compensation. While the SEC did not prescribe what a reasonable estimate would be, it noted in the adopting release that it may be appropriate for a company to use reasonable estimates in determining an amount that would approximate the change in actuarial present value of an employee's defined benefit plan. If a company uses a cost-of-living adjustment to identify its median employee, the company must use the same adjustment in calculating that employee's annual total compensation and, for comparison, disclose the median employee's jurisdiction and annual total compensation without the cost-of-living adjustment.

A company will be required to calculate the annual total compensation of its CEO in accordance with Item 402(c)(2)(x) of Regulation S-K. If a company had more than one non-concurrent CEO serve during its fiscal year, the company may calculate the annual total compensation of its CEO, for purposes of the pay ratio, in either of the following manners:

- calculate the compensation provided to each person who served as CEO during the year for the time that he or she served as CEO and combine those figures; or
- look to the CEO serving in that position on the date the company has selected to identify the company's median employee and annualize that CEO's compensation.

Disclosing the Pay Ratio

The ratio of the median annual compensation of all employees (except the CEO) to the annual total compensation of the CEO should be disclosed either: (a) as a ratio in which the median of the annual total compensation of all employees (except the CEO) is equal to one; or (b) narratively in terms of the multiple that the CEO total compensation amount bears to the median employee amount. For example, the disclosure may be formulated either as "1 to 200" or "the chief executive officer's annual total compensation is 200 times that of the median annual total compensation of all employees (excluding the CEO)."

If a company uses a cost-of-living adjustment to identify its median employee and calculate his or her annual total compensation, the company must use the same adjustment in calculating the pay ratio and, for comparison, provide the employee's annual total compensation and the pay ratio *without* making any cost-of-living adjustment.

Related Disclosures

A company must disclose and briefly describe the methodology and material assumptions, estimates, adjustments and exclusions (including relating to cost-of-living, non-U.S. employees, business combinations and acquisitions) used to identify its median employee and calculate that employee's annual total compensation. Technical analyses and formulas are not required to be disclosed. In addition, a company must disclose any methodology changes from the prior year where the changes have significant effects, as well as the reasons for such changes.

Any company with multiple CEOs during a year must disclose the methodology used to calculate CEO annual total compensation. In addition, any legal opinion relating to the data privacy law exemption must be included as an exhibit to the relevant filing.

A company is permitted, but not required, to supplement its required pay ratio disclosure with a narrative discussion (for example, a general description of the median employee's position to put his or her compensation into context) or additional ratios. Any additional discussion and/or ratio must be clearly identified, not misleading and not presented with greater prominence than the required pay ratio. The rule prohibits companies from disclosing personally identifiable information about the median employee, except for his or her compensation.

Compliance Dates

A company's first reporting period for the pay ratio and related disclosures is its first full fiscal year commencing on or after January 1, 2017. As a result, a calendar-year company would not be required to make this disclosure until 2018 (when it will report pay ratios based on fiscal 2017 compensation information).

Newly public companies subject to the rule may take advantage of a transition period whereby compliance is not required until the first fiscal year beginning on or after the date that the company becomes subject to the requirements of Section 13(a) or 15(d) of the Exchange Act.

Smaller reporting companies and emerging growth companies are exempt from the rule until the first fiscal year beginning on or after the date that such company ceases to be a smaller reporting company or emerging growth company.

Practical Implications

The new rule requires companies to disclose, for the first time, the median employee's annual total compensation. Once this is disclosed, 50 percent of each company's workforce will learn that they are in the bottom half of pay at their company. Employees will also have greater visibility into how their compensation stacks up against compensation at competitors and peers. All of this has the potential to create workforce morale issues—accordingly, Human Resources personnel should be actively engaged in the disclosure process, in addition to Investor Relations and Public Communications personnel.

Although the new rule provides companies with considerable latitude regarding how the median employee is identified, compliance has the potential to be burdensome, particularly for large or multi-national companies, and especially in the first year of compliance. For a calendar-year

company, this disclosure will first be provided in early 2018. In the interim, a company should consider consulting with counsel regarding its compliance with the rule and taking the following actions:

In the short term:

- Discuss the new rule and its implications with the company's compensation committee and the full board, as well as with Human Resources.
- Begin the process of considering how the median employee will be identified, taking into consideration, in particular, the significant flexibility provided by the rule (compensation consultants or other advisors may be able to be of assistance).

Over the long term:

- Ensure that payroll and HR systems and disclosure controls and procedures are adjusted as necessary to support the methodology chosen to identify the median employee, calculate his or her annual compensation and ensure that the company can make the other disclosures required by the rule.
    - For companies with more than five percent of employees outside the U.S., be cognizant that any reliance on the data privacy exemption will require prior efforts to obtain an exemption or relief from the relevant law or regulation, as well as a legal opinion from counsel in that jurisdiction, both of which could require significant lead time.
- Monitor the policies and preferences of key shareholders as they relate to pay ratios and prepare to engage with shareholders as appropriate.
- Follow future proxy advisory firm policy developments and recommendations with respect to pay ratios, including whether pay ratios of a particular magnitude are deemed to constitute a "problematic pay practice" or other governance failure that could warrant negative vote recommendations against say-on-pay and/or directors.
- Review pay ratio disclosures that any peer or other relevant companies make on a voluntary basis and gauge investor and public reactions.

Although it is possible that the new rule may be challenged in litigation (similar to several other recent SEC rulemakings required by Dodd-Frank), companies should not defer consideration of the significant steps that will be necessary to ensure compliance by the effective date.

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The CEO Pay Ratio Rule

Posted by Luis A. Aguilar, Commissioner, U.S. Securities and Exchange Commission, on Wednesday, August 5, 2015

Editor's Note: Luis A. Aguilar is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on Commissioner Aguilar's remarks at a recent open meeting of the SEC; the full text, including footnotes, is available here. The views expressed in the post are those of Commissioner Aguilar and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

Today [August 5, 2015], the Commission takes another step to fulfill its Congressional mandate to provide better disclosure for investors regarding executive compensation at public companies. As required by Section 953(b) of the Dodd-Frank Act, today's rules would require a public company to disclose the ratio of the total compensation of its chief executive officer ("CEO") to the median total compensation received by the rest of its employees. The hope, quite simply, is that this information will better equip shareholders to promote accountability for the executive compensation practices of the companies that they own.

The Congressional mandate under Section 953(b) has proven to be one of the most controversial rules that the Commission has been required to undertake under the Dodd-Frank Act. Since Congress first required the Commission to promulgate this rule just over five years ago, the Commission has received over 287,000 comment letters, with over 1,500 individual letters and the rest form letters. The diverse views expressed by these commenters reflect that Congress tasked the Commission with navigating a highly divisive subject—a boon or a bane, depending on one's perspective. Many of these commenters urged adoption of the pay ratio rule, and cited the benefits from such a disclosure. For example, they pointed to the ability of investors to use CEO-to-worker pay ratios as an additional metric in evaluating and voting on executive compensation matters, including "say-on-pay" votes. Other commenters noted that this disclosure could provide visibility into other hard-to-measure indicators of a company's long-term health, such as the effectiveness of its corporate governance. At the same time, a number of other commenters expressed general skepticism that pay ratio disclosure would provide any benefits, or otherwise expressed concern with the potential complexities, and associated costs, of complying with this Congressionally-mandated disclosure.

These diverse views reflect that while the CEO-to-worker pay ratio is a seemingly simple requirement—after all, the primary output of today's rule is just a ratio, like 296:1—getting to the ratio may require some effort. Pursuant to Section 953(b), issuers will need to determine the median employee, by annual total compensation, by considering "all employees of the registrant." Indeed, Congress did not expressly carve out any categories of employees, whether they are part-time, temporary or seasonal, or employees situated in the U.S. or abroad. For some companies, unless the information for "all employees" is already readily attainable, this could

require them to incur costs in creating compatible payroll systems across foreign borders, or across various business areas, in order to extract the necessary data.

In drafting the rule being considered today to fulfill the Dodd-Frank mandate, the Commission and its staff went to great lengths to consider all viewpoints, including how best to stay faithful to the values of the rule, while mitigating the potential challenges faced by issuers in its implementation. The end result provides a thoughtful and reasonable approach to fulfilling the Congressional mandate that permits issuers to have a great deal of flexibility in the methods of compliance with the pay ratio disclosure—and, at the same time, tries to ensure that the resulting disclosure will be useful to investors.

For example, in calculating the CEO-to-worker pay ratio, today's rule permits issuers to do the following:

- To choose a *reasonable method* to identify the median employee that is appropriately tailored to their business, including identifying the median employee using statistical sampling or any consistently applied compensation measure (such as payroll records);
- To exclude from the pay ratio calculation a *de minimis* amount of non-U.S. employees;
- To exempt from the pay ratio calculation non-U.S. employees from certain jurisdictions when foreign privacy laws make it illegal to provide the information necessary to calculate the pay ratio; and
- To calculate the median employee only once every three years, instead of every year, providing certain conditions are met.

These and other discretionary decisions were made to help ameliorate some of the complexities of implementing the statutory mandate while retaining the value of the disclosure to investors.

Ultimately, today's pay ratio rule should be viewed as a complement to other executive compensation rules mandated by the Dodd-Frank Act that promote corporate accountability and enhance the information available to investors. For example, today's rules complement the Commission's recently proposed rules that would require public companies to show the relationship between the executive compensation actually paid and the financial performance of the issuer. Furthermore, today's rules also provide investors with additional information to inform their Dodd-Frank-mandated "say-on-pay" advisory votes. In this way, today's rules are intended to promote better shareholder engagement on executive compensation issues.

Conclusion

In conclusion, today's pay ratio adopting release incorporates many discretionary decisions made by the Commission consistent with the Dodd-Frank statutory mandate. These decisions were designed to facilitate compliance with the rule in a manner that is reasonable and workable for issuers, while still providing for increased transparency and greater accountability in executive compensation matters. For these reasons, I will support today's rules.

Lastly, I would like to thank the staff from the Division of Corporation Finance, the Division of Economic Research and Analysis, and the Office of the General Counsel for their hard work on this rulemaking. I appreciate the important work you do to protect investors.

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Dissenting Statement on Pay Ratio Disclosure

Posted by Michael S. Piwowar, U.S. Securities and Exchange Commission, on Wednesday, August 5, 2015

Editor's Note: Michael S. Piwowar is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on Commissioner Piwowar's recent remarks at a recent open meeting of the SEC. The complete publication, including footnotes, is available here. The views expressed in the post are those of Commissioner Piwowar and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

When the pay ratio disclosure rule was originally proposed, I objected to its consideration on the grounds that the Commission and its staff should not spend our limited resources on any rulemaking that unambiguously harms investors, negatively affects competition, promotes inefficiencies, and restricts capital formation—especially when there is no statutory deadline for completion. Pursuing a pay ratio rulemaking was wrong then and remains wrong now.

Today's [August 5, 2015] rulemaking implements a provision of the highly partisan Dodd-Frank Act that pandered to politically-connected special interest groups and, independent of the Act, could not stand on its own merits. I am incredibly disappointed the Commission is stepping into that fray.

Section 953(b) of Dodd-Frank simply has nothing to do with protecting investors, ensuring fair, orderly, and efficient markets, or facilitating capital formation. The proposing release is candid about the fact that "neither the statute nor the related legislative history directly states the objectives or intended benefits of the provision or of a specific market failure, if any, that is intended to be remedied."

Indeed, the proposal itself never specifically identified any objective, goal, or benefit that the Commission believes the rulemaking is intended to accomplish. The proposing release only referenced a variety of conjectured benefits described by pre-proposal commenters, such as (i) considering vertical pay equity within companies; (ii) improving employee morale and productivity; (iii) evaluating the relative worth of a chief executive officer ("CEO"); (iv) increasing board accountability; (v) facilitating identification of a board's strengths and weaknesses; and (vi) providing insight into a board's relationship with its CEO. In other words, any benefits to be had are merely in the eye of the beholder.

Having been deprived of any clear description of what the statute or our proposal was intended to accomplish, commenters submitted their own views—and we heard from a lot of them, more than 287,000 in total. What did these commenters think? Over 70,000 form letters claimed that the pay ratio disclosure was needed because "the public has the right to know which corporations are fueling the yawning gap between rich and poor." Interestingly, this form letter was generated by an organization that receives funding from billionaire George Soros. Close to 13,000 other form

letters asserted that the pay ratio disclosure will show which corporations are “siphon[ing] money away from investors, and into the pockets of CEOs.”

Another commenter was very explicit about the “name and shame” motive of the pay ratio disclosure: “The SEC’s proposed disclosure mandate is valuable and necessary in that its implementation evidences government’s recognition of the dangers of disparity in gross pay strata…. If used effectively, compensation committees will use CEO pay ratio data to better moderate pay packages and reduce this hazard.” In other words, the pay ratio disclosure is a blatant attempt to limit executive compensation.

The push for pay ratio disclosure should come as no surprise to anyone familiar with the use of Saul Alinskyan tactics by Big Labor and their political allies. Nearly fifteen years ago, Big Labor supporters published a book called *Working Capital: The Power of Labor’s Pensions* that contained a strategy to re-make the capital markets with a so-called “worker-owner” viewpoint. The worker-owner approach would aim to “inject workers’ welfare, broadly understood, into investment priorities” and depart “from conventional investment wisdom by expanding the options, methods, and principles that guide capital allocation.” As one editor of *Working Capital* later said, “[t]hese decisions need not be driven by a solitary logic of return-seeking…. Other goals, values, and methods can, and should, come into play.” To put it another way, union-backed pension funds could use their investments to advance a social agenda to the detriment of risk-adjusted investment returns. Where possible, Big Labor would use legal and regulatory tools to further increase the influence of their shareholder power.

Working Capital observes that many “accomplishments of labor-shareholder activism are political rather than economic, and that they carry union credibility in the face of declining union membership and bargaining power.” Big Labor’s playbook identified three ways in which unions had used their power as shareholders to make gains for workers: (i) convincing management to recognize union organizing activity; (ii) assisting workers in strike settlement interventions; and (iii) ensuring that anti-union managers do not become entrenched.

This pay ratio rulemaking is literally a page from that Big Labor playbook. In a section entitled “Chief Executive Officer Compensation: Taming an Out-of-Control Expense,” the book contains a table labeled as “CEO Pay Packages and Consequences” that lists the compensation for the then-top twenty highest paid CEOs and the number of workers at each of their corporations. It then characterizes the ratio of these two numbers as the “CEO tax” paid by each worker, or “the amount that annual wages could have been increased if the CEO’s pay had been instead divided up equally among the companies’ workers.”

More recently, the concept of using a CEO pay ratio for substantive purposes has spread to other contexts. In California, a bill was introduced that would tie state corporate tax rates for publicly held corporations to its CEO pay ratio. In Rhode Island, the state senate has introduced a bill that would give preference in government contracting to firms whose highest paid executive does not receive more than 25 times the compensation paid to its median, non-executive employee. The federal government too could use the pay ratio as a basis for other purposes. For example, with respect to federal government contracts, if the President, by executive order, can mandate an increase to the minimum wage paid to workers of federal contractors, what is to stop the President from issuing a similar executive order that limits compensation of a CEO based on a pay ratio?

Today's rulemaking also unfairly targets publicly-traded companies that employ a large number of individuals in states with relatively lower costs of living. The labor market for hiring chief executive officers is markedly different than the market for hiring a non-executive employee of a company. CEO compensation is often set based on the supply and demand for CEOs, while cost of living and local labor market conditions often play bigger factors in setting compensation for other employees. Indeed, the adopting release recognizes and addresses this issue with respect to workers located in foreign countries, but it ignores potentially similar regional effects within the United States. States with a lower cost-of-living, such as Mississippi, Idaho, and Oklahoma, are potentially disadvantaged when compared to high cost-of-living states, such as California, New York, and Connecticut.

Let's return to the problem of there being no evident benefits of this rulemaking. The best we can do in the adopting release is say that the Commission finds "the informational benefit of facilitating shareholder engagement in executive compensation decisions as potentially a significant new benefit to shareholders when they exercise their say-on-pay voting rights." However, the adopting release inserts several major caveats to this supposed benefit, including (i) the pay ratio is but one data point among many that may be relevant for say-on-pay votes; (ii) since the say-on-pay vote is advisory and non-binding, it is difficult to link the pay ratio to potential changes in CEO compensation; (iii) it is even more speculative to link the pay ratio disclosure to an economic outcome at a company; and (iv) no commenter provided us with any data that would allow us to quantify potential benefits. Having identified only a speculative, unsupported benefit, the adopting release defensively retreats to the rationalization that Congress directed us to promulgate the rule and, therefore, must have believed there was some benefit to a pay ratio disclosure; thus the Commission should refrain from second-guessing that judgment. The adopting release simply brushes aside the estimated $1.3 billion in initial compliance costs.

If the Commission was serious about understanding how investors might react to the pay ratio disclosure, it would have engaged in investor testing. Section 912 of the Dodd-Frank Act made it much easier for the Commission to engage in such testing. That is one of the few provisions of Dodd-Frank that I wholeheartedly support and I have long called for such testing as part of disclosure-based rulemakings. Yet, despite the passage of more than five years since the enactment of Dodd-Frank and nearly two years since the proposing release, no such testing effort was undertaken.

Instead, the majority of the Commission looks to the opinions of commenters regarding the materiality of the pay ratio disclosure, particularly those commenters that asserted they incorporate social issues like pay equity into their decision-making. As support for this position, the adopting release cites a comment letter, for example, from one group whose executive committee contains representatives from Big Labor.

So to recap, there is no specific or convincing justification for this rulemaking. Nor is there an even arguably compelling reason for considering it today. The timing of this vote is quite peculiar given the recent moves by Congress to repeal the pay-ratio provision. Last week, six more co-sponsors signed on to a bill introduced in the House by Representative Bill Huizenga of Michigan to repeal Section 953(b), bringing the total number of co-sponsors to 23 members. Less than a month ago, Senator Mike Rounds of South Dakota introduced a pay-ratio repeal bill in the Senate, which added a co-sponsor two days ago. It does not seem coincidental that our open

meeting was scheduled for the week after the House of Representatives adjourned for August recess and one day before the Senate is expected to do the same.

Notwithstanding the misguided actions that we are taking today, I want to acknowledge the efforts of our hardworking staff, who faithfully carried out the instructions that were issued.

I have a lot more to say on today's adoption of the pay ratio disclosure, but in the interest of time, I will make one final point and my additional remarks will be available on the SEC website. Today's action is nothing more than a sad example of surrendering the Commission's agenda to politically-connected special interests and acquiescing to the bullying tactics of their political allies. Remember what we learned in school. Acquiescing to bullies only gives them more ammunition and makes it worse. And, yet, Commission leadership seems content to invite further blows. What will come next? Perhaps it will be political spending disclosure. Perhaps it will be share buyback prohibitions. To be sure, today's action ensures that the Commission's bullies will be back for more. It is undoubtedly too late to convince a majority of my fellow commissioners to end this losing strategy of appeasement by joining Commissioner Gallagher and me in standing up to the Commission's bullies by voting "no" on "name and shame." But I remain hopeful that Commission leadership will have the courage to stand up to the bullies and wrest back control of our agenda. The American people deserve nothing less.

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The CEO-Employee Pay Ratio

Posted by R. Christopher Small, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Monday February 23, 2015

Editor's Note: The following post comes to us from Steve Crawford of the Department of Accounting & Taxation at the University of Houston, and Karen Nelson and Brian Rountree, both of the Accounting Area at Rice University.

Will knowing how much the CEO makes relative to rank and file employees provide information to investors? We may soon find out as a result of a provision in the Dodd Frank Act that requires companies to report the ratio of the CEO's compensation to that of the median employee. A number of different sources have developed industry-based estimates of the ratio using information about CEO pay from corporate disclosures and employee pay from the government's Bureau of Labor Statistics. For instance, an article in *Bloomberg BusinessWeek* on May 2, 2013 found the ratio of CEO pay to the typical worker rose from about 20-to-1 in the 1950s to 120-to-1 in 2000, with the ratio reaching nearly 500-to-1 for the top 100 companies.

In our The CEO-Pay Ratio, which was recently made publicly available on SSRN, we take advantage of unique reporting rules for the banking sector, which requires disclosures concerning compensation to all employees, as well as the CEO. With this data, we calculate the ratio of CEO compensation to that of the average employee. Over the years 1995-2012, the ratio is relatively stable with an average of 16.58-to-1. In fact, it is only in the highest decile of CEO pay where we find ratios rising to the levels popularized in the financial press and policy debate. Thus, for the vast majority of corporations in the banking sector we find ratios that are well within the bounds espoused by management experts such as Peter Drucker.

A more important question is whether disclosure of the ratios will influence investor behavior. To provide some evidence on this issue, we investigate whether the ratios we calculate for the banking sector systematically relate to the way investors vote on Say on Pay (SOP) proposals. The Dodd-Frank Act also mandates that all corporations administer a non-binding shareholder vote on the compensation of executives reported in the firms' annual proxy statements. This portion of the law is currently in effect, providing us with three years of data on the preferences of shareholders as revealed through their voting behavior. We find that voting dissent is greatest at

both the lowest and highest levels of the ratio, consistent with information on pay disparity influencing voting behavior. Increased voting dissent at the highest levels of the ratio aligns with arguments that disclosure of the ratio may serve as a catalyst to reign in what investors believe to be excessive CEO compensation. However, it is interesting to note that dissent is also high for banks with the lowest levels of the pay ratio, which could be consistent with the view that some level of pay disparity is necessary to provide appropriate incentives for effort within organizations.

We further examine whether the ratios are predictive of future firm performance and risk to see if investors voting behavior is consistent with underlying firm outcomes. Our findings reveal a similar non-linear relationship where the highest and lowest pay ratios result in the lowest (highest) performance (risk). The economic magnitudes of these effects, however, are relatively small. Thus in the end, it appears that the pay ratio provides significant information concerning shareholder voting behavior, but only limited information about actual economic outcomes.

Overall, the results in our study help to inform the ongoing policy debate on the magnitude and consequences of pay disparity in public corporations. If the Securities and Exchange Commission issues its final pay ratio disclosure rule in 2015, investors may soon have this information to inform their voting decisions for a broad range of firms.

The full paper is available for download here.

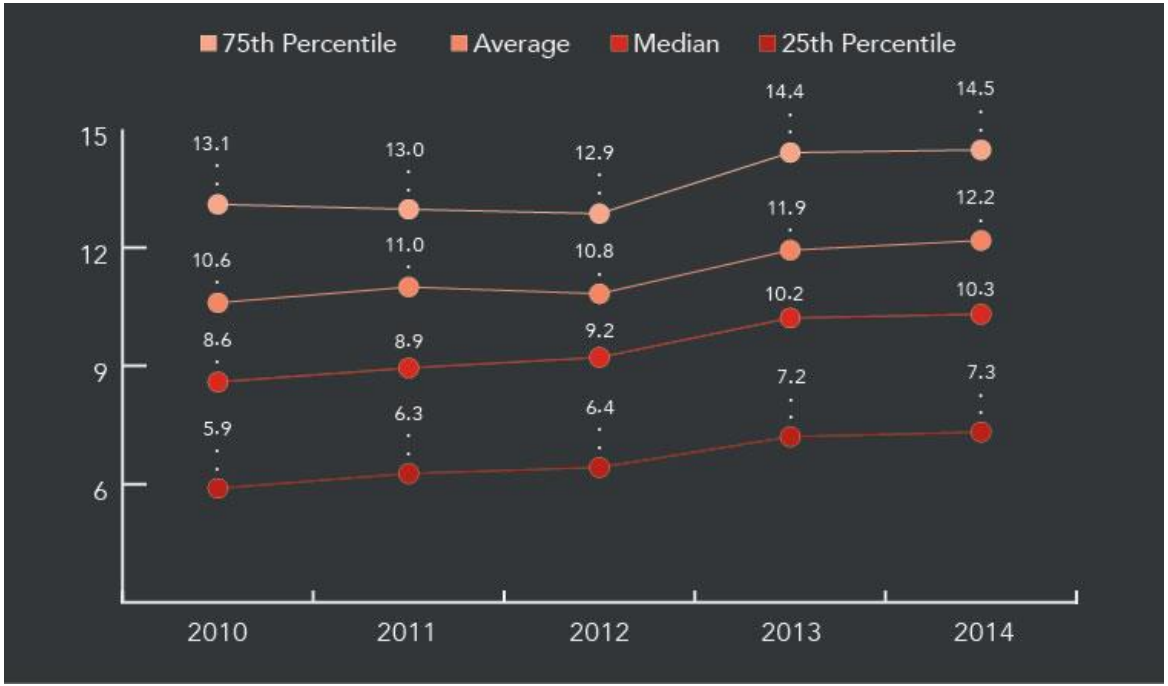
Tab 3: Executive Compensation Structures and Terms

CEO Pay Practices & Trends

David Chun
Founder and Chief Executive Officer, Equilar

S&P 500 CEO Total Compensation

- Median pay at the S&P 500 was $10.3M in 2014 and increased only 1% YOY
- From 2012 to 2014, median CEO pay increased ~$1M

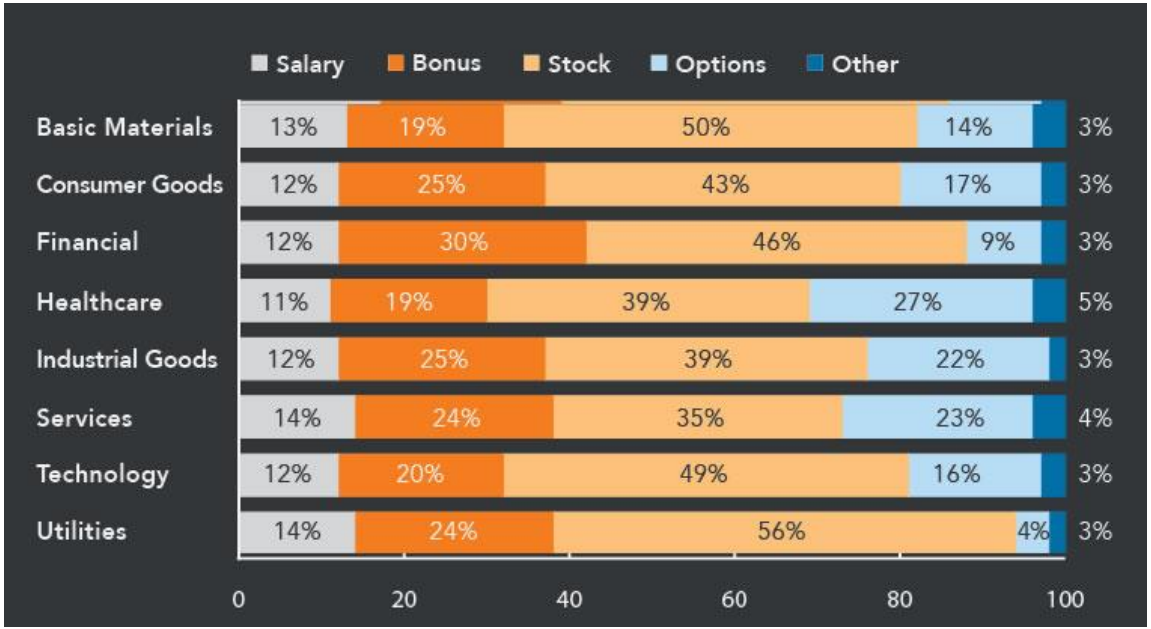


Pay Component Values

- In the S&P 500, stock awards continue to have the highest value and growth trend, $4.5M at the median in 2014
- The decline in options continues with a 6% decrease since 2013

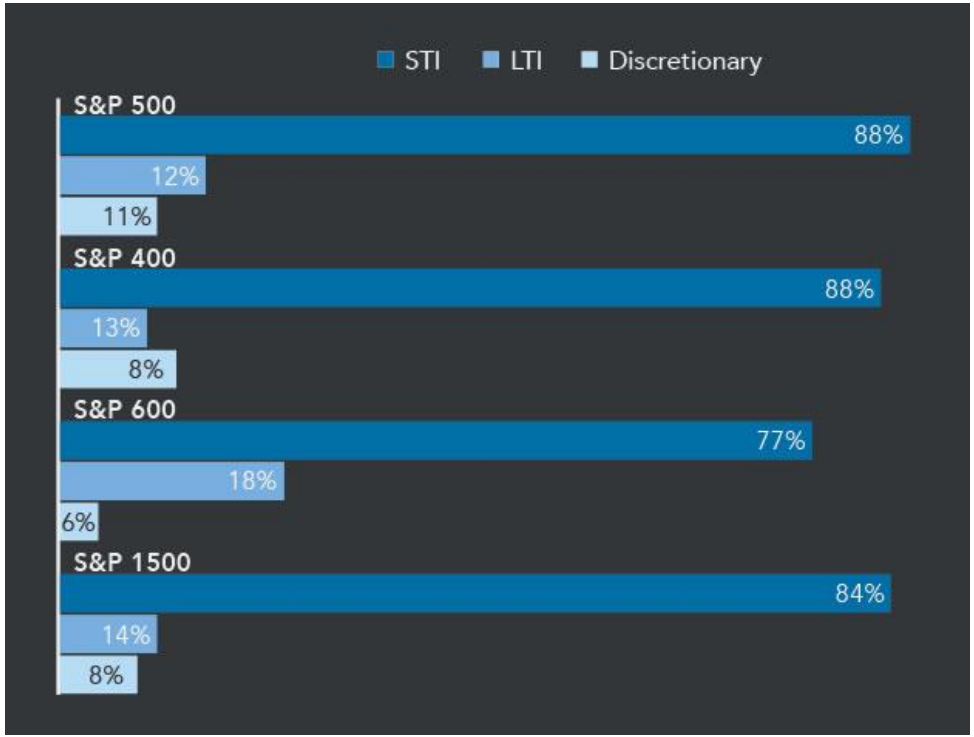
Pay Mix by Industry

- Bonuses had the highest average percentage of total compensation within the financial, industrial goods, and consumer goods sectors
- Options were particularly prevalent within the healthcare sector at 27%
- The highest salaries as a percent of total compensation were in the services and utilities sectors



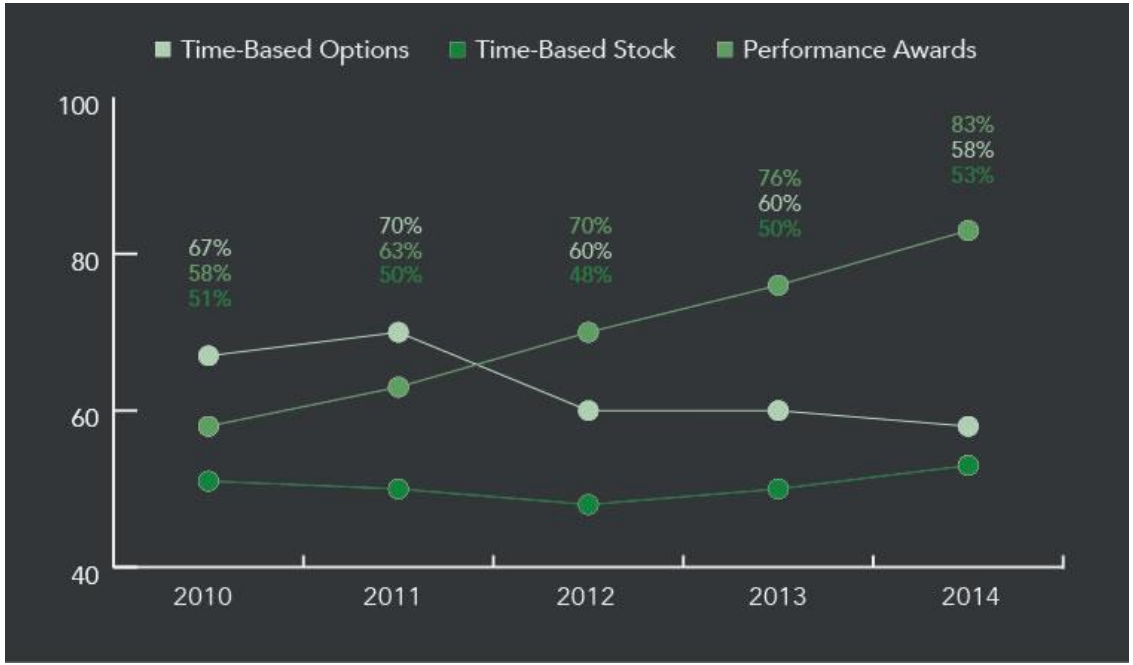
Prevalence of Cash Bonus Payouts

- 88% of CEOs received a short-term cash incentive payout in 2014
- Discretionary bonuses continue to be phased out with only 11% of CEOs receiving this type of payout in 2014

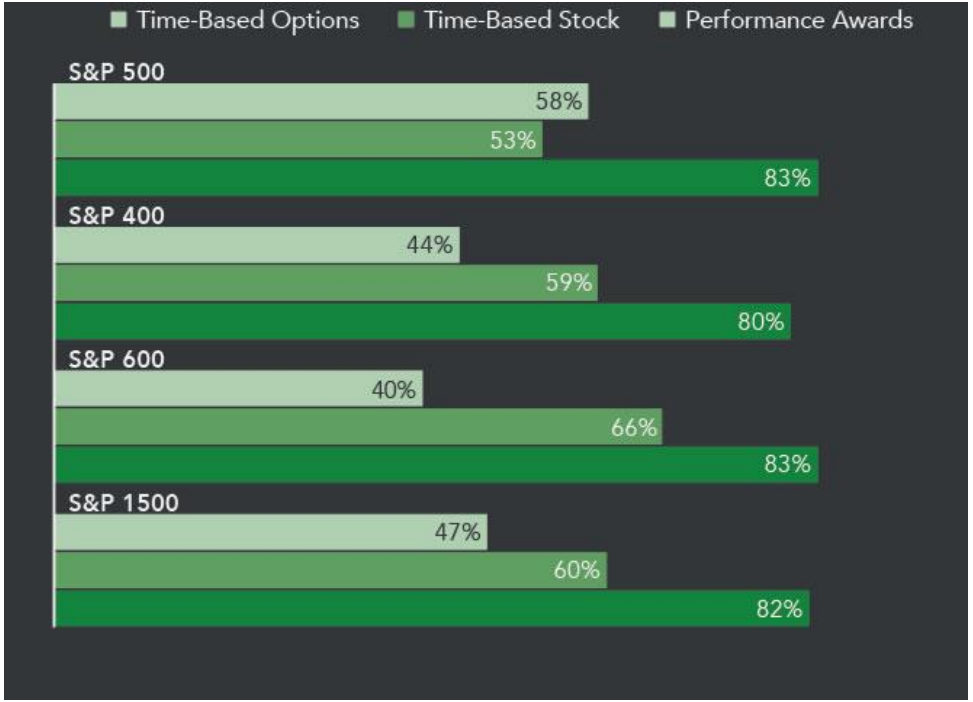


Prevalence of Equity Vehicles

- The share of S&P 500 CEOs receiving performance-based equity rose from 58% to 83% in 2014
- Although on the decline, time-based options were still more prevalent than time-based stock in the S&P 500

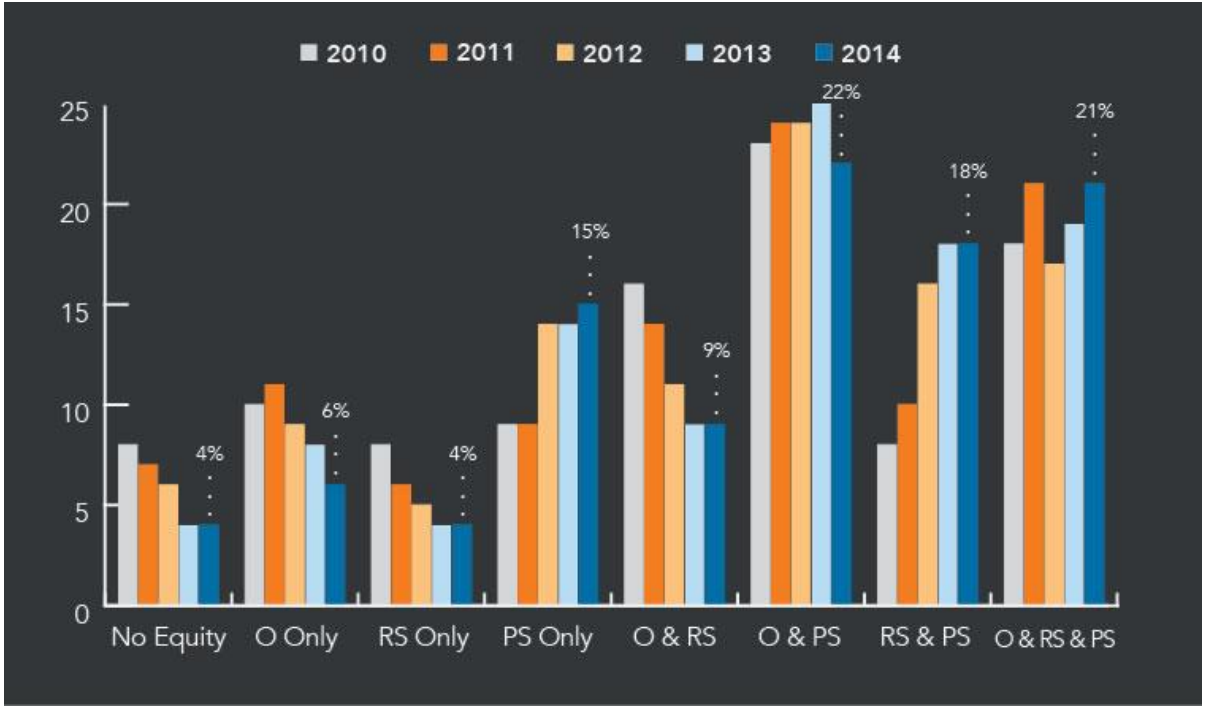


Equity Mix Comparison



- S&P 500 companies are making more use of time-based options and less time-based stock compared to mid and small-cap companies
- Performance awards are the most common equity vehicle within each individual sector

Equity Grant Mix



- The most prevalent grant practice consisted of options and performance shares
- The combination of RSUs and performance shares has seen the largest increase since 2010

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Making Executive Compensation More Accountable

Posted by Luis A. Aguilar, Commissioner, U.S. Securities and Exchange Commission, on Wednesday, July 1, 2015

Editor's Note: Luis A. Aguilar is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on Commissioner Aguilar's remarks at a recent open meeting of the SEC; the full text, including footnotes, is available here. The views expressed in the post are those of Commissioner Aguilar and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff. Related research from the Program on Corporate Governance about CEO pay includes Paying for Long-Term Performance (discussed on the Forum here) and the book Pay without Performance: The Unfulfilled Promise of Executive Compensation, both by Lucian Bebchuk and Jesse Fried.

When it comes to compensation, Americans believe you should earn your money. They also believe, just as strongly, that you should not keep what you did not earn. It's fundamental to our values. However, when companies have to restate their financial statements because they violated applicable reporting requirements, their executives may not be required to reimburse any incentive-based compensation that was erroneously paid. In other words, they get to keep what they never should have received in the first place.

And, quite often, we are talking about very large amounts. In today's corporate world, many executives are earning eye-catching sums. Much of the increase in executive compensation is commonly attributed to the impact of incentive-based compensation, including equity and other performance-based compensation plans.

Incentive-based compensation plans are intended to align the interests of company managers and shareholders. However, when a company is required to issue a restatement, and when its executives have been paid compensation based on inflated financial results, this alignment disappears. In such cases, it is only fair that these erroneously awarded payments be recovered.

To address this improper enrichment, Section 954 of the Dodd-Frank Act mandates that the Commission adopt rules to require that registered stock exchanges impose requirements that obligate listed companies to develop and implement policies that, in the event they are required to issue restatements, result in the recovery—or "clawback"—of erroneously paid incentive-based compensation.

To fulfill that mandate, the Commission is proposing Rule 10D-1 to the Securities Exchange Act of 1934. Consistent with the breadth of the statutory mandate, today's proposed rules define "incentive-based compensation" as compensation based in whole or in part upon achieving any "financial reporting measure." This would include compensation based on stock price and/or total shareholder return ("TSR"), which are now widely used. In fact, according to a study released on June 4, 2015, approximately 51% of the top 200 public companies making performance-based grants for executive compensation based it on a TSR measure. Today's rules recognize this

reality by defining incentive compensation to include performance-based compensation paid to executives based on a company's stock price and/or TSR.

To be clear, as the release points out, the definition of "incentive-based compensation" does not include all forms of executive compensation. For example, it does not include bonuses paid solely at the discretion of a company's board of directors, or equity awards that vest solely upon completion of a specified employment period. The release asks questions as to whether these or other forms of executive compensation should be included in the definition of incentive-based compensation.

Today's proposed rules also contain the following components, among others:

- First, today's proposed rules apply to incentive-based compensation paid to *any executive officers* of the issuer. This helps ensure that all of those in a position of responsibility for executive-level decisions would be held accountable for the integrity of the company's financial statements.
- Second, while the proposed rules would require companies to pursue recovery of all incentive-based compensation, there are two exceptions for situations where a majority of the board's independent directors determines that (i) pursuing such recovery would be impracticable because the direct expense of seeking recovery would exceed the recoverable amounts; or (ii) pursuing such recovery would violate foreign law. Under both of these exceptions, the issuer would be required to meet certain additional conditions designed to prevent these exceptions from undermining the effectiveness of the proposed rules. The release seeks public comment on whether the proposed rules include adequate protections to prevent these two exceptions from creating unintentionally large loop-holes.
- Third, listed companies will be required to disclose both the substance of their recovery policies and how they implement their policies in practice. The proposed rules would also require each company to disclose when a decision has been made to forego recovery of incentive-based compensation that would otherwise be subject to the clawback policy.
- Fourth, listed issuers would be prohibited from engaging in an end-run around the clawback policy by indemnifying any current or former executive officer against the loss of erroneously awarded compensation. Moreover, issuers would be prohibited from paying the premiums on an insurance policy that would cover an executive's potential clawback obligations.

Conclusion

In summary, taken together, the elements of the Commission's proposed Rule 10D-1 should go a long way toward prohibiting improper enrichment of executives for companies faced with a restatement. Moreover, the existence of a clawback policy should, among other things, incentivize executives to create a culture of compliance that results in accurate reporting of financial performance. The end result is that, hopefully, fewer financial statements will be required to be restated.

For all these reasons, I will support the staff's recommendation. At their core, today's proposed rules send the following message: if you did not earn your compensation, you should not keep it.

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Long-term Incentive Grant Practices for Executives

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Monday January 5, 2015

Editor's Note: The following post comes to us from Frederic W. Cook & Co., Inc., and is based on a publication by James Park and Lanaye Dworak. The complete publication is available here. An additional publication authored by Mr. Park on the topic of executive compensation was discussed on the Forum here. Research from the Program on Corporate Governance on long-term incentive pay includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried, discussed on the Forum here.

The use of long-term incentives, the principal delivery vehicle of executive compensation, has long been sensitive to external influences. A steady source of this influence has come under the guise of legislative reform with mixed results. In 1950, after Congress gave stock options capital gains tax treatment, the use of stock options surged as employers sought to avoid ordinary income tax rates as high as 91%. Some forty years later, Congress added Section 162(m) to the tax code in an attempt to rein in excessive executive pay by limiting the deduction on compensation over $1 million to certain executives. Stock options qualified for a performance-based exemption leading to a spike in stock option grants to CEOs at *S&P 500* companies.

Fast forward twenty years and the form and magnitude of long-term incentives continues to be a hot button populist issue. The 2010 Dodd Frank Act introduced U.S. publicly-traded companies to Say on Pay giving shareholders a direct channel to voice their support or opposition for a company's pay practices. Another legislative addition to the litany of unintended consequences, Say on Pay has magnified the growing number of interested parties, increased the influence of proxy advisory groups such as Institutional Shareholder Services (ISS) and Glass Lewis, heightened sensitivity to federal regulators, and provoked the increased interaction of activist investors.

Compensation Committees are challenged to balance the oftentimes conflicting interests of a growing number of stakeholders. As a result, we observe a narrowing range of long-term incentive practices and a growing bias for homogenous plan design. It is arguably easier for

companies to follow conventional market practices than to educate and defend innovative plan design.

These findings emanate from our study, the 42nd annual Frederic W. Cook & Co. Top 250 Report, which presents information on long-term incentives in use for executives at the 250 largest U.S. companies in the *Standard & Poor's 500 Index*. For access to the complete Top 250 survey, including detailed market findings and study methodology, please visit our website at www.fwcook.com. Notable trends and key findings from this year's study are presented below:

Summary of Grant Types in Use

Stock option use has stabilized over the past three years after an extended period of decline (71%). Once considered the most shareholder-friendly grant type due to its inherent alignment with shareholder interests, stock options appear to be recovering from mixed employee perceptions and investor concerns about potential dilution and performance orientation. The percent of companies granting restricted stock, including companies that disclosed performance-vesting criteria solely to satisfy 162(m) requirements, remained flat year-over-year at 63%.

The majority of Top 250 companies apply a uniform installment or ratable vesting approach (three equal installments) to stock options (81%) and restricted stock grants (54%). This is the first time we observed more than half of the companies using an installment vesting approach rather than a cliff vesting approach (100% vest at the end of the period) for restricted stock, but it is consistent with the broader trend towards greater use of the installment method for grant types that vest based on service.

On the other hand, performance awards rank as the most widely used grant type for the fourth consecutive year with 89% of the Top 250 granting performance awards settled in cash or stock. The proliferation of this award type is due, in large part, to Say on Pay as companies seek to demonstrate a relationship between pay and performance.

Long-term Incentive Mix

On average, performance awards comprise 50% of a Top 250 CEO's total long-term incentive value. Stock options represent 30% and restricted stock the remaining 20%. This mix is influenced by the fact that proxy advisors and some shareholders no longer view, or in the case of proxy advisors never viewed, stock options as "performance-based" awards. While this view is fiercely debated, many companies have conceded to classify stock options as an award that is "at-risk" but not performance-based.

Performance Award Design

Performance Metrics

TSR and profit-based measures continue to be the most prevalent performance categories among companies that grant performance awards at 58% and 50%, respectively. Since demonstrating alignment between pay and performance is a requisite for securing Say on Pay support, companies are rethinking what performance goals to measure and how to measure them (i.e., absolute goals measured against internal targets versus relative goals measured against external benchmarks).

TSR, specifically relative TSR, has emerged as the metric of choice under Say on Pay. For shareholders, there is an elegance to TSR in that it demonstrates the return relative to alternative investments and avoids the need for long-term goal setting. It is also the singular definition of corporate performance used by ISS. As such, some companies view relative TSR as a means to "check the box" with regards to shareholder and ISS preferences.

Critics of TSR as an incentive measure denounce the fact that it does not drive performance, that market valuation can become disconnected from financial/operating performance, and that consistently high-performing companies may be disadvantaged when compared against companies that exhibit a performance rebound during the measurement period. In light of these drawbacks, we observe that 70% of Top 250 companies using TSR do so in combination with one or more financial metrics.

The Top 250 companies are split on how many performance measures to use, with just under half (45%) using one measure with the other half using two or more. Glass Lewis discourages the use of a single performance measure, even if that metric is relative TSR. They argue that the use of multiple metrics provide a more complete picture of company performance and that a single metric may focus management too much on a single target. The risk of putting "all eggs in one basket" and the potential to overemphasize one metric at the expense of other business priorities are concerns shared by some shareholders.

Measurement Period

Performance is measured over a period of three years in 82% of performance award programs, indicating that most performance periods run in tandem with the award's vesting period. Companies that measure performance annually (i.e., reset targets each year over a three-year period) are included in this statistic. We anticipate this practice will decline as proxy advisors

scrutinize this treatment for failing to require the achievement of sustained long-term results (i.e., operates more like an annual incentive plan).

In a similar vein, performance periods of one year or less with an extended vesting tail (i.e., one-year performance period followed by two additional years of time-based vesting) have declined in prevalence (8% in 2014). Many companies voice challenges in setting realistic long-term performance goals due to market volatility. Some shareholders dispute this argument, particularly when a company's peers demonstrate the ability to set cumulative three-year goals and shareholders themselves make investments on the basis of company guidance and long-term performance expectations.

The complete publication is available here.

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Relative Total Shareholder Return Performance Awards

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Friday November 14, 2014

Editor's Note: The following post comes to us from Frederic W. Cook & Co., Inc., and is based on the Executive Summary of a FW Cook publication by David Cole and Jin Fu. The complete publication is available here.

Since 2010, performance-contingent awards have been the most widely used long-term incentive (LTI) grant type among the Top 250 companies[1] and are now in use by 89% of the sample. The prevalence of performance awards and investor preferences have spurred considerable interest in relative total shareholder return (TSR) as a performance metric. Relative TSR measures a company's shareholder returns[2] against an external comparator group and eliminates the need to set multi-year goals. Use of relative TSR performance awards among the Top 250 companies has increased from 29% in 2010 to 49% in 2014, and relative TSR is now the most prevalent measure used to evaluate company performance for performance awards.

The recent surge in relative TSR performance awards has been a topic of much discussion among the executive compensation community. Relative TSR plans are favored by proxy advisory firms, and proponents tout that such plans have strong shareholder alignment, are objective and transparent, permit multi-year measurement of performance, and do not require long-term goal setting. However, critics assert that relative TSR is not without its drawbacks. They highlight that TSR outcome is not entirely within management's control as external factors often affect stock price and that TSR and financial performance are not always strongly correlated, particularly over shorter measurement periods.[3]

In light of the growing focus on relative TSR performance awards, the report (available here) explores current relative TSR award design practices in the market. Key findings are as follows:

[1] The Top 250 companies represent the largest U.S. companies in the Standard & Poor's 500 Index by market capitalization.
[2] Reflects stock price change plus assumed reinvested dividends.
[3] As shown on page 11 of the complete publication, the correlation between TSR and financial performance is moderate in any given three-year period, but alignment between the two measures increases significantly over longer periods.

- Prevalence of relative TSR awards among the Top 250 companies has increased by 71% in the last five years (from
- 29% of the Top 250 companies in 2010 to 49% in 2014). However, companies that grant relative TSR awards tend to diversify their performance measures, with 71% of companies using relative TSR in combination with another financial performance metric.
- Relative TSR is predominantly used as an independent metric in performance share plans (85%), with only 15% using relative TSR as an award modifier.
- When used as a modifier, relative TSR typically adjusts the final performance award payout by between 15%-25%, with the majority of companies using a ±25% modifier.
- Eighty-eight percent of relative TSR awards use a component rank approach, with the most common threshold, target, and maximum goal levels set at the 25th percentile, 50th percentile, and 75th percentile of the comparator group, respectively.
- Performance leverage among companies using a composite index varies, but target payouts are typically earned for achieving TSR that is aligned with the index performance.
- A significant majority of relative TSR awards measure TSR over a three-year period (93%), with earned awards typically paid out at the end of the performance period (only 12% of plans have additional time-vesting restrictions). Among awards with multi-year performance periods, 93% measure TSR over the full performance period, 4% measure TSR in annual increments, and 3% use both an annual and cumulative measurement period.
- Approximately half of the relative TSR awards measure performance against an existing stock index, while the other half are split between using the company's compensation peer group or a custom relative TSR peer group. A few companies also use both an index and the compensation or custom peer group.

The complete publication is available here.

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Are Companies Setting Challenging Target Incentive Goals?

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Saturday, April 18, 2015

Editor's Note: The following post comes to us from Pay Governance LLC and is based on a Pay Governance memorandum by Ira Kay, Steve Friedman, Brian Lane, Blaine Martin, and Soren Meischeid.

Do companies set appropriately challenging goals in their incentive plans? How does a compensation committee determine whether management is recommending challenging goals? How important are earnings guidance and analyst expectations in goal setting? Are more challenging goals achieved as frequently as less challenging goals? How much are annual incentive payouts increased by the achievement of incentive goals? How does the stock market react to challenging goals?

The answer to these questions should be incorporated into the goal setting process at all companies. This is Pay Governance's latest research, which covers target goal setting and provides an indication of how large companies set their annual incentive goals and how the market responds. Our findings indicate that, in general, companies set challenging goals.

Key Findings

1. In general, our research shows that companies set challenging goal targets for their incentive plans.
2. Overall, 60% of companies beat their incentive goal and a surprisingly large 40% miss.
3. 59% of companies set their incentive goals at or above the midpoint of guidance. Only half of these companies hit their goal and half did not.
4. Only 37% of companies set their goals at or above analyst expectations, which most likely represent very challenging goals.
5. Setting a hard goal relative to guidance and analyst expectations is associated with higher TSR in the subsequent year than setting an easy goal.
6. Companies that beat their incentive goals have substantially higher payouts than those that miss.

Background

Ensuring pay and performance alignment is one of the top priorities of Boards in managing the executive pay model at their companies. Setting incentive goals at the appropriate level of "challenge" is essential to the success of the pay-for-performance model and thus shareholder alignment and credibility. On one hand, these goals need to be difficult enough to motivate superior performance and meet shareholder expectations. On the other hand, goals that are prima facie unachievable could be demotivating. This process has become even more important and complicated in the context of

say on pay votes and the scoring of the difficulty of goals by proxy advisors (ISS and Glass Lewis).

Many critics of the executive pay model believe that management sets, with the concurrence of lackadaisical compensation committees, easy target goals for their incentive plans in order to maximize payouts to executives. This is not our experience with individual companies, which we find set challenging goals, and also appears counter to the excellent performance of the stock market over the past 5-6 years. **We present here unique research on key issues related to setting goals in the context of company issued earnings guidance and analyst expectations.** We evaluated:

- **Whether companies set hard or easy goals;**
- **Whether they met or missed their goals;**
- **Had different shareholder return depending on the difficulty of goals; and**
- **How much higher they paid out for achieving goals relative to missing goals.**

We looked at 83 companies that (i) provided guidance for EPS or Net Income for 2012, (ii) used one or both in annual incentive goals for the year, and (iii) disclosed their target goal. We also obtained analyst expectations for their earnings. In analyzing goals, we define a hard or challenging goal as one that is at or above the midpoint of guidance or the analyst forecast.

Fundamentally, we show that companies that set challenging goals outperform companies that set easier goals, independent of whether they achieved the goals or not. This research can provide valuable data for management and compensation committees in setting their goals appropriately.

In Summary—Target Incentive Goals Relative to Company Investor Guidance

Goal Difficulty	**2012 Goals Vs. Guidance**			
	Prevalence	**TSR2013**	**Goal Achievement**	
Goal At or Above Guidance Midpoint	59%	36%	Achieved	53%
			Not Achieved	47%
Goal Below Guidance Midpoint	41%	30%	Achieved	71%
			Not Achieved	29%
Total Sample	100%	33%	Achieved	60%
			Not Achieved	40%

A. 59% of companies set their incentive goals *at or above* the *midpoint* of guidance—indication of a hard goal.
    - Only half of these companies hit their goal and half did not—further indication of a hard goal.
B. Of the remaining 41% (which set goals below guidance), approximately 70% beat their incentive goal. This could be an indication of an easier goal.
    - The compensation committee should understand the reasons, strategic or otherwise, for setting the goal at this level.

C. Overall, slightly greater than half of all sample companies (60%) achieve their target goal and 40% miss. This indicates that companies set their guidance and goals reasonably thoughtfully.
D. Setting a hard goal for 2012 was associated with higher 2013 TSR[1] than an easy goal:
    - TSR of 36% for the companies with goals at/above guidance (hard goals) versus
    - 30% TSR for the companies who set goals below the midpoint of guidance.
E. As expected, achieving a financial incentive goal results in a significantly higher bonus payout as a percent of target—131% versus 91%—relative to not achieving goals, despite other individual, qualitative, or strategic metrics that may also be factored into bonus payouts.
F. Overall, nearly two-thirds of companies set their goals with a consistent level of rigor year-over-year—hard or easy goals in both 2012 and 2013. This rigor can be reflective of a company's culture and performance philosophy.

In Summary—Target Incentive Goals Relative to Analyst Expectations

Goal Difficulty	**2012 Goals Vs. Valueline Analyst Expectations**			
	Prevalence	**TSR 2013**	**Goal Achievement**	
Goal At or Above Analyst Expectations	37%	35%	Achieved	52%
			Not Achieved	48%
Goal Below Analyst Expectations	63%	30%	Achieved	65%
			Not Achieved	35%
Total Sample	100%	33%	Achieved	60%
			Not Achieved	40%

A. Only 37% of companies set target goals above analyst expectations, which most likely represent very challenging goals. This is a surprising finding, which indicates that analysts are often predicting that companies will surpass the midpoint of the company's guidance.
    - In fact, for 71% of companies, we found analyst expectations to be greater than guidance by 1.5 percentage points of growth in earnings at median (there could also be timing differences and other explanations for this finding).
B. Consistent with our findings above for company guidance, companies with challenging goals relative to analyst expectations outperformed the companies with lower goals—TSR of 35% versus 30%.
C. Bonus payout results for difficult/easy goals relative to analyst expectations were consistent with results relative to company guidance.
D. One-third of companies set goals that were both at/above guidance and at/above expectations.

This research shows that setting a goal at or above guidance will not necessarily drive to performance that meets investor expectations. There usually are various potential internal and strategic reasons for such a situation, which further illustrate the tension between motivating executives and satisfying shareholders, as previously discussed. This is something the Board and Comp Committee should be aware of at the time goals are set.

[1] There are many challenges in selecting the ideal timing of the TSR relative to goal achievement. We will continue to study this issue.

Further Background

Companies expend significant resources—finance, strategy, executive, board, etc.—on determining their business plan guidance and then setting incentive goals and getting them reviewed and approved by the compensation committee. This process has historically started with and solely relied upon a “bottoms-up” approach aggregating the forecasts from the business units with a final corporate adjustment. The goals typically include a measure of profit such as EPS, Net Income, EBITDA, etc. This aggregation is used to develop a final budget and usually earnings guidance that is communicated to analysts and shareholders as a forecast for the year (80-90% of large companies provide some form of guidance to their shareholders). Setting and achieving guidance is extremely valuable and important to shareholders and can be highly impactful on stock prices, up and down.

The vast majority of companies use their budgeting process in an iterative manner to determine their guidance and goals for their annual and long-term incentive plans. Therefore, it is essential that boards and compensation committees have confidence that their incentive goals balance the aforementioned tension between challenge and achievability.

Over the past few years, many companies have begun to take a multi-pronged approach to evaluating the challenge in their incentive goals. This approach includes reviewing goal positioning against: guidance, analyst expectations, company history, and peer group analyses of relative performance. In our view, this approach has substantially improved both the integrity of the process of setting the goals plus the accuracy, efficiency, and motivational power of the goals themselves. The overall profit and stock market performance of the corporate sector give credence to this view.

Conclusions and Implications

Overall, we find that most companies set challenging target goals relative to earnings guidance and analyst expectations, and companies that set challenging goals have higher TSR than others. Further, 40% of companies miss their target level goals.

Our findings and experience suggest that the best practice approach for goal setting generally includes the following steps:

1. Ensure that goals are linked to the business model and business strategy.
2. Provide the compensation committee with a robust internal and external analysis of goal difficulty.
3. Set goals in the context of guidance, analyst expectations and other factors. If a goal is below guidance or expectations, that should be explained fully to the committee.
4. Review a multi-year history of goals, payouts and stock price reaction.

Methodology

1. We selected all of the S&P 500 companies that used EPS or Net Income as a metric for their annual incentive plan AND issued guidance on EPS for 2012 and 2013.
2. We focused our study on 2012 goals so that we could use full year 2013 TSR to reflect how the market responded to the difficulty of the goal that was set (from the 2013 proxy covering 2012 incentive plans), and whether the company beat the goal.
3. We used Value Line analyst reports published at the beginning of the fiscal year for the full year EPS forecast as representative of analyst expectations. Our experience is that Value Line's forecast is highly consistent with the average of analyst expectations.
4. We converted all earnings data to an EPS growth rate (as opposed to absolute dollar value) to provide a standard basis of comparison between goals, guidance and Value Line expectations.
5. We defined a "difficult goal" as one that was at/above the midpoint of guidance or at/above the Value Line forecast.
6. We tested whether hard goals were achieved more or less frequently than easier goals and how the stock market reacted.
7. We reviewed the actual bonus payout as a percentage of target for all companies and analyzed these results by goal achievement.
8. We looked at 2012 and 2013 goals for company patterns.
9. We plan to review goal difficulty for 2013 once full-year 2014 TSR data become available.

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SEC Proposes Rules on Mandatory Clawback Policies

Posted by Renata J. Ferrari, Ropes & Gray LLP, on Friday, July 3, 2015

Editor's Note: Renata J. Ferrari is partner tax & benefits department at Ropes & Gray LLP. This post is based on a Ropes & Gray Alert.

On July 1, 2015, the Securities and Exchange Commission proposed rules to require issuers of securities listed on U.S. stock exchanges to adopt and enforce clawback policies applicable to incentive-based compensation received by current and former executives in the three-year period preceding the date the issuer is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements. The proposed rules would implement the "no fault" clawback rule requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Section 10D of the Securities Exchange Act of 1934, as amended).

Which issuers are covered by the proposed rules?

The new rules would apply to all listed issuers (including emerging growth companies, smaller reporting companies, foreign private issuers and controlled companies and issuers of listed debt), with limited exceptions for issuers of securities futures products or standardized options, unit investment trusts, and registered management investment companies that have not awarded incentive-based compensation to any executive officer in the last three fiscal years (or, if shorter, since initial listing).

Which restatements trigger application of a clawback under the required policy?

A clawback would be triggered when an issuer is required to prepare a restatement to correct an error that is material to previously issued financial statements. Materiality must be analyzed in the context of particular facts and circumstances. Changes to an issuer's financial statements that do not represent the correction of an error would not trigger application of the clawback policy. Among other exceptions, restatements due to changes to accounting principles, certain internal restructurings, certain adjustments in connection with business combinations and revisions due to stock splits would not be considered "errors" triggering clawbacks.

When is an issuer "required to prepare an accounting restatement"?

An issuer would be deemed to be "required" to prepare an accounting restatement upon the earlier to occur of:

1. the date that the issuer's board of directors, committee of the board or the officer or officers authorized to take such action (if board action is not required), concludes, or reasonably should have concluded, that the issuer's previously issued financial statements contain a material error; or
2. the date a court, regulator or other legally authorized body directs the issuer to restate its previously issued financial statements to correct a material error.

Which persons are subject to the clawback policy?

The clawback policy would have to apply to current and former "executive officers," defined in the same way as the "officer" definition for Section 16 purposes. Former executive officers would include any individual who served as an executive officer at any time during the performance period for the affected incentive-based compensation.

What compensation is "incentive-based"?

The proposed rules define "incentive-based" compensation as any compensation that is granted, earned or vests based wholly or in part upon the attainment of any financial reporting measure. Financial reporting measures are measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures derived wholly or in part from those measures, and stock price and total shareholder return ("TSR").

The table below provides illustrative examples of covered and not-covered items of compensation:

Covered "Incentive-Based" Compensation	**Compensation Not Covered**
Bonuses earned wholly or in part based on satisfying a financial reporting measure performance goal	Salaries
Bonuses paid from a bonus pool, if the pool size is based wholly or in part on satisfying a financial reporting measure performance goal	Bonuses paid solely at the discretion of the compensation committee that are not paid from a bonus pool, the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal
Equity awards granted or vesting based wholly or in part on satisfying a performance goal based on a financial reporting measure, TSR or achieving a certain stock price	Bonuses paid solely on satisfying one or more subjective standards and/or continued employment

Proceeds received upon the sale of shares acquired under an equity award that was granted or that vested wholly or in part on satisfying a financial reporting measure performance goal	Bonuses earned solely based on achieving one or more strategic or operational measures (e.g., obtaining regulatory approvals) Time-based equity awards or equity awards earned based on attaining one or more non-financial reporting measures

How long would incentive-based compensation be at risk under the clawback policy?

The policy must apply for the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement, with a special rule for issuers changing fiscal years. Any incentive-based compensation "received" (as described below) during this period would be subject to recovery.

When is incentive-based compensation "received"?

Incentive-based compensation would be deemed received in the fiscal year during which the financial reporting measure specified is attained (regardless of when granted or paid), even if not all conditions to payment have been satisfied (such as additional service conditions or board certification of performance criteria).

What is the recoverable amount under the clawback policy?

The amount recoverable by the issuer is the amount of incentive-based compensation received by the covered individual that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement. Where the amount of erroneously award compensation is not subject to mathematical recalculation directly from the information in the accounting restatement (such as where incentive compensation is based on stock price or TSR), the recoverable amount may be determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. In that situation, an issuer would be required to maintain documentation of how it determined its reasonable estimate and provide such documentation to the relevant stock exchange. The recoverable amount would be determined on a pre-tax basis.

For equity awards, the recoverable amount will depend in part on whether underlying shares have been sold. If the award is still held at the time of recovery, the recoverable amount would be the number of shares or awards received in excess of the number that should have been received applying the restated financial reporting measure. If the award has been exercised, but the underlying shares have not been sold, the recoverable amount would be the number of shares underlying the excess portion of the award applying the restated financial measure. If the underlying shares have been sold, the recoverable amount would be the sale proceeds received by the executive officer with respect to the excess number of shares (net of any exercise price paid by the executive officer to acquire the shares).

Would the issuer be required to pursue recovery and what discretion may be applied?

The issuer must pursue recovery unless it would be impracticable because it would impose undue costs on the issuer or its shareholders or would violate non-U.S. home country law. Any decision on impracticability would need to be made by the issuer's committee of independent directors that is responsible for executive compensation decisions. Before concluding that it would be impracticable to recover amounts the issuer would first need to make a reasonable attempt to recover such compensation and would be required to document its attempt to recover and provide such documentation to the relevant stock exchange. Generally, the issuer cannot settle for less than full recovery but issuers may exercise discretion with respect to how to accomplish recovery, as long as it is done reasonably promptly.

What disclosure would be required regarding use of the clawback policy?

The proposed rules would require disclosure of whether a triggering restatement had occurred within the last year, the aggregate dollar amount of excess incentive-based compensation attributable to such restatement and the aggregate dollar amount of such compensation that remains outstanding at the end of the last fiscal year. If the clawback policy is triggered, certain disclosure about the affected persons and amounts to be clawed back would also be required. If an issuer did not pursue a recovery, the issuer would have to disclose the reasons for failing to do so, the individuals affected and the amounts involved. A U.S. issuer would be required to file its clawback policy as an exhibit to its Annual Report on Form 10-K.

When are public comments due and when would the new rules go into effect?

Public comments are due within 60 days following the publication of the proposed rule in the Federal Register.

The SEC has proposed that stock exchanges file proposed listing rules to implement this clawback rule no later than 90 days after publication of the final rule, and that those rules be effective no later than one year after that publication date. Listed issuers would then be required to adopt a clawback policy no later than 60 days following the date on which the exchanges' rules become effective. The clawback policies would apply to all incentive-based compensation received by covered individuals based on or derived from financial information for any fiscal period ending on or after the effective date of Rule 10D-1.

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Clawbacks of Erroneously Awarded Compensation

Posted by Michael S. Piwowar, Commissioner, U.S. Securities and Exchange Commission, on Thursday, July 2, 2015

Editor's Note: Michael S. Piwowar is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on Commissioner Piwowar's recent remarks at a recent open meeting of the SEC; the full text is available here. The views expressed in the post are those of Commissioner Piwowar and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

A few months ago, the baseball world celebrated the 90th birthday of Yogi Berra, the legendary former catcher and manager for the New York Yankees. Yogi Berra is well-known for his witty comments, often referred to as "Yogi-isms."[1] Several come to mind today, as we consider another rulemaking related to executive compensation.

"Pair up in threes."

Following our earlier efforts on hedging and pay versus performance, today's proposal is the *third*relating to executive compensation that we have considered in 2015. The Commission has yet again spent significant time and resources on a provision inserted into the Dodd-Frank Act that has nothing to do with the origins of the financial crisis and affects Main Street businesses that are not even part of the financial services sector. Why does the Commission continue to prioritize our agenda with these types of issues, when rulemakings that are directly related to the financial crisis remain unaddressed?

While we must ultimately implement the Dodd-Frank Act, its special interest provisions for which Congress declined to provide any deadline should not take precedence over important crisis-related initiatives. Indeed, much of the efforts during my tenure as Commissioner has related to topics such as conflict minerals, resource extraction, and the CEO pay ratio. More recently, unforced errors by our Enforcement Division in steering more cases to administrative forums rather than federal courts have become an increasing and unnecessary distraction to the Commission's important work.

"The future ain't what it used to be."

As I said previously, "a properly designed clawback rule could yield real benefits to shareholders."[2] In my view, such a clawback policy would be straightforward to implement and

[1] http://yogiberramuseum.org/just-for-fun/yogisms/.
[2] Andrew Ackerman, "SEC Eyes Broadened 'Clawback' Restrictions," The Wall Street Journal (Jun. 2, 2015).

would quickly recover from executives who fail to follow correct accounting procedures. It would be fully consistent with the Dodd-Frank Act, as well as the accompanying Senate report, which stated that the provision was intended to ensure that "shareholders do not have to embark on costly legal expenses" to recover losses.[3] Unfortunately, the broad approach of today's proposal is likely to impose a substantial commitment of shareholder resources and, unintentionally, result in a further increase in executive compensation.

This is not the first time that statutes or rules relating to executive compensation have created unintended consequences. In 1993, Congress enacted Section 162(m) of the Internal Revenue Code in an attempt to restrain compensation. As our former chief economist Chester Spatt observed, the limit on tax deductibility of executive salaries created conditions for corporations to substitute riskier, performance-based awards as compensation.[4] But a dollar of fixed compensation is worth more than a dollar of risky, contingent-based compensation. Thus, total executive compensation increased substantially after the enactment of Section 162(m), despite the Congressional intent.

A similar result is likely to occur with today's proposal. According to the release, the average issuer paid approximately 0.48% of its market value of equity to all named executive officers in the form of non-salary compensation. Our economic analysis notes that risk-averse executives prefer predictable compensation and that the proposal will introduce an additional source of uncertainty in compensation levels. Because the mandated recovery policy would be "no-fault," a material accounting error would require executives to return excess incentive-based compensation even if they had no role in the error.

A recovery policy would introduce uncertainty in the amount of incentive-based compensation that executives will ultimately retain. Prior research and experience suggests that this uncertainty will increase total executive compensation. In particular, corporate executives may lower the value that they attach to the incentive-based component of their pay and demand an offset to bear the increased uncertainty.

"It's déjà vu all over again."

The Commissioners received the original discussion sheet outlining the staff's thinking exactly one year ago today, on July 1, 2014. We then received the first draft of the proposal, having been prepared by the staff and approved by the Chair's office, at the end of May. Up until two weeks ago, I was fully prepared to vote in favor of the proposal until significant changes were made that, in my opinion, were unsupportable.

In many ways, this process is all-too-familiar. A thoughtful proposal consistent with the statute is drafted by the staff, cleared by the Chair's office, and discussed among the Commissioners. But at the very end, significant changes are agreed upon by the Chair's office in ways that diverge from Congressional intent. This happened in pay versus performance, credit ratings and nationally-recognized statistical rating organizations, and swap data repositories and security-based swap data reporting.

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[3] Senate Report No. 111-176 (Apr. 30, 2010), at 136.

[4] Chester S. Spatt, Financial Regulation: Economic Margins and "Unintended Consequences" (Mar. 17, 2006), available at https://www.sec.gov/news/speech/spch031706css.htm.

There is a reason that a discussion sheet is circulated so far in advance—to allow for a deliberative process to occur among Commissioners and staff. Discussion sheets often generate reactions and new ideas that are incorporated into the draft proposal. For that reason, the ability to engage our economists, attorneys, accountants, examiners, and data specialists with additional lines of research and inquiry is critical to ensuring that the final work product represents the culmination of extensive deliberation and thought. Repeated instances of substantial eleventh-hour modifications by the Chair's office deny the other Commissioners and the staff the benefits of such discussion.

"It ain't over 'til it's over."

Although I cannot support today's proposal, it represents only the commencement of the comment period. There are a couple areas in particular that I am interested in public comment.

First, to the extent that implementation of the proposal entails fixed costs, smaller reporting companies and emerging growth companies will incur a proportionately greater compliance burden than larger issuers. In looking at the data, more than one-third of larger companies are already voluntarily disclosing an executive compensation recovery policy compared to only 2-4% for emerging and smaller companies. This difference raises questions as to whether investors in smaller and emerging companies desire such policies. I would like commenters, especially investors, to provide their thoughts on whether we should make recovery policies voluntary for emerging and smaller companies.

Second, today's proposal requires the disclosures to be coded and tagged in XBRL format as a separate exhibit. This proposal, like pay versus performance, seeks to extend interactive data for proxy statements in a piece-meal fashion. Would it be better to have a more comprehensive approach to providing interactive data contained in the proxy statement, as well as the non-financial section of the annual report on Form 10-K, rather than adding individual items in an ad hoc manner?

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Excess-Pay Clawbacks

Posted by Jesse Fried, Harvard Law School, on Monday, April 11, 2011

Editor's Note: Jesse Fried is a Professor of Law at Harvard Law School.

In the paper, ***Excess-Pay Clawbacks***, which was recently made publicly available on SSRN, Nitzan Shilon and I identify substantial deficiencies in the clawback arrangements of public companies. We also explain why the Dodd-Frank Act's clawback requirement is likely to improve these arrangements, but does not go far enough.

The paper begins by highlighting the problem of "excess pay" – excessively high payouts to executives arising from errors in earnings and other compensation-related metrics. Such excess pay, we explain, can impose substantial costs on shareholders even if there is no manipulation or other misconduct. Unfortunately, directors frequently use their discretion to let current and departed executives keep excess pay. Thus, an optimal clawback policy would require directors to recover excess pay from either current or departed executives.

The paper then examines excess-pay clawback policies in S&P 500 firms prior to Dodd-Frank. We find that nearly 50% of S&P 500 firms had no excess clawback policy whatsoever. Of those firms with clear policies, 81% did not require directors to recoup excess pay but rather gave directors discretion to let executives keep excess pay. Of the remaining firms, 86% did not permit directors to recoup excess pay absent a finding of misconduct. As a result, fewer than 2% of S&P firms required executives to return the excess pay under any circumstances. Thus, on the eve of Dodd-Frank, most executives were not subject to sufficiently robust excess-pay clawback policies.

The paper then turns to Dodd-Frank's clawback requirement. Dodd-Frank mandates that firms adopt a policy to recover excess payments to executives when there has been a restatement, even if there has been no misconduct. Given the inadequacy of firms' excess-pay clawback policies, Dodd-Frank is likely to substantially improve the quality of clawback arrangements at most publicly-traded firms. In particular, Dodd-Frank will substantially increase the likelihood that excess pay will be recovered from executives and thus reduce the costs of excess pay to shareholders.

Unfortunately, we explain, Dodd-Frank does not appear to require the recovery of all types of excess pay. In particular, Dodd-Frank does not require firms to recoup excess pay from executives in the absence of an earnings restatement and does not appear to require firms to recoup from executives' excess pay arising from the sale of stock at prices inflated by earnings manipulation. We conclude by explaining why permitting executives to keep both types of excess pay is likely to be undesirable and suggesting how boards seeking to improve executives' incentives should address these two issues.

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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SEC Proposes Proxy Disclosure Rules for Hedging by Directors, Officers and Employees

Posted by Steven Rosenblum, Wachtell, Lipton, Rosen & Katz, on Thursday February 12, 2015

Editor's Note: Steven Rosenblum is a partner in the Corporate Department of Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell, Lipton, Rosen & Katz client memorandum by Mr. Rosenblum, Andrew R. Brownstein, and Sabastian V. Niles.

Pursuant to Section 955 of the Dodd-Frank Act, the SEC on February 9, 2015 proposed hedging disclosure rules for public comment and review. These rules, if adopted, would require proxy statements involving the election of directors to disclose whether the company permits employees (including officers), members of the board of directors or their designees to engage in transactions to hedge or offset any decrease in the market value of equity securities that are granted to the employee or board member as compensation or otherwise held, directly or indirectly, by the employee or board member, regardless of source.

The proposed rules treat hedging as a corporate governance matter relevant to shareholders making voting decisions about directors. They also contemplate a principles-based approach to required disclosures and accordingly would not be strictly limited to the use of financial instruments (such as prepaid variable forward contracts, equity swaps, collars and exchange funds) but would also reach other transactions with comparable economic consequences that "establish downside price protection."

In disclosing hedging policies, companies would be required to describe (i) which categories of hedging transactions are permitted and which are prohibited (or include blanket statements that all hedging transactions are permitted or prohibited, as applicable); (ii) which categories of persons are permitted to engage in hedging transactions and which are not (if treatment differs); and (iii) the scope of permitted transactions in sufficient detail to provide adequate explanation. The proposed rules would only cover hedging involving equity securities that are registered under Section 12 of the Exchange Act and issued by the company, any parent of the company or any parent or company subsidiary.

Existing executive compensation-related proxy rules require companies to disclose, within the context of discussing compensation of named executive officers, stock ownership guidelines and company policies regarding hedging the economic risk of such ownership, if material. The proposed rules would apply beyond NEOs to directors, officers and employees generally, eliminate the materiality overlay and apply broadly to company securities, whether or not granted for compensatory purposes. The proposing release also requests comment in several areas relating to the appropriate scope and coverage of the proposed rules, including potential exemptions.

Since at least 2010, companies have been actively reviewing their policies regarding hedging (and pledging) of company securities, deploying diverse approaches and engaging with shareholders and proxy advisory firms on this topic. Companies should review the SEC's proposing release closely and take the additional required disclosures into account in determining whether updates to policies and internal controls are appropriate.

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Aligning the Interests of Company Executives and Directors with Shareholders

Posted by Luis A. Aguilar, Commissioner, U.S. Securities and Exchange Commission, on Monday February 16, 2015

Editor's Note: Luis A. Aguilar is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on Commissioner Aguilar's recent public statement; the full text, including footnotes, is available here. The views expressed in the post are those of Commissioner Aguilar and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

Today [February 9, 2015], the Commission issued proposed rules on *Disclosure of Hedging by Employees, Officers and Directors*. These congressionally-mandated rules are designed to reveal whether company executive compensation policies are intended to align the executives' or directors' interests with shareholders. As required by Section 955 of the Dodd-Frank Act, these proposed rules attempt to accomplish this by adding new paragraph (i) to Item 407 of Regulation S-K, to require companies to disclose whether they permit employees and directors to hedge their companies' securities.

Over the last three decades, we have witnessed an unprecedented growth in the compensation of corporate executives. Much of that growth reflects the trend towards equity-based and other incentive compensation, which intends to meet the worthy goal of aligning the interests of the corporate overseers of public companies with their shareholders. However, some have suggested that company policies that permit hedging of the company's equity securities could have the opposite effect. By allowing corporate insiders to protect themselves from stock declines while retaining the opportunity to benefit from stock price appreciation, hedging transactions could permit individuals to receive incentive compensation, even where the company fails to perform and the stock value drops.

Just as problematic, hedging transactions can be structured so that executives or directors monetize their shareholdings while they still technically own the stock, which makes the fact that the hedging took place less transparent to investors. Indeed, in the absence of this proposed disclosure, shareholders may not be aware of the executive officers' and directors' true economic

exposure to the company's equity. Accordingly, the proposed hedging rules are intended specifically to address this lack of transparency, and attempt to provide greater clarity to investors regarding employees' and directors' actual incentives to create shareholder wealth. In addition, better information about equity incentives could be useful for investors' evaluation of companies, enabling investors to make more informed investment and voting decisions.

It is important to note what the proposed rules do not do: they do not prohibit hedging transactions by employees or directors of public companies. This is a disclosure rule that is intended to shed some sunlight on this practice. Accordingly, if a company specifically prohibits certain hedging transactions but allows others, it would need to disclose those hedging transactions that are permitted. However, the proposed amendments could result in companies implementing changes in hedging policies that improve the alignment of interest between shareholders and executive officers or directors.

The proposed rules on hedging disclosures are only one in a series of Congressionally-mandated rules that are intended to promote accountability by making executive compensation decisions more transparent to company shareholders. The Commission has already adopted some of these rules. Unfortunately, other significant executive compensation-related disclosure rules have yet to be adopted, including disclosures related to:

- The relationship between executive compensation actually paid and the financial performance of the issuer (known as "pay-for-performance");
- The ratio between the compensation of the chief executive officer and the total annual compensation of its average worker (known as "pay ratio"); and
- Reports by large investment managers of their advisory shareholder votes about executive compensation and golden parachutes (known as "say-on-pay" votes).

It is my hope that the Commission moves promptly to adopt these additional disclosure rules to provide maximum transparency to investors about companies' executive compensation decisions. Without such transparency, the true owners of public companies—the shareholders—most assuredly will have a difficult time holding company directors and officers accountable for their executive compensation decisions.

This proposing release is a positive step in the direction of providing more information to shareholders as to whether the interests of corporate insiders are truly aligned with their own. As with all proposing releases, this proposing release includes many requests for comment regarding the approach that the Commission has decided to take to implement the statutory mandate.

Public comments are always an important part of the rulemaking process, and I especially encourage investors to review and submit their thoughts on the proposed release.

Tab 4: Current Thinking on Engagement and Lessons from the 2015 Proxy Season

SULLIVAN & CROMWELL LLP

July 20, 2015

2015 Proxy Season Review

Proxy Access Proposals Most Significant Development of 2015; Significantly Higher ISS Support of Independent Chair Proposals Does Not Translate to Higher Votes; Board Withhold Recommendations Continue to Increase With Board Responsiveness a Key Driver in Resulting Votes

SUMMARY

This Paper summarizes significant developments relating to shareholder proposals to date during the 2015 proxy season. Although shareholder activists pursuing strategic or management changes continue to dominate the headlines, they do not choose to wage those campaigns through shareholder proposals made under Rule 14a-8, which are addressed by this Paper, choosing instead private or public pressure, and often a threatened or actual proxy contest. Nonetheless, the widespread governance changes brought about through successful 14a-8 proposals have played no small part in the continued growth and success of shareholder activism.

During the 2015 proxy season, proxy access has been the most significant development. Far more proposals have been made and support has been substantially stronger. There have been 82 proxy access proposals to date in 2015, as opposed to 17 in all of 2014. In 2015, shareholders have approved 48 proposals to date (as opposed to five for all of 2014), and the average votes cast in favor have risen to 55% from 33% in 2014. Perhaps most significantly, modestly more restrictive management-enacted proxy access provisions apparently did not deter shareholders from proposing, and, in many cases, winning on the now standard shareholder proposal format of 3%/3-year/25% of board.

When proxy access proposals are eliminated, overall governance proposals dropped 6%, with majority election of directors and board declassification proposals in particular being proposed much less frequently than in prior years. This decline, however, may principally reflect the previous adoption of these two governance arrangements by numerous companies. Although ISS support for independent

chair proposals increased significantly this year, based on its new approach to this proposal, average support and the number of successful proposals actually declined somewhat. In light of the SEC's decision to suspend no-action relief for conflicting proposals, conflicting proposals for proxy access and special meeting rights appeared in a number of proxy statements.

ISS recommendations to withhold or vote against directors increased in 2015 with notable increases in the number of withhold recommendations for a lack of responsiveness and for unilateral actions taken by the board that restricted shareholder rights (primarily through bylaw amendments), as well as for independence, compensation and overboarding issues. Average support on advisory say-on-pay votes remained strong, and largely unchanged from prior years.

The data in this Paper incorporates shareholder proposals made at meetings held on or before June 30, 2015. We estimate that about 415 of the S&P 500 companies had held their meetings by that date.

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[Pages 18-27 Omitted]

I. OVERALL TRENDS IN RULE 14A-8 SHAREHOLDER PROPOSALS

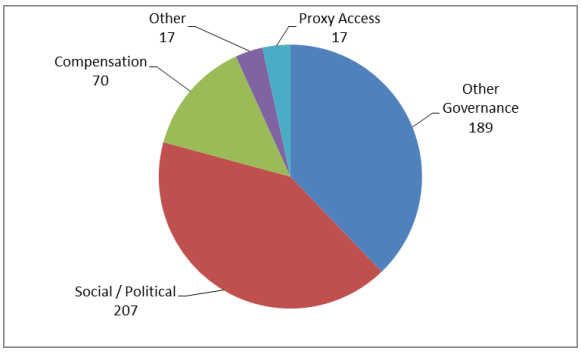
A. OVERVIEW OF SHAREHOLDER PROPOSALS IN 2014 AND 2015

The following table and pie charts summarize, by general category, the Rule 14a-8 shareholder proposals voted on at U.S. companies in 2014 and 2015, and the rate at which they passed.[1,2]

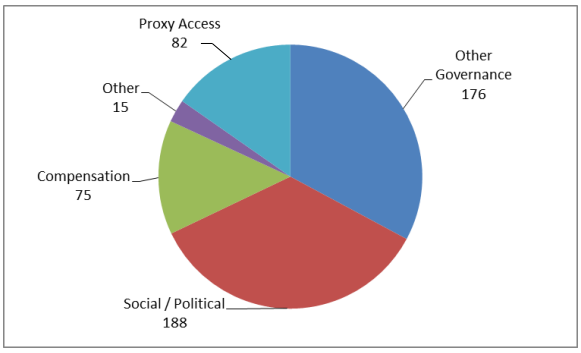
SUMMARY OF 2014 AND 2015 SHAREHOLDER PROPOSALS

	Total Shareholder Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
Type of Proposal	*2015*	*2014*	*2015*	*2014*	*2015*	*2014*
Proxy Access	82	17	55%	33%	48	5
Other Governance	176	189	40%	44%	38	53
Social and Political Issues	188	207	21%	22%	1	7
Compensation-Related	75	70	29%	27%	5	5
Other	15	17	16%	28%	2	2
Total	536	500				

Proposals Voted on in 2014



Proposals Voted on in 2015 (YTD)



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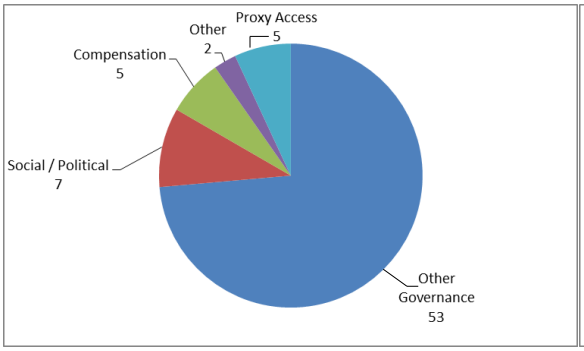
1 By "pass", we mean that the proposal received the support of a majority of votes cast, regardless of whether this is the threshold for shareholder action as a state law matter (including pursuant to the issuer's bylaws). This does not include abstentions in describing whether a shareholder proposal has "passed" or "failed," as this provides a consistent metric across all companies, and is consistent with the terminology used by ISS and many institutional investors and advisory firms. Under ISS's policies and those of other proxy advisory firms and institutional investors, failure to implement a shareholder proposal which was approved by a majority of the votes cast, even if that vote would not constitute passage under state law or the issuer's bylaws, is likely to result in negative recommendations for some or all incumbent directors in the following year due to "non-responsiveness." See Section II below for a discussion of negative recommendations for directors under these circumstances.

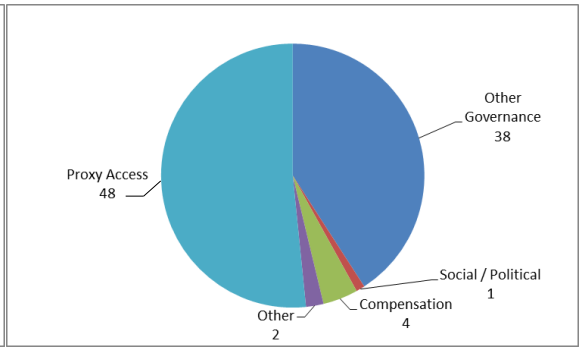
Throughout this publication, information on voting results for 2015 year-to-date generally includes annual meetings through June 30, 2015 and includes U.S. companies in the Russell 3000 index and voting results for 2014 reflect the full year.

2 Given the 400% increase in proxy access proposals, they have been placed into their own category to avoid obscuring developments in other governance proposals.

Proposals That Passed in 2014



Proposals That Passed in 2015 (YTD)

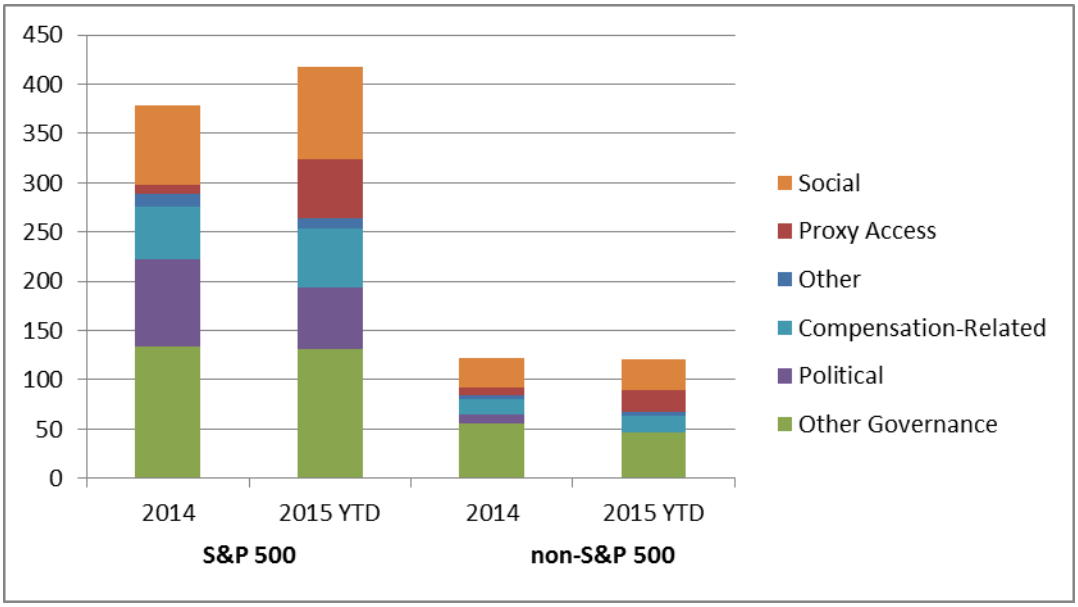


As indicated above, companies still receive a large number of social, political, and compensation related proposals, though it is also still the case that the vast majority of proposals that pass are those relating to governance issues. Only one out of 188 social/political proposals and five out of the 76 compensation-related proposals received a majority of votes cast in 2015 thus far.

B. COMPANIES THAT RECEIVED SHAREHOLDER PROPOSALS

Before turning to a detailed discussion of the various categories of shareholder proposals received by U.S. public companies in 2015, it is worth taking a moment to focus on *which* companies generally receive these proposals. Traditionally, the vast majority of shareholder proposals have been received by large-cap companies. Over time, this has led to a bifurcated corporate governance landscape, with so-called "shareholder-friendly" governance structures, such as destaggered boards, majority election of directors, special meeting rights and simple majority vote thresholds, being much more common at larger companies than smaller companies.

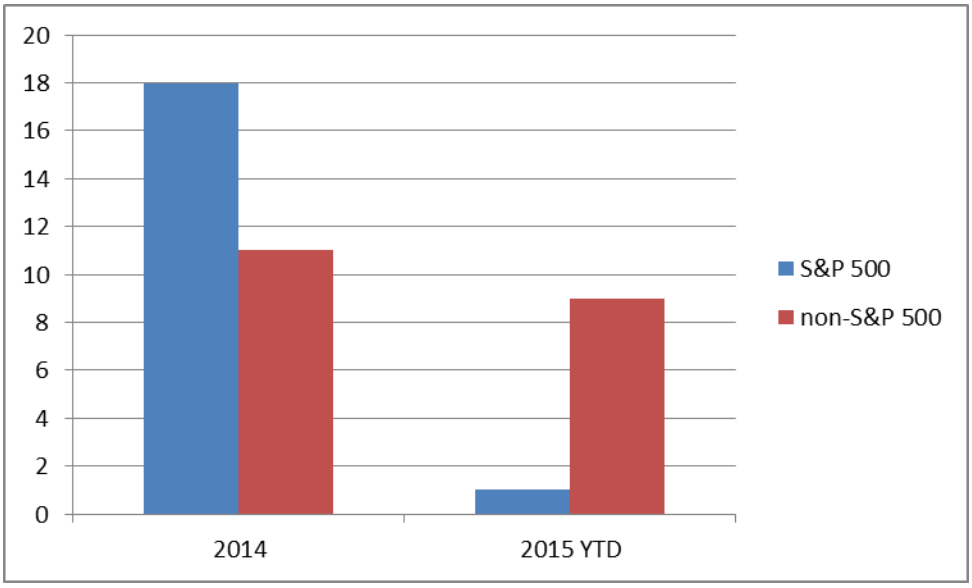
SHAREHOLDER PROPOSALS INCLUDED IN PROXY STATEMENTS (S&P 500 VS NON-S&P 500)



In 2015 so far, non-S&P 500 companies received 20% of all proposals voted on, although large-cap companies continue to be the primary focus of shareholder proposals across all categories of proposals.[3] The number of shareholder proposals at non-S&P 500 companies is substantially similar to 2014 despite the fact that no political proposals were made at non-S&P 500 companies in 2015 (nine were made in 2014).

The overall number of non-proxy access governance proposals at both S&P 500 and non-S&P 500 companies remained relatively constant, although the composition between the two groups has changed. As indicated by the chart below, the 2015 proxy season reveals a significant decrease in proposals for majority voting for directors at the S&P 500 (undoubtedly due to the fact that more than 80% of the S&P 500 now have majority voting for directors), but a much smaller decrease in that proposal at non-S&P 500 companies. The decline in proposals for majority election for directors and declassification at the S&P 500 in 2015 was largely offset by small increases in written consent, cumulative voting, and independent chair proposals. The 2% decline in non-proxy access governance proposals at smaller cap companies relative to 2014 would suggest that many proponents are not electing to direct their attention to smaller cap companies once the larger cap companies have adopted shareholder governance initiatives, with the possible exception of majority voting for directors.

PROPOSALS FOR ADOPTION OF MAJORITY VOTING PROVISIONS INCLUDED IN PROXY STATEMENTS (S&P 500 VS NON-S&P 500)



[3] Data throughout this publication relates to U.S. companies in the Russell 3000, unless otherwise noted, and is based on information from ISS and FactSet Shark Repellent, as well as our own selective review of public filings.

The impact of shareholder proposals is greater than is reflected simply in the numbers of proposals coming to a vote. Many shareholder proposals—or potential shareholder proposals—never make it to a shareholder vote, because the company determines to address the governance matter itself.

C. WHO MAKES SHAREHOLDER PROPOSALS

It is informative to review the identity of shareholder proponents. Based on data provided by ISS's voting analytics with respect to 969 shareholder proposals (including proposals which were withdrawn or excluded), John Chevedden, either alone or in conjunction with others, was associated with almost 200 proposals. In addition to the 75 proxy access proposals discussed below made by the New York City Comptroller on behalf of the New York City Pension Funds (again, often in conjunction with others), other public sector pension funds and entities were associated with over 80 proposals. Labor unions were involved with around 120 proposals. Entities which are often considered active in the shareholder proposal arena were less so this year based on this data—CalPERS made only three proposals, and Norgesbank one; CalSTRS had 11. The data also indicated that "socially responsible" entities were quite active—each of Trillium Asset Management, Calvert Asset Management, Walden Asset Management, and As You Sow Foundation was associated with more than 20 proposals and, as usual, religious organizations were primarily focused on social/political proposals.

D. SHAREHOLDER PROPOSALS ON GOVERNANCE STRUCTURE

Governance matters (board-related and antitakeover concerns) remain the primary focus of shareholder proposals in 2015.

The success of governance proposals remains highly dependent upon whether they are supported by ISS recommendations. As in 2013 and 2014, average support for these proposals in 2015 remains around 50% when supported by ISS recommendations, but only around 20% in cases when not supported. Because of the large increase in proxy access proposals, the overall number of governance proposals increased in 2015, up to 258 total proposals, an increase of 52 proposals from 2014, with proxy access more than making up for a slight decrease in other governance proposals.

1. Proxy Access Proposals

PROXY ACCESS					
Total Shareholder Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
2015 YTD	*2014*	*2015 YTD*	*2014*	*2015 YTD*	*2014*
82	17	55%	33%	48	5

a. The Growth of Proxy Access Proposals

As noted, proxy access is the most significant development of the 2015 proxy season. Proxy access proposals increased dramatically during 2015, increasing in number by more than 400%. 58% of the proxy access proposals passed, and ISS supported every proxy access proposal that was made. Companies, as a matter of preparedness, should be aware of proxy access developments and should be

considering the different strategies available to them as the pressure for proxy access increases. It should be assumed, given the high success rate, that there will be more proxy access proposals next year.

b. The Terms of Shareholder Proxy Access Proposals

In recognition of the failure in prior years of proxy access proposals with low ownership thresholds, this year all proxy access proposals had an ownership requirement of 3% and a holding period of three years.[4] Almost all proposals provided that the maximum number of directors that could be elected by proxy access was 25% of the board; in two instances, that percentage was 20%. With limited exception, there was no limitation in the proposal on the number of persons who could be considered a group in order to meet the ownership threshold.

c. Marginally More Restrictive Pre-Existing Proxy Access Bylaws

In ten instances, the issuer had a proxy access bylaw in place with a 5% ownership threshold[5] before the proxy statement was mailed (except Marathon Oil, which adopted it a few weeks later). In five instances the 3% proposal was successful and in five instances it failed. In eight of those ten cases, the board only added proxy access after the stockholder proposal was received, but timing did not seem to affect the outcome of the vote (management prevailed half of the time where the proxy access was in effect prior to the proposal being made and half of the time where it was not).

d. Use of Conflicting Proxy Access Proposals by Management

In light of the SEC Staff decision to suspend no-action relief for conflicting proposals under Rule 14a-8(i)(9),[6] seven issuers chose to include competing management proposals in the proxy statement, with the management proposal in six instances raising the ownership threshold to 5% (in the case of Expeditors International, the threshold was left at 3%, but a net long ownership requirement and a limitation of 20 persons constituting a group to hold the required percentage ownership were added, and the number of board seats was limited to 20%). In three instances, the management proposal was successful, in three instances, the shareholder proposal was successful, and, in one case, Chipotle

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[4] The vast majority (92%) of proxy access proposals were by one proponent, the New York City Comptroller on behalf of the New York City Pension Funds, and these proposals contained the same terms. Given the high success rate, it should be assumed future proposals will follow this format. In choosing 75 companies to make proxy access proposals in 2015, the Comptroller announced the initiative was focusing on three criteria: climate change, board diversity and excessive CEO pay.

[5] In the case of Boston Properties, the proxy access provision adopted by management had a 3% threshold, albeit with a five-person group limitation—the shareholder proposal failed in this instance.

[6] For a discussion of the SEC staff's decision, and the announcement by SEC Chair White that spurred it, see our publication, dated January 16, 2015, entitled "SEC Staff Suspends No-Action Relief on Conflicting Shareholder Proposals." Keith Higgins, Director of the SEC's Division of Corporation Finance, discussed considerations relating to the treatment of conflicting proposals in a February 10 speech, available at http://www.sec.gov/news/speech/rule-14a-8-conflicting-proposals-conflicting-views-.html.

Mexican Grill, neither proposal passed. In no instance did both proposals pass (nor were the votes particularly close), a point that SEC Chair Mary Jo White stressed in a recent speech.[7] The outcome at Chipotle was presumably largely due to the particular institutional shareholder positions there. These management proposals followed two approaches: five of them were advisory with the broad parameters of the proxy access rights spelled out, and two were binding votes on the proxy access bylaw (one of which was Chipotle's, and both of which failed).

e. Other Management Responses

Many issuers opposed the proxy access proposal, but took no other action. In those cases, the shareholder proposal passed 60% of the time. Where management took no position (one instance), or supported the proposal (two instances), the proposal passed. In four cases, management indicated future plans to adopt proxy access, often after further stockholder engagement, and in three of these cases, the proposal still passed (the fourth proposal at Pioneer Natural Resources received 49.4% of votes cast).

f. Lessons Learned

Why any issuer wins or loses on any shareholder proposal, including proxy access, is highly fact dependent, including the shareholder profile, the issuer's performance, the issuer's governance profile, the solicitation efforts used and the issuer's general policy of engagement with institutional shareholders. What was clear, however, from this year's results is that proxy access has widespread support and is generally likely to be approved, and that a fairly modest increase (from 3% to 5%) in the ownership threshold in a management-adopted proxy access provision is not a guarantee against either receiving a 3% proposal, or winning if such a proposal is made.

It is unclear at this point what parameters an issuer can include in a proxy access provision adopted after the shareholder proposal has been successful and still be considered "responsive." Unlike actual proxy access bylaws, the shareholder proposals are quite short. Issues such as the permissible size of a group of shareholders, whether holdings must be "net long", whether incumbent proxy access directors who are renominated by the board should reduce the number of board seats available for proxy access, and whether a very low vote received in a prior year should disable a proponent from using proxy access in the future are not addressed, and it is unclear whether including such provisions will be deemed by ISS and others to be responsive. A strong argument can be made that following market practice (and therefore including such common limitations as the number of persons that can constitute a group) is responsive and that the shareholder proponent would have specifically required the exclusion of such language had it found it objectionable. It is likely to be a number of months before issuers whose shareholders approved proxy access proposals adopt specific bylaws. Issuers who are planning to adopt

[7] See SEC Chair White Speech, available at http://www.sec.gov/news/speech/building-meaningful-communication-and-engagement-with-shareholde.html.

bylaws for that reason should review ISS's November policy updates to see if responsiveness is addressed in the proxy access context, as well as any FAQs which may be issued.

In any event, issuers who are implementing proxy access provisions in response to a shareholder vote should be mindful of the following factors listed by ISS in its FAQ on responsiveness in considering less than complete implementation of a successful shareholder proposal:

- Disclosed outreach efforts by the board to shareholders in the wake of the vote;
- Rationale provided in the proxy statement for the level of implementation;
- The subject matter of the proposal;
- The level of support for and opposition to the resolution in past meetings;
- Actions taken by the board in response to the majority vote and its engagement with shareholders;
- The continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals); and
- Other factors as appropriate.

There is also no clear answer as to whether it is advisable to proactively adopt a proxy access bylaw today. While last year the New York City Comptroller chose the issuers targeted based on criteria unrelated to specific governance provisions, future proponents may focus on issuers without existing proxy access bylaws. Given that a large number of issuers need to adopt proxy access before next year's proxy season in order to be responsive, the terms they choose, and the reaction to those terms, will provide further guidance as to market practice. Should ISS issue policy guidelines that indicate a particularly narrow view of responsiveness, however, greater consideration should be given to a pre-emptive adoption if the board would otherwise be unduly constrained in adopting a provision following a successful shareholder proposal.

At a minimum, management and the board should consider the various components of proxy access bylaws, consider what they would find acceptable, and stay abreast of these provisions as more are adopted. If the decision is not to adopt a provision in advance of receiving a proposal, having an internally acceptable form of bylaw would be advisable because it will facilitate negotiations with a proponent, or adoption of the bylaw unilaterally after receipt of a proposal. If the decision is to propose a conflicting provision, issuers must consider whether to present the entire proxy access bylaw for a binding vote, or, as most issuers with conflicting proposals did this year, present a summary of the key points for an advisory vote. Absent almost identical competing proposals, it would be difficult, if not impossible, to determine what element or elements caused shareholders to support the shareholder proposal as opposed to management's. A summary of the provisions of proxy access bylaws adopted to date, and a recommended form of bylaw, will be the subject of a future memorandum to clients.

2. Independent Chair Proposals

INDEPENDENT CHAIR					
Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
2015 YTD	2014	2015 YTD	2014	2015 YTD	2014
62	63	29%	31%	2	4

Proposals requesting that companies separate the roles of CEO and chair[8] continued to be popular in 2015, trailing only proxy access proposals in frequency. 62 such proposals were voted on so far in 2015, nearly tying the number of such proposals for all of 2014. Large companies have regularly received these proposals since the mid-2000s, reflecting the views of certain shareholders that having the CEO (or another member of management) serve as chairperson may undermine the independence of the board as a whole. These proposals tend to receive significant shareholder support, though only 3% passed in 2015.

ISS support for these proposals increased in 2015 by nearly 15% and now ISS supports these proposals in a majority of cases. This increased ISS support is significant, given its impact upon voting results for these proposals—the average level of shareholder support at S&P 500 companies was between 35-40% in 2013, 2014, and 2015 if ISS supported the proposal, but only around 20-25% if ISS did not. However, in 2015, substantially increased ISS support of these proposals did not result in an increase in the average number of votes in favor of the proposals—there was a 2% decline.

The increased support from ISS is a result of their 2015 policy updates regarding independent chair proposals. Previously, absent problematic governance or management issues, ISS would recommend against independent chair proposals if there was a counterbalancing governance structure, including a lead director with specific enumerated duties, a two-thirds independent board, fully independent key committees and established governance guidelines, as long as the one- and three-year total shareholder return was not in the bottom half of the issuer's industry group. Thus, issuers could be fairly certain as to the outcome of the ISS recommendation. For 2015, ISS adopted a "holistic" approach to consideration of factors, added additional factors including the absence/presence of an executive chair, recent board and executive leadership transitions and director/CEO tenure, and added a longer (five-year) TSR performance period. ISS noted at the time that, in backtesting, the new methodology resulted in a higher level of support for such shareholder proposals.

[8] These proposals are typically formulated either as a proposal to split the roles of CEO and chair or as a proposal that the chairperson be an independent director.

3. Decline in Proposals for Majority Voting and Board Declassification

	PRIMARY GOVERNANCE PROPOSALS					
	Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2015 YTD	2014	2015 YTD	2014	2015 YTD	2014
Declassify Board	10	17	77%	82%	10	16
Adopt Majority Voting	10	29	69%	58%	8	17

Proposals for the elimination of classified boards and the adoption of majority voting in director elections (rather than plurality voting) declined dramatically in 2015, after having declined in 2014 from levels in 2013. There are two primary reasons for this decrease. First, most large public companies have already enacted these governance changes since 2000, largely in response to shareholder pressure and evolving views of best corporate governance practices.[9] There was only one proposal for majority voting at the S&P 500 companies during 2015. Secondly, and perhaps more importantly, a Shareholder Rights Project clinic at Harvard Law School that was largely driving the momentum for declassification proposals did not make any proposals in 2015.

4. Shareholder Right to Act by Written Consent

RIGHT TO ACT BY WRITTEN CONSENT					
Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
2015 YTD	2014	2015 YTD	2014	2015 YTD	2014
36	28	39%	38%	2	0

Companies have continued to receive a significant number of shareholder proposals requesting that the company grant shareholders the right to act by written consent—the number of these proposals voted on so far in 2015 has already exceeded the total number in all of 2014, a continuation in the trend experienced since 2012. ISS supports these proposals in almost all cases and has recommended voting in favor of 94% of the cases so far in 2015.

In 2015, only 6% of the proposals have passed so far despite the strong support from ISS. This pass rate has increased from the 0% pass rate observed in 2014 but is still quite low given ISS support.

The corporate laws of most states provide that shareholders may act by written consent in lieu of a meeting unless the company's certificate of incorporation provides otherwise. Commonly, public companies provide in their charters that shareholders may *not* act by written consent, or that they may act by written consent only if the consent is unanimous (as opposed to permitting a written consent to be executed by shareholders representing the percentage of the voting power that would be necessary to approve the action at a meeting).

[9] As addressed above, more than 80% of S&P 500 companies have already enacted majority voting in director elections.

Some shareholders assert that companies should permit action by written consent on the basis that shareholder action should not be limited to the normal annual meeting cycle. The concern that companies have about giving shareholders the right to act by written consent is that the written consent process can frustrate an orderly and transparent debate on the merits of the proposed action, as would occur if it were raised at a shareholder meeting. Moreover, action by written consent can be seen as inherently coercive in that consent solicitations may not, in certain instances, give shareholders the benefit of the notice and disclosure requirements applicable to proxy solicitations. In addition, in the context of a hostile acquisition coupled with a written consent solicitation to remove the board, the uncertain timetable created by the fact that the removal is effective upon the delivery of the requisite number of consents could cause potentially interested third parties to be reluctant to enter into negotiations, given the risk that the board they are negotiating with could be removed at any time.

Up until recently, some companies, upon receiving a written consent proposal, have put forth a management proposal to adopt written consent rights, thereby allowing the company to exclude the shareholder proposal as "conflicting" under Rule 14-a-8(i)(9). These management proposals generally included provisions designed to reduce the coercive use of the process and to permit it to work in a more deliberative and organized manner, including provisions governing timing and disclosure requirements similar to those that would apply to a shareholder meeting.

However, as noted above, the SEC staff in 2015 suspended granting no-action relief because a shareholder proposal conflicted with a management proposal. Chair White has indicated that the goal with respect to this issue "is to provid[e] clarity for next year's proxy season."[10] Depending on the outcome of the SEC process, company management could adopt their own provision on a preemptive basis, present a competing proposal or allow the matter to go to a vote, and then propose a charter amendment the following year which includes provisions with the appropriate safeguards. These safeguards, which should be considered for any management proposal, whatever course is followed, include:

- An ownership threshold required to request action by written consent, ranging from 10% to 40%, with 20-25% being the most common, and in most cases conforming to the percentage required to call a special meeting at that company;
- Requiring the solicitation of all shareholders;
- A delay before consents could be delivered (e.g., 50 or 60 days) to ensure that shareholders have sufficient time to consider the matters subject to the consent;
- Timing limitations, such as denying the process if the request was delivered in the 90-day period prior to the anniversary of the prior annual meeting (because the company could have included a shareholder proposal in the annual meeting proxy statement), or if a similar item

[10] See SEC Chair White Speech, available at http://www.sec.gov/news/speech/building-meaningful-communication-and-engagement-with-shareholde.html.

had been considered within a prior period, ranging from 30-120 days before the request, and, in many instances, if the matter was included in the notice for an upcoming meeting; and/or

- Disclosure requirements calling for the same information to be provided as is required by the advance notice bylaws.[11]

ISS's FAQs have recognized that "reasonable restrictions" on written consent rights are acceptable in determining whether the board has been "responsive" following a successful stockholder proposal, but provide the following guidelines on what restrictions are considered reasonable:

- An ownership threshold of no greater than 10 percent;
- No restrictions on agenda items;
- A total review and solicitation period of no more than 90 days (to include the period of time for the company to set a record date after receiving a shareholder request to do so, and no more than 60 days from the record date for the solicitation process);
- Limits on when written consent may be used of no more than 30 days after a meeting already held or 90 days before a meeting already scheduled to occur; and
- A requirement that the solicitor must use best efforts to solicit consents from all shareholders.

Restrictions beyond these levels will be "examined in light of the disclosure by the company about its outreach to shareholders, the board's rationale, etc. on what they consider reasonable, equity structure of the company, etc."[12] If shareholders vote to support a shareholder proposal on written consent, subsequently proposing for shareholder adoption a more restrictive proposal than the limitations deemed reasonable by ISS could be considered "non-responsive" in ISS's analysis of the recommendation for voting for directors, depending on the terms proposed and the company's disclosure on shareholder outreach. While ISS would recommend a vote *for* the more restrictive written consent proposal, because it is better than no ability to act by written consent, ISS would likely recommend *against* incumbent directors for failure to substantially implement a proposal that received a majority of votes cast in a single year. ISS withhold recommendations on the basis of "non-responsiveness" generally have significant impact on voting results in director elections. Accordingly, given the increase in the number of these proposals, and the fact that two have been successful thus far this year, unless an issuer is relatively

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[11] Disclosure requirements, whether contained in the advance notice bylaws, or a special meeting or written consent right, which are so expansive that they effectively prevent the use of the action sought to be taken by shareholders run the risk of being found unreasonable in litigation (in the Allergan/Pershing Square litigation Allergan agreed not to require much of what was contained in the bylaw) and their adoption could result in a negative recommendation for the board of directors by ISS.

[12] *See* ISS, "*Frequently Asked Questions on U.S. Proxy Voting Policies and Procedures (Excluding Compensation-Related Questions) (April 30, 2014),*" at question 45, *available at* http://www.issgovernance.com/file/2014_Policies/ISSUSFAQsPoliciesandProcedures04302014.pdf ("ISS FAQs"). ISS gives Amgen as an example of a company that put forth a management proposal at an ownership level of 15%, but was deemed responsive by ISS because of the shareholder outreach disclosure in its 2012 proxy.

comfortable that it will prevail in the shareholder vote, waiting until after shareholders approve a written consent proposal to implement the provision may reduce the Board's flexibility in achieving a written consent provision that differs substantially from the ISS FAQs. It should be noted that, unlike with special meeting rights, no issuers proposed conflicting proposals for written consent in their proxy statement this year.

5. Shareholder Right to Call Special Meetings

	RIGHT TO CALL SPECIAL MEETINGS					
	Total Shareholder Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
	2015 YTD	*2014*	*2015 YTD*	*2014*	*2015 YTD*	*2014*
Adopt new right	9	6	50%	48%	3	4
Lower % on existing right	11	7	39%	36%	1	0

Proxy advisory firms and many shareholders support the right of shareholders to call a special meeting because this enables shareholders to act on matters that arise between annual meetings (such as the removal of a director, including in circumstances intended to permit an acquisition offer to proceed, or the amendment of bylaws). The right to call special meetings should be viewed in conjunction with the movement away from classified boards—in Delaware, directors of a non-classified board can generally be removed by shareholders without cause. Thus, given the trend of declassifying boards in the past several years, the ability to act outside the annual meeting to remove directors without cause can be viewed as the dismantling of an effective mechanism to provide directors with additional time to consider hostile takeover proposals and seek superior alternatives. About 60% of S&P 500 companies now provide shareholders with some right to call a special meeting, a development driven largely by shareholder proposals and shareholder support for the concept over the past few years.

In the past, shareholder proposals requesting the board to adopt special meeting rights usually sought to grant the right to call the meeting to holders of 10% of outstanding shares, which is a lower level than most companies and many shareholders see as appropriate. In 2015, however, five of the nine shareholder proposals raised the thresholds to 20% and to 25%. The only shareholder proposals that passed for the initial adoption (rather than amendment) of a special meeting right were those with a 20% threshold.

There were 10 unsuccessful proposals to lower the threshold required to call a meeting, for which existing thresholds ranged from 15-50%, and only one successful proposal to lower a threshold from 50% to 25%.

In light of the inability to exclude conflicting proposals, six issuers proposed alternate special meeting proposals in the proxy statement with higher thresholds than the shareholder proposal, and in all but one instance, the management proposals (five of which were at a 25% threshold and one at a 20% threshold) succeeded. All but one of the management proposals were binding charter (and in certain cases related bylaw) amendments. The vote at BorgWarner, which had an 80% vote requirement to amend its charter,

resulted in the anomalous outcome that the non-binding 20% proposal succeeded, while the 25% binding provision did not, although the latter received much higher votes in favor. Absent this supermajority vote, this would have been an instance of shareholders approving conflicting proposals. The issuers differed in their approach to the discussion of the conflict if both were approved, from not explaining what it would do, to saying it would implement the management proposal and consider the shareholder proposal, to saying it would implement the management proposal and *not* the shareholder proposal.

All of the foregoing, together with the fact that no shareholder proposal to lower a threshold was successful in either 2013 or 2014, is a clear indication that shareholders do not support 10% thresholds, and that generally a 25% threshold is acceptable. In particular, shareholders are now proposing higher thresholds, and conflicting management proposals with 25% thresholds defeated two 20% shareholder proposals.

Either the Staff will reinstate no-action on the basis of conflicting proposals, or, given the success of the conflicting management proposals this year, issuers are likely to continue proposing conflicting special meeting rights in the proxy statement, so issuers without such provisions should prepare themselves by considering what terms would be acceptable for a special meeting right, although ultimately any decision to make a conflicting proposal would depend in part on the assessment of the likelihood of success of the shareholder proposal. Terms that companies may wish to consider including in any management proposal for a special meeting right include:

- ***Threshold.*** Though practice varies considerably, 25% has emerged as the most common threshold for special meeting rights at public companies. Both Vanguard and T. Rowe Price have indicated that 25% is an appropriate level in their view. The following table shows the threshold for special meeting rights at the 301 S&P 500 companies that are incorporated in Delaware.[13]

SPECIAL MEETING THRESHOLDS (S&P 500 DELAWARE COMPANIES)	
Ownership Threshold for Calling Meeting	***Number of Companies***
No special meeting right	144
50% or more	31
30-40%	9
25%	***74***
20%	17
15%	13
10%	13

- ***Definition of ownership.*** Many companies require "record" ownership of shares (as opposed to "beneficial" ownership), essentially requiring street name holders to work through their securities intermediaries to become a record holder. This eliminates uncertainty as to

[13] Based on data from FactSet Shark Repellent. We have limited this analysis to Delaware companies, because certain other states provide a statutory default special meeting right at 10%.

proof of ownership, but introduces an additional administrative step for shareholders seeking to use the right. In addition, a number of companies have introduced a "net long ownership" concept into their special meeting provision—essentially reducing the shareholders' actual ownership level by any short positions or other hedging of economic exposure to the shares. Companies that do not include a "net long" concept should nevertheless ensure that the information required to be provided by the requesting shareholders includes details of any hedging transactions, so that the company and other shareholders can have a full picture of the requesting shareholders' economic stake in the company.

- ***Pre- and post-meeting blackout periods.*** In order to avoid duplicative or unnecessary meetings, many companies provide that no meeting request will be valid if it is received during a specified period (usually 90 days) before the annual meeting, or during a specified period (usually 90 or 120 days) after a meeting at which a similar matter was on the agenda.
- ***Limitations of matters covered.*** Special meeting provisions typically provide that the special meeting request must specify the matter to be voted on, and that no meeting will be called if, among other things, the matter is not a proper subject for shareholder action. Generally, the only items that may be raised at the special meeting will be the items specified in the meeting request and any other matters that the board determines to include.
- ***Timing of meeting.*** Companies typically provide that the board must set the meeting for a date within 90 days from the receipt of a valid request by the requisite percentage of shareholders. Often, the special meeting provisions provide that, in lieu of calling a special meeting, the company may include the specified item in a meeting called by the company within that same time period.
- ***Holding period.*** A few companies require the requesting shareholders to have held the requisite number of shares for a specified period of time prior to the request.
- ***Inclusion in charter versus bylaws.*** Companies should consider whether to include the special meeting provisions in the charter, the bylaws, or a combination. In most cases, companies include the critical provisions (such as ownership threshold) in the charter so that shareholders cannot unilaterally amend them, but provide the details and mechanics in the bylaws, so they can be adjusted by the board without a shareholder vote.

6. Other Less Successful Proposals

Some less frequent shareholder proposal types are addressed below. These proposal types are likely infrequent because they have been highly unsuccessful during the past few years of annual meetings. 2015 was no exception and generally those proposals that were brought to a vote failed.

- ***Dual Class.*** Proposals to approve a recapitalization plan where all stock has one vote per share are relatively infrequent, occurring only 11 times in 2015 so far. Despite ISS support in 100% of these proposals, only one of them has passed, and the overall average support rate is only 36%, likely because super-voting stockholders vote against these proposals.
- ***Cumulative Voting.*** Only two cumulative voting proposals were brought to vote in 2015, and neither of these proposals passed, garnering support on average of only 24% of votes cast.
- ***Vote on Poison Pills.*** This year, there was one shareholder poison pill proposal requesting the board to seek shareholder approval for the adoption, maintenance or extension of a pill, which passed. In an unusual decision, albeit not with respect to a shareholder proposal, ISS recommended against a management proposal this year for shareholders to approve a pill which had a 20% trigger, a three-year life and which terminated if shares were bought in a permitted offer. ISS found that the automatic termination of the rights in a permitted offer did not satisfy their requirement for a shareholder redemption feature for a qualified offer.

- ***Board Diversity.*** ISS has supported board diversity proposals in a majority of cases since 2012. 2015 was no exception to this and they supported three out of the five proposals thus far. Yet, only one such proposal has passed since 2012 and none of them have passed so far in 2015. They have only received an average support of 13%.
- ***Director Qualifications.*** Shareholder proposals pertaining to director qualifications have been brought to a vote five times so far in 2015. Despite ISS support in two of these proposals, cumulatively they only have garnered an average support of 10% of votes cast and none of them have passed.

Since the above proposals have had such a low rate of success in recent years, we would expect their infrequency to remain consistent going forward. While companies should be aware of these types of proposals, we do not anticipate many companies facing such shareholder proposals for the next season of annual meetings.

E. SOCIAL / POLITICAL SHAREHOLDER PROPOSALS

	SOCIAL/POLITICAL PROPOSALS					
	Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2015 YTD	2014	2015 YTD	2014	2015 YTD	2014
Political issues	63	97	27%	25%	0	6
Environmental issues	64	47	19%	21%	0	0
Human rights issues	16	19	8%	18%	0	0
Sustainability report	18	15	31%	20%	1	0
Anti-discrimination	10	10	15%	30%	0	0
Animal rights	9	6	7%	15%	0	1
Other social policy issues	8	13	11%	9%	0	0

The landscape for proposals on social and political issues was similar so far in 2015 to that in 2014[14]—these proposals continue to be common, but in almost all cases they fail (only one proposal at Nabors Industries requiring the company to report on sustainability matters has received more than 50% of the votes cast in favor), and usually by a wide margin. In 2015, as in 2014, one of the most common types of proposal related to political expenditures and spending—generally, a request for additional disclosure on political expenditures and/or lobbying costs or, in some cases, calls for an advisory vote or prohibition on political spending. In 2015, there has been a substantial increase in the number of proposals relating to environmental issues, but none of these proposals have passed thus far.

ISS supported 70% of the social and political proposals voted on in 2015, which is consistent with 2014 and higher than years prior, though this likely relates more to the types of proposals submitted than any change in ISS policy. Social and political proposals had an average support level of 28% if ISS recommended in favor, and 5% if ISS recommended against. The continued frequency of proposals on

[14] While the number of proposals reported in the table above varies significantly from year to year, the number of proposals thus far in 2015 is approximately the same number of proposals that were present at the same time during 2014. Thus, these proposals tend to be more scattered throughout the year, rather than clustered during the season of annual meetings like many other proposals.

social policy issues, despite their overwhelming failure to receive majority support, suggests that activist shareholders submitting these proposals are content to use corporate proxy statements as a forum for raising social issues in a high-profile manner.

F. COMPENSATION-RELATED SHAREHOLDER PROPOSALS

	COMPENSATION-RELATED PROPOSALS					
	Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2015 YTD	2014	2015 YTD	2014	2015 YTD	2014
Limit golden parachutes	32	25	36%	38%	4	5
Clawback	15	3	28%	29%	0	0
Stock retention	11	27	23%	22%	0	0
SERP-related	1	2	36%	35%	0	0
Limit death benefits	0	1	N/A	34%	N/A	0
Other compensation-related	15	10	14%	19%	0	0

Compensation-related proposals continue to be predominantly of one type: proposals to prohibit "golden parachutes" in the form of single-trigger accelerated vesting of performance and other equity awards. 2014 was the first time where "golden parachute" proposals actually received the support of a majority of votes cast—five such proposals passed in 2014, and so far in 2015 four such proposals have passed. An increasing number of companies have begun including "double-trigger" termination provisions (*i.e.*, those that accelerate outstanding awards only if a change in control occurs *and* the person is terminated) into their compensation arrangements, which should help a company avoid or defeat a "golden parachute" shareholder proposal.

The number of claw-back proposals, recommending the board adopt a policy requiring the recoupment of incentive compensation under certain circumstances, increased substantially in 2015, but no claw-back proposal was approved by shareholders. Stock retention proposals used to parallel golden parachute proposals in frequency, but so far in 2015 they have decreased dramatically. Proposals on more fundamental compensation issues (such as enhancing pay-for-performance linkage, avoiding repricing of options, and disclosing supplemental executive retirement plan obligations) continue to be far less frequent than they were in the years immediately before the advent of universal advisory say-on-pay votes. Say-on-pay appears to have provided shareholders with an alternative mechanism for expressing concerns over executive compensation.

ISS supported nearly 90% of the compensation-related proposals in 2015, and shareholder support averaged 32% for proposals where ISS recommended in favor, as compared to 5% for proposals where ISS recommended against.

Following increasing focus on director compensation in light of recent Delaware case law, including the *Calma v. Templeton, et al.* decision,[15] we expect to see more management-driven activity during the 2016 proxy season in the area of director compensation. In particular, we expect to see companies increasingly submitting to a shareholder vote limits on the size of equity awards or even total compensation that can be paid to non-employee directors in any particular year, in an effort to reduce the likelihood that individual director compensation decisions will be subject to the "entire fairness" standard of review. It remains to be seen whether an increase in director compensation-related management proposals will cause ISS and others to focus their attentions on director compensation more generally.

G. NOTE ON RECENT LITIGATION DEVELOPMENTS CONCERNING RULE 14A-8

The most common avenue, by far, for attempting to apply the exclusion criteria of Rule 14a-8 to shareholder proposals has been the SEC staff no-action process. In recent years, however, a number of companies have turned to the U.S. federal courts regarding the application of Rule 14a-8.

Shareholders putting forth a proposal also have recently taken to the federal courts. In a high profile case that began in 2014, Trinity Church challenged an SEC no-action letter which granted the exclusion of its proposal directed at gun sales by Wal-Mart. The district court, although choosing not to interfere with Wal-Mart's 2014 annual meeting, ultimately held that Wal-Mart improperly excluded the shareholder proposal because it related to substantial issues of social policy.

On appeal, the Third Circuit reversed the district court's decision, holding that Wal-Mart properly excluded the shareholder proposal. This decision buttresses the Staff's view that proposals seeking a report or board committee action on a particular subject should be analyzed according to whether the underlying subject matter relates to the company's ordinary business operations and provides a framework to evaluate whether a shareholder proposal "transcends" a company's day-to-day operations.[16]

II. ANALYSIS OF ISS NEGATIVE RECOMMENDATIONS AGAINST DIRECTORS

The widespread adoption of majority voting provisions, along with NYSE rule changes in 2009 that prevent brokers from exercising discretion to vote uninstructed shares in uncontested elections, has given

[15] *Calma v. Templeton*, 114 A.3d 563 (Del. Ch. 2015). In *Calma*, which involved a derivative suit challenging non-employee directors' decisions with respect to their own equity compensation, the Delaware Chancery Court confirmed that grants of equity awards to Citrix Systems' non-employee directors under an equity incentive plan that lacked meaningful limits on individual awards were self-dealing transactions subject to the "entire fairness" standard of review. After determining the appropriate standard of review, the Court went on to find that the plaintiff had raised "meaningful questions" as to the appropriateness of Citrix Systems' peer group and declined to dismiss the case at the motion to dismiss stage.

[16] For a discussion of the Third Circuit's opinion, see our publication, dated July 10, 2015, entitled "Excluding Shareholder Proposals—Trinity Wall Street v. Wal-Mart Stores, Inc."

[Pages 18-27 Omitted]

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Corporate Governance and Financial Regulation

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Building Meaningful Communication and Engagement with Shareholders

Posted by Mary Jo White, U.S. Securities and Exchange Commission, on Thursday, June 25, 2015

Editor's note: Mary Jo White is Chair of the U.S. Securities and Exchange Commission. The following post is based on Chair White's remarks at the national conference of the Society of Corporate Secretaries and Governance Professionals, available here. The views expressed in this post are those of Chair White and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

I am honored to be with you here in Chicago at the Society's 69th National Conference. Over the years, the Society has consistently provided thoughtful comments to the Division of Corporation Finance and the Commission on a wide variety of issues and proposed rules. You understand the complexities that can affect multiple parties and recognize the importance of the interests of shareholders. All of you play a critical role in corporate governance. It is the decisions you make, the practical solutions you advance and the views you share with your boards that can, in large part, dictate the relationship between shareholders and companies.

Because of your central roles in your companies, many of the Commission's initiatives are of interest to you: our disclosure effectiveness review; the audit committee disclosures concept release the staff is working on; and any number of our rulemakings. My hope is that you will see near-term activity in these and other areas, including rules mandated by the Dodd-Frank Act, such as the clawbacks rule as required by Section 954, the pay ratio rule under Section 953(b) and the joint rulemaking on incentive compensation as required by Section 956. So stay tuned for those developments.

But today my focus is on a selection of proxy-related issues, another area of particular interest to you. And my overall theme complements the theme of your conference, "Connect, Communicate, Collaborate." Be proactive in building meaningful communication and engagement with your shareholders.

One of the most important ways that shareholders have to express their views to company management is through the annual proxy process. We know of your deep involvement and interest in maintaining a fair and efficient proxy voting system, a priority we share at the SEC. So, this morning, I will offer some of my thoughts on four proxy-related subjects that are topics currently under discussion: the delivery of preliminary proxy voting results by intermediaries; the concept of a universal proxy ballot; so-called "unelected" directors; and shareholder proposals.

Each of these issues has frequently placed companies and shareholders at odds and each has been the subject of calls for Commission or staff action to clarify the scope of our rules, to step-in

to mediate a dispute, and, in certain cases, to write new rules. And we and the staff of the Division of Corporation Finance are reviewing the concerns raised to determine what the Commission or the staff can and should do in response. But, I ask you, as I share with you my views on these topics, to also consider what you could and should be doing in each of these areas.

Preliminary Voting Results

I will start with preliminary proxy vote information. As you know, in advance of a company's annual meeting, companies seek voting authority from their shareholders who do not plan to attend the annual meeting. Under the current system, proxy materials are distributed to shareholders directly, in the case of registered shareholders, and indirectly through brokers and banks, in the case of "street name" shareholders who own shares through their brokerage and bank accounts. Today, over 80% of the outstanding equity securities for publicly listed U.S. companies are estimated to be in street name.

The vast majority of banks and brokers retain an agent to send out the request for voting authority. In addition to delivering proxies to the company reflecting the instructions received from the beneficial owners, the agent makes preliminary vote tallies available to the company before the meeting. This allows the company to determine whether it will meet its quorum requirement. In addition to providing information on the quorum, access to this information also allows the company to assess the "direction" a vote is taking and to adjust its proxy solicitation strategy. That information is obviously not just valuable to companies, but also to the other participants who are conducting solicitations.

In the past, Broadridge, which is the single largest agent collecting vote tallies, had established the practice of providing the voting tallies of street name shares to a shareholder proponent when the proponent had mailed exempted soliciting materials to shareholders and signed a confidentiality agreement. It did this so long as the banks and brokers did not raise an objection. But, in May 2013, certain brokers objected to the early release of voting data to shareholder proponents. Broadridge's response was that, as an agent, it is contractually bound to follow the directions of the brokers. As a result, it no longer provides the preliminary voting tallies to shareholder proponents who have distributed exempted solicitation materials and are willing to sign a confidentiality agreement, unless the company subject to the solicitation affirmatively consents. Investor groups and academics have expressed concern about this turn of events and argue that equal access to the information is required.

A variety of interested parties have asked the Commission to either interpret existing rules or adopt new rules to clarify that brokers are obligated to require their agents to deliver preliminary vote tallies to all interested participants. The SEC's Investor Advisory Committee, for example, has stated that the requirement that brokers and their agents act in an impartial fashion in distributing proxy materials should include the delivery of preliminary voting information. The Advisory Committee and others have criticized the selective disclosure of such information to companies and not shareholders and its potential effect on voting results.

The proxy rules are silent on preliminary vote tallies. The staff in the Division of Corporation Finance, after reviewing the various rules that govern proxy solicitations, has acknowledged that

the current rules do not address directly whether a broker (or its agent) is required or permitted to share such preliminary vote tallies with other parties.

Our rules, of course, do not prohibit issuers from sharing this information. As I have said on other occasions, companies should seek to engage in a constructive dialogue with their shareholders and work to facilitate constructive solutions to issues they raise. In this context, since companies have direct access to the voting results, they should themselves consider leveling the field by agreeing or consenting to a mechanism that provides the interim vote tallies to shareholder proponents. We understand that it is customary in a contested, non-exempt solicitation for companies and shareholder opponents to share each other's voting information in advance of the meeting. So we know it can be done. I would ask you to consider whether providing this information to the shareholder in an exempt solicitation is really that different.

If the Commission were to advance a rulemaking in this area, it could take several forms. A rule could condition the broker's exemption from the proxy rules on an overall "impartiality" requirement to level the playing field, such that everyone gets preliminary vote tallies, or nobody gets them. Alternatively, a rule could permit brokers to provide issuers with the total votes that have been cast only in order to determine quorum, rather than a preliminary vote tally that would indicate how the shareholders have voted.

As with many issues, while rulemaking certainly can provide a remedy, I would like you to consider whether rulemaking is the only way to solve these concerns. I understand that a possible solution was being worked on by the Society, the Council of Institutional Investors and Broadridge, but those discussions broke down. That is unfortunate. A solution that you and the other interested parties develop together can achieve a good compromise and strengthen relationships. Indeed, companies should see this not as a problem to be solved, but as an opportunity to improve investor relations.

Universal Proxy Ballots

Universal proxy ballots: there has been renewed discussion about whether the proxy rules currently provide shareholders with a sufficient range of choice in exercising voting decisions in election contests if they are voting by proxy rather than in person at the company's annual meeting. There are calls, as there were a number of years ago, for the Commission to consider requiring universal proxy ballots.

As you know, in a contested director election, it is not generally possible for shareholders to pick freely from nominees on each side's proxy cards unless they attend and vote in person at the meeting. By operation of state law requirements, the proxy rules, and practical considerations, shareholders executing a proxy face an either/or proposition: they can vote for either the entire slate of candidates put forward by management or by a proponent—they cannot pick and choose the individuals that they believe are the best candidates from the two slates.

While a proponent putting forth a minority slate of candidates under our "short slate" rule may "round out" its slate with some company nominees, it is the proponent who chooses which company nominees shareholders using the proponent's proxy card must support. State law generally provides that a later-dated proxy revokes an earlier-dated one, which can make it impossible or at least impractical to vote for some nominees on each side's card. And while under

current proxy rules, both sides' nominees can consent to appear on each other's proxy cards, that consent is given very rarely, if ever.

Given these obstacles, some have requested that the Commission revise the proxy rules to facilitate the use of a "universal proxy ballot," a single proxy card that would list both management's and a proponent's nominees in contested director elections, allowing shareholders to vote for a mix of nominees of their own choosing.

As you know, we held a roundtable in February on ways to improve the proxy voting process. One panel focused on the state of contested director elections and whether changes should be made to the federal proxy rules to facilitate the use of universal proxy ballots. It was, as always, a lively discussion.

Some strongly believed that it was past time to consider adopting the universal ballot. Others questioned whether effecting only this change to the current proxy voting system was appropriate when so many other issues have also been raised, and expressed concern about possible unintended consequences. Panelists thus differed on whether the adoption of a universal proxy ballot would increase or decrease shareholder activism or otherwise impact the outcome of election contests. Some believed that it would embolden activists to run more contests. Others posited that it could stimulate increased cooperation and settlements between issuers and activists, thereby decreasing contests. No one specifically called into question the fundamental concept that our proxy system should allow shareholders to do through the use of a proxy ballot what they can do in person at a shareholders' meeting. Given the diverse set of views represented at our roundtable, I took this as at least a bit of a breakthrough.

All of the participants agreed that if the Commission were to revise the proxy rules to implement a universal proxy ballot, the "devil would be in the details." Questions include when a universal ballot could be used, whether it would be optional or mandatory and under what circumstances, whether any eligibility requirements should be imposed on shareholders to use universal ballots, what the ballot would look like, and whether both sides must use identical universal ballots. While I agree that the "devil will be in the details," I have asked the staff to bring appropriate rulemaking recommendations before the Commission on universal proxy ballots.

But, like so many issues that seem to unnecessarily have shareholders and companies at odds, this is one where you do not have to wait for the Commission to act. Give meaningful consideration to using some form of a universal proxy ballot even though the proxy rules currently do not require it. If a company's or proponent's nominees gave their consent to appear on the other side's proxy card, then all shareholders would have the full range of voting options available to them. I realize that putting this into practice may have its challenges and that companies could choose different ways of making it work. But it could be beneficial for your shareholders. And we would welcome hearing about your experiences as we consider rulemaking in this area. Providing shareholders with the same voting rights that they would have if they were present at the meeting and eliminating procedural obstacles should be a shared goal of both companies and shareholders.

“Unelected” Directors

Let me turn to the issue of directors who do not receive a majority of shareholder votes but who continue to serve on the board, sometimes—and not fondly—dubbed as “unelected” directors. A recent study showed that 85% of these directors were still board members two years after an unfavorable vote.

Although such situations are rare, the seeming indifference of management when they do occur has understandably garnered significant interest. What does the continued presence of such directors say about a company’s general responsiveness to its shareholders?

In recent years, there has been a shift away from corporate practices that simply allow directors to remain when less than a majority of shareholders wants them there. “Plurality plus resignation” and majority voting regimes have become the norm at larger companies, and require at least some action by the director and board.

Under a plurality plus resignation voting regime, the director nominees agree in advance to resign if they receive a majority of withhold votes. The remaining directors then determine, in their discretion, whether to accept or reject the resignation. Under a majority voting regime, directors are elected only if they receive a majority of the votes cast. But as a result of the “holdover” rule under state law, an incumbent director who does not receive the requisite votes may remain in office until the earlier of the successor’s election and qualification or the incumbent director’s resignation or removal. In these instances, the board may determine not to accept the incumbent director’s resignation until a successor joins the board.

Some recent data suggests that shareholders’ expression of disapproval in uncontested elections do have an impact. A 2015 study, for example, shows that withheld votes are associated with increased director turnover. The same study showed that directors who face even a 30% dissent rate are more likely to depart from the board, and if they remain, they are more likely to be moved to less prominent positions on the board.

Views differ on whether individuals should be prohibited from continuing to serve on boards when they do not receive a majority of shareholder votes. Ultimately, whether an individual can remain on the board following an election where they do not receive majority support is a question of state law and the governance decisions made by boards. Some, however, have recommended that the Commission require companies to disclose the specific reasons why the board chose to retain a director who did not receive a majority vote regardless of the type of voting regime in place. Others favor an approach where the NYSE and NASDAQ would impose new listing standards requiring listed companies to adopt a majority voting regime that imposes reasonable limits on the ability of boards to reject the resignation of such directors.

If a director receives a majority withhold vote and remains on the board, the company should consider that its shareholders may want to know about that director’s service on the board and the decision to let the board member remain. It is hard, indeed, to imagine that a company would not want to provide its shareholders with a specific explanation of the board’s thinking on retaining the board member.

We could certainly amend our proxy rules to, among other things, mandate more specific disclosures on these board decisions. But, any company that is serious about good corporate governance should provide such information on its own. It should share the board's thought process and reasons with shareholders—inform the shareholders in clear terms why the board member's resignation was not accepted, why the director was considered important for the strength of board decision-making, for the growth of the company, for the relevant experience represented, or for the expertise that would be lost. Be specific, and avoid boilerplate. Shareholders are interested and likely quite willing to listen to reasonable explanations. To be sure, they could evaluate the additional information and express disagreement with the decision not to remove the board member, which would provide further information for you to consider about your shareholders' views on removal.

Shareholder Proposals

My final topic is another area of shareholder engagement that is near and dear to all of you—shareholder proposals. As you know, it has been a busy and interesting season. The staff received more than 300 requests from over 200 companies to exclude shareholder proposals addressing a wide range of topics from human rights to proxy access. Overall, the number of requests was up approximately 10% from the prior season, but down slightly from two years ago.

This season, the matter that received the most attention was Rule 14a-8(i)(9), particularly as it related to proxy access proposals.

Rule 14a-8(i)(9), as you know, allows a company to exclude a shareholder proposal that "directly conflicts" with one of the company's own proposals. After an initial no-action letter was issued by the staff, questions, from me and others, were raised about the proper scope and application of the rule. After I directed the staff to review the application of the rule, the Division of Corporation Finance decided to express no view on the application of Rule 14a-8(i)(9) during this proxy season. These decisions were not made lightly as we fully recognize the need for clarity and certainty in the proxy process during every season. But it is important to get these issues right.

The suspension of staff views on the application of Rule 14a-8(i)(9) this season did give a window into some private ordering at work. More than 100 companies received proposals to adopt some form of proxy access. Proxy access proposals received majority support at more than 40 companies, as compared to four last year. At seven companies, the company's proxy access proposal was included alongside a proxy access proposal offered by a shareholder. Shareholders preferred management's proposals at three companies, and at three others, they preferred the shareholder's proposal. At one company, the shareholders did not approve either proposal and there were no instances where shareholders approved both proposals. While all of these results are informative, this last one may be of particular interest to you.

The Society and others were very concerned that shareholders would be confused by two "competing" proposals and that companies would not know what to do if shareholders voted in favor of both proposals. Based on this year's experience, that did not occur. It seems that shareholders were able to sort it all out and express their views. The staff is considering that fact and the other results of the season as it completes its review of Rule 14a-8(i)(9)—obviously with the goal of providing clarity for next year's proxy season.

Like the controversy about Rule 14a-8(i)(9), the issues that generally get the most attention each proxy season are those that are the subject of requests for no-action letters. But I would like to focus some attention on the shareholder proposals our staff never sees.

Each proxy season, SEC staff gets involved in roughly 300 to 350 proposals that companies seek to exclude. The staff generally does not track the proposals that companies do not seek to exclude, but we estimate that another 300 to 400 proposals are included in management's proxy statement without any staff involvement. Even with respect to the no-action requests, companies consistently withdraw 15 to 20% of them before the staff ever provides its views. We do not always know precisely what happens, but it is our understanding that management and the shareholders generally have arrived at some resolution on their own. That is good and evidence that the company/shareholder relationship is working.

I am not suggesting that management should never object to or oppose a shareholder proposal. Company management in good faith can believe that particular proposals are not in the best interests of their shareholders and there are also costs involved in processing shareholder proposals. But companies in many cases should consider other possible steps they could take in response to a proposal rather than just saying no. Sometimes, foregoing technical objections could be the right response. Letting shareholders state their views on matters may be a relatively low cost way of sounding out and preventing potential problems down the line.

More thoughtful treatment of shareholder proposals is not a one-way exercise. Briefing boards, analyzing issues and determining how to communicate the company's views to shareholders and markets take time and resources, as does hiring lawyers to analyze the proper interpretation of the Commission's grounds for exclusion and preparing communications with the staff. And I would urge shareholder proponents to be mindful of the costs they can cause to be borne by their companies—and thus, by their fellow shareholders—and to use the shareholder proposal process responsibly. Seek engagement with the company on an issue first before turning to a shareholder proposal. Direct engagement with a company is likely to be more meaningful than a precatory vote on a 500-word proposal. Some companies are better at engagement than others, but I would urge more companies to embrace it so that more shareholders will be incentivized to choose direct engagement as their preferred first approach.

Conclusion

The four areas I talked about today obviously represent only a small part of the broader company-shareholder relationship and a small sample of proxy-related issues we are considering at the Commission. We are very interested in what you think and how you are approaching the full range of issues and practices that relate to enhanced shareholder engagement and more meaningful communications. Your leadership can help to constructively address the issues and to develop and share best practices. I wish you success at that and a very productive conference. Thank you for all you do.

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Getting to Know You: The Case for Significant Shareholder Engagement

Posted by F. William McNabb III, Vanguard, on Wednesday, June 24, 2015

Editor's note: F. William McNabb III is Chairman and CEO of Vanguard. This post is based on Mr. McNabb's recent keynote address at Lazard's 2015 Director Event, "Shareholder Expectations: The New Paradigm for Directors."

I'll begin my remarks with a premise. It's a simple belief that I have. And that is: Corporate governance should not be a mystery. For corporate boards, the way large investors vote their shares should not be a mystery. And for investors, the way corporate boards govern their companies should not be a mystery. I believe we're moving in a direction where there is less mystery on both sides, but each side still has some work to do in how it tells its respective stories.

So let me start by telling you a little bit about Vanguard's story and our perspective. I'll start with an anecdote that I believe is illustrative of some of the headwinds that we all face in our efforts to improve governance: "We didn't think you cared." A couple of years ago, we engaged with a very large firm on the West Coast. We had some specific concerns about a proposal that was coming to a vote, and we told them so.

The proposal failed, and it was embarrassing for the firm. They responded by reaching out for feedback from all of their largest shareholders—or so they said. They didn't call their largest independent shareholder—Vanguard—nor did they apparently take into account the very specific feedback we had already provided.

In conversations afterward with them (once we finally got to the board), they told us, essentially, "You guys run index funds. We didn't think that you cared."

Well, we do care. A lot! Interesting postscript: Now that this company knows we care, they've taken substantive action in response to input from us and others.

A word about Vanguard

Let me pause for a moment to give you some additional context for Vanguard's point of view. Today we are the largest mutual fund firm in the world. We have $3.3 trillion in global assets under management. We have 159 funds in the U.S., and an additional 123 in markets outside the U.S. In the U.S., we have nearly $1.7 trillion in index equities and an additional $356B in actively managed equity funds.

What that all means is that Vanguard investors collectively own about 5% of every publicly traded company in the United States and about 1% of nearly every public company outside of the U.S.

And, remember, when it comes to our indexed offerings, we are permanent shareholders**.** To borrow a phrase from Warren Buffet: Our favorite holding period is forever. We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits.

In other words, we're big, we don't make a lot of noise, and we're focused on the long term.

That is *precisely* why we care so much about good governance. Vanguard funds hold companies in perpetuity. We want to see our investments grow over the long-term. We're not interested in managing the companies that we invest in. But we do want to provide oversight and input to the board of directors. And we count on boards to oversee management.

That perspective informs our approach to corporate governance. So let me share, at the very highest level, our six principles on governance. These are some of the same ideas that the panelists discussed earlier this evening:

1. **Independent oversight and, more broadly, appropriate board composition.** It is the single most important factor in good governance. If you think about it, we're in a representative democracy. We empower a group of people to oversee our interests as shareholders, to hire and fire the CEO, and to have a say in strategy, risk oversight, compensation, and so forth. We as shareholders are not there, and that group of representatives needs to be our eyes and ears. Who they are, how they interact, and the skills they bring to the table are critical from a long-term value standpoint.
2. **Accountability.** Management should be accountable to the board. The board should be accountable to shareholders.
3. **Shareholder voting rights that are consistent with economic interests.** This means one share, one vote. No special share classes for added voting power.
4. **Annual director elections and minimal anti-takeover devices.** We believe that shareholders benefit when the market for corporate control functions freely.
5. **Sensible compensation tied to performance.** The majority of executive pay should be tied to long-term shareholder value.
6. **Engagement.** I'd like to place my greatest emphasis on engagement tonight, because it serves as a touchstone for all of our other core principles.

At Vanguard, we've been on a journey toward increased engagement over the past decade or so. Our peers in the mutual fund industry have as well. Proxy voting is not poker. Our votes should not come as a surprise to companies and their boards.

Our outreach efforts began many years ago by simply posting our proxy voting guidelines on our website, then having ad hoc, issue-driven conversations with companies. A few years later, we began writing letters to companies from our CEO (my predecessor in the role, Jack Brennan, started this practice). We wanted them to know that we were a significant shareholder, and we wanted them to be aware of our guidelines.

As we've gone along, we've become more targeted in whom we mailed letters to and more prescriptive in our language.

In March, we sent out 500 letters to independent chairs and lead directors at companies across the U.S. In the letter, we talked about our six principles for corporate governance and the importance of engaging with shareholders. In just two months, we've received 164 responses, and they were almost all uniformly positive, thanking us for reaching out. Directors shared the various formats they use for engagement:

- Sometimes the lead director is in charge of shareholder engagement.
- Sometimes it's a committee of directors.
- Some companies have board members involved in "investor days" for their industry, where they're hearing from shareholders.
- And at other companies, the general counsel meets with different investor groups and reports back to the board.

What we're always advocating for, essentially, is thoughtful engagement. It's really "quality over quantity": knowing your shareholder base, knowing what they care about, and knowing how often they want to engage with you.

Engagement is bilateral and comes in many forms.

Engagement is a two-way street. It's not just about publishing proxy guidelines or investors voicing concerns. There are some great examples of boards being proactive and getting their messages out to investors. Two examples from recent years:

- **Microsoft**, in a number of instances, has used videos from their directors to communicate the board's perspective on issues. Whether it's the lead independent director describing the board's role in overseeing strategy or the chair of the audit committee describing the board's perspective on risk management, these insights into the board's thinking provide helpful context for investors. This is a great example of one form of "one-to-many" engagement that is simple, underutilized, and very much appreciated by us as investors.
- Another example: When **Dell** announced its intention to go private, we met with the special committee of the Dell board that had to make the decision on shareholders' behalf to sell at a specific price. We listened to their perspective, their decision-making process. and the things that they took into account. It put us in a better position to decide whether this was a good deal. The more opportunities we have to interact with directors in the normal course, the more we have an increased level of insight.
- An example that was resolved only a few hours ago, of course: **DuPont and Trian**. It's a cautionary tale of how no company is truly immune to activist investors. DuPont is well-known and highly regarded, and, most relevant to our discussion here, has been reaching out to investors and acting on their feedback for years. The board gets feedback early, and feedback influences strategy at the company. DuPont and Trian engaged with each other for two years beforehand. But a proxy struggle ensued nonetheless.

Practical engagement around board composition

Sometimes engagement can mean just being crystal clear about your expectations—and about how you think through certain issues. This applies to boards and to investors. For example:

- Do you have a set of written guidelines that spell out the type of expertise or perspectives that you want in your board members (i.e., these are the types of things we're looking for, and these are the people we believe embody them)? We're seeing an increasing number of companies offering this kind of perspective, and it's very helpful to investors.
- Do you have a way to assess appropriate board tenure, both at the aggregate and individual level? Investors might have questions about why, for example, a particular board member has served for 30 years and whether he or she is sufficiently independent of management.

There's a need to have a framework to raise important questions and have meaningful discussions between boards and investors to help facilitate a level of self-awareness for boards. A framework allows them to say, in essence: We realize that our board is comprised differently (or operates differently) than other firms in our business—and here's why.

There may be a good reason for a board to be an outlier. There may not be. But let's provide as much context as we can and invite the discussion. Because investors are going have these questions anyway. In the absence of additional context, they may draw their own conclusions.

Thinking like an activist

The outlier concept extends beyond board composition and gets into matters of business oversight and strategy. The best boards work to understand where their companies might be different or might be *perceived* as different.

Are those differences strengths or vulnerabilities? Some of this is a defensive mindset. Some of this is the continued evolution of the board's role in strategy. In many companies, we're seeing the board's role move beyond the historical perspective of "review and concur" to becoming more engaged in setting the strategy.

So how does a board inform itself? If you want to, as a director, you can be fed a steady diet of management's perspective on issues. And in many instances, if left to your own devices, that's what you get. Management comes in, gives you a presentation, and tells you why this is the right strategy. If that's all you've got, shame on you.

As an aside here: I'm continually sounding the warning about the danger of complacency to employees and leadership at Vanguard. The firm has been doing very well, particularly over the past several years, in terms of cash flow, performance, and large-scale initiatives that we've rolled out. It would be very easy for us to feel like we can take a breath, maybe relax a bit. Complacency is a temptation. But we can't succumb to that temptation. A relentless pursuit of excellence on behalf of our clients continues to drive everything we do. As Andy Grove, former CEO of Intel, put it, "Success breeds complacency. Complacency breeds failure. Only the

paranoid survive." I'd suggest that this is how boards need to be thinking—functional paranoia. Are you getting enough different viewpoints?

Healthy and vibrant boards think like an activist in the very best sense. They ask:

- Where should we be pushing harder or taking costs out? What are the management team's blind spots?
- What are the board's blind spots?
- And how do we correct that? Some boards bring in sell-side analysts that have a "sell" on the company to tell them what they're missing.

If all the board is listening to is management's perspective, they may be surprised when an activist shows up and says, "Hey, your cost structure is way out of line with your competitors."

Glenn Booraem, who heads up Vanguard's corporate governance team, was just telling me about a conversation he had last week with an activist. The activist's premise was, "As long as there are unhappy shareholders, activists have a role."

This particular activist has a theory about maximization mindset versus sufficiency mindset. An owner is going to have a maximization mindset: the owner wants to maximize the value of an investment over time. So as an owner, if you have significant money on the line, you might make different decisions than what this activist described as some boards' sufficiency mindset. If a board has a sufficiency mindset, then a presentation by the management team seeking approval for a big initiative might be met with, "Yeah, that looks good. That looks reasonable. You've made a sufficient case to make this capital investment."

But if you're looking at the presentation with a maximization mindset—you're spending your own money, in essence—you might say, "Can you do it for 5% less? 10% less? 15% less?"

This activist's contention was that some boards aren't pushing hard enough because they're not in the owner's seat and aren't thinking as owners of the organization might think.

Changing nature of activist investors

The nature of activist investing has changed significantly since the 1980s. Today, we're seeing a greater trend toward *constructive* activists rather than destructive activists. Activists are not inherently good or bad. They often raise legitimate questions.

When activists raise legitimate questions and tie their business cases to long-term shareholder value, that gets our attention. I can think of several cases where a board wasn't asking the right questions and eventually lost touch with how the company was being run and being perceived by investors. If the first time we're hearing from a company in our role as shareowners is when the company is under siege by activists, that's not good. The company is inherently on the defensive at that point. And they've lost control of the narrative, at least to some degree. Generally speaking, activism most often happens when something is broken.

I'll share two instances where Vanguard has sided with activist campaigns in recent years.

- **Canadian Pacific Railway:** In 2012, activist Bill Ackman identified some vulnerabilities in Canadian Pacific Railway. We agreed—as did many other large investors—that the company had been poorly run and governed. Ackman brought in an experienced CEO and a number of directors they thought could make a difference. It's been an activist success story by and large.
- **Commonwealth REIT.** Another example of us supporting an activist: In 2014, Corvex and Related Companies waged a successful campaign to replace the entire board of Commonwealth REIT. This was a company with a track record of poor performance and poor governance, and they were ultimately held accountable. Commonwealth was using a third-party management firm, RMR, that was run by family members of Commonwealth leadership. RMR extracted value from the public company. They didn't operate it well, but they were paid well nonetheless. We supported wiping the slate clean. In the case of Commonwealth, we were the largest shareholder. We were important to Corvex's case, but at the end of the day, I don't think they needed us. Eighty-one percent of Commonwealth shareholders voted to remove the company's board.

A caveat

There is a caveat that I want to mention, and it has to do with backbone. We're talking about how dangerous it is for companies to essentially write off any particular group of shareholders. Part of the board's role is to listen. If someone's going to buy up 5% of the company, you should at least listen.

That said, it doesn't mean that the board should capitulate to things that aren't in the company's long-term interest. Boards must have a backbone. To be frank, board members cannot be more worried about their own seats than they are about the future of the company they oversee. Boards must take a principled stand to do the right thing for the long term and not acquiesce to short-term demands simply to make them go away.

Don't be dissuaded by common concerns

We do hear concerns from boards who haven't fully embraced more significant shareholder involvement. The most common are:

- **"Strong shareholder engagement will disintermediate management."** This is not what large shareholders want in an engagement program. Boards will often choose to include management for legal support and to talk about operational issues. And then there are those matters that are the exclusive province of the board, such as CEO compensation, which we believe are appropriate for discussion with the board alone.
- **"We'll get tripped up on Reg FD issues."** Just to be clear, large shareholders are not looking for inside information on strategy or future expectations. What they're looking for is the chance to provide the perspective of a long-term investor. Companies individually have to decide how to best manage that risk, but it shouldn't be by shutting out the shareholders completely. Firms can train directors, include their legal counsel in shareholder conversations, and set clear boundaries for discussions.
- **"There is no time in our agenda."** Boards should talk about how much time to allot to engagement. I would say, of course, that time for engagement with significant

shareholders should be on the board's agenda. Investors are an important constituency whom boards represent.

- **"This would be too difficult to implement."** Leading companies already have substantive engagement programs in place. The Shareholder-Director Exchange Protocol is available online and offers guidance on setting up engagement programs.

If your company doesn't have an engagement program already underway, start where you are. Start now. The landscape has shifted, and companies cannot afford to be insular. The engagement train has left the station, and the leading companies are on board.

Shareholder engagement establishes common ground

A big part of the engagement process is establishing common ground, getting to the things that the shareholder and the board both know to be true, and getting to the things that they're both trying to accomplish. There should be an extraordinary degree of alignment between the interests of the shareowners and the board, because the board represents the shareowners.

One critical benefit of good relationships that I've seen is being able to provide background on some of the votes we've cast. As you know, shareowners have only two votes: for or against. But not every "for" vote is "*absolutely* for." A good relationship allows us to fill in those shades of gray between "absolutely for" and "absolutely against." We may vote "for" but have reservations at the margin. If we don't share those reservations, then the company has no opportunity to consider addressing those issues and might be very surprised to find that our vote has changed the next time. Or if we vote against the company's recommendation, a good relationship allows us to share why we voted that way and what the company would need to do to get our support.

If all we're doing is simply voting, it doesn't give the company the full picture. So the company is flying blind, in a way.

From Vanguard's point of view, we're in the relationship to maximize the value of the longest of long terms for our fund investors. We understand that things don't always go up in a straight line. So if we have a good relationship with a company, they have a great opportunity to tell us their story. If there are performance problems, for example, either own those problems or tell us what you're doing to fix them. For example, "We know we've got cost problems. We've got this initiative underway to trim $1 billion in costs for the next three years, and we think that's going to address our problems." Whatever the particular issue might be.

It's worth noting that in the vast majority of cases, we're happy to engage with management, too. Many times the questions or concerns we have are ones that we're very comfortable relaying to management and getting management's perspective on. In fact, many companies are including in their proxy statements more information about the engagement they've done with their investors. We've seen tables that show "what we heard" and the corresponding "what we did." We think that's a great trend.

So much of engagement gets back to the idea of self-awareness and knowing the places in which you're an outlier. Unless you know where you stand, both from a competitive standpoint and with your investors, you're a sitting duck.

Looking ahead: The future of engagement

I'll close my remarks with a few thoughts addressed directly to board members of public companies: We count on you to oversee the companies that our clients invest in. It's an important role. In the U.S. alone, Vanguard invests in some 3,800 publicly traded companies. We place a great deal of trust and confidence in you. And trust and confidence are built upon open communication. We want to continue to increase the levels of engagement we have with boards. We believe that directors—and investors—are moving in the right direction on that front.

As we look ahead, I believe we can do more.

- One idea: The **Shareholder-Director Exchange** that I mentioned. It provides a protocol and some tools and guidelines for institutional investors and directors to talk. It's a wonderful idea, and it has great promise. There's an open question on how best to measure the effectiveness of engagement on a wider scale. But from our perspective, every positive change that we can help to effect is a win for our investors.
- Another possible channel that I'm passionate about: The creation of standing **Shareholder Relations Committees** on public boards. It could be an incredibly effective way for boards to gather those outside perspectives I discussed earlier. Frankly, we're surprised that more boards don't solicit our views on general industry topics. For example, we have a very successful actively managed Health Care Fund—the world's largest health care fund, by a wide margin, at more than $50 billion in assets. I would think that the directors of pharmaceutical firms or biotech firms would be interested in talking to our portfolio manager to hear her opinions and outlook for the industry. There is a great opportunity for dialogue between investor and director on that level as well.

You, as directors, have a great opportunity to tell us how your bring value to investors. We want to listen. When you post a video to the company's website, we'll watch it! When you give a good explanation of an issue in your proxy statement, we're reading it very carefully. When you provide context, we're taking it in.

We are listening to your perspective. We want you to be aware of ours. We are your permanent investors. We care very deeply about the role that you play for our clients. And we thank you for doing the job well.

Thank you for listening.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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The Changing Dynamics of Governance and Engagement

Posted by David A. Katz, Wachtell, Lipton, Rosen & Katz, on Thursday, July 23, 2015

Editor's note: David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz specializing in the areas of mergers and acquisitions and complex securities transactions. The following post is based on an article by Mr. Katz and Laura A. McIntosh that first appeared in the *New York Law Journal*; the full article, including footnotes, is available here. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here), The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here), The Law and Economics of Blockholder Disclosure by Lucian Bebchuk and Robert J. Jackson Jr. (discussed on the Forum here), and Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

As anticipated, the 2015 proxy season has been the "Season of Shareholder Engagement" for U.S. public companies. Activist attacks, high-profile battles for board seats, and shifting alliances of major investors and proxy advisors have created an environment in which shareholder engagement is near the top of every well-advised board's to-do list. There is no shortage of advice as to how, when, and why directors should pursue this agenda item, and there is no doubt that they are highly motivated to do so. Director engagement is a powerful tool if used judiciously by companies in service of their strategic goals. As companies and their advisors study the lessons of the recent proxy season and look ahead, it is worth examining recent shifts in corporate governance dynamics. With an awareness of the general trends, and by taking specific actions as appropriate, boards can prepare and adapt effectively to position themselves as well as possible to achieve their strategic objectives.

Governance Dynamics Trends

Since 2000, the corporate environment has changed in many ways. A thoughtful white paper by The Conference Board discusses five of the most significant legal, social, and market trends during this time period that have contributed to the changing dynamics of corporate governance. These trends have been transformative, and, taken together, they are foundational to shareholder-director engagement today. The first is the increased influence of institutional investors. This is due primarily to the concentration of stock ownership in institutionally-held investment and savings accounts, and to a lesser extent to changes in voting rules and practices and proactive steps by institutional investors to influence corporate governance and direction. The second trend is a shift toward a purely commercial understanding of the purpose of a corporation. Though mid-20th century America generally agreed that a corporation had

responsibilities to society as well as to its shareholders, in recent years the prevailing view held by many investors is that public corporations exist primarily to maximize shareholder value. Conflicting interpretations of this goal have produced a further debate as to whether the appropriate timeframe for doing so is the long- or short-term horizon.

The third trend is declining public trust in business and its leaders. Public confidence in corporate America plummeted with the collapse of Enron and WorldCom and the financial scandals that followed, and it was further undermined by the bankruptcies, bailouts, and stock market losses that accompanied the 2008-2009 financial crisis.

The fourth trend, largely a reaction to the third, is the expansion in federal regulations designed to increase the accountability of directors and senior management and provide shareholders with greater power. Federal regulations over the last decade and a half have, among other things, expanded the range of mandatory company disclosures, provided the U.S. Securities and Exchange Commission (SEC) with authority to introduce proxy access, diminished companies' ability to exclude shareholder proposals from their proxy statements, required regular shareholder advisory votes on executive compensation, and identified shareholder fiduciary duties in certain types of proxy voting by some institutional investors.

This shift in the SEC's focus recently was clearly articulated by SEC Commissioner Dan Gallagher in his last public speech as a Commissioner: "Part of the SEC's tripartite mission is to protect investors. But too often, our concept of 'investor protection' reflects a prejudgment that a corporation is a democracy, where shareholders participate directly in the governance of the corporation." Commissioner Gallagher went on to argue for a more traditional view of federal versus state regulation:

> But, like the United States itself, a corporation can also be a republic, where shareholders elect directors, who in turn govern the corporation. The choice of a shareholder- or director-centric model is properly left to state law. The SEC increasingly has been disrespecting this distinction by interjecting opportunities for shareholder direct democracy into the securities laws. But the director-centric model is at least equally-well suited to the protection of investors, and so the SEC's rules should provide enough flexibility to accommodate either approach.

The fifth trend is the growing influence of proxy advisory firms. Proxy advisors successfully capitalized on the loss of public confidence in business leaders, the rise in share ownership of institutional investors, and the wide array of new regulations and governance requirements. Large investors turned to proxy advisors for guidance, smaller investors followed suit, and the soft power of proxy advisors has become disproportionately strong. Fortunately, over the last year or two, institutions and other large, influential investors have begun to distance themselves from proxy advisors. One factor in this reversal is the SEC's issuance of Staff Legal Bulletin 20 in 2014. SLB 20 contained a number of elements that together have prompted institutional investors to take responsibility for their proxy votes rather than outsourcing them to advisors such as Institutional Shareholder Services Inc. (ISS). Some large institutional investors have created internal departments to handle much of the work they previously outsourced to proxy advisors. Investment advisors are evaluating and overseeing the work of their retained proxy advisory firms more closely. As Commissioner Gallagher might put it, institutional investors are starting to move from a "compliance mindset" on proxy voting to a "fiduciary mindset."

The “Active” Investor

As they begin to retake the reins from proxy advisory firms and step into leadership roles in the governance community, institutional investors are becoming more active stockholders than they have ever been. This could be a welcome development for American business, for unlike the “activist” shareholders seeking to enrich themselves through short-term profits, many of the most influential institutional investors are deeply committed to maximizing long-term growth and prosperity. BlackRock chief executive Laurence D. Fink, for example, has made numerous public statements emphasizing the importance of consistent and direct shareholder-company engagement on issues of corporate governance and strategies for long-term growth. He recently noted, in a letter to chief executives, that BlackRock “engage[s] actively with companies on the key governance factors that in our experience support long-term, sustainable, financial performance.” In a recent letter to independent directors of portfolio companies, Vanguard Chairman and CEO F. William McNabb III wrote, “We’re indifferent as to how a board chooses to engage. What’s important to us is *that* it engages. And when they engage, boards should be prepared to enter into a dialogue on appropriate issues of interest to significant, long-term investors.”

BlackRock, State Street Global Advisors, Fidelity, Vanguard, and other large asset managers maintain their own proxy voting guidelines; because these investors have a vested interest in the success of the subject companies, these guidelines are far less rigid and agenda-driven than those of leading proxy advisors. State Street’s guidelines, for example, are explicitly predicated on the notion that State Street expects to engage with companies on the factors that lead to its voting decisions and to proactively raise concerns with companies in order to resolve them in a manner advantageous to the company and its shareholders.

Over the past several years, there has been a well-documented upswing in the amount and quality of contact between companies and investors. Increased shareholder engagement may initially have been spurred by the requirement of say-on-pay votes every three years, but it has taken on new dimensions as it has grown in scale and deepened in quality. Major institutional investors increasingly expect that companies will provide access to independent directors as well as to other corporate contacts, and not only in times of crisis (*e.g.*, when the company is facing an activist attack or a disappointing earnings release) but on an ongoing basis. An effective shareholder relations program in today’s environment will include opportunities for directors and senior management to build substantive relationships with investors over an extended period of time. Corporate secretaries play an important role in coordinating effective director engagement with shareholders.

One lesson to be drawn from the recent attempt by Trian Fund Management, L.P. to obtain four seats on the board of the E.I. du Pont de Nemours & Co. (DuPont) is that the increasingly active role of institutional investors in governance and engagement is good news for companies. In May 2015, DuPont defeated Trian’s proxy campaign, thanks to strong support from an unusually large retail shareholder base and, notably, because all three of its largest institutional shareholders—Vanguard, BlackRock, and State Street—declined to follow the recommendations of ISS and Glass, Lewis & Co. to vote in favor of the activist nominees. The independence of its shareholders from the hegemony of the proxy advisors enabled DuPont to continue to pursue its strategic transformation. DuPont effectively communicated its strategic direction by engaging with its investors (including the activists) over a period of years and responding quickly and

convincingly to public critiques by Trian. The independent directors, along with the chief executive and members of senior management, were personally involved in DuPont's shareholder engagement efforts and were key elements to DuPont's success.

DuPont did exactly what investment community leaders such as Laurence Fink have encouraged corporations to do—"engage with a company's long-term providers of capital; … resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners; and, most importantly, … clearly and effectively articulate their strategy for sustainable long-term growth." In his April 2015 letter to chief executives, Fink promised that "[c]orporate leaders and their companies who follow this model can expect our support." In the DuPont-Trian proxy fight, he and a sufficient number of other institutional shareholders held up their end of the bargain.

Some institutional investors have expressed concerns regarding the rapid increase in director engagement and how they, as large shareholders whose attention is much in demand, will allocate their resources to engage meaningfully. There is some concern that companies with smaller market capitalizations may find it difficult to engage the attention of large shareholders, as these investors are likely to prioritize engagement with companies in which they have more significant investments. Smaller companies may need to seek engagement earlier in the proxy season (or before the proxy season) in order to obtain meaningful access to their institutional investors.

The Corporate Secretary

The preeminence of corporate governance and the rise of shareholder engagement have resulted in a fundamental shift in the role of the corporate secretary. As the Society of Corporate Secretaries and Governance Professionals has observed, "In recent years the Corporate Secretary has emerged as a senior, strategic-level corporate officer who plays a leading role in the company's corporate governance." In addition, many corporate secretaries have become, as one commentator put it, "the primary point of information and influence between the executive management and the board." A 2014 U.K. study concluded that "[t]he role is changing: it is increasingly outward-focused (incorporating investor engagement and corporate communications), and not just about internal administration." A 2014 ISS report found that when investors reach out to engage with boards, they most frequently contact the corporate secretary. The second-most frequent point of initial contact for investor-driven engagement is the board chair (or lead director), with the investor relations office a weak third. When it is the company that initiates engagement, the investor relations office is most often the initial point of contact, with the corporate secretary the second-most frequent point of initial contact.

As a primary liaison with investors who is also close to the board and senior management, the corporate secretary is ideally positioned to help directors and chief executives understand and respond to shareholder concerns. Corporate secretaries are expected to monitor corporate governance developments generally and assist the board in regularly updating and refining the company's governance practices as appropriate. It may be advisable for corporate secretaries to purposefully build relationships with large shareholders, institutional investors, and proxy advisors, in order to be fully up-to-date on the general trends and specific issues that concern both active and activist shareholders, as well as the agendas of key participants in the corporate governance debate.

The 2014 U.K. study found that, for high-performing corporate secretaries, heightened responsibilities may result in complicated reporting structures. Many corporate secretaries report primarily to the non-executive chair of the board or lead independent director, while maintaining close ties to the CEO and senior management; some report primarily to the CEO, while still serving as a significant company contact for the lead independent director or non-executive chair. As a state-law-mandated corporate officer who is appointed by the board but typically hired by senior management, the corporate secretary has a foot in each sphere. Indeed, many corporate secretaries in the U.K. study described themselves as "the third person in the chairman/CEO relationship." Internal direct and indirect reporting lines are best determined in the context of a company's particular structure. The centrality of the role of the corporate secretary will depend in large part on the person occupying that role, on his or her capabilities, and on the quality of his or her relationships with the chairman and the other non-executive directors as well as the CEO and senior management.

When corporate secretaries have taken on significant responsibilities as liaisons between investors and directors, and as the face of the company in outward-focused corporate governance matters, boards and companies may consider splitting the roles of general counsel and corporate secretary, which traditionally have been combined at many companies. The two roles may simply become too large for one person to handle. Moreover, at some companies, the general counsel may be perceived to be more closely aligned with the CEO, while the corporate secretary is perceived to be the board chairman's or lead director's right-hand person, and, in certain situations, it may be simpler and more effective to separate the roles. When the roles are separated, the corporate secretary often reports to the general counsel, while in other situations, the corporate secretary may report to either the CEO or the board chairman, depending upon the particular company and circumstances.

Role of the Board

Corporate governance trends have wrought many significant changes in the management and oversight of U.S. corporations. The priorities and responsibilities of directors, investors, and senior executives have changed to varying degrees as all of the corporate actors adapt to new requirements, societal trends, and the increasingly interconnected corporate environment. Through mechanisms such as majority voting—which is becoming more widespread each year—shareholders are increasing the accountability of directors in annual elections. The hope is that these changing dynamics will have a beneficial effect. As Chief Justice Leo Strine of the Delaware Supreme Court has written:

> [I]t is clear that stockholders have more tools than ever to hold boards accountable and the election process is more vibrant than ever. The election of more accountable boards should come with less tumult, not more. More accountable boards should be given more, not less, leeway to make decisions during their term. This does not mean that corporation law should strip stockholders of their substantive rights to vote on mergers or major asset sales. But it does mean that the costs of further distracting corporate managers from focusing on managing the business to generate profit would outweigh the benefits that come from more corporate referendums.

Perhaps one outcome of increased independent director engagement with shareholders will be a decline in corporate referenda, allowing directors to focus on creating value in the long term. To date, unfortunately, that has not been the case.

Though certain aspects of the role of the board may be changing, the fundamental role and responsibilities of the board hold constant. As a matter of state law, the board is charged with managing, or directing the management of, the affairs of the corporation. No matter how active or activist a company's shareholders may become, their legal responsibilities extend only to the election of directors, votes on certain fundamental matters, and advisory votes on compensation. Some academics and activists argue that state law should be revised to expand the legal rights of shareholders; the merits of this suggestion are debatable, and in any event, it has not been implemented.

Shareholder influence likely will continue to grow, but the legal rights of shareholders remain limited, and the U.S. corporate model remains managerial and director-centric. Directors cannot allow their business judgment to be usurped or overly influenced by investors, advisors, or other board outsiders. Boards are encouraged to interact strategically with investors, to address their concerns, and to reinforce the company's long-term goals, and at the same time to keep in mind that activism, corporate governance, and engagement change nothing about the fundamental fiduciary duties of directors.

Tab 5: Proxy Access

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Proxy Access Proposals

Posted by Avrohom J. Kess, Simpson Thacher & Bartlett LLP, on Monday, August 10, 2015

Editor's Note: Avrohom J. Kess is partner and head of the Public Company Advisory Practice at Simpson Thacher & Bartlett LLP. This post is based on a Simpson Thacher memorandum by Mr. Kess, Karen Hsu Kelley, and Yafit Cohn. The complete publication, including footnotes, is availablehere. Related research from the Program on Corporate Governance includes Lucian Bebchuk'sThe Case for Shareholder Access to the Ballot and The Myth of the Shareholder Franchise (discussed on the Forum here), and Private Ordering and the Proxy Access Debate by Lucian Bebchuk and Scott Hirst (discussed on the Forum here).

This year was a break-through year for shareholder proposals seeking to implement proxy access, a mechanism allowing shareholders to nominate directors and have those nominees listed in the company's proxy statement and on the company's proxy card. It is estimated that over 100 proxy access proposals were submitted to public companies during the 2015 proxy season, 75 of which were submitted by New York City Comptroller Scott Stringer on behalf of the New York City pension funds he oversees. Stringer's "2015 Boardroom Accountability Project" affected companies in diverse industries and with a range of market capitalizations, but explicitly targeted companies with purportedly weak track records on board diversity, climate change or say-on-pay. The Comptroller's proposals, which were precatory and identical regardless of the company's market capitalization, generally called for the right of shareholders owning three percent of the company's outstanding shares for at least three years to nominate up to 25% of the board in the company's proxy materials.

As of July 26, 2015, 81 proxy access shareholder proposals have been submitted to a vote at Russell 3000 companies, compared to 17 proposals in 2014 and 13 proposals in 2013. Of the 81 proposals that have been voted on thus far this year, 48 proposals (or 59.3%) passed, and 33 proposals (or 40.7%) failed. So far this year, shareholder proposals submitted to a vote at Russell 3000 companies received average shareholder support of 54.7%. While this appears to depart from the average support of 30.9% garnered by proxy access shareholder proposals in 2014, it is in line with the 53.4% average support received last year for proposals with 3% / three-year thresholds.

Historical Background and Proxy Access Proposal Trends Through 2014

In 2010, after the Dodd-Frank Act clarified the authority of the Securities and Exchange Commission ("SEC") to issue a proxy access rule, the SEC adopted Rule 14a-11 under the Securities Exchange Act of 1934, as amended, which required publicly-traded companies to include shareholders' director nominees in their proxy materials, representing up to 25% of the

board. Under Rule 14a-11, a shareholder (or group of shareholders) was eligible to nominate proxy access candidates provided that the shareholder:

- held at least 3% of the voting power of the company's securities for a minimum of three years; and
- was not prohibited by state or foreign law or a company's governing documents from proposing a candidate.

Rule 14a-11, however, was challenged in the U.S. Court of Appeals for the D.C. Circuit by the Business Roundtable and the U.S. Chamber of Commerce. The court ultimately agreed with the plaintiffs that the SEC was "arbitrary and capricious" in promulgating the rule, finding that the SEC failed to adequately address the economic effects of the rule. The court thus vacated Rule 14a-11. The decision, however, left intact the SEC's amendments to Rule 14a-8, which generally permitted shareholders to submit shareholder proposals seeking to amend the company's governing documents regarding nomination procedures. This effectively allowed for the "private ordering" of proxy access through the shareholder proposal process.

Despite the court's 2011 decision, a limited number of proxy access shareholder proposals were submitted to public companies prior to the current proxy season. A total of 12, 13 and 17 proxy access shareholder proposals were submitted in 2012, 2013 and 2014, respectively. In 2014, for example, five of the 17 proposals submitted to public companies passed. While last year's proxy access shareholder proposals garnered an average of 30.9% of the vote, support levels for these proposals varied significantly depending upon the specific proposal being advanced. Proposals mirroring the 3% / three-year thresholds of the SEC's vacated rule received significantly higher shareholder approval rates than proposals with lower thresholds or those that provided the potential for shareholders to nominate up to 40% of the board or to circumvent the three-year holding requirement.

Proxy Access Shareholder Proposals in 2014

Proponent	Proposal Threshold/ Holding Period	Companies Targeted	ISS Position	Average Shareholder Support
NYC and Philadelphia Pension Funds	3% for three years	• Abercrombie & Fitch • Big Lots • Boston Properties • Comstock Resources • International Game Technology • Kilroy Realty Corp. • Nabors Industries • Oracle • SLM Corp. • Walgreens • Walt Disney*	FOR	53.4%
Harrington/ McRitchie	Either (a) holders with at least 1% but less than 5% ownership for two years or (b) 25 holders of $2,000 each with at least 1% but less than 5% for one year	• Apple • Bank of America • Citigroup • Goldman Sachs	AGAINST (ISS expressed concern over the low 1% threshold, the potential for replacement of nearly half the board in a single election, and the fact that the proposal discriminates against 5% shareholders).	4.9%
Young / McRitchie	(a) holders of 3% for 3 years and /or (b) 25 holders who each held for 3 years stock that, at some point in the preceding 60 days, was worth at least $2,000 and collectively 3%.	• Cisco • FedEx • Microsoft	AGAINST (ISS noted the potential ability of separate groups to nominate up to 40% of the board and the potential for a loophole to the three-year holding requirement).	6.7%

* Withdrawn after ISS recommendation.

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SEC No-Action Letters

"Directly Conflicting" Proposals Under Rule 14a-8(i)(9)

In addition to being marked by a proliferation of proxy access shareholder proposals, this proxy season was significantly impacted by the unusual, mid-season decision of the SEC's Division of Corporation Finance (the "Division") not to express any views during the current proxy season on the application of Rule 14a-8(i)(9), which permits the exclusion of a shareholder proposal "[i]f the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting." The Division's announcement immediately followed SEC Chair Mary Jo White's announcement of the same day that "[d]ue to questions that have arisen regarding the proper scope and application of Rule 14a-8(i)(9)," she had directed the staff to review the rule and report to the SEC on its review.

Chair White's announcement stemmed, in part, from the appeal filed by shareholder proponent James McRitchie with regard to the no-action relief granted by the Division's staff (the "Staff") to Whole Foods Market, Inc. in connection with McRitchie's proxy access shareholder proposal. McRitchie's shareholder proposal requested that the Whole Foods board amend the company's governing documents to allow any shareholder or group of shareholders collectively holding at least three percent of the company's shares for at least three years to nominate directors that would then be required to be listed in the company's proxy materials. The proposal added that parties nominating directors "may collectively make nominations numbering up to 20% of the Company's board of directors, or no less than two if the board reduces the number of board members from its current size." Whole Foods' board, however, opted to submit a proxy access proposal of its own for shareholder approval at the company's 2015 annual meeting.

The company's proposal sought to amend Whole Foods' bylaws to permit any shareholder (but not a group of shareholders) owning at least nine percent of the company's common stock for five years to nominate board candidates in the company's proxy materials. The company's proposal would have allowed a shareholder to nominate the greater of one director or ten percent of the board, rounding down to the nearest whole number of board seats.

In light of Whole Foods' management proposal, the Staff issued a no-action letter to the company on December 1, 2014, concurring that the company may exclude the shareholder proposal from its proxy materials pursuant to Rule 14a-8(i)(9). Pursuant to the Division's announcement of January 16, 2015 that it "will express no views on the application of Rule 14a-8(i)(9) during the current proxy season," however, the Staff reconsidered its position with regard to Whole Foods, responding to McRitchie's appeal with a notification that it "express[es] no view concerning whether Whole Foods may exclude the proposal under Rule 14a-8(i)(9)."

In the weeks between the Staff's initial grant of no-action relief to Whole Foods and its reconsideration, 24 companies that received proxy access shareholder proposals similarly sought no-action relief on the ground that the company intended to submit a "directly conflicting" management proposal to shareholders at the 2015 annual meeting. Each of these companies received a response that, given the Division's announcement of January 16, 2015, in light of Chair White's direction to the Division to review Rule 14a-8(i)(9), "we express no view on whether [the company] may exclude the proposal under rule 14a-8(i)(9)."

Other Substantive Grounds On Which Companies Based No-Action Requests

While the vast majority of substantive no-action requests regarding proxy access proposals were based on Rule 14a-8(i)(9) and thus received no determination from the Staff, four letters sought no-action relief on other substantive grounds. The two successful requests for relief argued that:

1. the proposal was substantially implemented and could, therefore, be properly excluded under Rule 14a-8(i)(10); or
2. the proposal is substantially duplicative of a previously submitted proposal and could, therefore, be properly excluded under Rule 14a-8(i)(11).

The two no-action requests that were denied argued that the proposal was excludable under Rule 14a-8(i)(3), which permits the exclusion of a proposal "[i]f the proposal or supporting statement is contrary to the Commission's proxy rules, including Rule 14a-9, which prohibits materially false or misleading statements in [a company's] proxy soliciting materials."

Substantial Implementation Under Rule 14a-8(i)(10): General Electric

The General Electric Company received a shareholder proposal from an individual proponent, requesting that the company's board adopt a bylaw permitting "a shareholder or group thereof" that has beneficially owned three percent or more of the company's outstanding stock continuously for at least three years to nominate directors in the company's proxy materials. The proposal provided that the number of shareholder-nominated candidates appearing in the company's proxy materials "shall not exceed 20 percent of the number of directors then serving."

General Electric's board subsequently adopted amendments to the company's bylaws, implementing proxy access. The amendments provided, in relevant part, that a shareholder or a group of up to 20 shareholders "who have owned 3% or more of the Company's common stock continuously for at least three years may include in the Company's proxy statement and on the Company's proxy card shareowner-nominated director candidates representing not more than 20% of the Board." Significantly, the proxy access provision adopted by General Electric included a group limit of 20 shareholders, while the shareholder proposal did not contain a group limit.

In its no-action request, General Electric argued that the board's adoption of the amended bylaws substantially implements the proposal, because the amended bylaws "address the essential objective of the Proposal: they provide a proxy access procedure under which a group of shareowners who have owned 3% or more of the Company's common stock continuously for at least three years may include in the Company's proxy statement and on the Company's proxy card shareowner-nominated director candidates representing not more than 20% of the Board." The SEC concurred that General Electric substantially implemented the proposal under Rule 14a-8(i)(10), notwithstanding the company's addition of the group size limit.

Duplication Under Rule 14a-8(i)(11): United Therapeutics

Rule 14a-8(i)(11) permits the exclusion of a shareholder proposal if the proposal "substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same meeting." United Therapeutics

Corporation sought to exclude a proxy access proposal it received from UAW Retiree Medical Benefits Trust on the ground that it was "virtually identical to, and therefore substantially duplicates" a proposal previously received from the New York City Comptroller's office that the company intended to include in its 2015 proxy materials. United Therapeutics argued that the "principal thrust" of each proposal is the same—to request that the company adopt proxy access—and that the proposals "seek to address this issue through the same process." Moreover, the company noted that aside from minor capitalization or spelling differences, the two proposals "are substantially identical in all substantive respects." The SEC agreed that the UAW proposal substantially duplicates the Comptroller's proposal and may, therefore, be excluded from the company's 2015 proxy materials pursuant to Rule 14a-8(i)(11).

Violation of Proxy Rule Under Rule 14a-8(i)(3): CSP and Rite Aid

Two companies submitted no-action requests to the SEC, arguing unsuccessfully that the proxy access shareholder proposal is excludable under Rule 14a-8(i)(3), which permits the exclusion of a shareholder proposal if it or its supporting statement "is contrary to any of the Commission's proxy rules, including Rule 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials."

In its letter to the SEC, CSP Inc. presented three reasons why it believed the proposal could be excluded pursuant to Rule 14a-8(i)(3). First, the company took issue with a portion of the proposal that quoted from a "fight letter" disseminated to the company's shareholders in 2013 in connection with a contested election of directors, arguing that its statements regarding the company's financial performance over the past 20 years are both "stale and materially misleading." Second, CSP contended that the proposal was materially misleading due to the statement that "[t]hree acquisitions cost stockholders approximately $7 million, yet the Company wrote off over $5 million … the full cost of an acquisition only one year after the purchase!" According to CSP, this language suggests the acquisitions were recent, "when in fact the Company's acquisition history must be traced back 17 years to find the acquisitions that were followed by goodwill write-downs." The company further argued that the proposal's language "misleadingly implies that the acquisitions failed to generate new, profitable areas of business for the Company, when the opposite is true" and that the proponents "do not explain to readers that there have been no goodwill write-offs by the Company in over five years." Finally, CSP argued that the proposal's statement that the company "has conducted value-destroying acquisitions, leaving our company with two disparate businesses that lack synergies, while enriching management and directors" has no basis in fact and "impugn[s] the character, integrity and personal reputation of the Company's management." The SEC did not accept these arguments, declining to grant CSP no-action relief.

Rite Aid Corporation similarly sought relief to exclude a proxy access shareholder proposal on the basis of Rule 14a-8(i)(3). Rite Aid presented two arguments in its no-action request letter. First, Rite Aid took issue with the supporting statement that "[t]he SEC fully supports this Proposal and the two largest institutional proxy advisory firms, ISS and Glass Lewis, generally support this shareholder protection proposal to include shareholder director nominees in Rite Aid's proxy statement and proxy cards, providing an inexpensive means for opposing management's slate." Rite Aid maintained that this is a materially false and misleading statement because "neither the Commission nor the Staff has reviewed the Proposal or expressed any view in relation to the Proposal or would ever express any view on how shareholders should vote on the Proposal."

Additionally, Rite Aid explained that "neither ISS nor Glass Lewis has reviewed the Proposal or its application to the Company or has expressed any views on the Proposal." It further noted that pursuant to their respective proxy voting guidelines, ISS will consider each proxy access proposal on a case-by-case basis, and Glass Lewis "considers several factors when evaluating whether to support" proxy access proposals. According to Rite Aid, because the language in the proposal's supporting statement is materially false or misleading, the proposal violates Rule 14a-9 and should be excluded under Rule 14a-8(i)(3).

Rite Aid further argued that the proposal is excludable under Rule 14a-8(i)(3) because it contains vague and indefinite language, rendering the proposal false or misleading. In particular, the company noted that the proposal, if adopted, would require Rite Aid to include in its proxy statement a supporting statement, defined in the proposal as "a Supporting Statement not exceeding the current SEC word limit." Rite Aid claimed that "it is not entirely clear whether the Proposal is referencing Rule 14a-8(d), in which case many shareholders may not be familiar with the word limit in that rule, or whether the Proposal is referencing some other 'current SEC word limit,' in which case there is complete uncertainty as to what that word limit may be." The company took the position that the proposal is, therefore, impermissibly vague and indefinite so as to be materially false and misleading.

Interestingly, while the SEC did not agree that the proposal could be excluded from Rite Aid's proxy materials in its entirety, it did opine that, pursuant to Rule 14a-8(i)(3), the company could exclude from the supporting statement the one sentence regarding the position of the SEC and the proxy advisory firms regarding the proposal.

Positions of the Proxy Advisory Firms

Institutional Shareholder Services, Inc. ("ISS")

Policy

On February 19, 2015, after the Division announced that it would not issue substantive responses to no-action requests predicated on Rule 14a-8(i)(9), ISS released a new policy on proxy access proposals.

Moving away from its previous case-by-case approach in evaluating these proposals, ISS's new policy provides that it will generally recommend a vote in favor of management and shareholder proxy access proposals with the following features:

- A maximum ownership threshold of three percent of the voting power;
- A maximum duration requirement of three years of continuous ownership for each member of the nominating group;
- "[M]inimal or no limits on the number of shareholders permitted to form a nominating group"; and
- A cap on shareholder nominees generally set at 25% of the board.

ISS noted that it will also "[r]eview for reasonableness any other restrictions on the right of proxy access" and will "[g]enerally recommend a vote against proposals that are more restrictive than these guidelines."

In addition, ISS will apply its governance failures policy to "generally recommend a vote against one or more directors (individual directors, certain committee members, or the entire board based on case-specific facts and circumstances)" where the company has excluded a properly submitted proxy access shareholder proposal without obtaining voluntary withdrawal from the proponent, no-action relief from the SEC, or a federal court ruling allowing it to exclude the proposal. ISS will recommend against directors in this case "regardless of whether there is a board-sponsored proposal on the same topic on the ballot." ISS added, however, that if a company "has taken unilateral steps to implement the proposal, … the degree to which the proposal is implemented, and any material restrictions added to it, will factor into the assessment."

Practice

Thus far this proxy season:

- ISS has recommended a vote "For" **each of the 83 proxy access shareholder proposals**submitted to Russell 3000 companies for which it has published a report.
- ISS has recommended a vote "Against" seven of the 11 proxy access proposals submitted by management for which they published a report.

Glass Lewis

Policy

Glass Lewis's policy provides that the proxy advisory firm "will consider supporting reasonable proposals requesting shareholders' ability to nominate director candidates to management's proxy" and will review such proposals on a case-by-case basis, considering the following factors:

- company size;
- board independence and diversity of skills, experience, background and tenure;
- the shareholder proponent and its rationale for submitting the proposal;
- the proposal's thresholds;
- shareholder base in both percentage of ownership and type of shareholder;
- responsiveness of board and management to shareholders;
- company performance and steps taken to improve poor performance;
- existence of anti-takeover protections; and
- opportunities for shareholder action (e.g., ability to act by written consent, right to call a special meeting).

Following the Division's January announcement, Glass Lewis published a blog post regarding its views on proxy access, reiterating that it "will continue to review each proxy access proposal,

along with the company's response, on a case-by-case basis." In addition, Glass Lewis noted that consistent with its "case-by-case approach to evaluating management and board responsiveness to shareholders in general, Glass Lewis will review a company's response to the submission of a shareholder proposal on proxy access, including an alternative management proposal submitted to shareholders in lieu of or in addition to the shareholder proposal, based on the specific facts and circumstances of the company and its actions," evaluating the "reasonableness and proportionality of the company's response to the shareholder proposal."

With regard to alternate management proposals, Glass Lewis indicated that it will take a variety of factors into account, including whether the proposal differs materially from the shareholder proposal, "the company's performance and overall governance profile, the board's independence, leadership, responsiveness to shareholders and oversight, the opportunities for shareholders to effect change, e.g. call a special meeting, other differences in the terms of the competing proposals, the number/type/nature of the shareholders above the proposed threshold as well as the nature of the proponent." Glass Lewis added that it may, in limited cases, "recommend against certain directors if the management proposal varies materially from the shareholder proposal without sufficient rationale."

Practice

Glass Lewis generally recommends "For" proxy access shareholder proposals. Thus far this proxy season, Glass Lewis has recommended a vote "Against" six of the 11 proxy access proposals submitted by management for which they published a report (*i.e.*, those management proposals with a 5% shareholding threshold).

Positions of Large Institutional Shareholders

At present, there is no consensus among the major institutional shareholders on the issue of proxy access. BlackRock and State Street Global Advisors, for example, currently consider proxy access proposals on a case-by-case basis. BlackRock's current policy reflects its belief that "long-term shareholders should have the opportunity, when necessary and under reasonable conditions, to nominate individuals to stand for election to the boards of the companies they own and to have those nominees included on the company's proxy card," provided that the proxy access mechanism will "provide assurances that the mechanism will not be subject to abuse by short-term investors, investors without a substantial investment in the company, or investors seeking to take control of the board." State Street Global Advisors evaluates "the company's specific circumstances, the impact of the proposal on the target company and its potential effect on shareholder value," taking into account considerations such as "the ownership thresholds and holding duration proposed in the resolution, the binding nature of the proposal, the number of directors that shareholders may be able to nominate each year, company performance, company governance structure, shareholder rights, and board performance."

The Vanguard Group also currently considers proxy access proposals on a case-by-case basis, but generally supports proxy access provisions that provide a shareholder (or group of shareholders) holding five percent of a company's outstanding shares for at least three years with the right to nominate up to 20% of the board's directors. The Vanguard Group "may, however, support different thresholds based on a company's other governance provisions, as well as other relevant factors."

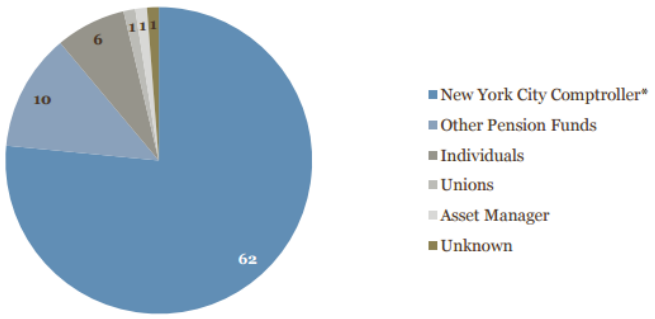
Finally, Fidelity Management & Research is currently opposed to proxy access, generally voting against management and shareholder proposals seeking to implement proxy access.

Proxy Access Proposal Trends

Overall Trends

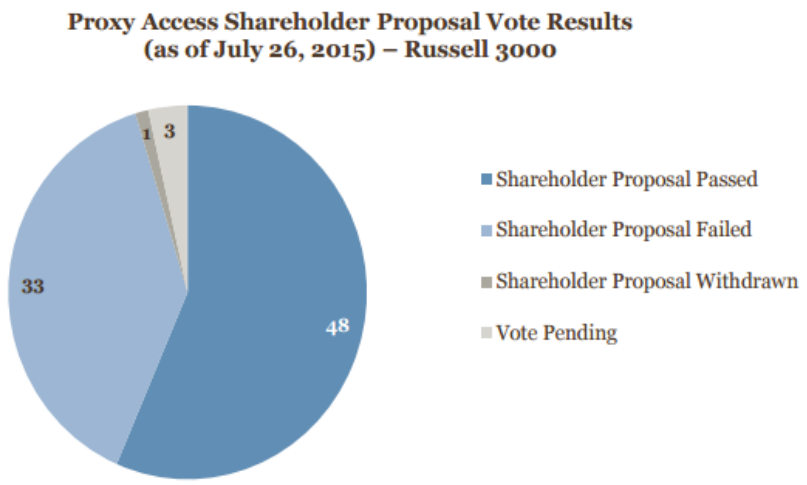
- **The number of proxy access shareholder proposals submitted to public companies skyrocketed this year, largely due to the Comptroller's initiative.** Proxy access shareholder proposals have been the most popular of the governance-related proposals in 2015, with a total of 81 proposals that have gone to a vote thus far among Russell 3000 companies. In contrast, between 12 and 17 proxy access shareholder proposals were submitted to a vote in each of the previous three years.
- **All proposals submitted to a vote at Russell 3000 companies called for proxy access at the thresholds of three percent and three years.** In contrast, of the 17 shareholder proposals submitted to a vote in 2014, only ten contained the 3% / three-year thresholds. Given the marked difference observed last year between the support of shareholders and proxy advisory firms for 3% / three-year proposals, on the one hand, and proposals with lower thresholds, on the other, shareholder proponents converged on the 3% / three-year thresholds this year.
- **The vast majority of shareholder proposals capped proxy access nominees at 25% of the board.** Of the 81 shareholder proxy access proposals submitted to a vote this year at Russell 3000 companies, 79 proposals (or 98%) provided that the nominating shareholder could nominate up to 25% of the board, while two proposals capped shareholder nominees at 20% of the board.
- **Almost all shareholder proposals were silent with respect to limits on the number of shareholders that can be aggregated to reach the shareholding threshold.** Only one of the 81 proposals submitted to a vote at Russell 3000 companies (submitted to Citigroup) included a group limit of 20 shareholders.
- **The New York City Comptroller's office submitted the vast majority of proxy access proposals.** While the New York City Comptroller's office submitted 75 proposals in all, 62 of which went to a vote at Russell 3000 companies so far this proxy season, there were other institutional and individual proponents that submitted similar proposals, as well.

Proponents of Proxy Access Proposals that Have Gone to a Vote (as of July 26, 2015) – Russell 3000

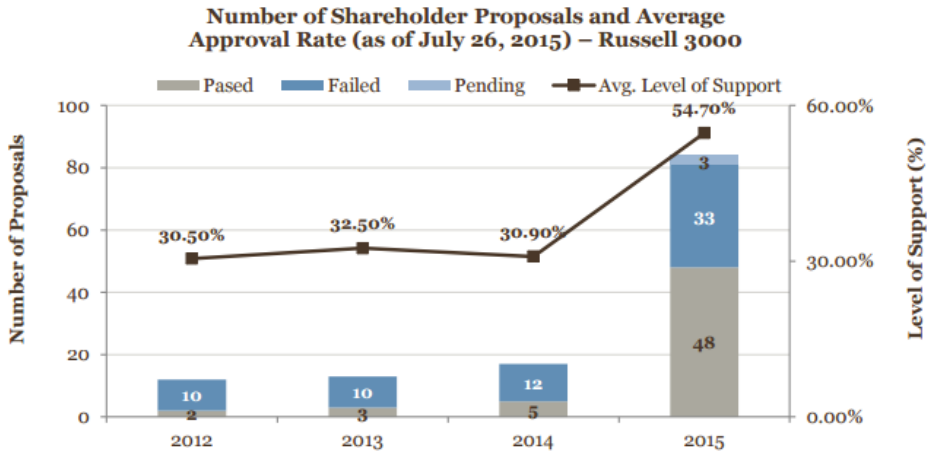


* A few of these were submitted with a co-proponent pension fund.

- **Vote results have been decidedly mixed, though the majority of proposals have passed.** Of the proposals that have been voted on at Russell 3000 companies so far this season, forty-eight shareholder proposals (or 59.3%) have passed, while 33 shareholder proposals (or 40.7%) have failed. One shareholder proposal, submitted to Comstock Resources, was withdrawn prior to the meeting. Another three proposals remain pending as of July 26.



- **Average shareholder support for proxy access shareholder proposals rose significantly from last year, but was consistent with average support received in 2014 for proposals with 3% / three-year thresholds.** Proxy access shareholder proposals among Russell 3000 companies received average support of 54.7% thus far in 2015, compared to 30.9% average support in 2014 and 53.4% average support for proposals with 3% / three-year thresholds in 2014. In cases where the shareholder proposal was submitted in addition to a conflicting management proposal, the shareholder proposal received an average of 55.1% of the vote. In cases where the company simply opposed the shareholder proposal, the shareholder proposal received an average of 53.9% of the vote.

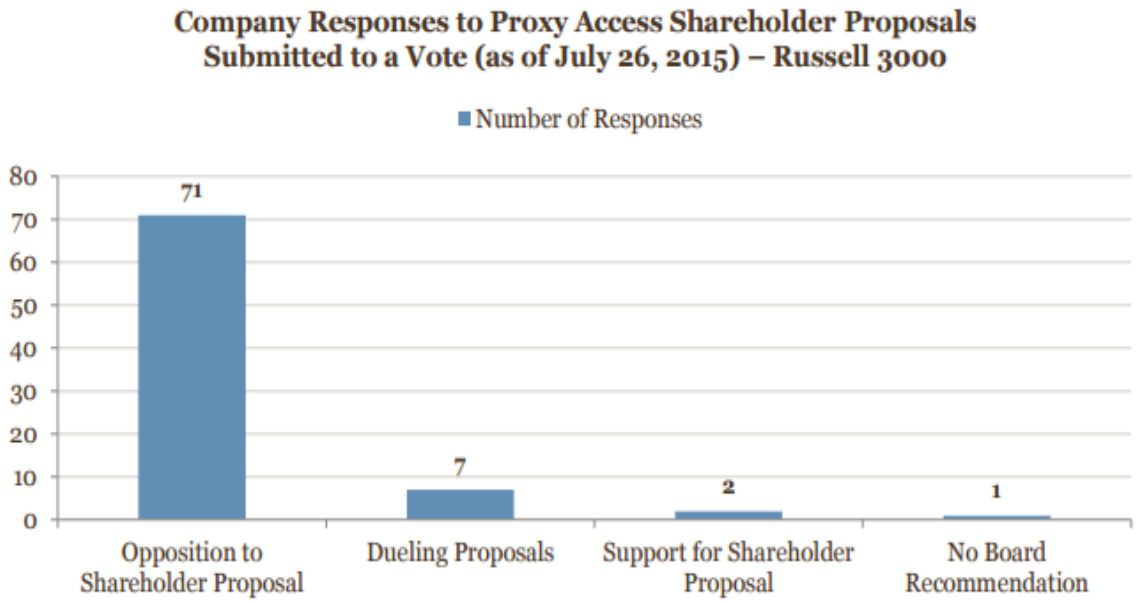


Management Responses to Proxy Access Shareholder Proposals

Following the Division's decision not to express an opinion on no-action requests based on Rule 14a-8(i)(9) and the proxy advisory firms' publication of their policies on proxy access proposals, companies chose to pursue different options in response to the shareholder proposals they received.

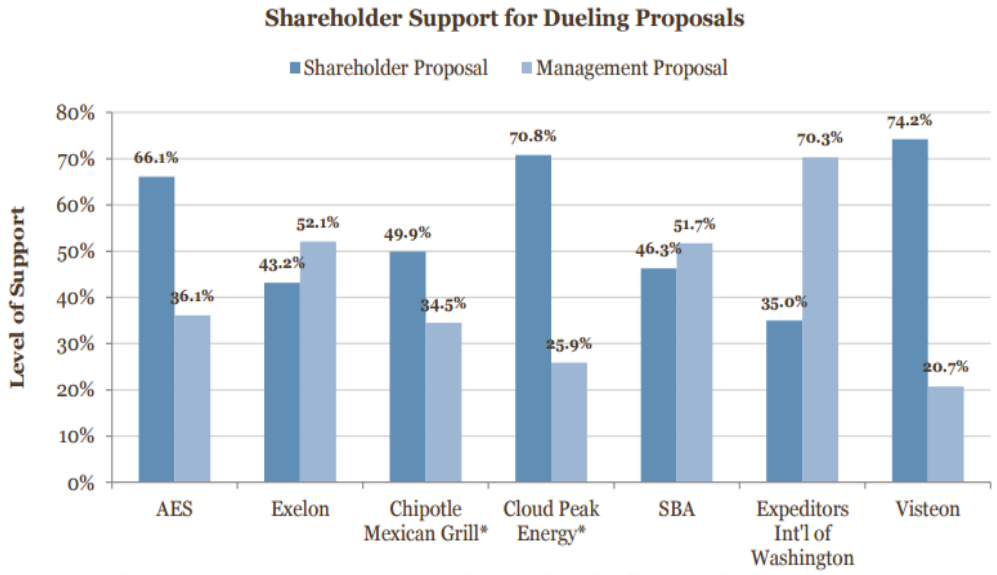
Option	Statistics (among companies across all indices and including those whose meetings are pending, as of July 26, 2015)
Opposition to the Shareholder Proposal	Approximately 78 companies (seven of which adopted proxy access in 2015 and one of which adopted proxy access in 2014) have included the shareholder proposal, accompanied by an opposition statement from the board.
Voluntary Adoption of Proxy Access	Approximately 16 companies, including General Electric, have amended their bylaws to adopt proxy access on their terms, virtually always following the receipt of a shareholder proposal and often following negotiations with the shareholder proponent. At least one of these companies, Prudential, had not received a proxy access shareholder proposal.
Negotiation	Based on publicly available information, at least six companies negotiated a compromise with the proponent. Five of these companies reached agreements with the Comptroller's office. Staples, Abercrombie & Fitch and Splunk agreed to submit board proposals on proxy access to their shareholders. Big Lots and Whiting Petroleum agreed to adopt bylaws to provide proxy access at 3% / three years / cap of 25% of the board / no group limit. In addition, one company (FirstMerit) negotiated an agreement with a different proponent to submit a management proposal with the thresholds 3% / three years / cap of 20% of the board / group limit of 20 shareholders. There may be additional companies that have reached an agreement with the proponent—namely, certain of the companies that have voluntarily adopted proxy access.
Dueling Proposals	Approximately seven companies decided to include both the shareholder proposal and their own proxy access proposal in their proxy materials. Two of these management proposals were binding, while five were non-binding (i.e., if they pass, they would not automatically implement proxy access if adopted).
Support for the Shareholder Proposal	Two companies, including Citigroup, determined to support the proxy access shareholder proposal contained in their proxy statements.
No Board Recommendation	One company provided no board recommendation in response to the proxy access shareholder proposal.

With respect to the 81 proposals that have been submitted to a vote thus far among the Russell 3000, companies pursued the following options:



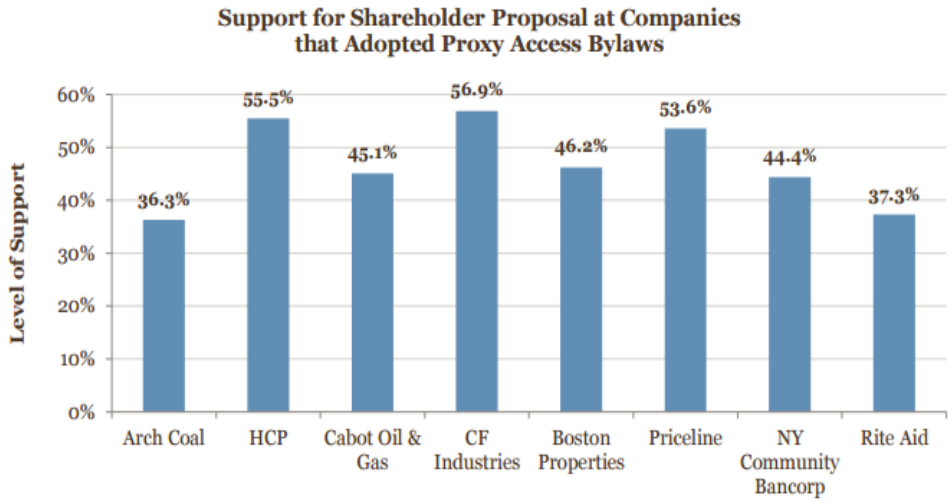
Trends Among Companies Submitting Dueling Proposals

Vote results for shareholder proposals that were submitted in conjunction with a conflicting management proposal were decidedly mixed. Of the seven shareholder proposals that were part of a pair of dueling proposals, three passed; the management proposals in each of those pairs garnered majority support. Among the four companies at which the shareholder proposal failed, the management proposal passed in three cases and failed in one case.



Trends Among Companies That Have Voluntarily Adopted Proxy Access

Of the 71 shareholder proposals that went to a vote among Russell 3000 companies and that were accompanied by an opposition statement of the board, eight were opposed in part because the company had already adopted its own version of proxy access. While average support for the shareholder proposal at companies that already adopted some form of proxy access was 46.9%—lower than the 54.7% average support among the Russell 3000 generally—the outcome of the vote among these companies was mixed, with the shareholder proposal garnering majority support at three of the eight companies. These results seem to indicate that prior adoption of proxy access was not, in itself, determinative of the company's chances of defeating the shareholder proposal.



In addition to the above eight companies that adopted proxy access and subsequently submitted the shareholder proposal to a vote, another eight companies that adopted proxy access bylaws did not submit a shareholder proposal to a vote. At least one of these companies did not receive a shareholder proposal on proxy access. The others most likely excluded the proposal pursuant to negotiation with the proponent or, in General Electric's case, pursuant to SEC no-action relief on the ground that the proposal was substantially implemented.

The 16 companies that have voluntarily adopted proxy access did so with the following thresholds (though there are some nuanced variations even among companies that generally adopted the same thresholds):

Companies	Thresholds Adopted
8 Companies: General Electric, YUM! Brands, Prudential Financial, Bank of America, Rite Aid, United Therapeutics, H&R Block, McKesson*	3% / 3 years / cap of 20% of board / group limit of 20
3 Companies: CF Industries, Arch Coal, Priceline Group	5% / 3 years / cap of 20% of board / group limit of 20
3 Companies: HCP, Cabot Oil & Gas, New York Community Bancorp	5% / 3 years / cap of 20% of board / group limit of 10

1 Company: Boston Properties	3% / 3 years / cap of 25% of board / group limit of 5
1 Company: Biogen	3% / 3 years / cap of 25% of board / group limit of 20

** subject to shareholder approval*

Takeaways

When the Division announced that it would not express any views on no-action requests based on Rule 14a-8(i)(9), many issuers that received a proxy access shareholder proposal engaged in thoughtful analysis regarding how to proceed in response to the proposal, ultimately choosing the path they thought would be most likely to yield favorable results. This season's voting results, however, indicate that the decision to either submit a conflicting management proposal alongside the shareholder proposal, oppose the shareholder proposal outright, or voluntarily adopt proxy access prior to submitting the shareholder proposal to a vote were not determinative of the outcome. Rather, a closer look at the voting results at each individual company that received the proposal suggests that the most relevant factors to influence the results were, in fact, the company's performance and its shareholder base.

Since the "private ordering" of proxy access at the thresholds of the SEC's vacated proxy access rule is very likely to continue, issuers should begin to think about how they will approach proxy access in the 2016 proxy season. In preparation for 2016, issuers and their in-house counsel should consider taking the following actions:

- **Educate the Board.** The board of directors should be prepared for the 2016 proxy season by being informed about the trends that have developed during the current proxy season, as well as the advantages and disadvantages of pursuing each potential option for responding to a proxy access shareholder proposal.
- **Evaluate the Company's Shareholder Base and Engage with Shareholders.** As noted above, there is no consensus among the large institutional shareholders on the issue of proxy access. Given the strong link between a company's shareholder base and its voting results on proxy access shareholder proposals, issuers should analyze their shareholder base and their shareholders' policies on proxy access and should begin to engage their largest shareholders.
- **Consider the Proxy Access Structure, If Any, Appropriate for the Company.** To the extent a company is open to voluntarily adopting a proxy access bylaw, it should consider what thresholds it would be comfortable with and what "bells and whistles" it might want to include in the provision.

Council of Institutional Investors
The Voice of Corporate Governance

August 2015

PROXY ACCESS: BEST PRACTICES

The Council of Institutional Investors (CII) believes that proxy access is a fundamental right of long-term shareowners. Proxy access—a mechanism that enables shareowners to place their nominees for director on a company's proxy card—gives shareowners a meaningful voice in board elections.

CII's members-approved policy on proxy access states, in part:

> ***Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least three percent of a company's voting stock, to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least two years.***

CII also generally supported a similar approach to proxy access that the Securities and Exchange Commission (SEC) adopted in 2010 but later vacated after a court challenge.

Given the many shareowner proposals seeking proxy access that received majority support during the 2015 proxy season, dozens of U.S. public companies have implemented access bylaw or charter amendments. More are considering adopting access mechanisms.

But some of those companies have included, or are considering including, in proxy access mechanisms provisions that could significantly impair shareowners' ability to use proxy access, or even render access unworkable.

The chart on the following pages highlights the most troublesome provisions that are of concern to CII and many of our members, and CII's position on them based on existing CII policies and related public statements.

CII urges companies that decide to adopt access mechanisms to talk to their shareowners about the approach they prefer and to avoid requirements that make access difficult to use or toothless.

Acknowledgements:

CII thanks the Office of New York City Comptroller Scott Stringer and Keir Gumbs of Covington & Burling LLP for their assistance with this report.

Proxy Access Bylaw Provision	CII Public Position	Explanation/Basis
Ownership threshold of 5%	CII policies support a 3% ownership threshold and we have publicly opposed a 5% or higher ownership threshold.	CII research from 2009 indicated that even if the 10 largest public pension funds were to aggregate their holdings of a single public company's securities, those funds combined would not be able to clear the 5% hurdle. Our review of current research found the same conclusion. CII's position is generally consistent with view of SEC, which in 2010 concluded that proxy access may not be consistently and realistically viable, even by a group of shareowners, if a uniform ownership threshold were set at 5% or higher.
Percent or number of board members that may be elected could result in fewer than two candidates	CII has publicly opposed limitations on the percent or number of shareowner director nominees that would prevent shareowners from nominating at least two candidates.	CII believes that it is important that shareowner nominees have meaningful representation on the board and that one director is insufficient to achieve that goal. Having at least two nominees helps ensure that the nominees, if elected, can serve on multiple committees and have greater opportunities to bring an independent perspective into board decisions.
Aggregation of shareowners limited to a specified number (up to 20 is currently most common, but some bylaws impose a cap of 10 or fewer)	CII policies and related public positions do not endorse limits or caps on the number of shareowners in the nominating group.	CII believes that shareowners should be allowed to aggregate their holdings in order to meet the ownership eligibility requirement to nominate directors. The ability to aggregate holdings is crucial to the effectiveness of proxy access—without it, a proxy access provision would not be viable. We note that without the ability to aggregate holdings even CII's largest members would be unlikely to meet a 3% ownership requirement to nominate directors. Our review of current research found that even if the 20 largest public pension funds were able to aggregate their shares they would not meet the 3% criteria at most of the companies examined. CII's position is generally consistent with the view of the SEC. In 2010, the SEC considered, but rejected imposing a cap on the permitted number of members in a nominating group. The SEC found that individual shareowners at most companies would not be able to meet the minimum threshold of 3% ownership for proxy access unless they could aggregate their shares with other shareowners.

Proxy Access Bylaw Provision	CII Public Position	Explanation/Basis
Lack of clarity on whether loaned securities count toward the ownership threshold during the holding period	CII has publicly stated that loaned securities should be counted toward the ownership threshold if certain conditions are met.	CII believes that there are reasons why, consistent with its fiduciary obligations, a shareowner may lend securities to third parties, while retaining the right to recall and vote those securities. We believe that loaned securities should be counted as belonging to a nominating shareowner if certain conditions are met. More specifically, CII has supported a requirement that nominating shareowners or each member of nominating group may include securities that have been loaned to a third party, provided that the participant represents that it has the legal right to recall those securities for voting purposes and will vote the securities at the shareowner meeting, accompanied by a representation that the participant will hold those securities through the date of the annual meeting. The SEC found that share lending is a common practice, and that loaning securities to a third party is not inconsistent with a long-term investment in a company.
Must continue to hold required percentage of shares after annual meeting	CII has publicly opposed a requirement that a nominator provide a statement of its intent to continue to hold the required percentage of shares after the annual meeting.	CII believes that as a practical matter, nominating shareowners may not know their intent to hold, sell or buy shares until after the election. We believe that depending on the outcome of a particular election, the nominator may purchase more stock or sell stock. CII has publicly stated that a pre-filing holding period, coupled with a requirement to hold shares until the date of the meeting, should suffice to achieve the goal of limiting proxy access to longer-term shareowners. CII's position is generally consistent with the view of the SEC, which in 2010 decided not to require nominating shareowners to hold the required percentage of shares after the annual meeting. The SEC did require a statement with regard to a nominating shareowner's, or group member's, intended ownership of the securities after the election of directors (which could be contingent on the results of the election of directors).

Proxy Access Bylaw Provision	CII Public Position	Explanation/Basis
Restrictions on re-nominations when nominee fails to receive a specific percentage of votes	CII has publicly opposed restrictions on re-nominations when a nominee fails to receive a specific percentage of votes.	CII believes that since resubmission requirements aren't applicable to management's candidates, they shouldn't apply to candidates suggested by shareowners. CII's position is generally consistent with the view of the SEC, which in 2010 considered, but rejected, imposing such restrictions. The SEC did not believe it was necessary or appropriate to include a limitation on the use of proxy access by nominating shareowners or groups that have previously used proxy access. The SEC also found that such a limitation would not facilitate shareowners' traditional state law rights and would add unnecessary complexity.
Nominee can have no compensation arrangement with any party other than the corporation, including compensation arrangements regarding service as a nominee	CII policies oppose onerous requirements that limit the pool of eligible candidates based on a compensation arrangement with a party other than the corporation.	CII believes the core objective of establishing eligibility requirements for director nominations is to ensure an orderly nominating process. To the extent possible, companies should defer decisions about the suitability of candidates to shareowner votes. More specifically, we believe limiting the pool of eligible board candidates by excluding those who receive candidacy fees would be an unduly onerous requirement. We, however, would support requiring additional disclosure about compensation arrangements with parties other than the corporation.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: CSC

CII on Proxy Access

Posted by Elizabeth Ising, Gibson, Dunn & Crutcher LLP, on Monday, August 17, 2015

Editor's note: Elizabeth Ising is a partner and Co-Chair of the Securities Regulation and Corporate Governance practice group at Gibson, Dunn & Crutcher LLP. This post is based on a Gibson Dunn client alert by Ms. Ising, Lori Zyskowski, and Ronald O. Mueller.

[On August 5, 2015] the Council of Institutional Investors ("CII"), a nonprofit association of corporate, public and union employee benefit funds and endowments that seeks to promote effective corporate governance practices for U.S. companies and strong shareholder rights and protections, published a report titled "Proxy Access: Best Practices" that describes CII's views on seven provisions that companies typically address when implementing proxy access. The CII report is available here, and was discussed on the Forum here.

Background

Proxy access refers to the ability of shareholders to include their director nominees in company proxy materials. In 2010, the Securities and Exchange Commission adopted a universal proxy access rule (Rule 14a-11), which prescribed many of the provisions addressed today by CII. Rule 14a-11 was vacated in 2011 when the DC Circuit ruled that the SEC had violated the Administrative Procedure Act in adopting the rule by failing to adequately evaluate its economic effects. However, other rule amendments permitting proxy access shareholder proposals and allowing companies to implement proxy access mechanisms under state corporate law were not challenged and went into effect in 2011.

Over 100 companies received proxy access shareholder proposals for consideration at 2015 meetings, making proxy access the most significant corporate governance issue during the 2015 proxy season. Of the 84 proxy access shareholder proposals voted on thus far in 2015, 49 (58%) received majority votes. To date, 35 companies have adopted proxy access.[1]

CII's Views on Proxy Access

CII views proxy access as a fundamental right of long-term shareholders, and has for several years maintained a policy advocating that companies provide proxy access to a long-term investor or group of long-term investors who have owned at least three percent of a company's voting stock for at least two years, for nominees representing a minority of a company's board. Today's report reflects CII's view that the proxy access provisions being adopted or proposed by

[1] This represents companies that have announced that they have adopted proxy access since Rule 14a-11 was adopted in 2010, but excludes companies that subsequently were acquired.

some companies "significantly impair shareowners' ability to use proxy access, or even render access unworkable" and sets forth the seven "most troublesome provisions that are of concern to CII and many of [its] members." CII's interim executive director was quoted in *The Wall Street Journal* as stating that as of late June, all of the companies that had adopted proxy access failed to comply with at least one of CII's seven "best practices." The seven "troublesome provisions" are described below, along with CII's position on what constitutes "best practices," the treatment of the issue under Rule 14a-11 and data on prevailing practices among companies that have adopted proxy access.

1. **Ownership requirement of 5% of outstanding shares:** CII supports a 3% share ownership threshold in order for proxy access to be available to one or a group of shareholders, which is the same threshold that was included in Rule 14a-11. Of the 35 companies that have adopted proxy access, 71% use a 3% threshold and 29% use a 5% threshold.
2. **Minimum of two proxy access candidates:** CII supports allowing at least two proxy access nominees. Rule 14a-11 provided that a company was required to include in its proxy materials no more than one proxy access nominee or a number of proxy access nominees representing 25% of the company's board, whichever was greater. Of the 35 adopting companies, only 14% provide for a minimum number of access nominees. All of these companies provide for a minimum of one access nominee, not two.
3. **Limits on the number of shareholders that can aggregate their shares to satisfy the ownership requirement (e.g., 20 shareholders):** CII does not endorse limits or caps on the number of shareholders in the nominating group. Rule 14a-11 did not include any aggregation limits. Of the 35 companies that have adopted proxy access, more than 85% have included a limit on the number of shareholders who can aggregate their ownership to utilize proxy access: 9% allow only one shareholder per group, 3% allow groups of up to five shareholders, 17% allow groups of up to 10 shareholders, 3% allow groups of up to 15 shareholders, and 54% allow groups of up to 20 shareholders. Only 14% of adopting companies allow unlimited group sizes.
4. **Counting loaned shares toward the ownership requirement:** CII supports counting loaned shares toward satisfying the ownership requirement and also requiring that the shareholder represent that it (1) has the legal right to recall those shares for voting purposes, (2) will vote the shares at the annual meeting, and (3) will hold the shares through the date of the annual meeting. Rule 14a-11 provided that loaned shares counted as long as the nominating shareholder had the right to recall the shares and did so upon being notified that any of its nominees were to be included in the company's proxy materials. Among the adopting companies, only 29% explicitly state that loaned shares count toward the ownership threshold, provided that the shareholder has the right to recall the shares. Eighty percent of these companies do not require that the shares actually be recalled, 10% require that they be recalled as of the date of the annual meeting, and 10% require that they be recalled as of the date of the shareholder notice and through the annual meeting.
5. **Requiring the nominating shareholder to continue to hold company shares after the annual meeting:** CII opposes requiring the nominating shareholder to state that it intends to continue to hold the requisite percent of the company's shares after the annual meeting. Rule 14a-11 required the nominating shareholder to state whether it intended to hold the shares after the annual meeting. Of the 35 adopting companies, 31% require the nominating shareholder to affirmatively state that it intends to hold shares for at least one year following the annual meeting. Another 66% require that the nominating shareholder

hold the shares only through the date of the annual meeting, although many of these companies require the nominating shareholder to state whether or not it intends to hold the shares for another year. Only 3% of adopting companies are silent on this issue.

6. **Restricting renominations of failed proxy access nominees:** CII opposes restricting the renomination of a proxy access nominee who fails to receive a specific minimum percentage of votes. This is consistent with Rule 14a-11, which did not include renomination restrictions due to a nominee's failure to receive a certain percentage of the vote. Of the 35 adopting companies, 97% have such a restriction: 89% prohibit the renomination of nominees who fail to receive at least 25% of the vote, 6% of the companies have lower renomination restrictions and 3% have a higher voting requirement in order for an unsuccessful access nominee to be renominated.
7. **Prohibiting compensatory arrangements between proxy access nominees and third parties:** CII opposes prohibiting proxy access nominees from having compensatory arrangements with anyone other than the company but supports requiring disclosure of such arrangements. Rule 14a-11 required disclosure of, but did not prohibit, such arrangements. Of the 35 adopting companies, 6% prohibit such compensatory arrangements, 71% require disclosure of such arrangements, 9% do not require disclosure but give the board discretion to exclude nominations of nominees with such arrangements, and 14% are silent.

In its report, CII urges companies that decide to adopt proxy access to talk to their shareholders about the approach they prefer and to avoid requirements that make access "difficult to use or toothless." The report highlights both the complexity of a proxy access mechanism and the fact that investors' views on how and when proxy access should be available (if at all) continue to evolve.