2014 Proxy Season: Early Indications

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It is still early days, but here is what we are seeing as the 2014 proxy season unfolds:

Institutional investors promote governance reforms and engagement efforts. Prior to the season Vanguard sent letters to S&P 500 companies seeking adoption of annual director elections, majority voting and the right of holders of 25% of the common stock to call special meetings. It was an unusually public move for a large institutional investor that, like others of its kind, tends to engage in quiet diplomacy. Also unusual was the call for universal adoption of this set of governance practices, in contrast to the case-by-case approach traditionally taken by institutional investors. It may signal that, at least on the governance side of these institutions, these practices are now viewed more as accepted norms than as just best practices. But there remains a disconnect between the governance and investment sides, as we continue to see institutional investors participate in IPOs for companies with none of these provisions.

This season we've also seen institutional investors promote various protocols for shareholder engagement. The frameworks all promote the concept but differ in the amount of involvement expected of directors and whether companies should try to talk to all investors about all issues. Our sense is that for the most part companies are increasingly open to shareholder engagement but that they are not rushing to embrace any of these particular frameworks, particularly those that present direct shareholder engagement with independent directors as a governance norm.

Different forms of activism start to converge. Activism takes many forms, ranging from full-scale board contests to less fundamental efforts, such as shareholder proposals, withhold campaigns against particular directors, and campaigns focused on executive compensation or other company-specific issues. Hedge fund activists are increasingly borrowing the playbooks of the traditional governance activists, as we've seen more 14a-8 shareholder proposals seeking share repurchases or corporate divestures. There is also rampant speculation that the large institutional investors are supporting these hedge funds behind the scenes, sometimes feeding them ideas. The intensity of hedge fund focus on corporate cash hoards led the CEO of BlackRock to fire off ***letters*** last month warning about the potential short-sightedness of returning cash to shareholders at the expense of long-term investments.

Negotiating with activist shareholders. The trend toward settling with activist shareholders has continued and perhaps accelerated. This trend reflects not just a desire on both sides to save time and money, but also the power of information: now that we are several years along in the activist boom, companies and activists have a greater ability to predict the outcome of a potential contest and to assess their leverage accordingly. A few examples:

- Carl Icahn agreed to withdraw his proposal for eBay to divest PayPal in exchange for a single independent director suggested by Icahn.
- Apple agreed to stronger language in its ***nominating committee charter*** with respect to board diversity.
- Disney obtained withdrawal of a proxy access proposal in exchange for amending its corporate governance guidelines to include a ***carefully hedged statement*** that in the future the chairman would "in the normal course" be independent unless the board determines otherwise.
- Exxon will make available information on climate change issues.

Board tenure is starting to draw attention. Board tenure may be the next frontier in the efforts of governance advocates to influence board composition. The average tenure for directors at S&P 1500

companies is approximately 10.8 years. Depending on your point of view this is either, as they say in Silicon Valley, a bug or a feature. One view is that it can take several years for a new director to come fully up the curve, and that longer-serving directors are often best positioned to effectively challenge management. It is perhaps for this reason that so few companies have term limits for directors. The contrasting view suggests that long-tenured directors may cease to be independent. ISS is examining whether to take a policy position on the issue. Currently the debate centers on whether, to encourage fresh blood, investors should target particular long-serving directors or instead examine the average tenure of the board. What constitutes a long tenure? The focus of the discussion is on directors who have served for ten or more consecutive years.

Say-on-pay trends. Few companies fail their say-on-pay votes, and fewer still have failed more than once. But companies cannot relax their diligence on say-on-pay, because changing compensation and financial performance mean that one year's result is no guarantee of the next. Many investors continue to rely on the proxy advisory firms for their analysis, and even the larger institutions, with their own staffs and policies, will often at least consider advisor recommendations. Portfolio managers' influence on voting decisions varies by firms, so some companies with great IR relationships may still face negative votes. Most companies have become sufficiently knowledgeable to be able to navigate the obvious landmines, and in light of the robust shareholder returns in 2013 we are not likely to see widespread say-on-pay issues this year.

But note that even if shareholders are less concerned this year, ISS still grades on a curve: every year, it seems, you can expect that it will issue negative recommendations on about 14% of companies. The specific issues are largely unchanged from prior years: issues related to the type of awards and whether they are adequately performance-driven, selection of peer groups, transparency as to targets and goals, and compensation practices deemed to be "poor."

Note also that this year companies that adopted a triennial vote will be holding their vote for the first time since the advent of mandatory say-on-pay. Those companies sometimes have different compensation profiles and shareholder demographics as compared to companies with annual say-on-pay. "

SEC agenda on governance matters grows. While we continue to wait for the SEC to adopt the pay ratio rules and to propose the three other executive compensation related rules mandated by Dodd-Frank, a variety of other governance-related matters are at least nominally on the agenda. A sample:

- The SEC held roundtables on proxy advisory firm influence, and Chair White has confirmed that the staff has prepared recommendations for possible SEC actions to address concerns regarding transparency and conflicts.
- The Council of Institutional Investors appealed to the SEC to take up the question of using universal ballots in proxy contests, which the M&A office in the Division of Corporation Finance has publicly declared to be an interesting idea. CII is also advocating for changes toward distribution of preliminary vote tallies in non-contested meetings, including the possibility of public disclosure of those initial results.
- The rulemaking petition toward speedier 13D disclosure, an initiative that companies have generally favored, has gained momentum.
- The SEC ***roundtable on cybersecurity*** last month included a discussion about boards' responsibilities in assessing cybersecurity risks.

We can only safely predict that the SEC will issue the rules required by Dodd-Frank, that the usual business groups will challenge them, and that the DC Circuit, which last week used a ***surprising theory*** to invalidate a portion of the conflict minerals rules, will once again get to decide the fate of an SEC rule package. Stay tuned.

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