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Preparing for the 2019 Proxy Season: Practical Guidance for Directors and Board Committees

Corporate governance circles are abuzz with discussions about board refreshment, sustainability proposals and the repercussions of the #MeToo movement, among other hot topics. For most companies, however, these topics do not warrant immediate reactions. This memorandum summarizes our recommendations and observations of emerging trends for the 2019 proxy season in response to the recent focus on these and other hot topics.

Nominating and Corporate Governance Committee Topics

- ***Board Refreshment Disclosures.*** Many companies have responded to the increased investor focus in recent years on board composition by including enhanced disclosure in their proxy statements about their board refreshment plans. Consistent with current practice, we expect these disclosures will continue to discuss the Nominating and Governance Committee's philosophy of board refreshment and general objectives, such as enhancing diversity. Companies that anticipate being subject to California's SB-826, which will require female representation on the boards of directors of publicly traded companies that identify as being headquartered in California by the end of calendar year 2019, should specifically consider how they comply or intend to become compliant with those requirements. Otherwise, unless the company is facing a shareholder activist or other specific investor criticism of the company's board composition, it likely is not necessary for the disclosure to provide details on the specific number of directors to be replaced in a specific timeframe.
- ***Board Self-Evaluations.*** Many boards now conduct an annual self-evaluation process. Some institutional investors have indicated that they expect boards will use an external consultant to conduct the evaluations at least once every few years. Although the manner in which the process is conducted may vary from company to company and year to year, it is important that any such process provides directors with an avenue to surface recommendations and concerns about the board's effectiveness. Increasingly, companies are disclosing information about their self-evaluation processes in their proxy statements and in discussions with investors.
- ***Mandatory Retirement Ages and Term Limits.*** Mandatory retirement ages and term limits have been raised as possible solutions to a lack of board diversity or excessive tenure, but in some cases strict quantitative requirements may actually be detrimental to the company. While some governance watchdogs argue that long-serving directors are *per se* not independent because of their long ties with management, this argument would only hold if the company's directors and managers have similarly

long tenures. Moreover, directors with long tenures can be an asset to the company and term limits may force the retirement of valuable directors. In its 2018 U.S. Proxy Voting Guidelines, ISS recommends that shareholders vote against proposals for mandatory retirement ages or term limits. For some companies, in lieu of imposing strict age- or tenure-based requirements, consistent attention to board refreshment and a thoughtful board self-evaluation process are sufficient to address tenure concerns.

- ***Director Compensation.*** In recent years, many companies have included a limit on non-employee director awards (typically structured as an annual cap) in stock incentive plans submitted for stockholder approval. This was in response to a line of Delaware Court of Chancery cases suggesting that if a company's shareholders approved a plan with "meaningful limits" on director awards, subsequent challenges to awards within those limits would be entitled to the more deferential business judgment rule rather than the entire fairness standard (which often survives a motion to dismiss). A December 2017 Delaware Supreme Court decision called into question whether these limits are adequate for business judgment protection. In the *Investors Bancorp* case, shareholders brought breach of fiduciary duty claims against the company's board in connection with the grant of equity awards to the ten non-employee directors with a purported grant date fair value of nearly $22 million under a stockholder-approved equity compensation plan with an aggregate limit on non-employee director grants equal to 30 percent of all option or restricted shares available for issuance under the plan. The non-employee director awards averaged $2,159,400, compared to prior year non-employee director compensation that ranged from $97,200 to $207,005 and an alleged peer average of $175,817. The Court of Chancery dismissed the case, but the Delaware Supreme Court reversed and remanded for an entire fairness review, holding that the stockholder ratification defense is unavailable where the plan "gives the directors *discretion to grant themselves awards within general parameters* and a stockholder properly alleges that the directors inequitably exercised that discretion" (emphasis added). The Court noted that the director compensation in *Investors Bancorp* was many times greater than historical annual compensation and compensation levels at the company's competitors. In response to this ruling, we expect to see an increasing trend of companies adopting plans with caps close to their current director compensation levels or plans with fixed compensation formulas, as *Investors Bancorp* reiterated that director awards made in accordance with shareholder-approved specific amounts or formulas will be protected. Whenever incentive plans are submitted for a shareholder vote, the proxy disclosure should contain sufficient detail to establish that the shareholder vote was obtained on a fully informed basis.
- ***Director Participation in Shareholder Engagement.*** It is becoming increasingly common for directors to participate in shareholder engagement meetings. In fact, some large institutional investors now report that directors attend as many as 40 percent of their engagement meetings. Shareholders are more likely to request that directors participate if they expect the meeting to cover governance or management compensation issues. Given this backdrop, companies should be proactive and identify which independent directors will act as spokespeople for the board if investors reasonably request director participation. For instance, where governance considerations are a concern for investors, companies could consider identifying the chairperson of the Corporate Governance and Nominating Committee to participate, while issues relating to executive compensation may be heard by directors on the Compensation Committee. Those directors could then participate in mock Q&A sessions with the CEO, CFO, and investor relations team to make sure they can accurately respond to a range of potential shareholder questions within the bounds of Regulation FD and in a manner that, to the extent appropriate, is consistent with the company's overall disclosure posture. Director participation should be seen as a supplement to—and not a substitute for—CEO and CFO participation.
- ***ESP Mandates.*** Some boards are amending their nominating and corporate governance committee charters to give that committee an expanded scope of responsibility over environmental, social, and political ("ESP") issues, such as sustainability. This appears to be a response to requests from investors for greater clarity concerning which committees have oversight of these issues, as well as some calls by institutional investors for companies to articulate their desired societal impact. In a January 2018 letter to CEOs, BlackRock's CEO said, "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society." Expanding the responsibilities of a committee in this manner is not strictly necessary; it is perfectly

appropriate at many companies for these issues to be in the purview of the full board. Any decision to make this change should take into consideration the existing workloads of the committee members and current committee meeting schedules and agendas, as well as perspectives on which directors may have relevant expertise in ESP-related issues.

Compensation Committee Topics

- ***Human Capital Management.*** Talent management and human capital management continue to be top areas of focus for investors and governance watchdogs. In a March 2018 statement, BlackRock stated that companies could suffer meaningful financial impacts by mismanaging human capital and identified human capital management as a priority in its engagement with companies for 2018, emphasizing that it "is both a board and a management issue." The statement also set forth certain topics on which Blackrock intends to engage with boards to encourage board accountability in overseeing the company's strategy "to create a healthy culture and prevent unwanted behaviors." These issues are not limited to compensation structure, but also touch on all matters that impact the talent pipeline and workplace culture, such as diversity and inclusion initiatives and the manner in which the company addresses workplace misconduct claims. Some companies have amended their compensation committee charters to provide that the compensation committee will have the authority to oversee these issues in the first instance. However, given their importance, these issues also merit periodic discussion by the full board (and, indeed, some companies' corporate governance guidelines require the full board to oversee these matters). In order to provide this oversight, many companies' boards now receive quarterly reports concerning reports made to their employee and compliance hotlines and require management to consult with the board prior to agreeing to any workplace misconduct settlement in excess of a specified dollar amount or involving senior executives. More specifically, the recent focus on the #MeToo movement has raised questions about the role of directors in providing oversight of management as it relates to workplace sexual misconduct allegations. Although it is generally not appropriate for the board to engage in day-to-day management of operational matters, including the management of employees, it is appropriate for directors to become more involved in situations where a senior executive is alleged to have committed misconduct or there appears to be a significant pattern of misconduct across a division or the whole company. As evidenced by recent corporate #MeToo incidents, allegations of sexual misconduct at public companies may not only have a material negative effect on share prices, but can also cause long-standing reputational harm for the companies and, potentially, their boards. Moreover, repeated allegations of sexual harassment at a company may expose the board to liability for allowing the misconduct to continue or for failing to respond to such allegations. We recommend that members of the board, or a designated committee, work with management to review periodically the company's code of conduct, particularly sections on sexual harassment policies and training procedures, as well as to ensure that the necessary reporting and enforcement mechanisms are in place. Although some companies have added explicit language on sexual harassment to employment agreements and equity plans, most employment agreements and equity plans already require compliance with the company's code of conduct, which generally prohibits such misconduct.
- ***Executive Compensation.*** We anticipate that companies will receive more shareholder proposals seeking reports or studies concerning the pros and cons of tying compensation metrics to qualitative factors. With the Tax Cuts and Jobs Act of 2017 amending Section 162(m) to remove a long-standing exemption under which certain performance-based compensation was not subject to the deduction limit, there is no longer a tax-related reason for compensation committees to tie compensation to objective criteria. However, because most compensation committees already retain discretion to consider qualitative factors in making compensation decisions (for example, through the exercise of negative discretion), it may not be necessary to establish explicit qualitative criteria. Moreover, ISS and Glass Lewis still favor metrics that are calculated using quantitative pay-for-performance methods. In any event, care should be taken to ensure that the compensation section of the company's proxy statement accurately describes both the quantitative metrics as well as any qualitative factors considered in determining employee compensation.

Trends in Proxy Statement and Website Disclosures

- ***ESP Information.*** In recent years, corporate governance advocates have increasingly sought expanded disclosure of companies' ESP information. The resulting lobbying and shareholder proposals cover a wide range of topics, including sustainability, climate change, water management, political and lobbying expenditures, the opioid crisis, and gun control. ESP proposals are expected to increase in frequency in the 2019 proxy season as ESP data become more relevant to investors in their evaluation of company strategies, risks, and opportunities. Passive fund managers and other investors include ESP data in their overall assessment of potential investments. Accordingly, companies should consider whether to update any of their website or SEC disclosures to address ESP information more directly. Among other things, additional disclosures may help companies secure better scores on their ISS E&S scorecards.
- ***CEO Pay Ratio and Gender Pay Ratios.*** Mandatory CEO pay ratio disclosure debuted during the 2018 proxy season under SEC rules, and companies are already planning for its inclusion in the 2019 proxy season. Although SEC rules permit companies to supplement the required disclosure with additional ratios, most companies have opted to provide only the mandated pay ratio in their 2018 proxy statements, and we expect this trend will continue into 2019. In addition, the U.K. gender pay gap reporting regulations (part of the Equality Act 2010) came into effect in April 2018, requiring companies in Great Britain with over 250 employees to comply with reporting obligations and publish data on the gender pay gap in their workforce on the companies' websites and on a government website. Many companies now disclose gender pay ratios comparing the wages paid to male and female employees outside of their proxy statements, and in some cases, these disclosures are drafted by non-lawyers without sufficient attention to potential legal issues, such as whether such information could be considered "additional soliciting material" that must be filed under SEC rules. Companies should ensure that any such disclosures receive appropriate review from legal counsel. Also, if a company's CEO or gender pay ratio (or the underlying trend in that ratio) is not in line with that of its peers, the disclosures may elicit a negative reaction as more investors start to digitize and calculate multi-year trend data. As such, the board should be briefed periodically on the data and methodology underlying these disclosures and, where necessary, information about the company's methodology should be included in the website disclosure.
- ***Sustainability Reports.*** Many companies are now publishing sustainability reports on their websites. These reports detail the ESP impacts of the company's activities and how the company's values and governance model facilitate the company's overall long-term strategy. SEC rules require that a company include disclosures on issues related to sustainability in its proxy statements or periodic filings if the company considers those issues to be material to its financial condition or results of operations. However, unless such disclosures are actually required under SEC rules, it is not advisable to incorporate all or parts of a company's ESP-related disclosures into its SEC filings. The inclusion of these disclosures in a SEC filing (rather than a "furnished" 8-K) may have unintended legal implications: namely, the incorporation by reference into a registration statement under the Securities Act of 1933, which could subject the company and its underwriters to Section 11 liability for these statements and, therefore, result in additional offering-related due diligence by the underwriters and external counsel.
- ***Costs and Benefits of Disclosures.*** More generally, companies should carefully consider whether they should expand disclosure to address any of the governance "hot topics" described above (such as board refreshment goals), add more disclosure concerning their long-term strategy, or refresh or modernize any part of their proxy statements. Because some changes may require a substantial expenditure of time and money, companies should conduct a cost benefit analysis to determine whether any changes are actually necessary before rushing to judgment. Among the largest companies, the ones with the most modernized proxy statements tend to be the ones that have faced issues with shareholder activists or disclosure-related shareholder proposals. At the same time, some changes (such as adding a summary section at the front of the proxy statement) are relatively easy to implement and allow companies to communicate more effectively with their shareholders. It is critical, however, that any additional proxy statement disclosure be subject to the rigorous disclosure controls and procedures that public companies are required to have, and all information contained in these additional disclosures must be adequately supported by the company's verification process.

Shareholder Proposals

- ***Recent SEC Guidance.*** Staff Legal Bulletin 14I ("SLB 14I"), issued by the SEC Staff in November 2017, provided companies with guidance on the Staff's views on the ability to exclude a shareholder proposal from the company's proxy statement when the proposal does not have "economic relevance" to the company's business pursuant to Rule 14a-8(i)(5). The SEC stated that, under this framework, shareholder proposals that raise issues of social or ethical significance may be excluded, notwithstanding their general or abstract importance, based on the application of quantitative analytics of the proposal's economic relevance to the company's business. Further, SLB 14I noted that issues around economic relevance raise difficult judgment calls that the board is generally best situated to analyze. To assist the Staff in its review of these types of no-action requests, SLB 14I invited companies to include in their no-action requests a discussion reflecting the board's analysis of the particular policy issue raised by the proposal and its significance in relation to the company. In its recent Staff Legal Bulletin 14J issued in October 2018, the Staff gave additional guidance around what factors it considered most helpful in describing a board's rationale for excluding a shareholder proposal on the basis of the "economic relevance" prong. Companies who wish to exclude a shareholder proposal on the basis of the fact that it is not economically relevant should consider these factors when preparing a "no action" request.
- ***ESP Proposals.*** Unlike governance-related shareholder proposals, a significant portion of ESP-related shareholder proposals are withdrawn, as proponents often choose to settle and the company voluntarily makes additional disclosures in response to such proposals. The timeframe for settlement (*i.e.*, between the deadline for the receipt of shareholder proposals and the deadline for mailing the proxy statement) is relatively compressed for most companies, so advance planning may be warranted to guide management on how to best handle certain recurring types of proposals. Because most ESP proposals are industry-specific, companies should look at how peer companies have dealt with similar proposals. A company should evaluate, even in the absence of such proposals, whether there are any ESP factors that could be reflected in its disclosures and whether the company should start to engage in any ESP activities that are a regular subject of shareholder proposals in its industry.

As investors become more concerned with sustainability and long-term strategy, public companies increasingly have had to engage with shareholders on sensitive topics, including board composition, gender diversity, human capital management, and ESP activities, often resulting in increased disclosure regarding the company's policies and initiatives. Boards should take note of this trend and understand that directors may be held accountable for the execution and development of the company's long-term value creation plan. Every company will encounter unique and specific issues as it navigates the upcoming proxy season. Thinking through engagement with shareholders on an ongoing basis, and preparing for the proxy season, should start now to best position the company and the board to meet shareholders' needs proactively.

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