Proxy Season Review & Outlook

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Agenda

- Shareholder Engagement Trends
- Director Election and Succession
- Environmental and Social Issues
- Key Shareholder Proposals in 2014
- SEC Developments
- Proxy/Compensation Litigation
- Executive Compensation
- Takeaway Advice

Shareholder Engagement Trends

- All-time high for company-shareholder engagement (according to IRRC-ISS Study)
  - More firmly rooted, with more engagements and more reported degrees of success, although companies more often felt engagement was successful
  - Corporate directors more likely to participate
  - Both sides devoting more resources to efforts
  - Getting more comfortable with engagement on more topics
    - Sustainability
    - Environmental and social issues
    - Risk factors including director and management succession and industry-specific risks
    - Company-specific issues
  - Governance and compensation still most common engagement topics
  - More emphasis on outreach to retail shareholders

Shareholder Engagement Trends

- Institutions using letters to push for governance reforms and engagement
  - **Vanguard:** "quiet diplomacy" letters to S&P 500 companies seeking annual director elections, majority voting and right to call special meetings at 25%
  - **State Street:** letters to companies regarding new policy on board refreshment and director succession practices
    - New director tenure policy screens using 3 criteria: market average, board average, and whether board classified
    - 1/3 of board should be new-tenured, 1/3 mid-tenured and 1/3 long-tenured
    - Could lead to voting against long-tenured directors that serve on key committees and/or chair of nominating and governance committee AND long-tenured directors serving on classified boards
  - **BlackRock:** letters to S&P 500 executives warning against the perils of short-term thinking
    - Relying too much on dividends and buybacks
    - Mixed responses from CEO's
  - **CalSTRS / CalPERS:** letters to 131 California companies without any female directors

Shareholder Engagement Trends

- Shareholder-Director Exchange (SDX)
  - Letters sent to Russell 1,000 companies requesting they consider adopting formal policies in connection with shareholder-director engagement
  - Eight institutional investors signed the letter, including Blackrock, Vanguard, CalSTRS and Hermes
  - 10-point protocol: Scope, clear policy, identify topics, request engagement, select participants, determine engagement method, preparation, participation, annual review of the process, customization and modification
- Significant number of early settlements of shareholder proposals this season
  - Diversity, proxy access, reduction of carbon emissions, independent chair, reports on climate change, majority voting for directors
- Increase in hedge fund activism through 14a-8 and floor proposals seeking share repurchases and divestitures (e.g., Icahn push for eBay to carve-out IPO of Paypal)
  - Institutional work behind the scenes with activist hedge funds to target underperforming companies
  - R.F.A. (request for activist): institutions that approach activists
- "Vote No" campaigns – more this year on say-on-pay, with filed solicitation materials

Shareholder Engagement Trends

CTW (Change-to-Win) continues to target companies with performance and pay issues

- CTW typically files and mails a "Vote No" letter to target company shareholders, using a share range of 40,000 shares and above, coordinated through Broadridge
- CTW will issue a press release promptly after advisory firm reports are issued if their recommendations are consistent with CTW's
- Domino's Pizza: **Vote No** Campaign on Say-on-Pay and Compensation Committee Chair (Andrew Balson)
  - ISS recommended Against Balson and For Say-on-Pay
  - Glass Lewis recommended Against Balson and Against Say-on-Pay
  - Results: 70% support For Balson, 76% support For Say-on-Pay
- Chipotle Mexican Grill: **Vote No** Campaign on Say-on-Pay
  - ISS and Glass Lewis recommended Against Say-on-Pay
  - Result: only 23% For Say-on-Pay

Shareholder Engagement Trends

- *McDonald's*: **Vote No** Campaign on Say-on-Pay
  - ISS and Glass Lewis recommended For Say-on-Pay
  - Result: 93% support For Say-on-Pay
- *Duke Energy*: CalPERS and NY Comptroller **Vote No** campaign against 4 members of Regulatory Policy and Operations Committee in connection with coal ash spill
  - ISS recommended For all directors
  - Glass Lewis recommended withhold on director Carlos Saladrigas – longest serving member of regulatory policy and operation committee
  - Duke, CalPERS and NYC Comptroller's office participated in Glass Lewis Proxy Talk
  - Result: 85% support For director Saladrigas. The three other targeted directors averaged 94% support

Shareholder Engagement Trends

- More engagement with proxy advisory firms
  - Increased requests for engagement due to SOP
  - Inquiries on specific policies or particular issues
  - Vote-no campaigns
  - Shareholder proposals
  - M&A
  - Fights
- ISS now speaks to majority of S&P 500, and a fair number of Russell 3000
  - Interaction ranges from short call to meeting with management to meeting with independent directors
  - Calls can be just as good as meetings and email reminders can be helpful at last minute if you think firms may miss something (but not walking through whole proxy statement)

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Shareholder Engagement Trends

- As with other engagements, have a detailed agenda with company participants so that proxy advisory firms know whom to bring on their end and can be prepared
  - If you have a deck, send enough in advance for firms to review, if possible
- Off-season engagement is best
- In-season engagement can rarely turn recommendations, but occasionally can if additional disclosure or change in practices to "cure" issue and if additional filing in time to alert clients five business days before the annual meeting (ISS)

Director Election and Succession

Director Tenure and Its Impact on Independence

- Average director tenure at S&P 1500 companies is 10.8 years, per ISS, which sees connection between longer average tenure and worse governance policies
    - o Per Spencer Stuart, it was 8.6 years for S&P 500 in 2013
- The maximum tenure is generally between 9 and 12 years
- Academic studies appear mixed with longer tenured directors more secure in challenging management and perhaps companies perform better versus causing governance problems at such companies
- On radar screen in CII policy (as consideration for director independence) and ISS QuickScore 2.0 (with penalty for 9 years as “excessive”) which could signal move into voting recommendations
- Some companies have started to include tenure charts in their proxy statements, given recent concerns expressed by investors, ISS QuickScore, CII and abroad

Director Qualifications

- Use your proxy statement disclosure (both bios and matrices), to tell your story

Director Election and Succession

Diversity – related to refreshment to make room for more women, with 30% Coalition joined by new UK 30% Club – though not collaborating, both call for 30% women on all boards by 2015

- More women in S&P 500 boards in 2013: 18% of all S&P 500 directors, per Spencer Stuart
- Fortune 500 companies with the highest representation of women board directors attained significantly higher financial performance, on average, than those with the lowest representation of women board directors (Catalyst study)

Dissident director bylaw amendment

- Prohibits any dissident nominees who received third party compensation from standing as candidates in proxy contests or from being seated as a director
- ISS and Glass Lewis responded by issuing withhold recommendations on nominating and governance committee members
- A number of companies have rescinded the bylaw

Declassification and Majority Voting – Increased attention to mid- and small-cap companies

Environmental and Social Issues

Calls for enhanced disclosure, monitoring and management of related risks

- **Ceres' Carbon Asset Risk Initiative** aimed at challenging 45 of the world's largest oil and gas companies to incorporate climate risk into business planning and begin transitioning to clean energy solutions
- **University Endowments' Divestments** – Stanford announced that their $19 billion endowment (4th largest) will no longer make direct investments in and will divest from coal mining companies (approximately 100 US public companies)
- **2014 CPA-Zicklin Index on political activities and lobbying** expanded its benchmarking from the top 200 to the top 300 of the S&P 500, with same indicators as in 2013
- **SASB (Sustainability Accounting Standards Board) –** promoting industry-specific reporting standards

Key Shareholder Proposals in 2014

- **Reports on Political Contributions and Lobbying Activities (89)** – 25% average support, with 1 passing this year and 2 companies in 2013. Largest number of proposals submitted.
- **Require Independent Board Chairman (62)** – 31.2% average support, with 4 passing this year and 6 companies in 2013.
- **Require Majority Voting in Director Elections (28)** – 58.5% average support, with 16 passing this year and 17 companies in 2013.
- **Provide Right to Act by Written Consent (28)** – 38.4% average support, with none passing this year and 3 companies in 2013.
- **Stock Retention / Holding Periods (28)** – 22.3% average support, with none passing this year and last.
- **No accelerated vesting of equity upon CIC (22)** – 36.1% average support, with 4 companies passing this year and none in 2013. Some trend toward adopting.

Number in parenthesis represents the number of proposals through September 2014 for Russell 3000 Companies

Key Shareholder Proposals in 2014

- **Declassify Board (16)** – 83.2% average support, with 14 passing this year and 30 companies passing in 2013. Shareholder Rights Project with Harvard's Lucian Bebchuck and various pension funds.
- **Report on Sustainability (16)** – 23.8% average support, with none passing this year and 1 company in 2013.
- **Adopt Proxy Access Right (14)** – 36.8% average support, with 5 passing this year and 4 companies in 2013.
  - Management adopted now at HP, Western Union, Verizon and Nabors – all with 3%/ three years, except Nabors with 5%/ three years trying to ward off 3% proposal.
  - REIT Kilroy Realty settled by agreeing to implement by-law amendment at their 2015 annual meeting.
- **Provide Right to Call Special Meetings (13)** – 41.6% average support, with 4 passing this year and 4 companies in 2013.
- **Reduce Supermajority Vote Requirement (12)** – 67.3% average support, with 8 passing this year and 16 companies passing in 2013.

Number in parenthesis represents the number of proposals through September 2014 for Russell 3000 Companies

Key Shareholder Proposals in 2014

- **Report on Climate Change (9)** – 22.1% average support, with none passing this year.
- **Provide for Confidentiality of Vote Tallies (5)** – 36.2% average support, with none passing for this new resolution
  - Apparently only one instance this season where interim vote tallies were released to proponent filing a non-exempt solicitation, after they requested and issuer agreed to provide them through Broadridge.
  - John Chevedden and Jim McRitchie targeted several companies.
- **Adopt Policy and Report on Board Diversity (3)** – 30.1% average support, with none passing this year and last.
  - Almost none go to vote, since most withdrawn by negotiating board diversity policy (CF Industries), including women and minorities in the pool of board nominees and reporting to shareholders on board diversity efforts (Jarden), and appointing women to board (Freeport-McMoran).

Number in parenthesis represents the number of proposals through September 2014 for Russell 3000 Companies

ISS Draft Policy Review - Independent Chair Shareholder Proposals

- **Currently:**
  - ISS' current policy is to recommend For independent chair shareholder proposals unless the company satisfies criteria that includes a lead independent director who satisfies specific duties and the company has sufficient TSR performance
  - In 2014, ISS recommended against approximately half of the shareholder proposals
- **Proposed:**
  - More holistic review will include new governance, board leadership and performance factors
  - These new factors would include the absence/presence of an executive chair, recent leadership transitions, director and CEO tenure and a longer TSR performance period (5 years)
  - ISS backtesting of proposed new policy yielded higher level of support of the shareholder proposals

Most Active Shareholder Proposal Sponsors

Indvidual/Organization	Number of Proposals	Most Common Proposals Submitted
Chevedden, J.	67	Independent Board Chair, Provide interim confidential vote tallies, One share-one vote, Action by written consent, Stock retention
Steiner, K.	21	Independent Board Chair, No accelerated vesting, Limit excessive directorships, Right to call special meeting, Stock retention
UBCJA (Carpenters and Joiners)	15	Political spending
McRitchie, J.	15	Simple majority voting, Independence Chair, Proxy Access, Written Consent, Right to call special meeting
New York City and State Pension Funds	18	Political contributions and Lobbying, Independent board chair, Amend EEO policy, Clawback policy on incentive compensation, Various environmental issues
Steiner, W.	10	Limit accelerated vesting, Written consent, Ability to call special meetings, Stock retention
AFL-CIO	8	Report on lobbying and political spending, Report on human rights, Stock retention, No accelerated vesting
Laborers	8	Independent board chair, Report on lobbying, No accelerated vesting
Longview	7	No accelerated vesting of equity awards upon CIC

S&P 1500, January through July, 2014

SEC Staff Legal Bulletin No. 20:

Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms

- Bulletin highlights corporate issuer concerns with the review and error correction process of advisory firm reports
- Obligation of investors to ensure responsible voting decisions are being made
- More onus on proxy advisory firms to disclose potential conflicts of interest
- Investment advisers required to determine capacity and competency of proxy advisory firms to adequately analyze proxy issues
- Ensure advisory firm recommendations based on materially accurate information
- Fiduciary duties of investment advisers do not require they vote every proxy; flexibility in determining how and when to exercise proxy voting authority

Other SEC Developments

- Unfinished Dodd-Frank rulemaking unlikely to affect 2014 proxy
  - Pay ratio rules were proposed in Sept. 2013
  - No proposals yet on clawbacks, hedging disclosure or pay-for-performance disclosure
- Ongoing disclosure effectiveness project
- Push for voluntary enhanced disclosure in audit committee reports
- January 2014 CDIs on unbundling (Rule 14a-4)
- “Broken Windows” approach to enforcement

Proxy/Compensation Litigation

- Excessive Compensation Claims
  - Claims that executive officer compensation is excessive are very hard for plaintiffs to win
    - Board's decision is generally protected by business judgment rule (i.e., court won't second guess an unconflicted board)
    - Waste claims require showing compensation is so one sided that <u>no</u> reasonable person would consider it to be appropriate
  - Plaintiffs have had more success in challenging director pay
    - Default review standards is "entire fairness" (rather than business judgment) given inherent self-interest of directors
    - Existence of meaningful plan limits on equity grants to directors makes it easier for company to win dismissal
    - Recent Claim: Espinoza V. Zuckerberg (absence of plan limits means Facebook directors could award themselves $145m a year)

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Proxy/Compensation Litigation

- Say-on-Pay Related Claims
  - Private litigation (mostly brought in 2011, after first Dodd-Frank SOP vote) has largely been unsuccessful
  - Plaintiffs alleged breach of fiduciary duties by directors at companies with failed SOP votes
    - Argued that failed vote established fiduciary lapse
  - Claims mostly dismissed
    - Failed SOP vote by itself does not create reasonable doubt that compensation decisions were protected by business judgment rule
    - Courts have acknowledged that Dodd-Frank did not alter directors' fiduciary duties
  - Some companies entered into settlement agreements
  - These types of claims are no longer common

Proxy/Compensation Litigation

- Disclosure Claims
  - Plaintiffs law firms have expanded their business model of disclosure suits around M&A transactions to attack routine matters at annual meetings
  - After initially focusing on SOP, focus is now on plan proposals (new plans and share increases under existing plans)
  - Shortly before meeting date, plaintiffs send letter demanding supplemental proxy information and threatening to seek to enjoin the meeting
    - Plaintiffs emboldened by some early settlements
    - Suits mostly unsuccessful when litigated, but while pending put company at risk of having to unwind stock grants
    - Primary targets most recently are smaller/newer companies
    - Long-term, plaintiffs appear to be banking on a continuously rising bar for what is considered adequate disclosure

Proxy/Compensation Litigation

- Plan Non-Compliance Claims
  - 2007: Stock option backdating cases
    - Courts focused on violations of shareholder-approved plan provisions requiring that exercise price not be less than 100% of fair market value on date of grant
  - 2012: Grants in excess of IRC §162(m) per participant limits
    - Companies often rescind (and regrant) excess awards and pay (or continue to fight about the need to pay) plaintiffs' counsel a fee
  - June 2014: Cheniere Energy postponed its annual meeting following complaint claiming 25 million shares (now worth $1B) have been improperly awarded because underlying plans did not receive proper shareholder approval due to error in treatment of abstentions

Executive Compensation

- Say-on-Pay Vote Results
    - o Statistics generally consistent with prior three years' votes
        - 2,356 votes (Russell 3000 thru July 2014)
        - 54 failed votes (2.4%) as of Sept. 30, 2014 (2013: 2.5%; 2012: 2.6%; 2011: 1.4%), 56 Russell 3,000 companies failed Say-on-Pay at this point last year
    - o Average vote: 91.7% support
    - o 74% with more than 90% support
    - o 92% with more than 70% support
    - o 6% with between 50% and 70% support – so called "Red Zone"
    - o 2% with less than 50% support- Failed
- But substantial changes in companies in failed category
    - o Of 33 companies with failed 2013 votes; average support increased by 37%
    - o Only 1.0% of companies have failed more than once; two companies have failed four times

Executive Compensation

- Most common contributing factors for failures:
  - Pay and performance relationship
  - Problematic pay practices (e.g., tax gross ups, repricing without shareholder approval)
  - Rigor of performance goals
  - Shareholder outreach disclosure
  - Non-Performance Based Equity
  - Special awards/Mega-grants
  - Benchmarking Practices

ISS Draft Policy Review – Equity Plan Methodology

- New Scorecard approach
- EPSC: Equity Plan Scorecard
- Three Categories of Factors:
  - o **Plan Cost (SVT)** – Based on the shareholder value transfer (SVT) concept, which measures the total dollar cost of a company's equity plans against a company-specific limit relative to industry and market cap peers. SVT itself is retained but is bifurcated into two separate measurements:
    - New shares + shares available for grant + outstanding awards (the current approach)
    - New shares + shares available for grant (new analysis)

    * *ISS proposes to eliminate the option overhang carve-out policy, which has seen limited practical application*
  - o **Plan Features** – several equity plan provisions are singled out:
    - Automatic single-trigger vesting
    - Discretionary vesting authority

    * *Minimum vesting periods for grants under the plan*

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ISS Draft Policy Review – Equity Plan Methodology

- Three Categories of Factors: (cont'd)
  - **Company grant practices** – Several areas will receive attention:
    - Three-year average burn rate relative to industry/market cap peers
    - Vesting provisions for the most recent CEO grants
    - Estimated duration of plan based on the size of the share request and prior share usage
    - Proportion of the CEO's equity grants that are subject to performance conditions
    - Presence of a clawback policy
    - Existence of post-vesting/exercise holding requirements.

    * *Burn-rate commitments, which in the past could be applied as a mitigating factor for cases of excessive share usage, will no longer be considered*

Takeaway Advice

- Early prep is key
  - Were results in-line with expectations?
  - Identify problematic issues
- Run N-PX vote research to see how your top mutual funds actually voted on the key proposals (N-PX data is available starting Aug. 31)
- As the end of the year approaches:
  - Update shareholder composition and institutional contact list
  - As results of modeling analyses (e.g., ISS PFP or Comp Consultant) become available, consider running early vote projections based on anticipated advisory firm recommendations and institutional shareholder reaction
  - As shareholder proposal deadlines approach, run vote projections on each to determine levels of anticipated support and plan of action

Takeaway Advice

- Always discuss and determine the scope and timing of each solicitation
  - How many institutions should be solicited in light of the proposals being presented and the anticipated challenges?
  - Who should participate in the process?
  - When should advisory firms be reached out to?
  - Should supplemental filings be used?
  - Should you reach out to retail shareholders?
- Ultimate goal: minimize the element of surprise, meet or exceed expectations and achieve favorable vote results

Questions?