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A Proxy Season Guide to 2018

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With a new proxy season fast approaching, it's time for public companies to do a deep download of key securities law updates and business developments of the past year so the company is positioned for success in 2018. Below is a review of the 2017 proxy season, along with a summary of new and anticipated changes that may impact reporting and disclosure requirements for the upcoming 2018 proxy season.

2017 IN REVIEW

During the 2017 proxy season, proxy access, a predominant topic over the past few years, officially became a standard practice across large companies, with over 60% of the S&P 500 adopting access bylaws, up from the less than 1% in 2014. The SEC's 2010 proxy access rule, Rule 14a-11, provided a shareholder was eligible to nominate proxy access candidates if the shareholder held at least 3% of the voting power for at least three years and was not prohibited from proposing a candidate under law or the company's governing documents. Although this rule has not been in effect since 2011, submitted shareholder proposals have been based both on Rule 14a-11 and the SEC's amendments to Rule 14a-8. While the widespread season change to proxy access bylaws has been driven largely by "please adopt" shareholder proposals, this year a majority of companies faced with a proposal adopted proxy access bylaws voluntarily, which is a stark change from the last decade's unsupportive sentiments. The less popular "fix-it" proposals, where shareholders request alterations to an existing bylaw, remain unsuccessful.

Overall shareholder support for "say-on-pay" and "say-when-on-pay" remained high at 91%. However, when it came to shareholder say-on-pay, approximately 7% of companies did not satisfy the 70% shareholder support threshold this season. When looking at the shareholders' say-when-on-pay though, about 88% of companies received majority support for annual votes, over 11% supported the vote occurring every three years, and less than 1% for every two years.

The 2017 proxy season was also characterized by a continued rise in governance activism, with a focused attention on environmental, social and governance (ESG) issues. Trending ESG topics were climate change, certain sustainability incentives and reports, board diversity, gender pay equity, and environmental and social issue board qualifications. Many institutional investors believe how a company navigates environmental risks and opportunities is an indicator of a company's long-term value so it should come as no surprise that shareholder proposals requesting companies report on how they are assessing that risk has climbed over 26%. Three proposals even secured majority support for the first time, marking a historic shift in investor attitudes. Aside from climate change concerns, gender pay equity and board diversity, particularly asking boards to report on and increase their diversity, also emerged as key themes.

The content of shareholder proposals was not the only topic of conversation this past season. Processes and procedures of shareholder proposals were also discussed. Under the most scrutiny were virtual-only shareholder meetings and multi-class share structures with unequal voting rights. Unequal voting structures are under fire because many investors have long held that one share should equal one vote, believing voting power in the hands of company insiders can lower board accountability, thereby increasing governance-related risks. Though virtual-only meetings have not yet become the new normal, they are still rising in popularity among public companies, and investors are similarly concerned with accountability and the opportunity to be heard. Part of what worries investors is the lack of choice to attend a shareholder meeting in person—it is almost viewed as a fundamental right for investors to be able to confront the board face-to-face.

While shareholder activism continued to receive a great deal of attention last season, proposals and proxy contests decreased compared to the same period last year. Moreover, the average length of campaigns decreased dramatically, demonstrating that boards are increasingly negotiating with investor activists and settling faster in order to avoid a shareholder vote.

In regulatory news, newly confirmed SEC Chairman Jay Clayton revealed a few of the principles that will guide his term, citing the need for the SEC to evolve with markets, promote capital formation and be conscious of the additional burdens that regulatory change creates. Several unfinished items from Dodd-Frank are no longer being prioritized, including: pay-for-performance disclosures, clawbacks, universal proxy ballots and enhanced board diversity disclosure rules.

The 2017 proxy season was marked by a series of historic firsts, including the launch of the Framework for U.S. Stewardship and Governance, a set of stewardship principles for institutional investors, but it was also marked with regulatory and legislative uncertainty, most notably, shareholders' ability to submit proxy access proposals. Despite this uncertainty, investors are steadfast in their commitment to higher levels of accountability, transparency and engagement, which will likely continue into the 2018 proxy season.

The comment periods have expired for proposed changes in municipal securities disclosure, Inline XBRL filing of tagged data, Investment Advisers Act of 1940 rules to reflect changes made by the Fixing America's Surface Transportation Act of 2015 (the FAST Act), covered securities pursuant to Section 18 of the Securities Act of 1933, and the FAST Act modernization and simplification of Regulation S-K. Note, however, these changes, except for the designation of certain securities as covered securities for purposes of Section 18(b) of the Securities Act, have not been finalized. At this time, there is no anticipated date for implementation of these proposed changes, meaning there will be no effect on 2018 filings.

NEW FOR 2018

Division of Corporation Finance Issues Shareholder Proposals Guidance

The SEC's Division of Corporation Finance published guidance on November 1, 2017, providing information and its views on shareholder proposals. The Staff Legal Bulletin No 14I (SLB 14I) covered in turn: (1) the "ordinary business" exception, (2) the "economic relevance" exception, (3) proposals submitted by proxy, and (4) the use of images in shareholder proposals. Under Rule 14a-8(i)(7) and Rule 14a-8(i)(5), the division would expect a company's no-action request to include a discussion that reflects that board's analysis of the particular policy issue raised and its significance. However, the division will now apply these analytical frameworks separately. In its SLB 14I, the division also reaffirmed their viewpoint and provided detailed guidance as to proposal proxy and images. Going forward, companies should review SLB 14I and use it as a reference when undertaking an analysis for exclusion of a shareholder proposal.

SEC Adopts T+2 Settlement Cycle for Securities Transactions

Effective September 5, 2017, the SEC now requires companies to settle securities transactions within two business days of the transaction date, rather than three. This is often referred to as "T+2." This rule amendment was adopted by the SEC on March 22, 2017, to minimize risk by reducing the total number of outstanding unsettled trades and to promote industry innovation. The final rule amendment essentially prohibits broker-dealers from executing a contract for the purchase or sale of a security (other than certain exemptions) that contracts for payment and delivery later than the second business day after the date of execution. Companies should note this change for 2018 and anticipate the SEC may still further reduce the settlement cycle in the near future.

Relaxed Disclosure Requirements for Emerging Companies and non-EGCs

The SEC Chairman Clayton clearly wants to increase the number of companies seeking public funding, and in response the SEC is starting to take action with new guidance regarding EGCs and non-EGCs. On August 17, 2017, the SEC clarified its position and prior guidance regarding what financial information both EGCs and non-EGCs can omit from their draft registration statements submitted confidentially. The clarification came from a range of sources, including (1) an update to the Division of Corporation Finance's June policy announcement, (2) a revision of the SEC's FAST Act FAQ (published Dec. 2015) and a new compliance and disclosure interpretation (C&DI), and (3) a new C&DI of the FAST Act EGC accommodation to a broader issuer group. EGCs and non-EGCs alike should carefully review these SEC guidance documents before submitting their draft registration statements.

Approaching CEO Pay Ratio Rule Disclosure Requirements

The “pay ratio” rules became effective for fiscal years beginning on or after January 1, 2017, and absent repeal by Congress by means of the Financial Choice Act currently being considered by the Senate, or a delay by the SEC, most public companies will need to comply with these long anticipated rules implementing Section 953(b) of the Dodd-Frank Act beginning with the 2018 proxy season. The final pay ratio rule requires public companies to disclose the pay ratio between their CEO’s annual total compensation and the annual total compensation of the companies’ median employee. Smaller reporting companies, EGCs, foreign private issuers, and registered investment companies are not required to comply with this rule. The pay ratio disclosure must be included in any filing that requires executive compensation disclosure under Item 402 of Regulation S-K, which include registration statements, proxy and information statements, and annual reports on Form 10-K.

There are various issues and considerations associated with complying with the CEO pay ratio disclosure rule requirements and companies must be diligent in preparation for their proxy, but the SEC has issued some interpretation and guidance. The most recent guidance on Item 402(u) is an interpretive release titled “Commission Guidance on Pay Ratio Disclosure”, a SEC statement “Division of Corporation Finance Guidance on Calculation of Pay Ratio Disclosure”, and revised Regulation S-K C&DI. The Commission’s Guidance on Pay Ratio Disclosure acknowledged companies should approach their disclosures in a way that allows shareholders to better understand and assess the company’s compensation practices, and that cannot be but with a tailored approach addressing companies’ specific facts and circumstances. The revised Regulation S-K C&DI largely eliminated the need to consider the issue of pay for independent contractors, broadened the standard to calculate reliable compensation measures, and gave permission for companies to disclose that their pay ratio calculation is an estimate. Together, the C&DI, alongside the Division of Corporation Finance, provides assurance that the pay ratio rule requires disclosures on a practical, good faith, but “reasonable” basis, and that the rule is not an empty excuse for enforcement action.

Although statements by members of the Trump administration have indicated the pay ratio disclosure rules are a target for repeal, and despite legislative efforts to repeal portions of the Dodd-Frank Act and former Acting SEC Chairman Piwowar’s February 2017 effort to solicit comment on implementation of the rule, affected companies should continue to anticipate and prepare for disclosure in their spring 2018 proxy statements. In preparation for this disclosure, companies must assemble the appropriate internal teams and external advisers and consider the implications of methodology on the required pay ratio disclosure, along with the potential for negative reactions from the company’s shareholders.

PROXY ADVISORY FIRM UPDATES

ISS Updates

Institutional Shareholder Services (ISS) updated its Proxy Voting Guidelines Updates for 2018, which include several changes and modifications, a summary of which is outlined below.

Director Election on Non-Employee Director Compensation: ISS introduced a change to its policy that will explicitly provide for adverse vote recommendations on the re-election of board members responsible for approving/settling non-executive director (NED) compensation when there is a recurring pattern—such as two or more consecutive years—of excessive NED pay. Due to the recurring pattern requirement, the update will not impact 2018 vote recommendations.

Director Election on Shareholder Rights Plans (aka “Poison Pills”): For the 2018 year, ISS simplified its policy on companies with poison pills. If a company has a poison pill that was not approved by shareholders, then ISS will vote against or withhold its vote from all nominees. If, however, the board adopts an initial pill with a term of one year or less, depending on the rationale and certain of other factors, ISS will adopt a case-by-case approach on the nominees.

Gender Pay Gap Shareholder Proposals: ISS is also adopting a new case-by-case policy to address shareholder proposals seeking disclosures related to a company’s gender pay gap by considering the company’s current policies and disclosures, whether the company has been subject to recent case or controversy, and whether its reporting is behind its peer group. This new approach to gender pay gap shareholder proposals provides more clarity as we move into 2018.

Climate Change Risk Shareholder Proposals: In an effort to better align with The Task Force on Climate-Related Financial Disclosures, ISS updated its climate change risk policy to clearly seek transparency around the board and management’s role in identifying, measuring and managing financial, physical or regulatory risks and opportunities in addition to the disclosure of such. Although there is no real effect in the coming year, it is likely a precursor for future movements.

Pay for Performance Quantitative Methodology: ISS’ pay-for-performance methodology will be modified to add a new test to its quantitative pay for performance screenings by better examining the alignment of pay and financial performance. The methodology for 2018 will include the rankings of CEO total pay and company financial performance within a peer group, each then measured over a three-year period. Though not a surprise, this test creates metrics for concern.

Director Independence Classification: The now standing three categories of (1) Inside Director, (2) Affiliated Director, and (3) Independent Outside Director will be changed respectively to Executive Director, Non-Independent Non-Executive Director, and Independent Director. Due to this change there are select directors who will now be considered insiders due to their controlling interests and thus moved to the Non-Independent Non-Executive Director category.

In its publication, ISS also (i) highlighted boards with no gender diversity, albeit without adverse recommendation; (ii) exempted new, part-time directors with poor attendance from negative recommendations; and (iii) codified certain policies' already existing approaches.

A copy of the full ISS 2018 Proxy Voting Guidelines Updates is available here.

Glass Lewis Updates

Glass, Lewis & Co. (Glass Lewis) also recently published its 2018 Proxy Paper Guidelines, which include several changes and modifications, a summary of which is outlined below.

Board Gender Diversity: Glass Lewis added to the discussion about what is considered to be gender diversity on boards of directors, but there will be no changes to proxy voting in 2018. However, beginning with the 2019 proxy season Glass Lewis will recommend shareholders vote against the chair of the nominating committee, and possibly other nominating members, for companies that have no female directors—excepting a sufficient rationale.

Dual-Class Share Structures: The firm also discussed how Glass Lewis considers dual-class share structures, such as disproportionate voting and economic rights, when analyzing a company's governance, reaffirming their position that these dual-class share structures are traditionally not in the best interests of common shareholders. In furtherance of their long-standing belief, Glass Lewis introduced a number of new protective-of-shareholders policies. Recently IPO'd or spun-off companies in particular should review these new policies.

Board Responsiveness: In support of its long-advocated standards, Glass Lewis has clarified its position on the responsibility of the board to respond to situations where shareholders vote contrary to management's recommendations. The firm clarified its position by stating it considers the board to generally have an imperative to respond to shareholder dissent from a proposal at an annual meeting of more than 20% of votes cast, with special attention to cases of compensation or director election proposals.

Virtual Shareholder Meetings: The firm voiced its awareness of the relatively small but growing contingent of companies electing to hold shareholder meetings by virtual means only and its belief that technology can be useful to expand participation but that it can also be a hindrance. There is nothing to worry about for 2018, but in looking toward the 2019 season Glass Lewis will generally recommend withholding votes from members of the governance committee when there will be virtual-only shareholder meetings and no proxy pledge of equal voting rights.

In its update, Glass Lewis also made minor clarifications to the director overboarding policies, pay for performance mechanics and CEO Pay Ratio disclosure.

A copy of the full Glass Lewis 2018 Proxy Paper Guidelines is available here.

OTHER SECURITIES LAW DEVELOPMENTS

Hyperlinking of Exhibits

The SEC adopted rules which now require public companies to use hyperlinks to exhibits listed in their exhibit index of any registration statement or report filed with the SEC. The rules are slightly different for non-accelerated filers and smaller reporting companies, but all companies should prepare to include hyperlinks, along with certain other formatting and submission changes, in their future 2018 SEC filings.

Accounting and Auditors

Areas of change in the accounting and auditing realm involve Inline XBRL, the Public Company Accounting Oversight Board (PCAOB), and revenue recognition and lease accounting. To tack onto the other formatting changes the SEC has also proposed new rules to allow a company's financial statements to be provided in the

Inline XBRL format for ease of access. The PCAOB's new reporting standards require a description of critical accounting matters or a lack thereof revealed during the audit and the auditor's response. Finally, in respect to revenue recognition and lease accounting, companies are now required to provide transition disclosures of the impact that accounting standards, when adopted, will have on their financial statements. Application of the aforementioned revenue standards applies to fiscal years that begin after December 15, 2018. Companies should monitor the proposed Inline XBRL rules and continue to implement and reevaluate its internal controls over financial reporting pursuant to Rule 13a-15 to mitigate risk.

Conflict Minerals and Resource Extraction Rules

Affecting companies doing business in the oil, natural gas and mineral extraction industries, the Congressional Review Act (Feb. 2017) eradicated the requirement that those companies have to disclose payments they make to governments. Going forward, oil, natural gas and mineral extraction companies no longer have to disclose these payments. More specific to companies reporting about conflict minerals in their products, the SEC issued no-action guidance relative to Item 1.01(c) of Form SD. Many companies have continued to respond to Item 1.01(c) but a response is no longer necessary in light of the SEC's newly issued guidance.

NYSE Dividend Notification Requirements

The SEC approved NYSE Arca Rule 5.3(i)(1)(i)(H), requiring all issuers to provide the NYSE with at least 10 minutes notice before the company announces any dividend or stock distribution or the fixing of a record date thereof, even if the announcement is made outside of trading hours. The NYSE adopted these amendments on August 14, 2017 and they will likely become effective and fully implemented by February 1, 2018.

TAKEAWAYS

The past calendar year was an undoubtedly historic year—across the board and affecting boards. In review, the 2017 proxy season was a time of change. Through the key securities law updates and business developments, the theme for 2017 was that of reciprocal activism and engagement. Activism on ESG issues gained momentum and was met with increased cooperation, and at times a shared sense of commitment. Engagement with shareholders, investors and constituents is no longer seasonal; in today's reality it is a year-round process. Money is progressively being put where shareholders' mouths are, and though the result is forthcoming it is predictably clear that this energy will continue into the 2018 proxy season.

Following the year of the *Fearless Girl* statue there are fewer new rules to deal with in 2018, but change seems to be accelerating, in part because of the efforts of shareholders and investors to fill in what they perceive as a regulatory void. That is where the focus of the SEC and activists diverge. The SEC's focus tends to be on GAAP and non-GAAP, traditional securities violations, whistleblower protections and on individuals; whereas activist investors' focus tends to follow the trends, all the while advocating for transparency. Because investor landscape impacts trends, and vice versa, the number of climate change, political contributions and lobbyist proposals is expected to surge. To prepare for the 2018 proxy season, companies should review the new rules and trends and take inventory of their base, policies and procedures. Preparing for this season is as much about hedging risk as it is about strategically planning for the future. As we move forward into 2018, remember while communication, cooperation and collaboration are commendable, to be wary about being voluntary by artfully balancing the risks with opportunity.