July 2, 2013

2013 Proxy Season Review

Results Show Positive Impact of Shareholder Engagement, Particularly on Say-on-Pay; Shareholder Proposals on Board Declassification, Majority Voting and Elimination of Supermajority Provisions (and, to a Lesser Extent, Special Meeting and Written Consent Rights, Proxy Access and Separation of CEO and Chair) Continue to Receive Strong Support

SUMMARY

The 2013 proxy season saw a continued high rate of governance-related shareholder proposals at large U.S. public companies, including those calling for declassified boards, majority voting in director elections, elimination of supermajority requirements, separation of the roles of the CEO and chair, the right to call special meetings and action by written consent. As in prior years, many of these governance-related proposals received high levels of support, and a number received majority support from shareholders.

In addition, during the 2013 proxy season, U.S. public companies had, on average, slightly better results on their say-on-pay votes. Large-cap companies, in particular, showed an improved ability to avoid negative results, and most companies that failed say-on-pay votes in 2012 received strong support in 2013. These results reflect companies' increased efforts to engage with shareholders, understand and anticipate their concerns, and communicate the company's actions and positions.

Shareholder proposals on social issues (particularly those related to political contributions and lobbying costs) and compensation-related issues (particularly those relating to stock retention and acceleration of vesting upon a change-in-control) also remained common but, as in the past, these proposals generally received far lower support than corporate governance proposals, rarely received a majority vote and served primarily as a vehicle for shareholder activists to focus attention on these issues.

In this memorandum, we:

- Quantify and discuss various categories of shareholder proposals voted on this season, and highlight important trends and legal developments, including trends in management proposals to implement governance reforms;
- Analyze the results from 2013 say-on-pay votes, including the greater success of large companies in avoiding problematic vote results;
- Discuss the primary drivers of negative recommendations by Institutional Shareholder Services on say-on-pay proposals;[1]
- Analyze the key reasons that directors of U.S. companies received "withhold" or "against" recommendations from ISS in 2013, and the impact of these recommendations on voting results; and
- Highlight the increased use by shareholder proponents of new avenues for publicizing their arguments and counterarguments regarding their proposals.

More detailed information on shareholder proposals, governance initiatives, executive compensation disclosure and the proxy process, as well as other issues and developments facing public companies, is available in PLI's *Public Company Deskbook*, authored by partners of our firm.[2]

Sullivan & Cromwell LLP will host a client webinar this summer to discuss 2013 proxy season developments. Information on this webinar will be disseminated shortly.

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[1] We focus in this publication on ISS recommendations because, although only a minority of institutional investors expressly follow these recommendations, ISS's policies are formulated in large part on the basis of annual investor surveys and often influence, to at least some extent, the voting policies adopted by a larger number of institutional investors.

[2] For more information on the *Public Company Deskbook*, see http://www.pli.edu/Content/Treatise/Public_Company_Deskbook_Sarbanes_Oxley_and/_/N-4lZ1z13i7y?ID=67129.

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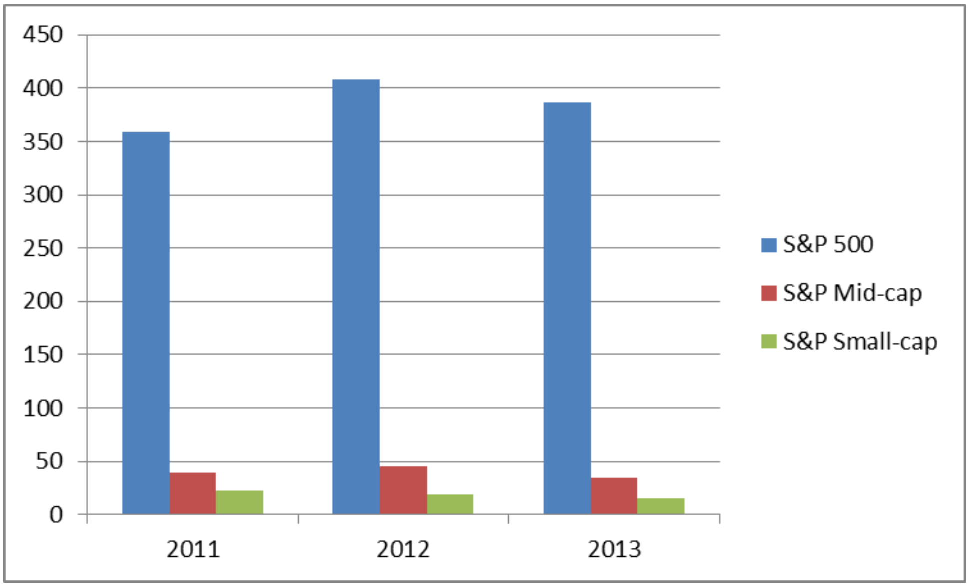
I. OVERALL TRENDS IN RULE 14A-8 SHAREHOLDER PROPOSALS

A. SHAREHOLDER PROPOSALS STILL LARGELY AN S&P 500 PHENOMENON

We discuss in this section the various categories of shareholder proposals received by U.S. public companies in 2012 and 2013 under SEC Rule 14a-8, but as an initial matter it should be noted that, as evidenced by the below chart, the vast majority of shareholder proposals continue to be received by large-cap companies.[3]



This disproportionate focus on large-cap companies suggests that the activist shareholders who submit these proposals are, as a general matter, focused primarily on obtaining the most visible platform for expressing their views. In addition, because shareholder activists continue to focus primarily on large companies, many of the governance changes described in the following section are far less common at smaller companies, resulting in a bifurcated corporate governance landscape, depending on the market capitalization of the company.[4]

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3 Data throughout this publication is based on information from ISS and FactSet Shark Repellent, as well as our own review of public filings. Data generally includes annual meetings held through June 21, 2013.

4 For example, according to data from FactSet Shark Repellent, less than 12% of the S&P 500 have classified boards, as compared to approximately 45% of the S&P 400 (mid-cap) and S&P 600 (small-cap). Similarly, over 83% of S&P 500 companies have majority voting in director elections, compared to 47% of the S&P 400 (mid-cap) and 25% of the S&P 600 (small-cap).

B. OVERVIEW OF SHAREHOLDER PROPOSALS IN 2012 AND 2013

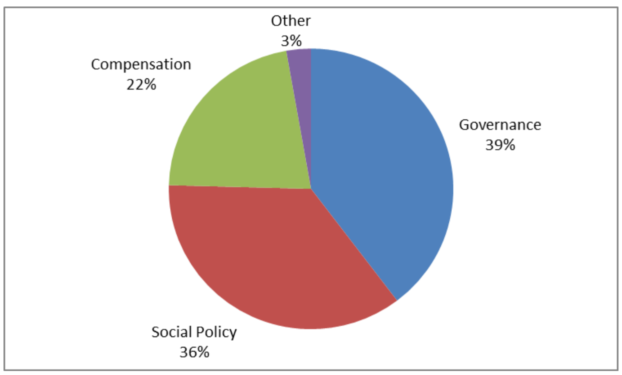
The following table summarizes, by general category, the shareholder proposals voted on at U.S. S&P 500 companies in 2012 and 2013.

SUMMARY OF 2012 AND 2013 SHAREHOLDER PROPOSALS (U.S. S&P 500 COMPANIES)

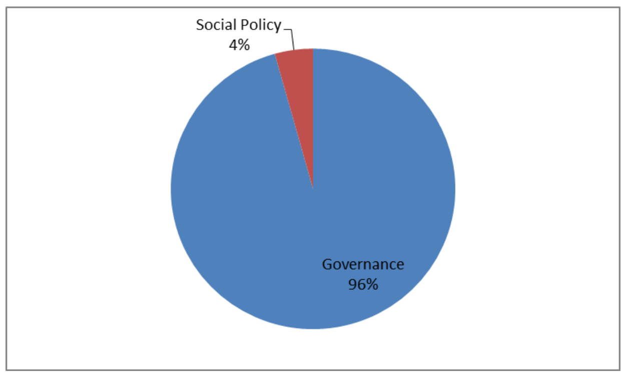
	Total Shareholders Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
Type of Proposal	*2013*	*2012*	*2013*	*2012*	*2013*	*2012*
Governance (Board/Voting Structure)	142	182	44%	50%	44	76
Social and Political Issues	128	128	21%	20%	2	0
Compensation-Related	78	62	27%	26%	0	0
Other	10	14	11%	20%	0	2
Total	358	386				

As indicated above, companies still receive a large number of social, political and compensation-related proposals, but with very limited exceptions, only proposals on governance issues have a chance of actually receiving majority support, regardless of whether ISS and Glass-Lewis support them.

Proposals Voted on in 2013



Proposals Passed in 2013



A more detailed analysis of each particular type of proposal follows.

C. SHAREHOLDER PROPOSALS ON GOVERNANCE STRUCTURE

1. The Most Successful Three Proposals – Declassifying the Board, Majority Voting and Elimination of Supermajority Voting Provisions

	GOVERNANCE PROPOSALS (U.S. S&P 500 COMPANIES)					
	Total Shareholder Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
	2013	*2012*	*2013*	*2012*	*2013*	*2012*
Declassify Board	15	40	78%	81%	14	38
Adopt Majority Voting	13	18	54%	58%	6	9
Eliminate Supermajority Provisions	14	13	72%	65%	13	10

The shareholder proposals that have had, by far, the greatest success rate in recent years, including in 2013, are those that seek to bring the governance practices of certain companies in line with what many shareholders see as baseline practices for good governance at large public companies – in particular, the elimination of classified boards, the adoption of majority voting in director elections (rather than plurality voting) and the elimination of supermajority voting provisions (that is, provisions in the charter or bylaws requiring a supermajority to remove directors, amend the charter or bylaws or approve major transactions, among other things).

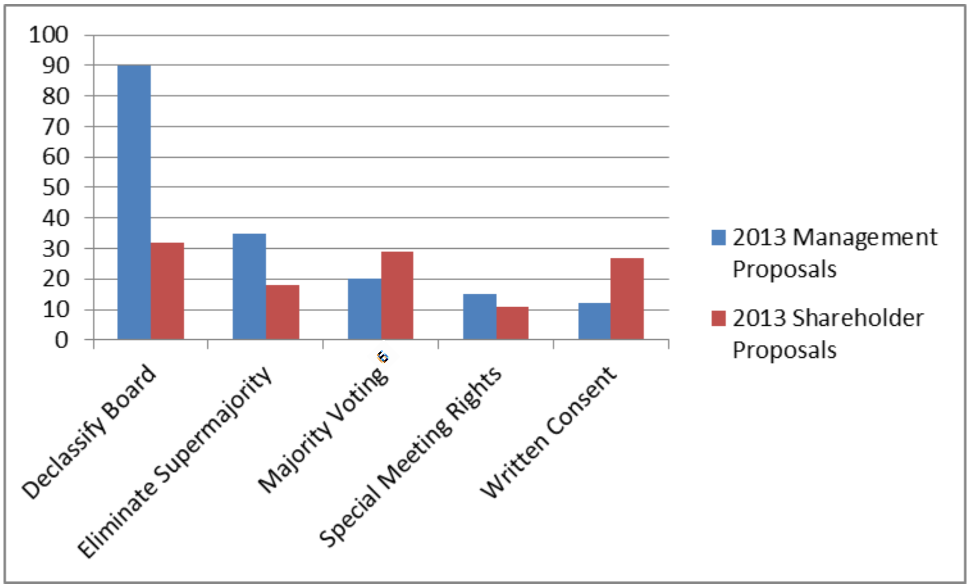
A sizeable majority of large public companies have already enacted these governance changes since 2000, largely in response to shareholder pressure and evolving views of market practice.[5] A number of companies, however, continue to believe that the elimination of these types of anti-takeover protections is not ultimately to the benefit of the company or its shareholders because these provisions can encourage continuity and stability on the board and better position the board to protect all shareholders from the use of coercive tactics by a party seeking to change control of the company. In making decisions on governance structure, a board of directors should act in what it believes to be the best interests of the corporation – the business judgment rule will continue to protect directors making determinations in good faith, notwithstanding the existence of a precatory shareholder "mandate" as to governance structure (though these directors may face withhold recommendations and votes in future years under the policies of ISS and others, described below and in Section III.H).

As indicated in the table above, a sizeable majority of these proposals passed at S&P 500 companies (and, in fact, at those smaller companies at which they were proposed), in many cases by very wide margins. ISS revised its director withhold policies at the end of 2012 in a manner that significantly changes the considerations for a company determining how to respond to a shareholder proposal that has a good chance of passing. Under ISS's new policies, beginning in 2014, ISS will recommend a vote against or withhold from some or all directors if the board does not act on a shareholder proposal that received a majority of *votes cast* in the prior year. In the past, ISS would make such a recommendation only if the shareholder proposal had received a majority of *shares outstanding* in the prior year, or a majority of votes cast in the prior year and one of the two previous years.

In light of this ISS policy change, we expect that companies are giving greater consideration to adopting an acceptable provision in advance of or in response to receiving a shareholder proposal, rather than allowing the shareholder proposal to go to a vote – because the proposals in the table above are very likely to receive a majority of votes cast, boards that expect to implement these changes eventually stand to gain little (other than a year of time) by waiting for a shareholder vote before taking action. This change

5 As noted above in footnote 4, these governance changes are less prevalent at smaller companies, which have faced less pressure from activist shareholders to remove provisions that the board deems beneficial to the corporation and shareholders in general.

may be among the reasons that, as shown in the following chart, there were more management-directed changes in governance structures than there were shareholder proposals brought to a vote on certain of these topics. Many shareholder proposals – or threatened shareholder proposals – on these subjects never make it to a shareholder vote, because management determines to address the governance concern through its own proposal, allowing it to exclude the shareholder proposal as "conflicting" under Rule 14a-8(i)(9). In addition, some of these management proposals reflect the board making a determination to implement shareholder proposals that passed in prior years.[6]



The large number of management proposals on declassification is consistent with information put out by the Harvard Law School Shareholder Rights Project, which coordinates with institutional investors and pension funds to sponsor many of these proposals. According to the Project's website, most of their successes in convincing companies to declassify their boards are achieved through negotiation and not through shareholder proposals actually coming to a vote.[7]

2. Independent Chair

INDEPENDENT CHAIR (U.S. S&P 500 COMPANIES)					
Total Shareholder Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
2013	*2012*	*2013*	*2012*	*2013*	*2012*
44	44	31%	35%	3	3

6 Note that the majority voting column in the chart understates the number of management-directed adoptions of majority voting in director elections, because in most cases management would effect this change through a bylaw amendment that would not require a proposal to be put to shareholders at all.

7 See http://srp.law.harvard.edu/companies-entering-into-agreements.shtml.

This proxy season saw a continued flow of proposals requesting that companies separate the roles of CEO and chair,[8] with 44 such proposals voted on at S&P 500 companies so far in 2013, the same number as voted on in all of 2012 and nearly twice as many as were voted on in 2011. Large companies have regularly received these proposals since the mid-2000's, 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 solid shareholder support, though relatively few actually pass. In 2013, the average level of shareholder support declined, which partially reflected a decrease in the percentage of proposals supported by ISS (ISS supported 45% of the proposals in 2013, compared to 68% in 2012). ISS's support has had a significant and consistent impact on voting results for these proposals – the average level of shareholder support at S&P 500 companies was nearly 40% in each of 2012 and 2013 if ISS supported the proposal, but only 24% in each year if ISS recommended a vote against the proposal.

ISS's policies on these proposals are consistent with the views of a number of large institutional shareholders – they generally will not support a proposal to separate the CEO and chair roles if the company has a suitably empowered lead independent director (and particularly if the company has performed relatively well). This focus on independent board leadership dovetails with stock exchange rules adopted in 2003 requiring the appointment of a presiding independent director and SEC rules adopted in 2009 requiring proxy disclosure of board leadership structure, including whether the company has a lead independent director and what specific role that director plays in the leadership of the board.

ISS's policies include specific duties that the lead independent director must have in order for ISS to recommend against a proposal to split the CEO and chair positions, and ISS has shown little tolerance for seemingly modest variations from its policies in this regard – for example, ISS has deemed statements that the lead director will "review and consult" on board agendas and materials, rather than "approve" them, to be unacceptable. Companies seeking to satisfy ISS's requirements in this regard should consider tracking ISS's language closely to avoid these "foot faults" that may lead ISS to support the shareholder proposal.

An additional complication is that, even if a company has a lead independent director with "acceptable" duties, ISS will recommend in favor of a proposal to separate the CEO and chair roles if the company's one-year and three-year total shareholder return is in the bottom half of the company's four-digit GICS industry group or if the company has what ISS deems "problematic governance or management issues."[9]

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[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.

[9] Global Industry Classification Standard, or GICS, is an industry taxonomy developed by Standard & Poor's and MSCI that categorizes companies based on two-digit "sector" codes, four-digit "industry group" codes within those sectors, six-digit "industry" codes and eight-digit "sub-industry" codes.

The outcome of this vote for particular companies in 2013 shows that shareholder outreach and communication, coupled with strong performance, can reduce shareholder support for these proposals. For example, at JPMorgan Chase & Co., this proposal (which was supported by ISS[10]) received the support of only 32% of votes cast, down from over 40% in 2012, following outreach efforts by JPMorgan to explain to shareholders why the company chose its particular leadership structure and highlighting the strong performance of the company and its CEO.

One additional note on excludability of these proposals under SEC rules – during 2013, the no-action letters issued by the SEC staff shed additional light on the very limited circumstances in which proposals may use extrinsic definitions of independence for the purposes of defining the level of "independence" that an independent chair should have. The staff has previously indicated that inclusion of a reference to a third-party definition (such as that of the Council of Institutional Investors) causes a proposal to be excludable under 14a-8(i)(3) as "vague and indefinite" because a reader would need to refer to external sources to understand the proposal.[11] Consistent with this position, SEC no-action letters over the past year have confirmed that a proposal defining "independence" solely by reference to NYSE or Nasdaq independence rules, absent further explanation of what the listing exchange's definition of "independent director" means, is excludable under Rule 14a-8(i)(3).[12] The staff found such proposals excludable on the grounds that neither the shareholders voting on the proposal, nor the company in implementing the proposal (if adopted), would be able to determine with reasonable certainty what actions or measures the proposal would require. However, the SEC staff has deemed similar proposals to be non-excludable if they contain even a brief description of what "independence" means for these purposes,[13] or even if they merely include the phrase "independent director" without definition at all.[14] The SEC staff's views on the excludability of these proposals seems to turn on very nuanced differences in the wording of the proposals, so companies that receive such a proposal should consult with counsel to determine how the staff would likely come out.

[10] ISS supported the proposal despite JPM having a strong lead independent director. ISS cited as its reasons the governance failure in connection with the company's Chief Investment Office, the size and complexity of the company's business, and the continued challenges faced by the company.

[11] *See, e.g.,* Boeing Corp. (Feb. 10, 2004).

[12] *See, e.g.,* McKesson Corp. (Apr. 17, 2013), reconsideration denied (May 31, 2013), KeyCorp (Mar. 15, 2013), Chevron Corp. (Mar. 15, 2013), The Clorox Co. (Aug. 13, 2012).

[13] *See, e.g.*, Aetna Inc. (Mar. 1, 2013).

[14] *See, e.g.*, Dean Foods Company (Mar. 7, 2013).

3. Shareholder Right to Call Special Meetings

	RIGHT TO CALL SPECIAL MEETINGS (U.S. S&P 500 COMPANIES)					
	Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2013	2012	2013	2012	2013	2012
Adopt new right	5	7	41%	53%	2	6
Lower % on existing right	4	7	33%	31%	0	0

Proxy advisory firms and many shareholders generally support the right of shareholders to call a special meeting because this enables them 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). 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 what was once a powerful tool to provide directors with additional time to consider hostile takeover proposals and seek superior alternatives. A majority 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.

Shareholder proposals requesting the board to adopt special meeting rights usually seek to grant the right to holders of 10% of outstanding shares, which is a lower level than most companies and many shareholders would see as appropriate. The shareholder proposals generally specify that the shareholder right should not contain any exclusions unless they are also applicable to special meetings called by the company.

As indicated in the chart in Section I.C.1 above, management proposals for special meeting rights have been at least as common as shareholder proposals in recent years. These management proposals are typically made in response to the receipt of a shareholder proposal or upon approval of a shareholder proposal in prior years, and are generally at higher percentage levels and contain exclusions that would not apply to a meeting called by the company.

The results in the table above show that adopting a special meeting right does not mean that a company will necessarily be free from future proposals on this topic. In 2012 and 2013, many of the proposals voted on at S&P 500 companies were at companies that already had a special meeting right – the proposals were seeking to reduce the threshold for invoking the right. However, these proposals did not pass, and have generally not passed in prior years, indicating that if a company adopts a special meeting right at a reasonable threshold – 25% has become common – then shareholder efforts to reduce the threshold are not likely to be successful.

Even in the absence of a shareholder proposal, boards should consider discussing the terms of a special meeting right that they might find acceptable, if one were ever to be put in place. If it is decided at year-end to put a management proposal up for a vote at the annual meeting (including in response to the receipt of a shareholder proposal), there may be very little time at that stage to evaluate market practice, shareholder views and legal considerations in order to develop an appropriate proposal and, as necessary, to submit a no-action letter request to exclude a shareholder proposal on this subject. In order to avoid a last-minute scramble, it may be useful to have provided background to the board or relevant board committee, and to have discussed potential terms.[15]

4. Shareholder Right to Act by Written Consent

RIGHT TO ACT BY WRITTEN CONSENT (U.S. S&P 500 COMPANIES)					
Total Shareholder Proposals Voted On		***Average % of Votes Cast in Favor***		***Shareholder Proposals Passed***	
2013	***2012***	***2013***	***2012***	***2013***	***2012***
26	20	41%	45%	3	6

One of the most notable recent developments in the shareholder proposal area has been the increased rate of shareholder proposals requesting that the company grant shareholders the right to act by written consent. The number of these proposals so far in 2013 exceeds the number received in all of 2012, although the average vote and the number of proposals passed have declined.

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).

Some shareholders believe that shareholders should be permitted to act by written consent because this provides a mechanism for shareholder action outside the normal meeting cycle. The concern that companies have about giving shareholders the right to act by written consent is that the written consent process, by its nature, is not conducive to 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 give shareholders the

[15] Terms that companies may wish to consider including in any management proposal for a special meeting right include aggregate ownership thresholds, holding period requirements, "net long" ownership definition, pre- and post-annual meeting blackouts, and timing considerations. For a more detailed discussion of these potential terms, see our publication entitled 2012 Proxy Season Review, dated July 9, 2012. Market practice in this area is developing continuously. We have worked with numerous clients in evaluating market practice and crafting potential special meeting provisions. Companies should feel free to contact us for more information.

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. Any concern that shareholders should be able to act between annual meetings could be addressed by giving shareholders the right to call special meetings, as an increasing number of companies have done (as discussed in the preceding section).

Our 2012 Proxy Season Review publication discussed written consent proposals that had been proposed by issuers, and suggested provisions that should be considered to provide parameters around the written consent process to permit it to work in a deliberative and organized manner and to provide similar timing and disclosure as a shareholder meeting. Since then, ISS has issued an FAQ on what restrictions management could include in a written consent provision in order for ISS to consider the board to be "responsive" to a previously passed shareholder vote.[16] These include:

- an ownership threshold (to commence the written consent process) of no more than 10% (which, as discussed below, is lower than the threshold that most issuers have included in their own written consent proposals);
- no restrictions on agenda items;
- a total review and solicitation period of no more than 90 days;
- timing exclusions of no more than 30 days after a meeting already held and 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, however, "be examined in light of the disclosure by the company on its outreach to shareholders on what they consider reasonable, equity structure of the company, etc."

So far in 2013, 10 issuers have adopted written consent provisions,[17] and something of a market practice is beginning to coalesce. In particular:

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16 See http://www.issgovernance.com/files/2013ISSFAQPoliciesandProcedures04112013.pdf (Q.11 under Board Responsiveness).

17 Based on a review of SEC no-action letters, of these 10 companies, six excluded a shareholder written consent proposal from the 2013 proxy statement on the basis that it "conflicted" with management's written consent proposal under Rule 14a-8(i)(9). Of the other four companies, two had a shareholder written consent proposal pass by a majority of votes cast twice in the prior three years, which would trigger withhold votes against directors by ISS if the company did not implement a written consent proposal.

- Most provisions had 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 issuer.
- The provisions were equally split between requiring the solicitation of all shareholders and requiring compliance with the proxy rules without relying on the 10-holder exception (which would result in a public filing of soliciting materials). The references to the proxy rules could be the result of an ISS negative comment last year that a requirement to solicit all holders would increase the cost of the solicitation. In light of the new ISS FAQ discussed above, we would expect more issuers to require the solicitation of all holders.
- Most provisions required a delay before consents could be delivered of 50 or 60 days to ensure that shareholders have sufficient time to consider the matters subject to the consent.
- The timing exclusions were generally more extensive than those in ISS's FAQ, with most provisions denying the process if the request was delivered in the 90-day period prior to the anniversary of the prior annual meeting (because the issuer could have included a shareholder proposal in the annual meeting), or if a similar item 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.
- Finally, most provisions required the same information to be provided as was required by the advance notice bylaws, and one provision required that the shares calling the meeting must have full economic and voting rights.

ISS recommended for adoption of all the written consent provisions. It should be noted that where the right to act by written consent does not exist, ISS is likely support a management proposal even if its terms exceed the restrictions ISS finds reasonable, because it views a restricted right to act by written consent as preferable to no right. For that reason, issuers who would prefer higher ownership thresholds to commence the process, and longer exclusionary periods, may want to consider proposing a written consent provision in advance of receiving a shareholder proposal, or proposing one upon receipt of such a proposal and seeking to exclude the proposal. If shareholders vote to support a shareholder proposal on written consent, adopting 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.

All the shareholder written consent proposals voted on at S&P 500 companies in 2013 were at companies that had no right to act by written consent at all. This is in contrast to special meetings, where half of the 2013 proposals were requests to lower the threshold on existing rights.

5. Proxy Access Proposals

PROXY ACCESS (U.S. S&P 500 COMPANIES)					
Total Shareholder Proposals Voted On		***Average % of Votes Cast in Favor***		***Shareholder Proposals Passed***	
2013	***2012***	***2013***	***2012***	***2013***	***2012***
9	8	32%	28%	2	1

Pursuant to SEC rule changes that took effect in September 2011, shareholders are permitted to submit and vote on "proxy access proposals" – that is, proposals to give shareholders the right to include director nominees in the company's proxy materials. In the 2012 proxy season, many of the proposals that were submitted by shareholders were deemed excludable by the SEC staff based on drafting errors and ambiguities. Shareholders corrected these problems in the proposals submitted for the 2013 proxy season, resulting in around the same number of proposals coming to a vote (that is, fewer proxy access proposals were submitted to companies in 2013, but more of those submitted actually made it to a vote). In addition, the average level of support was slightly higher.

The following is a summary of the various forms of proxy access bylaws that were submitted for the 2013 proxy season:

SUMMARY OF 2013 PROXY ACCESS PROPOSALS

Proponent	***Threshold/ Holding Period***	***Company***	***ISS Rec.***	***Outcome***
Norges Bank (Precatory)	1%/1 year	Charles Schwab	For	32% of votes cast
		CME Group	For	33% of votes cast
		Staples	For	37% of votes cast
Harrington/ McRitchie/Young (USPX form) (Precatory)	Either (a) holders with at least 1% but less than 5% for 2 years or (b) 50 holders of $2,000 each with at least 0.5% but less than 5% for 1 year	Bank of America	Against	9% of votes cast
		Goldman Sachs	Against	5% of votes cast
		iRobot Corp.	Against	18% of votes cast
		Netflix	Against	4% of votes cast
Hermes Equity/Other Individual Shareholders (Precatory)	3%/3 years	CenturyLink	For	72% of votes cast
		Verizon	For	53% of votes cast
		Walt Disney	For	40% of votes cast

a. Norges Bank Precatory Proposals (1%/1 year)

Terms of Proposals. Norges Bank Investment Management, which manages the Norwegian government pension fund, submitted a number of precatory proposals that requested a bylaw amendment giving a proxy access right to a shareholder or group that holds 1% of the outstanding stock and has held those shares for at least one year. Each eligible shareholder or group would be permitted to nominate up to one quarter of the board. There is no overall limit on the number of nominees, though the number of access nominees actually elected to the board cannot exceed one quarter of the board. Notably, following the 2012 proxy season, Norges Bank revised its proxy access proposals to be precatory instead of binding, in an attempt to be more palatable to investors and avoid the possibility of a technical bylaw drafting error causing the proposal to be excludable.

Voting Results. The Norges Bank proposal failed at all the companies where it came to a vote, garnering the support of between 32% and 37% of shares voting, despite receiving a "for" recommendation in all cases from ISS.[18] It seems likely that many institutional investors believed that a 1% threshold is simply too low.[19]

b. U.S. Proxy Exchange Form of Proposal (1%/50 Holders)

Terms of Proposals. One form of proxy access proposal this year was based on a model issued by the United States Proxy Exchange, a shareholder advocacy group. Although the U.S. Proxy Exchange temporarily suspended its operations in October 2012, individual shareholders have continued to file tailored proxy access resolutions at several companies. This precatory proposal requested a bylaw amendment permitting holders of between 1% and 5% of the outstanding stock for a two-year period, or alternatively 50 holders who have held continuously for one year at least $2,000 of stock and collectively between 0.5% and 5% of the stock, to include director nominees in the company's proxy statement. The number of shareholder nominees would be capped at 48% total: 24% for each the two options under which holders may qualify for proxy access. If either group exceeds the 24% limit, opportunities to nominate would be distributed among the parties "as evenly as possible."

Voting Results. This form of proposal came to a vote at four companies in 2013, and received the support of between 4% and 18% of votes cast. Despite revision of such proposals in response to negative ISS recommendations in 2012, ISS maintained its recommendation "against" such proposals in 2013, noting that the 50 shareholder provision could allow a nominee supported by shareholders holding a negligible percentage of the company.

c. Precatory 3%/3-Year Proposals

Terms of Proposals. Following the "3% for three years" ownership requirement of the SEC's now-vacated proxy access rule, several individual shareholder activists and Hermes Equity Ownership Services, a U.K. fund manager, submitted precatory proposals at CenturyLink, Verizon and Walt Disney. These proposals would create a proxy access right for 3% shareholders (or groups) who have held their stake for at least three years, and would cap the number of shareholder-nominated candidates in the proxy materials at 20% of the number of directors then serving.

Voting Results. These proposals passed at both CenturyLink (with the support of 72% of votes cast) and Verizon (with the support of 53% of votes cast), but failed at Walt Disney (with the support of 40% of votes cast). ISS recommended "for" the proposal in the case of all three companies. Despite the proposal's failure at Walt Disney, the passage of 3% for three years proxy access proposals at CenturyLink and Verizon in 2013, and at Nabors Industries and Chesapeake Energy in 2012, indicates

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[18] ISS does not have a bright line policy on proxy access proposal, but reviews them on a case-by-case basis, in light of the company's shareholder base and the terms of the proposal.

[19] For example, the proxy voting policies of T. Rowe Price indicate that they support proposals suggesting an ownership level of at least 3%.

that a proposal such as this one, which tracks the thresholds that the SEC sought to impose under its mandatory access rule, would achieve a significant level of support at many companies that did not already have a proxy access provision.

D. SOCIAL POLICY SHAREHOLDER PROPOSALS

	SOCIAL POLICY PROPOSALS (U.S. S&P 500 COMPANIES)					
	Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2013	2012	2013	2012	2013	2012
Political issues	73	69	23%	21%	1	0
Environmental issues	35	37	15%	16%	0	0
Sustainability report	6	5	40%	40%	1	0
Labor issues	3	2	20%	29%	0	0
Animal rights	2	8	3%	8%	0	0
Anti-discrimination	4	5	32%	33%	0	0
Other social policy issues	5	2	9%	3%	0	0

The landscape for proposals on social and political issues was very similar in 2013 to that in 2012 – these proposals continue to be common, but in almost all cases they fail, and usually by a wide margin. In 2013, as in 2012, most of these proposals related to political issues – 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.

It should be noted that the range of support levels for political proposals varies greatly – proposals calling for advisory votes or flat prohibitions on spending generally received negligible levels of support, while those focused on expanded disclosure of political expenditures or lobbying costs received, in some cases, well over 40% support.

ISS supported around half of the social policy proposals voted on in 2013. These proposals had an average support level of 30% if ISS was recommended in favor, and 7% if ISS recommended against. Because the proposals almost always failed, however, ISS's recommendation has not had a significant actual impact.

The continued frequency of proposals on social policy issues, despite their consistent 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.[20]

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[20] Whether corporate proxy statements are an appropriate forum for shareholders to debate social issues has long been a focus of attention under the SEC's proxy rules. In 1945, the SEC addressed the question in a release, stating that the rule was not intended "to permit stockholders to obtain the consensus of other stockholders with respect to matters that are of a general political, social or economic nature." The SEC stated that "[o]ther forums exist for the presentation of such views" and that such matters are thus not "proper subjects" for shareholder action. Release No. 34-3638 (Jan. 3,

(footnote continued...)

E. COMPENSATION-RELATED SHAREHOLDER PROPOSALS

	COMPENSATION-RELATED PROPOSALS (S&P 500 COMPANIES)					
	Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2013	2012	2013	2012	2013	2012
Stock retention	32	26	24%	23%	0	0
Limit golden parachutes	27	11	34%	37%	0	0
Link pay and performance	3	8	32%	27%	0	0
SERP-related	3	2	30%	31%	0	0
Limit death benefits	2	2	38%	40%	0	0
Other compensation-related	11	13	11%	18%	0	0

Overall, the number of compensation-related shareholder proposals was somewhat higher in 2013 than in 2012 (78 in 2013 versus 62 in 2012) but this was entirely due to an increase in two types of proposals – proposals seeking stock retention requirements for executives (typically extending beyond retirement) and proposals to prohibit "golden parachutes" in the form of single-trigger accelerated vesting of performance and other equity awards. Moreover, once again no compensation-related proposals passed and the average vote in favor of these proposals remained roughly the same as in 2012.

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 has provided shareholders with an alternative mechanism for expressing concerns over executive compensation.

ISS supported nearly 90% of the compensation-related proposals in 2013, and shareholder support averaged 29% for proposals where ISS recommended in favor, as compared to 8% for proposals where ISS recommended against. However, all these proposals failed, despite the ISS recommendation.

(...footnote continued)

1945). The current position of the SEC and its staff, requiring companies to include proposals that raise significant policy issues, is, of course, in marked contrast to this early view.

II. SAY-ON-PAY VOTES

A. IMPROVED SAY-ON-PAY RESULTS, PARTICULARLY FOR LARGE-CAP COMPANIES

2013 was the third year of say-on-pay votes under SEC Rule 14a-21(a), which was adopted in January 2011 to implement Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The following table summarizes the 2012 and 2013 say-on-pay voting results:[21]

	All U.S. Companies		*S&P 500*	
	2013	*2012*	*2013*	*2012*
Percent of issuers receiving a negative ISS recommendation	11%	13%	9.9%	14%
Average support for all issuers (for/for+against)	92%	91%	91%	89%
Average support with ISS positive recommendation	95%	95%	94%	94%
Average support with ISS negative recommendation	68%	65%	64%	60%
Votes failed (<50% support of votes cast) [22]	1.8%	2.5%	0.5%	2.3%
Votes with <70% support of votes cast	7.1%	8.0%	7.3%	10%

U.S. companies, broadly speaking, had slightly better results on say-on-pay votes in 2013 as compared to 2012. In particular, as indicated by the highlighted data in the table above, S&P 500 companies had a lower incidence of negative results, on average – that is, a lower rate of ISS negative recommendations in 2013, greater success in receiving at least 70% of votes cast and fewer large companies receiving less than a majority of votes cast (only two U.S. S&P 500 companies in 2013, as opposed to 10 in 2012). Companies continued to show an ability to rebound from negative votes in prior years – of the 10 U.S.

[21] Data throughout this publication is based on information from ISS and FactSet Shark Repellent, as well as our own review of public filings. Data generally includes annual meetings held through June 21, 2013. As of that date, 384 U.S. S&P 500 companies and approximately 2,500 U.S. companies overall had held a say-on-pay vote in 2013.

[22] Throughout this publication, we use a "majority of votes cast" threshold, which does not include abstentions, in describing whether a say-on-pay vote or shareholder proposal has "passed" or "failed," as this provides a consistent metric across companies, and is consistent with the terminology used by ISS and many institutional investors and advisory firms. Given that say-on-pay votes are non-binding, passage as a matter of state law, which often would include abstentions in the denominator in determining the outcome, is not determinative. Failure to obtain the approval of 70% of the votes cast may, under the policies of ISS and others, result in a negative vote recommendation for the compensation committee and, in exceptional cases, the entire board, as well as for the management say-on-pay proposal in the following year, depending on the company's disclosure of engagement efforts with major institutional investors, the specific actions taken by the company to address the issues that contributed to the low level of support, and other recent compensation actions taken by the company; thus, 70% is a significant vote threshold to consider. Similarly, under ISS's and others' policies, 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, will result in negative recommendation for those directors in the following year due to "non-responsiveness," as discussed further in Section III.H below.

S&P 500 companies that had failed say-on-pay votes in 2012, eight have passed their votes this year (one failed, and one has not had its annual meeting yet). Those eight companies had average shareholder support of over 82% in 2013.

These results are consistent with our experience, as counsel to public companies, that larger companies have continued to move up the learning curve in terms of effectively engaging with shareholders, understanding their concerns, and addressing these concerns through changes in compensation practices and/or clearer compensation disclosure. Both companies and shareholders, as well as shareholder advisory firms, have become more adept at effective off-season communications where the company can obtain feedback on the most recent voting results, as well as expectations and concerns for the coming year. These off-season communications, which we expect to become a regular feature of corporate governance and shareholder relations for many companies, help the company anticipate and address shareholder concerns, whether by adjusting compensation practices, crafting responsive disclosure, or both.

Companies have increasingly engaged with proxy advisory firms in the off-season as well – for example, to address any misconceptions evident from the prior vote and to discuss issues that may be relevant to the next year's vote. ISS[23] and Glass-Lewis[24] post their engagement policies on their websites. The policies of both firms restrict their ability to engage with issuers during the solicitation period for the annual meeting, which means broader discussions with these firms can occur in the off-season.

B. OVERALL ISS APPROACH ON SAY-ON-PAY EVALUATION

ISS has a multipronged approach to assessing executive compensation for the purposes of recommending a vote for or against the management say-on-pay proposal.[25] However, an analysis of ISS's 2013 negative recommendations for S&P 500 companies suggests that, as in 2012, the most important criterion is the pay-for-performance assessment, and that the most important factor under this pay-for-performance assessment is the alignment of CEO pay (as reported in the Summary

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23 ISS's engagement policies are available at http://www.issgovernance.com/policy/EngagingWithISS.

24 Glass-Lewis's engagement policies are available at http://www.glasslewis.com/for-issuers/glass-lewis-corporate-engagement-policy/.

25 Glass-Lewis's executive compensation assessment policy appears to be less formulaic than ISS's, though Glass-Lewis publicly discloses less detailed information about its policy than ISS does. Based on Glass-Lewis's published information, it evaluates compensation based on four factors: overall compensation structure, disclosure of executive compensation policies and procedures, amounts paid to executives, and the link between pay and performance. In evaluating pay for performance, Glass-Lewis looks at the compensation of the top five executive officers, not just the CEO. In addition, Glass-Lewis looks at performance measures other than total shareholder return – it measures performance based on five "indicators of shareholder wealth": change in operating cash flow, earnings per share growth, total shareholder return, return on equity and return on assets. See http://www.glasslewis.com/issuer/say-on-pay-faqs/ for more information.

Compensation Table in the proxy statement) with total shareholder return in relation to the ISS-determined peer group.[26]

ISS's policies provide that it will recommend a vote against a company's say-on-pay proposals if any of the following is true:

- There is a significant misalignment between CEO pay and company performance (pay-for-performance);
- The company maintains significant problematic pay practices (for example, excessive change-in-control or severance packages, benchmarking compensation above peer medians, repricing or backdating of options, or excessive perquisites or tax gross-ups); or
- The board exhibits a significant level of poor communication and responsiveness to shareholders.

ISS applies these standards by assigning companies a "high," "medium" or "low" level of concern for each of the five evaluation criteria listed in the following table, which shows the number of "high concerns" under each criterion for U.S. S&P 500 companies that received a negative say-on-pay recommendation from ISS in 2013:

	U.S. S&P 500 Companies with Negative ISS Recommendations
Total	38
Number that had "high concern" on:	
• Pay-for-Performance	29
• Compensation Committee Communication and Effectiveness	9
• Severance/Change-in-Control Arrangements	6
• Non-Performance-Based Pay Elements	3
• Peer Group Benchmarking	2

These results indicate that, although pay-for-performance is just one factor in the overall compensation assessment, it is clearly the most important determinant of ISS's outcome on the say-on-pay vote. This was also the case in 2012. A more detailed discussion of ISS's pay-for-performance policies and how they were applied in 2013 follows.

C. ISS PAY-FOR-PERFORMANCE ANALYSIS

Beginning with the 2012 proxy season, ISS adopted a new methodology for evaluating the pay-for-performance prong of its assessment of executive compensation in the context of say-on-pay proposals. This methodology remained largely unchanged for 2013.[27] ISS's assessment methodology begins with a

[26] See Section II.C.3 below for a discussion of the significant comparability issues that can arise from the use of the Summary Compensation Table numbers and the ISS peer group construction.

[27] ISS made a small number of changes to its say-on-pay methodology for 2013, including aligning its peer group selection more closely with company-selected peer groups and adding "realizable" pay (as compared to grant date pay) as a new qualitative factor. The technical document on the

(footnote continued...)

quantitative analysis of both relative and absolute alignment of pay-for-performance. If the quantitative assessment reflects an apparent pay-for-performance disconnect (i.e., a "high" or "medium" concern), ISS applies a qualitative analysis, including an in-depth review of the Compensation Discussion & Analysis, to "identify the probable causes of the misalignment and/or mitigating factors."[28]

1. Components of Quantitative Analysis

The three components of ISS's quantitative assessment are as follows:

a. ***Relative Alignment of CEO Pay and Total Shareholder Return (One-Year and Three-Year).*** The metric that is given the greatest weight in the quantitative assessment is the relative alignment of CEO pay and total shareholder return, or TSR,[29] to those of a peer group. The relative alignment metric looks at the difference between (a) the percentile rank within the ISS-selected peer group of a company's TSR and (b) the percentile rank within that peer group of a company's CEO pay.[30] The company's score is based on this difference calculated on a one-year basis and a three-year basis (weighed 40% and 60%, respectively). The scoring system effectively gives greater weight to this metric by triggering "high concern" at a relatively low level – specifically, if the weighted pay percentile exceeds the weighted TSR percentile by 30 percentage points or more. *As discussed below, this metric appears to be the strongest predictor of ISS recommendations and of overall voting results.*

b. ***Relative CEO Pay to Peer Group Median (One-Year).*** The second relative component of the pay-for-performance assessment is prior-year CEO pay as a multiple of the peer group median. ISS's scoring system may trigger a "high concern" if this multiple is 2.33x or higher.

c. ***Absolute Alignment of CEO Pay and Total Shareholder Return (Five-Year).*** The third component measures alignment between the trend in the CEO's pay and the company's shareholder returns over a five-year period. This does not depend on year-by-year sensitivity of CEO pay to changes in TSR, but instead compares the straight-line slopes of five-year trend lines (based on a linear regression) for each of CEO pay and TSR. A "high concern" may be triggered if the CEO pay trend slope exceeds the TSR trend slope by 30 percentage points or more.

(...footnote continued)

implementation of ISS's methodology and additional guidance is available on the ISS website at http://www.issgovernance.com/policy/2013/policy_information. See our publication, ISS Finalizes 2013 Proxy Voting Updates, dated November 20, 2012, for further discussion of ISS's 2013 policy changes.

[28] See ISS's U.S. 2013 Compensation Policy Update FAQs at http://www.issgovernance.com/policy/2013/USCompensationFAQ.

[29] TSR measures how much an investment in the stock would have changed over the relevant period, assuming the reinvestment of dividends.

[30] See Section II.C.3 below for a discussion of how "CEO pay" is calculated and some potential comparative problems this may cause.

2. 2013 Results of ISS Quantitative Analysis

The following table summarizes the outcome of these quantitative tests for the 38 U.S. S&P 500 companies that received a negative ISS recommendation on say-on-pay in 2013:

	U.S. S&P 500 Companies with Negative ISS Recommendations
Number that had "high concern" on pay-for-performance overall	29
Number that had "high concern" on the:	
• Relative Alignment of CEO Pay and TSR (1-year and 3-year)	24
• Relative CEO Pay to Peer Group Median (5-year)	4
• Absolute Alignment of CEO Pay and TSR (1-year)	3

As the table indicates, most large companies that received negative ISS recommendations had a "high concern" on the one- and three-year alignment of CEO pay and TSR versus peer groups. In contrast, each of the other two quantitative tests yielded a "high concern" at only a small minority of these companies. These results reflect the importance of the relative TSR alignment test in driving ISS recommendations. Companies should be mindful of the variables that go into these tests, some of which (such as their stock price and ISS's peer group selection) companies may have little control over, and which bring a level of arbitrariness to the calculation.

3. Potential Problems with Quantitative Analysis

Certain features of ISS's quantitative analysis have been subject to some criticism and may yield inappropriate results in certain circumstances. Many companies have raised these or other arguments in supplemental proxy filings that seek to rebut a negative recommendation from ISS. If a company receives, or thinks it is going to receive, an adverse outcome under the ISS quantitative test in circumstances where it is not warranted, the company should reach out as appropriate to ISS to make sure that the qualitative portion of the test takes into account any special circumstances, and should maintain a dialogue with shareholders to gauge their level of concern and ensure that they are viewing the results of the quantitative assessment in the proper context.

a. Peer Group Construction

As the above numbers show, the "relative alignment" between CEO pay and TSR when compared with the company's peer group is an influential element of ISS's calculation. Accordingly, the selection of an appropriate peer group is a critical factor. ISS's peer group construction in 2012 was the subject of significant criticism, including that it caused many companies – particularly large companies – to be placed in peer groups with companies that operate in different industries, or different segments of their industry. ISS attempted to address these concerns by adopting new policies applicable in 2013 that incorporate information about a company's self-selected peers into ISS's methodology for selecting peer groups. This change did seem to have a positive effect, as there was a reduction in supplemental proxy filings by companies criticizing ISS's peer group construction. Companies should review their peer group used in ISS's 2013 report to confirm whether it is appropriate in light of a particular company's business and competition for talent. If the ISS peer group contains companies that the company believes are not, in fact, suitable comparisons, or omits peers the company believes should be included, the company may want to discuss with ISS in the off-season the appropriateness of the peer group construction, or consider whether the inclusion of a different self-selected peer group in the proxy statement may lead to a more appropriate ISS peer group under ISS's policies.

Glass-Lewis uses a less formulaic approach to peer group construction than ISS does, stating that its approach "avoids the limitations of arbitrary financial cut-offs or discrete industry groupings and better represents the complex relationships that exist in a competitive marketplace." Glass-Lewis instead bases its peer groupings on an analysis of the proxy disclosure by various companies of the peers they use for compensation benchmarking purposes, combined with "analytics from the social networking space." Glass-Lewis (through its partnership with Equilar, a compensation benchmarking firm) then uses this data to create a "peer network" through which it ranks a company's peers based on the strength of their connection as indicated by these analytics.[31]

b. Determination of Total CEO Pay

All the ISS quantitative metrics look at the level of "CEO pay." The "CEO pay" for a particular year for these purposes is the total compensation reported in that year's Summary Compensation Table in the proxy statement under SEC rules. Among other problems, this introduces potential comparative difficulties, because different forms of compensation are reflected differently in the table even though they may pertain to services in the same period. For example, equity awards for services in a particular year that are made shortly after year-end are included in the Summary Compensation Table in the proxy statement for the subsequent year (because that is when the grant occurred), but awards that are made in cash and already earned are included in the Summary Compensation Table for the current year. In addition, differences in equity granting practices may skew results – for example, in the case of special one-time grants. Furthermore, this measurement does not take into account any post-grant change in value of an equity award due to an increase or decrease in the stock price.

ISS introduced "realizable pay" as a new qualitative factor for S&P 500 companies for 2013, in an effort to address concerns that the quantitative "grant date" calculation does not capture when or whether compensation is actually earned. "Realizable pay" is the sum of relevant cash and equity-based grants and awards made during a three-year measurement period, based on equity award values for actual earned awards, or target values for ongoing awards, calculated using the stock price at the end of the measurement period. The qualitative analysis involves a consideration of whether the total pay granted

[31] Information on Glass-Lewis's say-on-pay and pay-for-performance assessment policies is available at http://www.glasslewis.com/issuer/pay-for-performance/.

during the three-year period is significantly higher or lower than the realizable pay at the end of the period. This metric, however, still involves a valuation of unearned compensation, albeit at the end of a period rather than as of the grant date, and thus continues to mix elements of grant date and earned compensation in a way that can yield disparate results.

c. Use of TSR over Fixed Periods

The formulaic use of one-, three- and five-year TSR can place undue emphasis on short-term spikes or drops in stock price at the start or end of the measurement periods and does not provide an opportunity for a nuanced analysis of the factors relating to the company, its industry or the markets generally that may be contributing to the shareholder return. Companies should seek to ensure that their shareholders and ISS recognize and take into account any meaningful factors that cause the TSR in the tests used by ISS to be not reflective of the company's performance in the context of its compensation decisions.

4. ISS Qualitative Analysis

If ISS's quantitative analysis reflects an apparent pay-for-performance disconnect, then ISS uses a further qualitative review to determine a final vote recommendation. Under ISS's policies, the qualitative review takes into account a range of factors, including:

- the ratio of performance-based equity awards to time-based equity awards;
- the overall ratio of performance-based compensation to total compensation;
- the completeness of disclosure and rigor of performance goals;
- peer group benchmarking practices;
- financial and operational performance (both absolute and relative to peers);
- realizable pay compared to grant pay; and
- any special circumstances for example, a new CEO or anomalous equity grant practices.

Based on our review of the narrative in the relevant ISS reports, we have summarized below the qualitative factors that most commonly contributed to the negative recommendation for U.S. S&P 500 companies:

- ***Failure of incentive compensation to be rigorously performance-based.*** This was the most common negative factor, and is discussed by ISS at 32 of the 38 U.S. S&P 500 companies that received negative ISS recommendations on say-on-pay. This is perhaps not surprising, because it would seem to be closely related to the pay-for-performance alignment that the quantitative tests are intended to address. ISS's identified concerns in this regard generally fall into one or both of two categories:
    - ***The use of time-based awards rather than performance-based awards.*** ISS identified this concern at nearly half the S&P 500 companies that received negative recommendations. ISS's failure to consider time-vested option awards or other equity awards to be performance-based has been the subject of criticism because such awards can give the holders a stake in the performance of the company and align the interests of executives with those of shareholders.

  - ***The use of performance conditions that are not sufficiently rigorous, or insufficient disclosure of performance goals.*** Even if a company does utilize performance-based awards, ISS will see the awards as problematic if ISS views the goals as too easy to meet, or if the goals are not disclosed in sufficient detail for ISS to make an assessment. SEC rules permit companies to omit performance goals from the proxy if the disclosure would cause competitive harm to the issuer. Companies that take advantage of this provision, however, risk negative assessments from ISS. ISS identified this concern – failure to have (and disclose) rigorous performance goals – at 25 of the 38 of the S&P 500 companies that received negative recommendations.

- ***Benchmarking above peer-group median.*** For nine of the 38 companies, ISS took issue with the practice of the company (typically, the compensation committee) to target executive compensation at a level higher than the median of the peer group identified by the company. ISS notes in its reports for many of these companies that "above-median pay targeting in the absence of strong performance conditions can lead to the ratcheting of pay."

D. ISS NON-PERFORMANCE-RELATED FACTORS

ISS's policies take into account various non-performance-related factors that can, in certain circumstances, trigger a negative recommendation even where a company does not have a "high concern" on pay-for-performance. The most common non-performance-related factor of "high concern" in 2013 involved insufficient compensation committee communication and effectiveness, which ISS found at nine of the 38 U.S. S&P 500 companies that received negative say-on-pay recommendations. In addition, six of the 33 companies had a "high concern" in this area of change-in-control ("CIC") severance arrangements. ISS considers it a problematic practice to have CIC payments that exceed three times base salary and the last bonus, that are payable without involuntary job loss ("single trigger") or that involve the payment of parachute excise tax gross-ups.

Other concerns that ISS had at particular companies were excessive perquisites, tax gross-ups on perquisites and the use of retention or recruitment awards resulting in high CEO pay.

E. COMPANY REBUTTALS TO ISS SAY-ON-PAY RECOMMENDATIONS

A significant number of the companies that received negative ISS vote recommendations regarding their say-on-pay proposals filed supplemental proxy materials to communicate to shareholders their disagreement with ISS's assessment.[32] These supplemental filings not only serve the important purpose of educating shareholders and encouraging a thoughtful consideration of the issues, but for many institutional investors these communications, together with any direct discussions with the company, can also serve as documentation to support the investor's decision to reject a negative ISS recommendation and vote with management.

[32] *See, e.g.*, supplemental materials filed by Best Buy Co., Inc., CONSOL Energy, Inc. and Chesapeake Energy Corporation.

Common arguments made in supplemental proxy filings by companies against negative ISS vote recommendations included criticism of ISS's peer group selection (despite the 2013 policy changes), arguments as to why stock options should be considered performance-based compensation, ISS's improper use of a company's one-year and three-year TSR as performance metrics, and the company's strong financial performance.

F. OFF-SEASON REVIEW OF SAY-ON-PAY ISSUES

As noted above, many public companies – particularly larger companies – increased their efforts after the 2012 proxy season to analyze say-on-pay voting results, and obtain feedback from shareholders and proxy advisors on their concerns and expectations regarding compensation. This outreach took various forms at different companies, including face-to-face meetings, one-on-one phone calls, group conference calls and web meetings, and in some cases included board members. Companies conducting such outreach must be mindful that company representatives may not disclose material non-public information (for example, significant changes in compensation plans) in these discussions due to selective disclosure concerns under Regulation FD. This is typically not a concern, however, because the purpose of these meetings is for the company to gather information from shareholders – that is, to listen, not to speak.

In addition, companies should ensure that the appropriate personnel at institutional clients are involved in the discussions and the decision process – often institutional investors have both governance experts and investment professionals, each of whom will have critical input into the voting process, but may have varying views.

The analysis and feedback from these discussions can reduce the chance that companies are caught off-guard by shareholder concerns or negative recommendations that arise during the proxy season, and can inform year-end compensation and disclosure decisions. For example, some of the changes made and actions taken by particular companies after obtaining feedback from their shareholders were:

- Enhancing the performance-based aspects of compensation, including shifting from purely time-based awards to performance-based awards, reducing the use of discretion and limiting the use of stock options.
- Expanding or clarifying the disclosure of their goals and actual performance results in their 2013 proxy statements.
- Addressing pay practices that, in their particular circumstances, shareholders viewed as problematic, including tax gross-ups, above-median benchmarking versus peers, excessive perquisites and certain CIC/severance arrangements (such as "single trigger" payments).
- Announcing more stringent equity retention policies on executives in order to align their interests more closely with those of shareholders, or clarifying disclosure of stock retention and hedging/pledging policies.
- Expanding use of independent compensation consultants to benchmark compensation levels and practices and help make changes responsive to shareholder concerns.

Companies that undertook these types of efforts typically included clear and prominent disclosure in their 2013 proxy statements specifying the shareholder outreach that occurred and any steps taken by the company to adjust compensation practices to address shareholder concerns. It is important to understand that under ISS's policies a company will get no credit for compensation changes or shareholder outreach except to the extent that they publicly disclose it.[33] Companies may want to consider highlighting actions taken in response to a negative say-on-pay vote in some or all the following locations:

- the Compensation Discussion and Analysis, or CD&A, section of the proxy statement, in which a company is required by SEC rules to disclose whether and how the company considered the most recent say-on-pay vote in determining compensation policies and decisions;
- management's supporting statement for its current-year say-on-pay vote;
- a proxy statement summary or CD&A summary (which many companies have begun including in an effort to make their proxy statements more readable and user-friendly); and/or
- supplemental soliciting materials, such as a presentation, slides or a letter to shareholders, addressing the relevant subject in particular.

Companies and their boards should, of course, continue to design compensation programs that they believe are in the best long-term interests of the corporation. It is important, however, that companies understand the shareholder concerns that drove say-on-pay voting judgments and take these concerns into consideration in making compensation decisions, and – critically – craft the company's disclosure to provide sufficient detail and context. This approach will enable shareholders to understand how their concerns were considered by the company and embodied in the company's compensation practices, and provide a basis for proxy advisory firms to take the company's actions into account.

[33] As discussed above in footnote 22, disclosure of shareholder outreach efforts is an important factor under ISS policies for recommendations on directors and the say-on-pay vote if a company's prior year say-on-pay proposal received the support of less than 70% of the votes cast.

III. ANALYSIS OF ISS NEGATIVE RECOMMENDATIONS AGAINST DIRECTORS

In recent years, the increased adoption of majority voting provisions, along with NYSE rule changes that prevent brokers from exercising discretion to vote uninstructed shares in uncontested elections, has given more potency to negative recommendations on, and votes against, directors. Negative votes against directors (whether they arise from the application of the voting policies of proxy advisory firms and shareholders or from active campaigns launched by dissident shareholders) can have significant direct and indirect effects on companies and their directors, even in uncontested elections. For companies that have majority voting provisions, the negative votes can trigger a director resignation policy, but more broadly negative votes can cause reputational harm to individual directors and the company, discourage qualified directors from continuing to serve (or new qualified candidates from agreeing to be nominated), and generally impair a company's public and investor relations efforts. Companies should therefore be aware of the primary reasons that shareholders may vote against specific directors, committee members or the board as a whole, and the likely impact of these reasons on voting results.

ISS's policies provide a number of reasons why they will recommend "withhold" or "against" votes against directors.[34] In 2013, ISS issued negative recommendations against approximately 10% of the directors up for election – that is, approximately 3,000 negative recommendations in total (at around 1,100 different companies). Of these directors, only 50 (or less than 1.5%) received more "against" votes than "for" votes in 2013. S&P 500 companies fared generally better – 115 directors at 38 companies received negative recommendations, which is around 3% of the total directors up for election at S&P 500 companies. Only nine directors at S&P 500 companies received less-than-majority support.

[34] SEC rules require that, even in an uncontested election, shareholders be given the opportunity to "withhold" votes from, or vote "against," a director. Typically, the option to vote "against" a director rather than "withhold" applies at companies with majority voting provisions. In this memorandum, we refer to both types of votes as "negative" votes on the director or "votes against" the director.

The following table summarizes the frequency of negative recommendations, the resulting shareholder vote, and the number of directors receiving less-than-majority support during 2013 for all U.S. public companies, broken down by the rationale given by ISS for the negative recommendation:[35]

	2013 ISS DIRECTOR "WITHHOLD" OR "AGAINST" RECOMMENDATIONS (ALL U.S. COMPANIES)		
	Number of Directors Receiving Negative ISS Recommendations	***Average Shareholder Vote for Directors (% of votes cast)***	***Number of Directors Receiving <50% of Votes Cast***
Independence issues (non-independent directors on key committees or failure to maintain a majority independent board)	817	90%	0
Excessive non-audit fees paid to auditors, or failure to disclose a breakdown of fees	736	98%	0
Absence of a formal nominating or compensation committee	500	90%	4
Compensation issues	182	83%	3
Poison pill issues (e.g., maintaining a pill with dead-hand provisions or failing to put a pill up for a shareholder vote)	165	73%	10
Poor attendance at board and committee meetings (<75%)	123	80%	6
Failure to address material weakness in internal controls	65	89%	0
Failure of risk oversight due to pledging of shares by executives	62	83%	0
Lack of responsiveness to shareholder concerns (e.g., failure to implement a successful shareholder proposal)	40	60%	8
Failure to opt out of amendment to Indiana law resulting in classified board	35	89%	0
Overboarding	25	83%	1

A. BOARD INDEPENDENCE

The most common rationale for a negative ISS recommendation against a director was related to independence issues. In particular, ISS will recommend against directors that ISS deems non-independent if, among other things, they serve on the audit, compensation or nominating committees

35 Based on our analysis of data provided to us by ISS, supplemented by a review of publicly available information. The amounts in the columns of this table do not total to the aggregate amounts in the preceding paragraph because the table omits recommendations for which no rationale was included in the data provided to us by ISS, and because some directors received recommendations for more than one reason.

or if the board is not made up of a majority of independent directors under the ISS "independence" definition.[36]

Directors in this category received average shareholder support of 90% of votes cast, and no directors who were in this category received less-than-majority support. This suggests that shareholders broadly do not view a violation of ISS's independence standards (which are, in some circumstances, more stringent than the company's own independence policies under stock exchange rules) as a significant negative problem.

B. AUDITOR FEE ISSUES

Another common reason for an ISS negative recommendation in 2013 was the payment of high levels of non-audit fees to the company's independent auditors[37] or (as was more often the case) the failure to disclose a breakdown of fees to enable ISS to make this evaluation. A negative recommendation for this reason, however, seemed to have negligible effect on voting results – directors in this category averaged support levels of 98%.

C. LACK OF FORMAL NOMINATING AND COMPENSATION COMMITTEES

Under ISS's policies, the absence of a formal nominating or compensation committee will trigger a negative recommendation for all non-independent directors, even if these responsibilities are undertaken by the independent directors as a group, as is expressly permitted for listed companies under Nasdaq rules (though recent changes to Nasdaq rules will require listed companies to have formal compensation committees). As noted in the table above, ISS issued a significant number of negative recommendations for this reason in 2013, but directors in this category still generally received high levels of shareholder support, indicating that shareholders generally do not share ISS's concerns in this regard. There were, however, four directors with less-than-majority support in this category.

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36 For a discussion of the varying definitions of "independence" used by ISS, Glass Lewis and various other institutional shareholders and shareholder groups, see our publication entitled 2012 Proxy Season Review, dated July 9, 2012. Companies should consider including in the board's annual independence review process some discussion of whether any particular relationships are expected to trigger adverse recommendations or votes from proxy advisory firms or from the company's significant shareholders. Boards are, of course, in no way required to comply with the director independence definitions of these parties, but an assessment of perceived independence issues under these definitions can help the company identify and prepare for potential adverse votes from shareholders.

37 Specifically, ISS will consider non-audit fees to be excessive if the non-audit ("other") fees are greater than the sum of audit fees, audit-related fees and tax compliance/preparation fees. Typically, this leads to a recommendation against all audit committee members.

D. COMPENSATION ISSUES

At a number of companies, ISS identified various purported deficiencies in the oversight of executive compensation as a basis for negative director recommendations, including approval of problematic pay practices, failure to be responsive to perceived executive compensation best practices and pay-for-performance disconnects. Under ISS's policies, if a management say-on-pay proposal is up for a vote in a particular year, ISS will not issue negative recommendations against directors for compensation-related reasons, except in "egregious situations." Therefore, all negative recommendations for compensation-related reasons in 2013 were either at companies that did not have a say-on-pay vote in 2013 (because they are on a biennial or triennial cycle) or at companies where ISS deemed the compensation oversight concern to be egregious.

Approximately 75% of the companies that had a director with a negative ISS recommendation in 2013 for compensation-related reasons were in the first category – that is, they did not have a say-on-pay vote in 2013 and, therefore, ISS directed their concerns on compensation issues toward director withhold recommendations (typically against the compensation committee, though "in exceptional cases" ISS will recommend a vote against the full board).

The other 25% of companies where directors received negative ISS recommendations in 2013 for compensation-related reasons did have a say-on-pay vote in 2013, but apparently ISS found the compensation-related issues to be sufficiently egregious to warrant negative recommendations against directors anyway. In about one-third of these situations, the company had received less than 70% shareholder support for their 2012 say-on-pay vote and ISS found that the company failed to respond to the issues underlying those results. In the other two-thirds of the situations, ISS focused on idiosyncratic compensation decisions or practices for the most recent year to support their negative recommendation against the director.

The average level of shareholder support for directors receiving negative ISS recommendations for compensation-related reasons was 83% of votes cast. This breaks down as follows based on the categories discussed above: an average of 86% of votes cast where the company did not have a say-on-pay vote in 2013; an average of 74% of votes cast where the company did have a 2013 say-on-pay vote, but ISS identified idiosyncratic compensation decisions or practices for the most recent year; and an average of 54% where the company received less than 70% on its 2012 say-on-pay and was not seen by ISS as having taken sufficient responsive action. Only three of the 183 directors that received negative recommendations for compensation-related reasons received less-than-majority support.

E. POISON PILL ISSUES

The rationale that resulted in the most directors receiving less-than-majority support involved poison pill issues. In particular, ISS will recommend against directors if: the company has a poison pill with a "dead-hand" feature that limits the ability of a future board to remove the pill; the board adopts a poison pill with a term of more than 12 months without shareholder approval; or the board materially amends an existing poison pill without shareholder approval. Shareholders generally tended to follow ISS's recommendation in this situation more than in other situations – 10 of the 50 directors that received less-than-majority support in 2013 received negative ISS recommendations for this reason, and overall directors receiving negative recommendations for this reason had average voter support of only 73%, the second lowest of all categories.

F. POOR ATTENDANCE AND OVERBOARDING

ISS will recommend a negative vote in the case of a director that attended less than 75% of all board and committee meetings in the relevant year. In addition, ISS will recommend a negative vote in the case of directors that (a) sit on more than six public company boards or (b) are the CEOs of public companies and sit on more than two public company boards besides their own. The voting results (as indicated in the table above) suggest that shareholders share, to some extent, ISS's concerns about directors that have these issues, though relatively few directors in this category received less-than-majority support.

G. PLEDGING BY INSIDERS

ISS's policy changes for 2013 included a new policy that any amount of hedging or the significant pledging of stock by directors or executives would be viewed as a "failure of risk oversight" that can lead to recommendations against some or all directors. ISS issued an FAQ clarifying that whether pledged securities were "significant" is determined by measuring the aggregate pledged shares in terms of common shares outstanding or market value or trading volume.[38] A total of 62 directors received negative recommendations due to pledging by insiders; none received negative recommendations due to hedging by insiders. Voting results for these director averaged 83%, and none received less-than-majority support.

H. BOARD RESPONSIVENESS TO SHAREHOLDERS

As highlighted in the table above, the lowest average vote results occurred when the negative recommendation is based on a perceived lack of responsiveness to shareholder concerns – typically, if the board has failed to act on a successful shareholder proposal from a prior year. Shareholders as a group seem to take this issue particularly seriously – directors in this category received the support of an average of only 60% of votes cast (the lowest of any category), and 20% of the directors that received a negative recommendation for this reason received less-than-majority support of votes cast.

ISS continued its policy in 2013 of recommending negative votes on all incumbent directors if the board fails to act on a shareholder proposal that was supported by a majority of *shares outstanding* in the prior

[38] See http://www.issgovernance.com/files/2013ISSFAQPoliciesandProcedures04112013.pdf (Q.12 under Board Accountability).

year, or that was supported by a majority of *votes cast* in two of the last three years. As discussed in Section I.C.1 above, ISS changed its policy, beginning with director elections in 2014, such that it will now recommend against directors for failure to implement a proposal that received a majority of *votes cast* in a single year.

In any event, the significant impact of negative recommendations for this reason in 2013 illustrates the importance of working with investor relations personnel, proxy solicitors, legal counsel and others to manage the shareholder proposal process to avoid this outcome, if at all possible.

IV. SHAREHOLDER PUBLICITY TRENDS

Under the SEC proxy rules, shareholder proponents are permitted to include a supporting statement of up to 500 words, and management may include an opposition statement of any length it likes (with a copy to be sent to the proponent at least 30 days prior to the mailing of the proxy). However, an increasing number of shareholders have found avenues for expanding their supporting arguments, and rebutting the company's opposition statement, in a way that creates more of an ongoing debate through the proxy season.

A. VOLUNTARY USE OF EDGAR FILINGS

This proxy season saw a continued increase in Edgar filings by shareholder proponents under SEC Rule 14a-6(g). These filings, which show up on the company's Edgar website on www.sec.gov under the form code "PX14A6G," are required by SEC rules if a holder of more than $5 million in stock engages in a "solicitation" that is otherwise exempt from the proxy rules (for example, because the proponent is not an affiliate and does not itself solicit proxy cards). Although there is no indication that the SEC intended these forms to be used on a voluntary basis by small shareholders to amplify and expand their supporting statements, an increasing number of shareholder proponents have seized upon the fact that there is nothing in the form or the mechanics of the Edgar system that expressly prohibits such usage.

To date in 2013, there have been 75 of these filings, compared to 71 in all of 2012, and 49 in all of 2011. Some of these filings indicate that the holder does, in fact, hold over $5 million in stock, while others are silent on the point, or expressly state that the form is being filed "voluntarily in the interest of public disclosure and consideration of these important issues." Arguably, many of these filings would not be required even for large shareholders, because they may not fall under the definition of a "solicitation" at all.[39]

[39] Rule 14a-1(l) provides that broadly disseminated statements by a shareholder of how it intends to vote and the reasons therefor do not constitute "solicitations."

Proponents have used these filings to expand on their supporting statements for shareholder proposals, to rebut the company's opposition statement, and to raise arguments against the company's say-on-pay vote or director candidates. Absent SEC rulemaking or guidance that limits the use of these forms to significant shareholders who are required to file them, companies should expect that their use as a forum for debate by small shareholders will continue.

B. SHAREHOLDER MAILINGS THROUGH BROADRIDGE

SEC Rule 14a-7 provides a process for shareholders who wish to send materials to other shareholders regarding a proxy matter – these shareholders must request that the company either provide them with a shareholder list or conduct the mailing on behalf of the shareholder. Rule 14a-7 contains specified requirements that the shareholder must satisfy to require the issuer to provide the information or conduct the mailing, including providing proof of stock ownership, an attestation as to the proposal the communication relates to, and a confidentiality commitment.

However, in recent years, shareholders have made more frequent use of an alternative distribution method that avoids involving the issuer at all. Broadridge Financial Solutions, the company that manages the proxy process for the vast majority of issuers, also serves as proxy processing agent for most brokers and securities intermediaries. Acting in this capacity, Broadridge will (for a fee) circulate soliciting materials to its broker clients without the approval of (and in many cases without the knowledge of) the issuer.[40] Activist shareholders often used this distribution mechanism, together with "PX14A6G" filings discussed above, to publicize their arguments in favor of their proposals, or against management proposals, without satisfying the requirements of Rule 14a-7.

C. USE OF WEBSITE WITH ADDITIONAL INFORMATION

In 2012, a number of shareholders (including Norges Bank) began utilizing a novel tactic to advance their arguments in favor of shareholder proposals – inclusion in supporting statements of the web address for a dedicated website that had extensive, company-specific arguments in favor of the proposal. This essentially enabled them to make more expansive and detailed points than the SEC 500-word limit would have allowed in the proxy statement. Many companies objected to the SEC, arguing that, because the address referenced in the supporting statement did not at that time lead to an active webpage, the proposal was excludable as vague and misleading. The SEC staff disagreed, noting that the proponent provided the companies with the information that would be on the webpage upon filing of the proxy

[40] Until recently, Broadridge also had a policy of giving preliminary voting results upon request to shareholders who had made such distributions and who entered into confidentiality agreements with Broadridge. According to its public statements, Broadridge has recently stopped this practice upon determining that it did not have authority to disseminate this information under its agreements with brokers.

statement, and that the companies did not allege that the webpage material was materially false or misleading.

In October 2012, in response to concerns regarding this inclusion of references to websites or supporting statements in a proposal, the SEC staff issued Staff Legal Bulletin No. 14G ("SLB 14G"). In SLB 14G the staff provided that a reference to a website or supporting statement will not subject a proposal to exclusion under Rule 14a-8(i)(3) so long as the information contained in the website only supplements the information contained in the proposal, and shareholders and the company can understand with reasonable certainty what actions or measures the proposal requires solely from the information provided in the proposal.

Together, these developments demonstrate that shareholder proponents are becoming more aggressive and inventive in disseminating their views and not allowing the company to have the last word through its opposition statement. Companies will need to monitor these sorts of shareholder communications and rebuttals actively throughout the proxy season to gauge shareholder sentiment and determine whether additional outreach or further counterarguments are necessary.[41]

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[41] Additional soliciting materials distributed by issuers during the proxy season would need to be filed on Edgar on form DEFA14A no later than the date they are first sent or made available to any shareholder.

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CONTACTS

Beijing	(+86-10) 5923-5900
Frankfurt	(011) (4969) 42 72 52-00
Hong Kong	(852) 2826-8688
London	+44-20-7959-8900
Los Angeles	+1-310-712-6600
Melbourne	(613) 9635-1500
New York	+1-212-558-4000
Palo Alto	+1-650-461-5600
Paris	+33 1 73 04 10 00
Sydney	(61-2) 8227-6700
Tokyo	(813) 3213-6140
Washington, D.C.	+1-202-956-7500